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UNDERSTANDING DIRECTOR'S PAY IN EUROPE:
A COMPARATIVE AND EMPIRICAL ANALYSIS

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Abstract

This paper analyses the regulatory framework which applies to the determination of directors' remuneration in Europe and examines the extent to which European firms follow best practices in corporate governance in this area, drawing on an empirical analysis of the governance systems that European firms adopt in setting remuneration and, in particular, on an empirical assessment of their diverging approaches to disclosure. These divergences persist despite recent reforms. After an examination of the link between optimal remuneration, corporate governance and regulation and an assessment of how regulatory reform has evolved in this area, the paper provides an overview of national laws and best practice corporate governance recommendations across the Member States, following the adoption of the important EC Recommendations on directors' remuneration and on the role of non-executive directors in 2004 and 2005, respectively. This overview is largely based on the answers to questionnaires sent to legal experts from seventeen European Member States. The paper also provides an empirical analysis of governance practices and, in particular, firm disclosure of directors' remuneration in Europe's largest 300 listed firms by market capitalisation. The paper reveals that, notwithstanding a swathe of reforms across the Member States in recent years and related harmonisation efforts, disclosure levels still vary from country to country and are strongly dependent on the existence of regulations and best practice guidelines in the firm's home Member State. Convergence in disclosure practices is not strong; only a few basic standards are followed by the majority of the firms examined and there is strong divergence with respect to most of the criteria considered in the study. Consistent with previous research, our study reveals clear differences not only with respect to remuneration disclosure, but also with respect to shareholder engagement and the board's role in the remuneration process and in setting remuneration guidelines. Ownership structures still 'matter'; these divergences tend to follow different corporate governance systems and, in particular, the dispersed ownership/block-holding ownership divide. They do not appear to have been smoothed since the EC Company Law Action Plan was launched and notwithstanding the harmonisation that has been attempted in this field.

Keywords: Directors' remuneration, corporate governance, disclosure, European regulation

JEL Classifications: G30, G38, J33, K22, M52

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INTRODUCTION

Few other issues have generated as much interest in the corporate governance field in the past decade as executive remuneration. Major corporate scandals internationally, such as Enron, Worldcom, Ahold, Vivendi, and Skandia, were associated with flawed executive pay structures and the related generation of perverse management incentives.[1] The focus on executive remuneration has since sharpened further with the 2007-2009 financial crisis, as flawed executive pay structures have been linked to excessive risk-taking by banks and financial institutions.[2] Shareholder and stakeholder interest in executive remuneration has remained acute in recent years and persisted after the intense focus of the Enron-era.[3] Remuneration structures have also evolved, reflecting the wider dynamism of corporate governance but also the perceived centrality of remuneration to strong corporate performance. Boards constantly re-evaluate their firms' remuneration structures in order to respond to changes in their operations and to evolving best practices in their home markets and beyond. This focus is rational; executive remuneration structures can provide a powerful mechanism for managing the risks which arise from the separation of ownership and control in large firms.[4] Agency theory suggests that the performance-based remuneration contract, which links pay to shareholder wealth via performance indicators such as share prices and accounting-based targets, is a powerful way of attracting, retaining and motivating managers to reflect shareholders' interests. This is particularly the case in dispersed ownership corporate structures where agency costs can be high and where different instruments, including performance-related remuneration

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[1] See: J.C. Coffee (2006), *A Theory of Corporate Scandals: Why the US and Europe Differ*; P. Davies, *Enron and Corporate Governance Reform in the UK and the European Community*; S. Deakin and S. J. Konzelmann, *Corporate Governance after Enron: An Age of Enlightenment*, in J. Armour and J. A. McCahery (eds.), "After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US", Oxford: Hart Publications; J. Hill (2006), *Regulating Executive Remuneration: International Developments in the Post-Scandal Era,* European Company Law, Vol. 3, p. 64.

[2] See for example, Financial Services Authority (FSA), *The Turner Review. A Regulatory Response to the Global Banking Crisis* (2009), pp. 79-81.

[3] Shareholder activism on remuneration in the UK increased sharply over the financial crisis and in particular in early 2009: Editorial: *Shareholder duties*, Financial Times, 11 May 2009, p. 10.

[4] For an analysis of the executive pay contract in the context of dispersed and block holding systems see G. Ferrarini and N. Moloney (2005), *Executive Remuneration in the EU: The Context for Reform,* 21 Oxford Review of Economic Policy, p. 304.

schemes, but also monitoring by outside directors and reviewing by independent auditors, may mitigate agency costs and risks.

The debate on executive remuneration is multi-faceted. Extensive analysis has, for example, been carried out on the optimal pay structure for aligning pay with performance in order to reduce agency costs. Reflecting the assumption of much of the 'law and finance' literature that 'law matters', executive remuneration has also recently become characterised as a regulatory issue, with flaws in executive remuneration structures being linked to insufficient regulation. Remuneration has also become a public policy issue and regarded as a target for legislation, [5] as public outrage, particularly over the financial crisis and with respect to 'rewards for failure, has led to pressure for visible action and retribution.[6] The risks of executive remuneration accordingly now extend beyond the corporate decision-making sphere and are squarely within the regulatory and legislative sphere, and so include the many risks associated with regulatory intervention.

The debate is also multi-jurisdictional, reflecting the changing dynamics of remuneration, regulation and corporate efficiency in different governance systems. The European Union (EU), in particular, provides a richly fertile ground for the directors' remuneration debate.[7]

This paper places the remuneration debate in a post-Enron, EU regulatory context and considers the impact of the corporate governance reforms in the 2003 Company Law Action Plan. It also provides an empirical analysis of the governance structures which apply to the determination of

[5] R. Posner (2009), *Are American CEOs Overpaid, and, If So, What if Anything Should Be Done About It?*, 58 Duke L.J. 1013, 2009.

[6] Well-illustrated by the UK experience and widespread public hostility to the pension payments made to RBS ex-chief execution Fred Goodwin. But public hostility at payments to leaders of failed institutions has been widespread, although the US and British public remain more sympathetic, by contrast with their continental counterparts, to bonus-based payment in principle: R. Milne, *Sharp divide in public opinion on bonus culture, Financial Times*, 14 April 2009, 6.

[7] For previous studies on executive remuneration and respective EU reforms see the following: G. Ferrarini and N. Moloney (2004), *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, in Ferrarini, Hopt, Winter, Wymeersch (Eds.), *Reforming Company and Takeover Law in Europe*, Oxford University Press, p. 267; G. Ferrarini, N. Moloney, C. Vespro (2004), *Executive Pay: Convergence in Law and Practice Across the EU Corporate Governance Faultline*, in Journal of Corporate Law Studies, Hart Publishing, Cambridge (UK), p. 243; G. Ferrarini, N. Moloney and C. Vespro (2003), *Executive Remuneration in the EU: Comparative Law and Practice*, ECGI Law Working Paper 09/2003; Ferrarini and Moloney, *supra* note 4.

remuneration in European firms, particularly with respect to firms' disclosure of remuneration policy and practices just before the financial crisis.[8]

As we show in this paper, different types of crisis provoke different reactions to remuneration and generate different perspectives on the remuneration design debate. The technology bubble in the latter half of the 1990s was a consequence of a speculative era which was also reflected in the approach adopted to executive remuneration over that period.[9] The corporate scandals that occurred during the 2001-2003 'Enron-era' saw share option pay, in particular, become associated with the distortion of management incentives and with the related manipulation of financial disclosure. The Enron-era also led to calls for better alignment between management interests and shareholder interests through executive remuneration structures and, in particular, to support for high-powered and long-term incentives in the form of equity-based pay. The debate did not, for the most part, however, focus on remuneration policy generally; the characterisation of executive remuneration as a device for minimising agency costs to shareholders and aligning management and shareholder interests remained the dominant one. Following the 2007-2009 crisis, however, stronger legislative intervention in the remuneration area is being advocated in order to achieve better alignment of remuneration with risk-taking by financial institutions and to support increased stakeholder engagement. In particular, the emerging 'stakeholder value' analysis of remuneration is expanding the range of interests to which remuneration should align management interests to include counterparties, auditors, analysts, customers and the public interest in financial stability. The stakeholder analysis is also being expressly advocated by the European Commission with the two Commission Recommendations on remuneration following the financial crisis advocating 'stakeholder' rather than simply 'shareholder' monitoring of the remuneration process. For example, the Commission has affirmed that both its 2009 Recommendations are "without

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[8] When using the term 'director', we follow the Commission's definition of the director as "any member of the administrative, managerial or supervisory bodies of a listed company": see 2004/913/EC, Art. 2.1. We refer to 'regulation' as the mix of public regulation, recommendations and best practice codes.

[9] P. Bolton, J. Scheinkman and W. Xiong (2005), *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, ECGI - Finance Working Paper No. 79/2005, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=691142.

prejudice to the rights, where applicable, of social partners in collective bargaining". In particular, the Recommendation on remuneration in the financial services sector underlines the importance of compliance with standards governing the relationship with interested parties, such as clients.

The need for firms to focus on long-term rather than on short-term performance is a recurring theme of the reform movement, whilst the new swathe of reforms similarly emphasises the need for remuneration to be symmetric with effective risk management. The remuneration model which led to the financial crises caused perverse incentives that amplified excessive risk-taking, which, in the end, threatened the global markets. The emerging remuneration model is likely to include incentives which encourage better risk management and penalise failure. But there is also a strong public concern that, to be optimal, pay should also be 'fair'. But here intervention becomes risk-laden and difficulties with contractual rights arise. Establishing rules or guidelines on optimal pay, which also respond to public concerns with respect to fairness, is not an easy task. It is even more difficult on the European stage.

Our research shows that transposition of the less ambitious 2004 and 2005 Recommendations into Member States' regimes has been achieved only in part. Additionally, and consistent with previous research,[10] our study reveals clear divergences between countries in their requirements with respect to remuneration disclosure, shareholder engagement, board's role in the remuneration process and pay guidelines. These divergences are in line with different corporate governance systems and appear not to have been smoothed since the Commission's Company Law Action Plan was launched.

Although the influence of corporate governance regimes is marked, the persistent divergences may also be in part related to how the Commission approached harmonisation. In its first wave of reforms in 2004-2005, the Commission opted for a self-regulatory, market-based approach, based on non-binding Recommendations, thereby respecting differences in national traditions. In practice, most of the Recommendations' provisions have been transposed on the

[10] See Ferrarini and Moloney, *supra* note 4 and 7; Ferrarini et al., *supra* note 7.

‘comply or explain’ basis rather than through public legislation. As a result, convergence of regulations on board practices, disclosure and shareholder participation in the directors’ remuneration process is far from being achieved. Notwithstanding the limited success of the earlier Recommendations, however, a new wave of reforms has been launched with the 2009 Recommendations, which make provision for an increased role for the board in remuneration governance, address clawbacks and ‘golden parachutes’ and the adjustment of remuneration to effective risk management. More harmonisation and greater regulatory intervention in the remuneration process is also envisaged. But experience with the first wave of reforms makes their success questionable.

Our research on the degree of conformity of European firms with the Commission’s 2004 and 2005 Recommendations and with international best practices reveals, in particular, that disclosure of directors’ remuneration, central to effective monitoring of remuneration, varies from country to country. Disclosure practices appear to be strongly dependent on local rules and best practice guidelines in home Member States. Only a few core requirements are followed by the majority of firms; for the most, the pattern is one of divergence with respect to the different criteria considered in this study. Firms tend to place the highest importance on basic requirements, such as the existence of the remuneration committee, the adoption of a remuneration policy and individual disclosure of emoluments; requirements for more detailed disclosure with respect to directors’ terms of contracts and qualitative information regarding performance-linked remuneration have generated lower interest from firms. Boiler-plate disclosures, of limited use in practice, are common in firm disclosure. But the effective assessment of remuneration by key stakeholders requires adequate and effective disclosure on the remuneration contract. Although disclosure has somewhat improved following the 2004-2005 EC Recommendations, a clear and comprehensive overview of companies’ remuneration has not been achieved. This prejudices effective remuneration governance and obstructs effective assessment of the remuneration system adopted by firms. Overall, the Recommendations have not led to a proper understanding of remuneration structures in European companies. Given the increased complexity of remuneration structures, understanding, in practice, has weakened.

The paper is structured as follows. Section 2 highlights how appropriate governance can drive more efficient remuneration structures and how the related regulatory reform agenda has developed in recent years in the EU. Section 3 provides an overview of the EU's harmonisation efforts (namely the Commission's Recommendations on the role of non-executive director and on directors' remuneration) and of local responses at Member State level. Our analysis of Member State regulation of directors' remuneration is based in large part on the answers to questionnaires sent to legal experts in seventeen European Member States. Section 4 examines European firms' remuneration governance and disclosure practices, as evidenced by the disclosure provided by Europe's largest 300 listed firms by market capitalisation with reference to 2007. The last Section concludes and suggests reform proposals.

2. DIRECTORS' REMUNERATION FRAMEWORK

2.1 Pay alignments

In principle, levels of executive remuneration seem inexplicable. In 2005, average total US CEO annual pay was $2,164,952, comprised of approximately 27% base salary and 62% variable pay (largely composed of long-term incentives). In 2007 the median pay of CEOs of S&P 500 companies was $8.8 million.[11] In Europe, levels of pay were somewhat lower, but variable elements were also predominant; the median CEO total salary in 2007 was €5,020,000, with a median base salary of 1,300,000.[12] However troubling levels of pay may be, performance-based bonuses and long-term incentives typically form the main part of executives' remuneration. But is variable pay of this kind aligned with the performance measures on which it is notionally based? The optimal

[11] R. Thomas (2008), *International Executive Pay: Current Practices and Future Trends*, Vanderbilt Law and Economics Research Paper No. 08-26, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1265122.
[12] See study done by Hay Group, *How Chief Executives are paid*, January 2008.

design of executive remuneration and its alignment to corporate performance was traditionally an issue for boards and shareholders, and so a function of their characterisation of the determinants of strong corporate performance, typically profits and growth, and of the ability of these performance indicators to align remuneration efficiently. This is now changing. Although the Enron-era saw a sharper focus on the link between flawed executive pay structures and wider market efficiency, the 2007-2009 financial crisis has seen executive remuneration move from the shareholder agenda and become associated with wider financial market stability and a concern for a wide stakeholder community, including regulators, investors and the public generally. In particular, the risks of flawed remuneration structures have become associated with the catastrophic failure of market discipline implicated in the crisis. The traditional primacy of the shareholder interest in executive remuneration and the link between remuneration and profits/growth, however flawed in its execution, is therefore being challenged by a wider stakeholder interest as the systemic risks from poor remuneration structures within banks in particular have become clearer.

The crisis has also seen the traditional view that high levels of remuneration are justified as long as remuneration aligns shareholder and management interests effectively come under threat. It appears that public opinion on remuneration levels changes with different economic cycles. In their provocative book, Bebchuk and Fried suggest that any levels of compensation would be acceptable as long as the "incentives effects actually serve shareholders".[13] But Gordon has suggested that the executive remuneration debate takes place in two forums: one focuses on maximising shareholder value; the other focuses on the social implications of wealth and power.[14] Reflecting the latter dynamic, the 2007-2009 financial crisis has led to widespread public hostility to the notion that high levels of remuneration are justifiable.[15] The executive remuneration question has evolved from a concern as to how to achieve optimal pay structures that reward performance into a concern as to

[13] L. Bebchuk and J. Fried, "Pay Without Performance: The Unfulfilled Promise of Executive Compensation", Harvard University Press.

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

[15] Milne, *supra* note 6.

whether pay structures are 'just' and, in particular, do not reward failure.[16] As noted above, the remuneration debate is also being linked to the achievement of wider stakeholder objectives, particularly with respect to systemic stability.[17] Similarly, the wider stakeholder value debate is also impacting on the remuneration debate; other stakeholders such as employers, customers, auditors, analysts, and the public at large are regarded as having an interest in firms' remuneration policy and are being empowered to assess independently the economic and financial status of the firm.

Whatever the performance indicators which are at stake and whether they are shareholder or stakeholder driven, both short-term and long-term incentives seem poorly designed for the purpose of connecting remuneration and performance. It is now clear that executive remuneration has not closely followed company performance; remuneration packages seem to buck wider economic trends. For example, the most recent studies covering the period when the financial crisis began to emerge show that CEO compensation in S&P 500 companies was approximately USD 8.4 million in 2007 and did not reduce in 2008 when the economy was weakening.[18] More generally, executive compensation has increased steadily, as firms have increased in size, in the past three decades. Gabaix and Landier indicate that the average CEO total compensation and firm size have increased six times between 1980 and 2003.[19] This sharp increase in executive compensation has led to a strong public sentiment that CEOs are overly compensated for firm performance that is largely related to wider economic factors. The increase in CEO compensation is also seen as linked to the increase in CEO power.[20]

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[16] Although the Turner Review was careful to distinguish between the debate on levels of remuneration, which it did not regard as its concern, and the debate on appropriate incentive alignment with respect to stability, which was its concern.
[17] For example, the FSA is considering the adoption of a Code on executive remuneration which would have rule status for systemically important institutions: Turner Review, p. 80, *supra* note 2.
[18] Understood as average total pay. This is mainly evidenced at banks. See OECD, *Corporate Governance Lessons from the Financial Crisis*, 2009; the Associated Press study at http://www.shareholderforum.com/sop/Library/20080919_Deal.htm.
[19] X. Gabaix (2008) and A. Landier, *Why has CEO pay increased so much*?, Quarterly Journal of Economics 123, 49-100.
[20] See L. Bebchuk and J. Fried (2003), *Executive Compensation as an Agency Problem*, Journal of Economic Perspectives, vol. 17, pp. 71-92; L. Bebchuk, J. Fried and D. Walker (2002), *Managerial Power and Rent Extraction in the Design of Executive Compensation*, University of Chicago Law Review 69, 751-846; Posner, *supra* note 5; L. Bebchuk and J. Fried (2003), *Executive Compensation as an Agency Problem*, Journal of Economic Perspectives, vol.

2.2 Remuneration governance

A range of factors seem to combine to produce faulty remuneration design. Prior to the financial crisis, the literature focused on the 'missing link' between remuneration and corporate performance and highlighted governance failures in how remuneration was determined.[21] The 2007-2009 crisis has also revealed poor 'remuneration governance' as a main contributor to the failure of remuneration structures to capture excessive risk-taking allowing design failures to emerge through conflicted pay-setting processes and disclosure failures.[22]

'Remuneration governance' has a number of elements including disclosure of remuneration, board monitoring of remuneration structures (particularly by independent directors) and shareholder voice (or the controversial 'say on pay' mechanism). These elements are interlinked. Corporate governance codes typically affirm that one of the board's central responsibilities is to align key executive and board remuneration packages with the long-term interests of the company and its shareholders.[23] But comprehensive disclosure supports stronger board monitoring by strengthening the board's ability to withstand managerial pressure and, through reputational and publicity dynamics, stimulating shareholder and public reaction which can lend further legitimacy to a board's position and enhance the public perception of the social value of remuneration.[24] 'Say on

17, pp. 71-92; L. Bebchuk, J. Fried and D. Walker (2002), *Managerial Power and Rent Extraction in the Design of Executive Compensation*, University of Chicago Law Review 69, 751-846.

[21] See for example Coffee Jr. and John C. (2005) *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*, Oxford Review of Economic Policy, 21(2), p. 198–211; Coffee Jr. (2003), *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, Columbia Law and Economics Working Paper No. 237; J.E. Core, R.G. Wayne and R. Thomas (2004), *Is US CEO Compensation Inefficient Pay Without Performance*, Vanderbilt Law and Economics Research Paper No. 05-05; U of Penn, Inst for Law & Econ Research Paper 05-13; L. Enriques and P. F. Volpin (2007), *Corporate Governance Reforms in Continental Europe*, Journal of Economic Perspectives, Vol. 21, No. 1, pp. 117-140, G. Ferrarini and P. Giudici, (2005) *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, in Armour, McCahery (Eds.), "After Enron", Hart Publisher, 2006, p. 159.; J. Hill, *Regulating Executive Remuneration: International Developments in the Post-Scandal Era*, European Company Law, Vol. 3, p. 64, 2006; B. Holmstrom (2005), *Pay without Performance and the Managerial Power Hypothesis: A Comment*, *Journal of Corporation Law, 30(4)* 703-713.

[22] *Report by High-Level Group of Financial Supervision in the EU*, chaired by Jacque de Larosière, February 2009; The Turner Review, *supra* note 2; Viral A. and M. Richardson (Eds.) (2009), *Restoring Financial Stability: How to Repair a Failed System*, NYU Stern.

[23] See OECD Principles of Corporate Governance, 2004, Principle VI.D.4; see also corporate codes of EU Member States, available at ECGI website, http://www.ecgi.org/codes/all_codes.php.

[24] See analysis of executive remuneration remedies by Gordon, *supra* note 14.

pay' mechanisms are similarly of limited value unless they are coupled with extensive and effective disclosure.

The intuition that strong remuneration governance should lead to more effective remuneration structures and to a better alignment of director and shareholder interests is reflected in the evidence that firms with sound remuneration governance structures are more compliant with other governance principles, as compared to firms that appear to be in compliance as a matter of form but are not compliant as a matter of substance.[25] It is also reflected, more generally, in the emerging, if controversial, evidence (based on assessments of firm-level corporate governance in different countries) that sound corporate governance is related to firm value. Some studies suggest a positive relationship between corporate governance practices and growth.[26] But the link between corporate governance practices and growth is not entirely clear. There is evidence to suggest that there might not be a relationship between firms' corporate governance practices and their performance.[27] It has also been suggested that firm value depends on country-level shareholder protection laws as well as on firm-level corporate governance attributes[28]. On the other hand, the costs related to the implementation of corporate governance mechanisms seem to be lower than the monitoring benefits which result in higher cash flows accruing to investors and lower costs of capital for firms.[29] Accordingly, firms should understand the importance of different elements of sound corporate governance and, particularly, the determinants of effective remuneration

[25] Referring to financial firms, which can be extended to all industries: Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, April, 2009.
[26] See M. Ammann, D. Oesch and M. Schmid (2009), *Corporate Governance and Firm Value: International Evidence*, Swiss Institute of Banking and Finance, University of St. Gallen; R. Aggarwal and R. Williamson, *Did New Regulations Target the Relevant Corporate Governance Attributes?*, Working Paper, Georgetown University; available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891411; V. Bruno and S. Claessens, *Corporate Governance and Regulation: Can There be Too Much of a Good Thing?*, ECGI Finance Working Paper No. 142/2007 and World Bank Policy Research Working Paper, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=956329; V. Chhaochharia and L. Laeven (2007), *Corporate Governance, Norms and Practices*, ECGI Finance Working Paper No. 165/2007, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=965733.
[27] For example N. Fernandes (2005), *Board Compensation and Firm Performance: The Role of "Independent" Board Members*, ECGI Finance Working Paper No. 104/2005; L.D. Brown, and M.L. Caylor, (2008), *Corporate Governance and Firm Operating Performance*, Rev Quant Finan Acc (2009) 32:129–144; S. Bhagat, B. Bolton and R. Romano, *The Promise and Peril of Corporate Governance Indices (2007)*, ECGI Law Working Paper No. 89/2007, Yale Law & Economics Research Paper No. 367, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019921.
[28] Bruno and Claessens, *supra* note 26.
[29] Ammann et al., *supra* note 26.

governance, and regard effective remuneration governance as an opportunity rather than as an obligation which imposes costs.

But it is also clear that remuneration governance has not been effective. As outlined above, boards appear to have failed in aligning remuneration to performance, whether in terms of traditional growth/profit determinants or in terms of wider stakeholder interests. Either regulation has been weak, its application 'in action' has been flawed, or there have been failures on both counts. But it could also be that the assumption that, in principle, performance-based variable remuneration delivers stronger shareholder value, which has underpinned the remuneration debate, is neither a robust assumption for understanding executive remuneration or on which remedies can be based, given the extent to which performance-based remunerations structures can be manipulated to deliver excessive payments to directors (as outlined further below).[30] A series of global corporate scandals have repeatedly revealed serious flaws in remuneration practices and raised questions as to remuneration governance and, in particular, the efficiency of the board.

Governance reform has been central to the EU's remuneration agenda. The EC Treaty grants competence to the institutions to act in the corporate governance sphere, affirming that economies only work if companies are run efficiently and transparently and are sensitive to concerns of their shareholders and, where relevant, of their stakeholders.[31] The EU's response to the various corporate scandals and to the repeated failure of pay to align interests has been to focus on governance. It has promoted best practices and supported greater convergence through a mix of binding and non-binding governance measures which respect the diversity of the different corporate governance systems within the EU as well as ongoing changes in market practices. The design of executive remuneration was not, however, a concern of the EU prior to the financial crisis, although this position has since changed. The 'Enron-era'/Company Law Action Plan reforms focused

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[30] See several critiques to Bebchuk and Fried book "The Unfulfilled Promise of Executive Compensation", which argues that the compensation levels are best explained by managerial rent-seeking: J. Gordon, supra note 14; Bolton et al., *supra* note 9; Ferrarini, G., *Grande paghe, piccoli risultati: "rendite" dei managers e possibili rimedi (a proposito di un libro recente)* (Italian), Rivista della Società, N.4.

[31] Article 44(2) of the EC Treaty.

instead on improving remuneration disclosure and on ensuring the independence of the remuneration process. The details of the EU regime and its application into national regulations and practices are analysed in Section 3 and 4 of this paper.

Disclosure

Disclosure is central to the adoption of effective remuneration contracts in the EU. As well as improving monitoring (as discussed below), disclosure can respond to the particular agency costs of executive pay across both dispersed and blockholding systems and so minimize regulatory intervention in governance choices and structures.[32]

If investors are to be able to assess remuneration relative to performance, boards, as a matter of good practice, should produce and disclose a remuneration policy statement covering board members and key executives, explaining the relationship between remuneration and performance and including measurable standards that emphasise the long-term interests of the company. In the wake of the financial crisis, it is also clear that firms should also demonstrate to regulators and their other stakeholders that their compensation policies are sound, thereby facilitating constructive engagement with stakeholders and, in particular, diluting potentially unhelpful ‘outrage’ effects.

But disclosure policy must be nuanced and effective; disclosure must be ‘processable’[33] and relevant. Enhancing disclosure does not simply mean providing more details about remuneration packages. Remuneration disclosure must be published in a clear and exhaustive manner and allow for easy assessment of the performance link and, ideally, easy industry comparison. Most analysis supports the view that the UK and US disclosure systems provide the most complete accounts of directors’ remuneration, by requiring separate remuneration reports that include all elements of remuneration governance as well as details on remuneration packages. Although disclosure policy

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[32] Ferrarini and Moloney, *supra* note 4.

[33] For example J. Cox. and J. Payne (2005), *Mutual Fund Expense Disclosures: A Behavioural Perspective*, 83 Washington University Law Quarterly 907.

must be carefully managed to avoid the risks associated with disclosure,[34] the benefits of effective disclosure are potentially considerable; it can support stronger shareholder monitoring, better board discipline, mitigate the risks of board capture and of remuneration becoming an occasion for looting by directors (as outlined below), and increase board accountability to the shareholders.

Board Independence

The effectiveness of executive remuneration is also related to board independence.[35] The remuneration contract is typically regarded as a remedy for the agency costs of dispersed ownership and it may also protect minority shareholders against abuses of power by controlling shareholders in blockholding governance.[36] But executive remuneration can also be regarded as generating agency costs in that the setting of executive remuneration provides conflicted directors with an opaque device for extracting benefits from the firm. A conflicted board may use the pay-setting process to influence remuneration to the detriment of the shareholders by, for example, adopting weak performance targets, awarding share option packages which reward wider market gains and resetting performance targets where they are not met.[37] Boards may become conflicted in a number of well-documented ways;[38] a dominant CEO, for example, can prejudice the independence of the remuneration process (as well as the appointment of robust and independent-minded non-executive directors), while the absence of shareholder influence in the director selection and compensation process generally also undermines board independence[39]. Corporate scandals are often examined in term of boards' failure to fulfill their role as independent monitors of the remuneration process.

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[34] Downside effects have also been expressed: see for example Gordon, *supra* note 14. Additional disclosure may contribute to escalation of executive compensation because of increased transparency.
[35] See extensive analysis of independent directors in Gordon, J. (2007), *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, Stanford Law Review, Vol. 59, No 6.
[36] See further Ferrarini and Moloney, *supra* note 4.
[37] For further analysis of the executive pay and agency model see Ferrarini and Moloney, *supra* note 4.
[38] See further Ferrarini et al., *supra* note 7.
[39] See Bebchuk comments on corporate elections: L. Bebchuk (2005), *The Case for Increasing Shareholder Power*, Harvard Law Review, Vol. 118, No. 3, pp. 833-914, January 2005 (Previously titled *The Case for Empowering Shareholders*).

In mitigation, the monitoring role of the independent non-executive director is typically viewed as essential in areas that are vulnerable to conflict of interest risk, including the nomination of directors and audit, but also remuneration. The independent director has a role to play in both dispersed and blockholding systems. In dispersed ownership systems, shareholders are unable to monitor management closely. Non-executive directors, however, can close the information and monitoring gap to which shareholders are exposed. But this depends on the independence of the non-executive directors from the executive board. In blockholding companies, controlling shareholders have the power to monitor and influence management as they have easier access to information and strong ties to the board. But minority shareholders can be protected and conflicts of interest can be avoided by non-executive directors who are independent from the controlling shareholders.

Regulation in this area therefore typically seeks to ensure sufficient director independence,[40] although there is some evidence the board independence is not related to the long term performance of a firm.[41]

‘Say on Pay’ and Shareholder Voice

The remuneration governance matrix also includes shareholder voice and the engagement of shareholders in the pay-setting process. The ‘say on pay’ mechanism, supported by effective disclosure, might be regarded as fundamental to effective remuneration governance, although it is of widely varying importance across Europe. Remuneration is currently a ‘hot topic’ at general meetings; what has been described as a ‘spreading shareholder revolt’ on remuneration is currently underway in the UK,[42] primed by co-ordinated institutional investor activism. But shareholders’

[40] Sometimes “sufficient” is understood as “full” independence. In Section 3 we explain the different approaches in various Member State regulation.

[41] For example, Bhagat et al., *supra* note 27; B. Bhagat and B. Black (2002), *The Non-Correlation Between Board Independence and Long Term Firm Performance,* Journal of Corporation Law, Vol. 27, p. 231-273.

[42] K. Burgess and J. Croft, *Provident bonuses shot down by shareholders*, Financial Times 7 January 2007 p.21. Shareholders have either voted against remuneration policies, or shown large dissenting minorities, in a number of high-

rights to monitor remuneration policy or to participate in its design differ across Europe, reflecting different ownership structures and the diverging role of the general meeting. In blockholding systems, the presence of controlling shareholders may reduce the importance of a vote, given their implicit influence upon the board and their primary interest in extracting rents; of course, in theory, shareholder votes on board strategies, including remuneration policy, is nonetheless considered a best practice mechanism for protecting minority shareholders. There may also be wider resistance to a 'say on pay' by other interest groups. In Germany, for example, where current employees may serve as members of the supervisory board, employee unions typically do not support a shareholder 'say on pay' as this would reduce their power in the supervisory board. And although shareholder voice is more usually associated with dispersed ownership, collective influence "behind the scenes" in these companies could also diminish the importance of the actual vote[43]. Nonetheless, recent UK corporate practice suggests enthusiastic reliance on the shareholder remuneration vote.

The impact of shareholder votes on remuneration policies is not as yet clear, particularly where the vote is advisory only. Nevertheless, a connection in principle between shareholders and corporate remuneration policy is, at least, created where the mechanism exists.[44] Whether advisory or binding, a shareholder vote on the remuneration policy can have significant influence upon the board, as long as it is compulsory. For example, the UK vote was introduced by law in 2002[45] and is advisory, insofar as payments made or promised to directors do not have to be repaid in the event that the ordinary resolution on remuneration (requiring a 50 per cent majority of those voting) is not passed.[46] However, the failure to obtain approval effectively amounts to a vote of 'no confidence' in the remuneration committee, is regarded as a significant blow to the board's authority and is typically widely reported. Companies facing a negative vote usually have good warning of

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profile UK companies including Provident Financial, TRG and BP, with some predicting that 'no' votes will become more common: K. Burgess, *Shareholders to adopt tougher stance*, Financial Times, 7 May 2009, p. 23.

[43] B. Cheffins and R. Thomas (2001), *Should Shareholders Have a Greater Say Over Executive Pay? Learning from the US Experience*, Journal of Corporate Law Studies 1: 277-315.

[44] For an analysis of the 'say on pay' effects see Gordon, J. (2008), *Say-on-Pay: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In*, ECGI - Law Working Paper No. 117/2009, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262867.

[45] Companies Act 2006 s. 439.

[46] In case of a negative vote, payments made or promised to directors would not have to be repaid.

impending problems – for example, via press and shareholder comment and flagging by representatives of institutional investors (such as the Association of British Insurers) and/or proxy voting. On the other hand, thorough engagement by remuneration committee members with institutional shareholders once a problem has arisen often enables a negative vote to be avoided. In this way remuneration committees, by means of the potential effects of the 'say on pay,' have more power in setting the remuneration of executives and in facing down hostile boards and remuneration governance is strengthened. Where the committees are also assisted by external advice, they have greater ability to negotiate with influential shareholders, as long as remuneration consultants are not already captured by the firm.

But the picture is blurred. Shareholder votes may become a hostage to populism. Shareholders in every Member State are entitled to vote on share schemes such as stock options or free grants of shares.[47] But this has not improved remuneration design: general opinion turned against equity and option-based compensation after the corporate accounting scandals came into light and, more recently, after the financial crisis began in 2007. This is not surprising given that executive compensation has a history of being targeted by populist attacks following market declines and scandals. But it may obstruct the ability of boards to adopt effective remuneration structures where shareholders are sensitive to the vagaries of public opinion.[48]

The dynamics of shareholder voice in practice are also more complex than a voting right might suggest. Some companies have gone beyond legal requirements in seeking shareholder input on their pay practices.[49] Institutional shareholders are also privileged in their access to boards'

[47] The origin of this rule was in the protection of shareholders against dilution of capital. Now the scope of the rule is broader and its rationale different, including and not limited to issues of design, to increase shareholders' return on investment.

[48] S. Bhagat and R. Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term,* 2009; Michael C. Jensen and Kevin J. Murphy, *Performance Pay and Top Management Incentives*, Journal of Political Economy (April, 1990), pp. 225-265; reprinted in Michael C. Jensen, "Foundations of Organizational Strategy", (Harvard University Press, 1998).

[49] See Wall Street Journal, "Companies Seek Shareholder Input on Pay Practices", 6 April 2009. In its March 26 proxy, Amgen Inc. (US) directed shareholders to a 10-question online survey. Queries included whether the plan is based on performance and whether the performance goals were clearly disclosed and understandable.

policies. But the core issue remains: from the outside it is difficult to assess whether remuneration is 'fair'.

2.3 Reforms

After the initial round of post-Enron reforms in 2004-2006 (the relevant European reforms are discussed in section 3 below), international policy makers engaged in a new round of executive remuneration reforms in response to the financial crisis and to the rescue of financial institutions; these reforms stand in stark contrast to the earlier reform movement in that, rather than focusing on the remuneration/shareholder interests link, they reflect a concern to address excessive risk-taking by systemically significant institutions and to align remuneration with 'sustainable' or 'long-term' performance, as well as political pressure to restrict levels of remuneration in failing institutions in receipt of tax-payer funds. They also focus on the design of remuneration, particularly the deferral of bonuses, to a much greater extent than earlier reforms.

The US financial rescue legislation contains several provisions directed at restricting the compensation of executives in institutions in receipt of government funds.[50] In the UK, the FSA has included remuneration in financial institutions in its proposed reforms to the financial system. In October 2008, it issued a 'Dear CEO' letter (to about 20 of the largest UK banks and investment firms) which asked CEOs to review their remuneration policies against a set of high-level criteria for good and bad remuneration policies for directors' remuneration.[51] This was followed in February 2009 by a draft Code of Practice on remuneration policies[52] and in March 2009 by a Consultation Paper on "Reforming Remuneration Practices in Financial Services", which set out a revised Code of Practice (applying to large banks and investment firms) and in which the FSA

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[50] "The American Recovery and Reinvestment Act of 2009" bill (February, 2009) aims to significantly rewrite the original executive compensation and corporate governance provisions of Section 111 of the Emergency Economic Stabilization Act of 2008 (12 U.S.C. 5221, "EESA") and will apply to all institutions that have received or will receive financial assistance under the Troubled Asset Relief Program ("TARP").
[51] FSA, *Dear CEO* Letter, October 2008: Remuneration Policies.
[52] FSA, Draft Code on Remuneration Practices, March 2009.

consulted on its proposal to incorporate the Code into its Handbook, thereby giving it rule status.[53] The wide-ranging Turner Review also highlighted the FSA's reforms to remuneration within financial institutions as part of it efforts to achieve more effective risk management. In October 2008 the German government approved strict conditions for banks that made use of its rescue package, including limits on managers' salaries, bonuses and severance. At the beginning of 2009, the French government toughened its approach to remuneration in banks in receipt of public money. In return for a €10.5bn tranche of state capital in December 2008, it required them to curb severance payments and to offer share options to management only if they were available to all employees; the banks have complied with these requirements. In March 2009 the Committee of European Banking Supervisors (CEBS) published its principles on remuneration policy, which address the key aspects of a well functioning remuneration policy and seek to support the sound operation of banking institutions. In its Communication to the Spring European Council ("Driving European Recovery"), the Commission announced new regulatory reforms in the financial services sector designed to improve risk management and align pay incentives with sustainable performance;[54] two new Recommendations on executive remuneration followed (discussed further in section 3 below). One strengthens the 2004 and 2005 Recommendations on directors' remuneration and on the role of the non-executive directors;[55] the other addresses remuneration policies in financial institutions.[56] Both Recommendations are accompanied by a Commission Communication on remuneration.[57] Earlier

[53] FSA, Consultation Paper 09/10, *Reforming Remuneration Practices in Financial Services* (2009). In the first instance, the FSA proposes to apply the code to large banks and authorised investment firms (the Code will therefore apply to about 45 institutions) but it may extend the Code to all other FSA-authorised firms. The Consultation Paper suggested that 'although it is hard to prove a direct causal link, there is widespread consensus that remuneration practices may have been a contributory factor to the market crisis' in that they provided incentives for unduly risky practices (p. 3) The Code (which includes rules, evidential provisions and guidance) includes the rule that a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.
[54] COM(2009) 114.
[55] The 2004 and 2005 Recommendations: EC Recommendation fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC); EC Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC); the 2009 Recommendation: Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (C(2009) 3177).
[56] Commission Recommendation on remuneration policies in the financial services sector (C(2009) 3159).
[57] COM (2009) 211.

the Financial Services Forum (FSF) agreed on an international code of practice on remuneration policies for financial institutions.[58]

Whether or not this increased intensity of intervention will impact on remuneration policies remains questionable, particularly given the ambition of the current proposals, and, as discussed in section 3, the only limited success of the 2004-2005 reforms. Empirical research on US firms' behaviour indicates that companies often find a way to elude limitations on compensation through adjustments to pre-regulation optimal compensation contracts. The result can be higher and more opaque compensation.[59] There is little evidence of the impact of regulation on European pay practices as yet, as the detailed restrictions being placed on financial institutions are being implemented at the time of writing. The initial wave of legislation was aimed at prohibiting incentive compensation for executives of financial institutions in financial difficulty and which were the main recipients of governments' funds. But given public sentiment concerning the high levels of compensation received by market participants, restrictions on executive compensation may extend beyond the financial sector.

Shareholders and boards of directors have a common interest in addressing the current policy and regulatory concerns as to remuneration, in particular through compliance with the current provisions, as any new legislative intervention is likely to reduce their scope for manoeuvre. Nonetheless, compliance with current remuneration requirements and best practices remains variable across the Member States.[60] Despite current tensions, the UK market has generally responded well to the essentially self-regulation-based requirements which govern executive remuneration (primarily through the Combined Code on Corporate Governance), with active

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[58] FSF principles, *supra* note 25.
[59] Following US Congress' restrictions on income tax deductibility of cash compensation to $1 million, US firms altered their mix of compensation to reduce cash salaries and increase incentive compensation: T. Perry and M. Zenner (2001) *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, Journal of Financial Economics, vol. 62, issue 3, p. 453-488. Similarly, after the Sarbanes-Oxley Act of 2002 required clawbacks of incentive-based compensation, US firms increased fixed compensation and decreased incentive compensation: D. Cohen et al. (2007), *The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Managerial Risk-Taking*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027448.
[60] See Section 4 of this paper.

discussions between companies and investors on remuneration.[61] Communications between companies and investors have also been enhanced by the introduction of a binding disclosure obligation concerning remuneration disclosure and the mandatory, if advisory, vote on remuneration policy (section 3 below), although relations between investors and companies are currently somewhat uneasy. By comparison, the Continental European approach has often been criticised for poor compliance with best practice and low levels of enforcement of legislative requirements. Nevertheless, there is concern across the board regarding remuneration at present and reforms are likely to be widespread. The differences in approach between the UK and Continental Europe will probably become less visible once new rules are in place. Practical evidence also shows that differences in compliance with the Commission's Recommendations in the Member States are related to the ownership structures of the companies – dispersed and blockholding ownership – and to the board models.

But it is difficult to design effective remuneration rules and the scale of the current reform project poses some risks, particularly given the evidence that earlier reforms have not been effective. On the other hand, it appears that law-makers and remuneration consultants have previously focused too much on linking pay to corporate performance and on aligning remuneration with shareholder interests, characterised in terms of corporate profits and growth. It has been argued that the performance-oriented elements of remuneration, designed to align shareholder and management interests, distorted incentives as managers focused on achieving specific performance targets, rather than on shareholder value generally.[62] Perverse incentives also amplified the excessive risk-taking that threatened the global markets. This may, paradoxically, have been exacerbated by the long-term performance indicators which have become a feature of the current debate; long-term performance, without an acknowledgment of the relevant risks may, in practice, have turned directors' focus towards achieving short-term performance. Downside risks that might

[61] For analysis of the UK corporate governance system, see A. Cadbury (2002), "Corporate Governance and Chairmanship", Oxford University Press.
[62] B. Cheffins (2009), *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, ECGI Law Working Paper, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1396126.

have been realised later were not as relevant to directors.[63] Nor were the exogenous factors driving firms' performance. Remuneration policy also failed to penalise directors for failures; firms' losses were borne entirely by the firms, its shareholders and society, and not by the directors. Some firms have since introduced bespoke compensation contracts.[64] While these aim to reduce incentives for taking short-term risks, they represent "crisis" measures and do not seem to set the trend for more accountable, forward-looking remuneration policies. Individual institutions cannot change their systems of remuneration on their own, as they face the risk of losing talented staff to the competition. So regulators may have to step in, and the risks of the reform project may be worth taking, given the weaknesses of the current approach.

Certainly, intervention may be much more aggressive under the current reform movement. The post-crisis debate on remuneration has not only assessed the link between remuneration and performance, it has also suggested that remuneration design must seek to achieve an appropriate balance between risk appetite and risk controls, and between individual or local business unit goals and firm-wide objectives.[65] A variety of reforms are being canvassed. The Basel Committee, for example, has suggested that risk-adjusted remuneration could be addressed by the capital regime. The Basel II capital accord already contains mechanisms in Pillar II which enable regulators to impose additional capital charges for incentive structures that encourage risky behaviour. These provisions were consequently endorsed by the European Commission in the Larosière Report.[66] But reform options differ. Some policy makers prefer remuneration caps, while others choose to allow pay structures which reflect the economic position of individual firms. In the UK, for example, the FSA's approach is based on assessing remuneration by reference to the overall risk posed by a financial institution, and on assessing the link between remuneration and excessive risk-taking; it is

[63] See various articles providing analysis in this regard in: Viral and Richardson, *supra* note 24.

[64] Banking firms were the first to introduce bespoke pay contracts. For example UBS (See *UBS adopts new executive pay model*, Reuters, November 2008) Citibank (See *Citi set to reward cooperation with overhaul of bonus system*, Financial Times, 30 June 2008), Merrill Lynch (See *Merrill vows to reform bonus system*, Financial Times, 19 January 2008), Deutsche Bank (See *Deutsche Bank eyes 'multi-year' bonus system*, Financial Times, 29 May, 2008).

[65] Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, Basel, 2008.

[66] See De Larosière *Report, supra* note 22.

not based on dictating pay levels.[67] The FSF recommendations on compensation, based on a 'one size does not fit all' principle, are intended to reduce incentives towards excessive risk taking that may arise from the structure of remuneration schemes, whilst seeking to avoid prescribing particular designs or levels of individual compensation.[68] The Commission's Recommendations are similarly designed to avoid excessive risk-taking but while they only have the status of voluntary Recommendations, they appear to be considerably prescriptive with respect to remuneration design.

The reform debate has therefore changed and so have the instruments for intervention, with intervention 'hardening', particularly in the EU The main objectives pursued by the Commission's Company Law Action Plan in 2003, which set the foundations for the first wave of remuneration reforms, were to strengthen shareholders' rights and to foster the global efficiency and competitiveness of EU businesses as part of the wider effort to integrate the EU's capital market. These objectives have been achieved, at least in part. But the financial crisis has exposed the need for a new set of objectives and the link between effective corporate governance, executive remuneration, and risk management. In order to achieve the objectives of the 2003 Action Plan, the Commission initially preferred not to impose mandatory rules on Member States, but instead proceeded by way of encouraging the convergence of practices and regulations across the EU through non-binding recommendations. As a result, Member State implementation of the related reforms varied; studies also show that soft law was preferred to legislation, as a means of implementation, for most of the provisions.[69] This approach may not necessarily point to poor compliance. Firms that voluntarily adopt a more rigorous corporate governance structure are rewarded with a positive effect on their firm value.[70] But poor levels of compliance in practice by market participants has made the current approach of European policy makers more stringent. The

[67] H. Sants, *Recent market events and the FSA's response*, Speech, FSA, 20 May 2008.
[68] FSF principles, *supra* note 25.
[69] See Member State Questionnaires on Directors' Remuneration in Listed Companies, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm. Answers to questionnaires were provided during the period 2007-2009, before the latest European reforms in corporate governance and legislation were adopted in response to the financial crisis.
[70] Study by Chhaochharia and Laeven (*supra* note 26) shows that market rewards companies that are prepared to adopt governance attributes beyond those required by laws and common corporate practices in the home country by distinguishing between firm-level and country-level corporate governance.

latest wave of reforms, certainly at Member State level, envisage more binding rules rather than flexible ‘comply or explain’ guidelines. The Commission has also warned that the two 2009 Recommendations represent the ‘first stage’ in a series of proposals to realign remuneration incentives with ‘sustainable long term performance’ and has suggested that it will be presenting proposals which will empower national supervisors to compel financial institutions to implement policies consistent with effective risk management.[71] Although the current wave of reforms is focusing on the financial sector, momentum dynamics and public hostility are such that wider application, through binding legislation, cannot be ruled out.

3. THE EUROPEAN REGULATORY FRAMEWORK

3.1 Overview

3.1.1 The EU Remuneration Regime and Recent Reforms

The first wave of reforms on executive remuneration, which are considered in this section, relate to the 2003 Company Law Action Plan. The Enron-era sequence of scandals and efforts to make European industry more competitive, to strengthen shareholder rights and to reinforce protection for companies’ stakeholders led the Commission to issue its Company Law Action Plan in May 2003. This has set the European agenda in the corporate governance field. As part of the Action Plan’s corporate governance agenda the EU adopted two important Recommendations: the 2004 Recommendation fostering an appropriate regime for the remuneration of directors of listed companies[72] and the 2005 Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.[73] A number of Directives adopted under the EU’s Financial Services Action Plan (FSAP) also form part of the EU’s remuneration matrix by improving corporate transparency generally and with respect to

[71] COM(2009) 211 p. 5.
[72] 2004/913/EC.
[73] 2005/162/EC.

remuneration and by addressing insider dealing risks.[74] In March 2009 the Committee of European Banking Supervisors (CEBS) also published its principles on remuneration policy, which address the key aspects of a well functioning remuneration policy and is designed to support the sound operation of credit institution institutions.[75]

But the 2004 and 2005 Recommendations are the heart of the EU's remuneration regime. The Recommendation fostering an appropriate regime for the remuneration of directors provides for high standards of disclosure on directors' pay and recommends greater involvement of shareholders in decisions relating to remuneration. The Recommendation adopts four mechanisms in support of efficient remuneration: i) disclosure of information on companies' remuneration policy, its structure and performance criteria;[76] ii) a shareholders' vote on the remuneration policy, which can be either binding or advisory;[77] iii) disclosure of individual directors' remuneration package;[78] iv) prior approval of share option schemes.[79]

The 2004 Recommendation on directors' remuneration must be considered in conjunction with the 2005 Recommendation on the role of non-executive directors and board committees, given the role that non-executive directors and remuneration committees play in remuneration matters.

[74] The Transparency Directive enhances the transparency in reporting including the remuneration policies, total remuneration paid, any contingent or deferred compensation and benefits in kind granted to each member of administrative, management or supervisory body. The Accounts Modernisation Directive encourages consistency across Member States in the level of narrative reporting presented in the annual report. The Market Abuse Directive makes provisions for senior executives to notify any share transactions and refrain from any insider dealings. The Prospectus Directive makes provisions related to employee share plans and grants of options.

[75] Draft high-level principles of Remuneration Policies (2009), available at www.c-ebs.org.

[76] The remuneration statement should include the following information: i) explanation of the relative importance of the variable and non-variable components of directors' remuneration; ii) sufficient information on the performance criteria on which shares or variable compensation is based; iii) sufficient information on the linkage between remuneration and performance; iv) the main parameters and rationale for any annual bonus scheme and non-cash benefits; v) description of the main characteristics of supplementary pension or early retirement schemes; vi) summary on the terms and duration of contracts, provisions for termination payments; decision-making process used for determining the remuneration policy.

[77] The agenda of the annual meeting should contain information related to the role of the relevant bodies responsible for setting directors' remuneration, the remuneration policy and any significant change to the remuneration policy.

[78] Individual disclosure of: i) total amount of salary paid, including attendance fees fixed by the AGM; ii) remuneration paid in the form of profit-sharing and/or bonus payments and the reason for granting; iii) compensation in connection with the termination of contract; iv) total estimated value of non-cash benefits considered as remuneration; v) number of share options offered or granted; vi) number of shares exercised, exercise price or value of interest; vii) number of shares unexercised, exercise price, exercise date, main conditions for exercise of rights; viii) loans, advance payments and guarantees, including the amount outstanding and interest rate.

[79] Approval of: i) grant of share-based schemes, including share options to directors; ii) determination of their maximum number and the main conditions for granting; iii) term within which options can be exercised; iv) conditions for any subsequent change in the exercise price of the options.

This Recommendation aims to improve shareholders' control over executive management by reinforcing the presence of independent directors on boards and board committees. The Recommendation includes two principles which are closely related to remuneration governance: it recommends that board committees be created for issues particularly vulnerable to conflict of interest (i.e. nomination, remuneration and audit committees) where these tasks are not the direct responsibility of shareholders; it also recommends that there be a strong presence of independent directors in board committees and suggests that there be a clear delineation of the role of such bodies. In particular it recommends that the remuneration committee should be comprised exclusively of non-executive or supervisory directors, a majority of whom should be independent.

Since differing approaches to corporate governance are deeply rooted in national traditions, the Recommendations provide for a certain degree of flexibility in the ways in which Member States can apply the relevant principles. A self-regulatory, market-based approach, based on non-binding recommendations, and thereby avoiding a ‘one-size-fits-all’ solution, has been adopted This approach reflects Member States’ different views concerning the role of firms, the bodies responsible for determining the remuneration policy for directors and the structure and level of remuneration of each director.

Member States are free to adopt the Recommendations, if at all, either through legislation or through soft law, based on the ‘comply or explain’ principle.[80] Our research reveals that the Recommendations have been mainly transposed by means of soft law and on a ‘comply or explain’ basis.[81] Given the flexibility of this principle, investors have a paramount role to play in carefully evaluating a firm’s corporate governance; they should examine the reasons provided by the firm whenever it departs from the Recommendations or fails to comply with the same, making a

[80] On 6 March 2006, the European Corporate Governance Forum issued a statement clarifying the ‘comply or explain’ principle: see Statement from the European Corporate Governance Forum on the principle of "comply-or-explain", available at http://ec.europa.eu/internal_market/company/ecgforum/index_en.htm. To ensure that the principle is effective, there must be a real obligation to comply or explain.

[81] Except for Greece, where the ‘comply or explain’ principles is not available. See Answers to Questionnaire on Directors’ Remuneration in Listed Companies: Greece, by E.E. Perakis, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

reasoned judgment in each case. The effectiveness of 'comply or explain' and of investor monitoring is, however, doubtful, given low levels of conformity with the relevant Recommendations, considered in Section 4 of this paper. [82]

The two Recommendations have as their main objective the achievement of appropriate governance controls through enhanced transparency and a strengthening of shareholder rights. As discussed in section 2 above, the global financial crisis has, however, extended these objectives further. As part of the EU's response to the financial crisis, and given that the implementation of the existing Recommendations was not satisfactory, the EU supplemented the existing Recommendations with two new Recommendations in 2009.[83] The scale of the Commission's ambition is considerable. By contrast with the earlier 2004-2005 reforms which sought to align shareholder and management interests, with these reforms the EU is seeking, more ambitiously, to redress imbalances in directors' pay in all listed companies, to deliver specific reforms to the design of pay packages and to reform remuneration policies in the financial sector.

The general 2009 remuneration Recommendation focuses to a much greater extent than the 2004/2005 Recommendations on the design of remuneration. It makes specific recommendations concerning the design of employees.[84] It also recommends more extensive disclosure[85] and seeks to strengthen the remuneration committee.[86] The parallel financial services Recommendation focuses in particular on risk-taking in 'financial undertakings' (including credit institutions, investment firms and insurance companies) and by those personnel whose professional activities have a material impact on the risk profile of the financial undertaking. It recommends that remuneration policies in these institutions should be consistent with sound risk management and the

[82] In July 2007 the EC published two reports on Member State application of the two EU recommendations: COM SEC(2007) 1022, *Report on the application by EU Member States of the EC Recommendation on directors' remuneration*, July 2007; COM SEC(2007) 1021, *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*, July 2007. Both reports conclude that the application of corporate governance standards regarding remuneration has improved, but some weaknesses remain.
[83] Both Recommendations require Member State transposition by 31 December 2009.
[84] C(2009) 3177, Rec. 9.
[85] Particularly with respect to performance criteria (C(2009) 3177, Rec. 5).
[86] For example, by recommending that at least one member have knowledge of and experience in the field of remuneration policy (C(2009) 3177, Rec.7).

undertaking's long-term interests,[87] makes specific recommendations with respect to the design of pay,[88] seeks to strengthen governance[89] and disclosure (to stakeholders generally),[90] and calls for supervision of remuneration by the relevant supervisory authorities.[91] When advocating increased disclosure under the new regime, the Commission has implied that the level of the information to be disclosed should take into account the nature, size and scope of the financial institution.[92] Accordingly some degree of competition between financial undertakings' might be expected with respect to disclosure; industry peer groups may therefore play a greater role in the remuneration process. As noted above, it also appears that the Commission intends to issue further legislative proposals for financial institutions. The main objective of the new legislation would be to subject remuneration policy to prudential oversight.[93] In other words, financial institutions will be asked to put more money aside if they want to reward their directors in a way that could encourage excessive risk taking. Specifically, the Capital Requirements Directive will include certain provisions regarding remuneration in the financial sector. [94]

The Commission is, accordingly, aiming, albeit through soft law, to embed a managerial culture which seeks the long-term sustainability of companies, rather than quick but risky short-term results, as often pursued in previous years. To reach this goal, it has also made some ambitious design recommendations. The general 2009 Recommendation recommends vesting periods of at least three years for director share awards and share options and also requires directors to hold a substantial number of shares in their firms until the end of their employment. This recommendation is designed to increase directors' long-term commitment to the firm. Several other related

[87] C(2009) 3159, Rec. 3.
[88] Including that a maximum limit is placed on variable remuneration, that a major part of significant bonuses be deferred, that bonuses be repaid where they have awarded on the basis of data which subsequently proves to be mis-stated, that performance assessment be placed in a multi-year framework and reflect non-financial criteria, including compliance (C(2009) 3159, Recs. 3-5).
[89] C(2009) 3159, Rec. 6.
[90] C(2009) 3159, Rec. 7-9.
[91] C(2009) 3159, Recs. 10-12.
[92] COM 2009/3159, art 9 (III).
[93] See EC Communication, IP/09/674, 29 April 2009.
[94] At the time of writing, the European Parliament adopted the new rules on capital requirements (6 May 2009), to be implemented by banks by 2010.

provisions are common to both Recommendations and are therefore applicable to issuers across all sectors.[95]

While ambitious, most of the new recommendations build on provisions already adopted in some Member State regulations, principally in corporate governance guidelines. Accordingly, and in addition to the substantive objectives mentioned above, the Commission also aims to achieve greater harmonisation in this area. Whether this will be achieved is uncertain. Given the cross-border nature of financial institutions which typically adopt group structures, some degree of convergence with respect to the recommendations for financial institutions might be expected.[96] But on the other hand, only limited harmonisation has been achieved with respect to the earlier Recommendations and it will be interesting to assess whether the financial sector will behave differently from other sectors. Convergence pressure is likely to be increased, however, given that the Recommendations reflect and are based on an international reform movement and given the international market within which financial institutions operate.[97]

3.1.2 Reviewing the Remuneration Regime

The remainder of section 3 reviews remuneration law and best practice, following the adoption of the first wave of Recommendations in 2004-2005, in specific areas (the remuneration committee, 'say on pay, disclosure, non-executive director pay, pay design, and recent financial crisis reforms). A large part of our analysis is based on the answers to a questionnaire sent to specialists from 17 European Member States.[98] Our findings emphasise the persistent differences in regulation across the EU with respect to remuneration disclosure, policy and certain elements of remuneration design. While most Member States have amended their laws and best practice

[95] The main common provisions are: i) an appropriate balance between fixed and variable pay; ii) clawback provisions; iii) deferral of bonus with a minimum deferment period; iv) termination payments linked to performance.

[96] "Principles on sound remuneration policy should apply at group level to the parent undertaking and to its subsidiaries", COM 2009/3159, art. 1.4 (I).

[97] See FSF principles, *supra* note 25.

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

guidelines, adherence to the 2004 and 2005 Recommendations has, however, been partial. Our findings show that the framework for directors' remuneration has been implemented by policy makers mainly through soft law and only to a lesser extent through regulation. This situation changed in 2008, however, with governments intervening in an attempt to enhance public rules for remuneration.

The main recent national reforms include the following. In 2006 a number of changes were made to the UK Combined Code on Corporate Governance, which already contained important guidelines on executive remuneration, complementing the earlier 2002 company law reforms (now in the 2006 Companies Act) which introduced the advisory 'say on pay' and required more detailed disclosure through a remuneration report requirement. The Code is also complemented by the industry ABI guidelines on policies and practices for executive remuneration and the ABI/NAPF Joint Statement on Executive Contracts and Severance, which recommend a closer link between incentives and the achievement of targets.[99] They focus on the importance of rewarding performance and place responsibility on the remuneration committee in the remuneration-setting process.

A law regulating the transparency of executive pay came into force in Germany in 2006, under which companies are obliged to publish the amount and structure of the remuneration of individual directors.[100] Further amendments were made to the German Corporate Governance Code in 2008 which strengthen the responsibility of the supervisory board for management board compensation.[101] In Italy the new Corporate Governance Code was published in March 2006. This Code contains many changes to its predecessor, e.g.: the definition of the remuneration structure and terms distinguishes between executive and non-executive directors; the duties of the remuneration committee are also specified. In Spain, the new Unified Corporate Governance Code

[99] Association of British Insurers (ABI), *Executive Remuneration – ABI Guidelines on Policies and Practices*, 3 December 2007; ABI/NAPF *Joint Statement on Executive Contracts and Severance*, 18 February, 2008.
[100] Disclosure of Board Compensation Act ("Vorstandsvergütungsoffenlegungsgesetz") (2005).
[101] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Germany, by P.O. Mülbert, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

was published in May 2006.[102] It provides that the remuneration report should be submitted to the AGM for an advisory vote and that the remuneration of individual directors should be disclosed in the remuneration report. France's MEDEF/AFEP issued two recommendations concerning the compensation of executive directors in 2008, aimed at enhancing disclosure and introducing guidelines on a clear link between remuneration and performance in the area of incentive-based pay and severance payments.[103] The Dutch Corporate Governance Code, as amended in 2008, aims to align remuneration closely with the company's strategy and related risks and encourages a remuneration policy that creates long-term value.[104] The new 2009 Belgian Corporate Governance Code pays most attention to the recommendations concerning executive remuneration, advocating complete transparency about remuneration and severance towards shareholders.[105]

Several other European corporate governance codes have been amended in the period following the 2004-2005 Recommendations; the revisions generally emphasise increased transparency, new guidelines on remuneration and greater shareholder power over the remuneration process.[106] Other reform proposals, particularly by financial supervisory authorities, are mentioned later in this Section.

International reforms have also taken place over this period, with the European governance reforms developing in parallel with related US initiatives. Notable US reforms include the 2006 SEC rules concerning the transparency of executive remuneration, related party transactions,

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[102] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Spain, by I. Farrando, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.
[103] AFEP/MEDEF *Remuneration of Executive Corporate Officers of French Sociétés Anonymes: Legal and Tax Rules*, June, 2008; *Recommendations Concerning the Compensation of Executive Directors of Companies whose Shares are Admitted on a Regulated Market*, October, 2008.
[104] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: The Netherlands, by C. Van der Elst and A. Gülsum, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.
[105] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Belgium, by L. Van den Steen and C. Van der Elst, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.
[106] Including, among others: Austria: Code of Corporate Governance, revised (2007); Luxembourg: The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange (2006); Denmark: Committee on Corporate Governance, Recommendations for Corporate Governance of August 15, 2005, revised (2008); Finland: Finnish Corporate Governance Code (2008); Hungary: Corporate Governance Recommendations (2008); Poland: Code of Best Practice for WSE Listed Companies (2007). All codes, previous and amended versions, are available at http://www.ecgi.org/codes/all_codes.php; Portugal: CMVM Regulation n.1/2007, CMVM Code on Corporate Governance (Recommendations on Corporate Governance) (2007), Sweden; Code of Corporate Governance, revised (2008).

director independence and directors' ownership of shares. The reforms aim to make proxy and information statements, annual reports and registration statements more user-friendly and to ensure that shareholders are better informed about the remuneration of directors. Most international organisations that are active in corporate governance have also amended their guidelines, including provisions related to remuneration.[107]

3.2 Remuneration Committee

In the ongoing debate on executive remuneration, certainly prior to the financial crisis, questions as to the resilience of the link between remuneration and corporate performance have often been raised. The transformation, in some case, of 'pay-for-performance' into a 'rewards-for-failure' mechanism has been linked to poor governance during the remuneration process and, in particular, on ineffective remuneration committees which can exert significant influence on the setting of remuneration.

The 2005 Recommendation on the role of non-executive directors as well as international corporate governance guidelines require that a dedicated board remuneration committee be established. This committee is designed, in part, to increase the efficiency of the (supervisory) board in that it should reduce conflicts of interest with respect to directors' remuneration. To achieve this purpose, the committee should, according to the Recommendation, be composed of exclusively non-executive directors, who are in the majority independent. The Recommendation allows for some flexibility in how the committee is constituted by allowing the responsibilities of the nomination, audit and remuneration committees to be combined. Firms must, however, explain both the reasons why they have chosen an alternative approach and how the combined committee meets the objectives which are identified for the three separate committees. The Commission's

[107] See International Corporate Governance Network (ICGN), Remuneration Guidelines, 2006, available at www.icgn.org; United Nations (UN), Guidance on Good Practices in Corporate Governance Disclosure, 2006, available at www.unctad.org; Organization for Economic Co-operation and Development (OECD), Principles of Corporate Governance, 2004 and OECD Corporate Governance Lessons from the Financial Crisis, 2009, both available at www.oecd.org; FSF principles, *supra* note 25.

2009 Recommendation on directors' remuneration sets out additional principles on the role and operation of the remuneration committee in order to increase its responsibility in the remuneration process and to avoid conflicts of interest in the exercise of its functions.[108]

Most Member State corporate governance codes require that a remuneration committee be established and apply this requirement on a 'comply or explain' basis. We found, however, that the wording of different corporate governance codes reveals differences in the importance attached to, and composition of, the remuneration committees. Generally the Codes accommodate 'joined committees' (which usually combine the nomination and remuneration committee functions), although the ability of committee members to focus effectively on the different tasks of these functions is questionable. On the other hand, the nomination and remuneration processes are interlinked and efficiencies may follow.

The composition of the remuneration committee across the Member States is influenced by the different definitions that the different Codes adopt with respect to the independence of directors. Each country's best practice guidelines adopts its own definition of independence. Boards are also typically charged with determining what constitutes independence according to their own judgment.[109] We also found variations in the best practice (corporate governance code) requirements for the composition of the remuneration committee; the independence requirements ranged from, i.e., "exclusively" independent members to a "majority", to a "sufficient" number of independent members. This variation is significant as it may have an impact on the activity of the committees established by firms in various countries and, implicitly, on their remuneration process.

[108] COM 2009/3177, art. 7, 8, 9 (III).

[109] Perhaps one of the most complete approaches is offered by the UK Combined Code that encourages a firm's own judgment as to the most appropriate behaviour towards directors' independence: the Code refers to "independent in character and judgment" and involves a consideration as to "whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment" (A.3.1).

The UK Combined Code on Corporate Governance – applicable to the UK and Ireland[110] – and the Dutch Tabaksblat Code recommend the creation of a separate remuneration committee, composed entirely of non-executive, independent directors. Additionally, in the Netherlands no more than one member of the remuneration committee may be a member of the management board of another Dutch listed company. The Austrian Code of Corporate Governance[111] and Luxembourgish principles of corporate governance recommend a "sufficient" number of independent members. [112] Polish best practice guidelines provide for a remuneration committee to be established within the supervisory board; however, they do not address the composition of the committee, nor lay down its tasks or procedures.[113] In most other countries, corporate governance best practices/codes recommend the creation of a remuneration committee composed of all non-executive, but in the majority independent directors.

The chairmanship of this committee also exposes differences between the Member States. Best practice guidelines in the UK, Ireland and the Netherlands stipulate that the chairperson of the board may not chair the remuneration committee (although the UK Combined Code permits the chairman to sit on the committee as long the chairman met the Code's independence requirements on initial appointment). Other best practice guidelines allow for the common chairmanship of the board and the remuneration committee, but often recommend that only a non-executive director (including the board chairperson) should chair the committee. According to the Austrian guidelines, the chairperson of the remuneration committee should always be the chairperson of the supervisory

[110] Ireland follows the same regulations as UK, including the Companies' Act and the Combined Code of Corporate Governance, with the exception of the Listing Rules. Until October 2007, the Irish Stock Exchange applied the listing Rules set by the FSA in the UK, with a supplement adapting the Listing Rules to Irish conditions and the Irish legal context. However, it now produces its own set of Listing Rules, which tend to track FSA's Rules closely. For an analysis of the Irish corporate governance system of remuneration, see Answers to Questionnaire on Directors' Remuneration in Listed Companies: Ireland, by B. Clarke, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

[111] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Austria, by S. Kalss, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

[112] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Luxembourg, by P.H. Conac, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

[113] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Poland, by M. Majcher, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

board.[114] German recommendations and practices in this area vary significantly from the position in other Member States. The Cromme Code indicates that it is good practice for many companies to have special committees for specific tasks, but does not give a clear indication concerning the remuneration process and does not include strict rules concerning independence. It does, however, provide that such committees should be comprised of at least three members, including at least one worker representative. But the German supervisory board's scope for discretion was substantially curtailed in 2005 following the ruling by the German Federal Court of Justice (criminal division) in what has become known as the 'Mannesmann-Case'. The core question at issue was the legality of appreciation awards granted in the context of the takeover of Mannesmann by Vodafone in 2000.[115]

The remuneration committee is not always central to remuneration-setting. In some Member States, shareholders have wide decision-making powers on remuneration issues.[116] The general meeting has, by law, the sole competence to decide on the remuneration of directors in a number of countries. This may involve decisions on the remuneration packages of individual members or the approval of the total amount of remuneration. In countries where companies have dual boards, shareholders are generally responsible for determining the remuneration of supervisory board members, according to the articles of incorporation of the company.[117] Remuneration fixed by the

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

[115] The German court stated that, as a general rule, payments of that particular kind (golden parachutes) may only be made if the employment contract between the company and the executive director ex ante provides for such an obligation stipulated ex ante. In the absence of the said clause the company may make such gratuitous payment only if the company will benefit from it. Relevant benefits to be taken into account are only those that are 'simultaneous' and 'adequate'. A payment that does not fulfill these requirements qualifies as a waste of the company's assets, and the members of the supervisory board can be held liable for the criminal offence of a fraudulent breach of trust. Consequently, some uncertainty has arisen regarding severance awards. See brief on the 'Mannesmann Case' in Answers to Questionnaire by P. O. Mülbert, *supra* note 101. Additional literature on the Case: C.J. Milhaupt and K. Pistor (2008), *The Mannesmann Executive Compensation Trial in Germany*, in "Law and Capitalism, What Corporate Crises Reveal About Legal Systems and Economic Development around the World", The University of Chicago Press; P. Kolla (2004), *The Mannesmann Trial and the Role of the Courts*, 5 *German Law Journal* No 7 – Private Law; M.P. Rolshoven (2004), *The Last Word? – The July 22, 2004 Acquittals in the Mannesmann Trial*, 5 German Law Review No 8.

[116] COM SEC(2007) 1022.

[117] There are deviations from the norm, due to governance systems. For example, a Swedish company's board is usually made up exclusively of non-executive directors, except for the CEO. Board's remuneration is decided by the general meeting with single majority, usually after a proposal from the largest shareholder or a nomination committee. The Board decides upon the remuneration to the CEO, and the CEO decides upon remuneration to other management. The AGM shall decide upon remuneration principles for the CEO and the top management of the company. The principles are binding upon the board when they set remuneration for the CEO and on the CEO when he or she decides upon remuneration to management (Swedish Corporate Governance Code (2008), Swedish Companies Act.

articles can be modified by the general meeting through a simple majority.[118] The remuneration of the members of the executive or management board is fixed by the supervisory board, following proposals made by the remuneration committee, where it exists. In some Member States, the remuneration policy is submitted for approval to the general meeting of shareholders.

Corporate governance codes across the Member States generally adopt guidelines regarding the role and particular functions of the remuneration committee. However, as with all the remuneration guidelines, differences are common. For example, the 2009 Belgium Code of Corporate Governance also makes provision for the responsibility of the remuneration committee to make proposals to the board on the remuneration policy for non-executive directors.[119] But typically, the role of the remuneration committee in most Member States includes the following: it makes proposals on general remuneration policy for executive or managing directors; it makes proposals on individual remuneration packages; it monitors compliance by the company with its remuneration disclosure obligations; it debates the company's general policy on the granting of share-based incentive schemes and makes related proposals to the board; it reviews the remuneration information provided in the annual report; it consults with the chairman / CEO on remuneration issues; it appoints, and consults with, external advisors on remuneration. As already emphasised, the independence of the remuneration committee and of any external consultants in relation to the management / executive board is an essential element of best practice. In this regard, and in order to minimise potential conflicts of interest between board remuneration and that of the rest of the company, it is generally desirable that advisers are appointed by the committee and do not advise the company or the executive directors in the same time.[120]

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[118] In Greece, any other remuneration, the amount of which is not provided by the articles, has to be approved by special resolution of the general meeting (but, if excessive, is subject to reduction by a court decision at the request of a minority of 1/10 of the capital).

[119] For corporate governance developments in Belgium see Answers to Questionnaire on Belgium by L. Van den Steen and C. Van der Elst, *supra* note 105, Van der Elst, C. (2008), *The Belgian Struggle for Corporate Governance Improvements*, ECGI Law Working Paper, N°.114/2008, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1261448.

[120] E.g. this is a recommendation of the new Recommendation C(2009) 3177.

3.3 Say on Pay

The role of the general meeting of shareholders in remuneration-setting varies across the EU. In order to increase board accountability, the 2004 Recommendation on directors' remuneration recommends that remuneration policy be an explicit item on the agenda of the annual general meeting. Member States may, however, provide that a vote will be held only if requested by shareholders representing at least 25% of the total number of votes held by shareholders present or represented at the general meeting. Shareholder approval is also recommended by the Recommendation for all share schemes, share options or any other right to acquire shares, by way of resolution at the general meeting prior to their adoption; the approval relates to the scheme itself, and not to the grant of particular share benefits under the schemes.[121] The 2009 Recommendations reinforce the importance of shareholder engagement in the remuneration process, recommending that shareholders and, in particular, institutional shareholders, should be encouraged to attend general meetings where appropriate and make 'considered use' of their votes. But the Recommendation is merely exhortatory and does not substantively strengthen the 'say on pay'.

Although shareholders usually have a say in determining the remuneration of the (supervisory) board, only a few Member States have encouraged companies to involve shareholders to a greater extent in the determination of remuneration policy for the management board/executive management, even if only on an advisory basis.[122] In most jurisdictions the vote on the remuneration report or remuneration policy is not a separate item on the general meeting agenda; approval of the annual accounts, for example, only implicitly constitutes approval of the remuneration policy.[123] This approach may reflect the role of controlling shareholders in the respective jurisdiction or in the individual firm, as discussed in Section 2 above, and the more limited role of the general meeting. In a notable exception, but reflecting a different shareholder voice model, the 2006 Companies Act (reflecting earlier reforms in 2002) requires quoted

[121] 2004/913/EC, Art. 6.
[122] See COM SEC(2007) 1022.
[123] 2004/913/EC, Art. 4.1, 4.2.

companies to prepare a directors' remuneration report and to put the report to a shareholder vote.[124] The vote is advisory and requires a 50% majority of those voting. Recently, however, other Member States have introduced a vote on the company's remuneration policy. In the Netherlands and Sweden, the remuneration policy must, by law, be submitted for approval at the general meeting ex-ante.

According to the Spanish corporate governance guidelines, boards should submit a consultative report on the directors' remuneration policy to the vote of the general meeting of shareholders as a separate item on the agenda. Conversely, other Member State regulations do not specifically require shareholder approval of the remuneration policy, despite providing that the general meeting has a function in this respect. For example the Danish and Portuguese guidelines simply state that a declaration on the policy for remunerating members of a company's corporate bodies should be submitted to the attention of shareholders at the AGM, but does not provide further explanation or suggest that approval be obtained.[125] In Italy, approval of remuneration policy is required only for banks.[126] In Germany, the general meeting plays only a very limited role in determining the remuneration of the members of the management board. The law neither mandates shareholder approval of directors' remuneration nor approval of the remuneration policy or a remuneration report. The general meeting is even barred from adopting a pertinent resolution on a voluntary basis, since the general meeting may only decide on matters concerning the management of the company if requested by the management board.[127]

Most Member States, however, have recommended or imposed shareholder approval of share-based incentive schemes as a matter of company law, although divergences also exist here.

[124] Companies Act 2006, ss. 420-421 and s. 439.
[125] Danish Committee on Corporate Governance's Recommendations for corporate governance, of August 15, 2005, section VI revised by February 6, 2008. See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Sweden, by H. Birkmose, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm. For Portugal: CMVM Recommendations on the Governance of Listed Companies, 2007. See also Answers to Questionnaire on Directors' Remuneration in Listed Companies: Portugal, by J.E. Antunes, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.
[126] Bank of Italy, *Supervisory Provisions Concerning Banks' Organization and Corporate Governance*, March, 2008.
[127] German Stock Corporation Act, Section 119 (2).

Some States limit approval requirements to certain types of share-based remuneration. Whilst they have little say in the setting of remuneration, German shareholders do, however, have a vote with respect to some forms of performance-based remuneration. This holds true for stock options funded by contingent capital, as well as for stock options funded by own shares, if the company first has to acquire the shares. In Austria, in case of a contingent capital increase to be distributed among members of the management board (as well as members of the supervisory board, employees or senior management), the par value of the share capital cannot be more than 20%. On the other hand, if the options are assigned to the management board, employees or senior management, the general meeting will then be allowed to fix a total amount. If own shares are used for the stock option program, the general assembly will not be competent to decide upon the stock-option program. In Luxembourg and Sweden, only share-based remuneration involving new share issues, share options and any other new share acquisition rights are to be approved by the general meeting.[128] Most other regulations are generic, requiring approval of share schemes by shareholders. But in all cases, for share schemes to be approved, the policy for these schemes should be clearly explained in the report and to the general meeting when shareholders are asked to authorise the award of share options or shares.

It remains to be seen whether the vote on remuneration policy will be adopted in practice in all European jurisdictions, although the initial experience does not augur well.

3.4 Disclosure

The EC's 2007 evaluation of the implementation of the 2004 Recommendation shows that the recommendation on remuneration policy disclosure is followed by about 60% of the Member States, although half of these Member States only follow the Recommendation in part and in a number of the Member States the specific disclosure requirements are not specified.

[128] See COM SEC(2007) 1022.

Most Member States do not specifically require companies to produce a separate remuneration report (although the UK requires that a separate Directors' Remuneration Report is produced)[129]. Most local regulations provide that the information related to remuneration of directors, including remuneration policy and levels, can be included anywhere in the annual report, i.e. in the corporate governance report,[130] in the management report and/or in the notes to the financial statements. In this case, the remuneration policy gets shareholder approval indirectly, through a vote on the annual report. In many cases, some or all information is duplicated in the notes. Exceptions exist on both extremes: legal requirements to produce a distinct remuneration report (e.g. UK)[131] or no specific requirements whatsoever (e.g. Greece)[132]. The requirement for disclosure of the remuneration policy varies and not all Member States require that information which reflects the details outlined in the 2004-2005 EC Recommendation be presented.[133] Although there is some convergence with respect to disclosure and non-disclosure,[134] our research found that Member State regulations differ, particularly with respect to areas outlined below.

Individual directors' pay

Under the 2004 Recommendation, remuneration reports should contain clear and comprehensible information about the remuneration of individual directors, which is easy to understand and enables the shareholder to monitor its compliance with the company's remuneration

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[129] Companies Act 2006 ss. 421-421.

[130] According to Spanish and Portuguese regulations, listed companies are required to publish a report on corporate governance to be presented either as a chapter of the annual report or in the form of an appendix to the said report and one of the chapters of this report shall include details of the remuneration framework. Spanish report on corporate governance has a standardised Q&A format that, generally, only addresses the questions of compliance with corporate governance aspects including remuneration, mentioning but without actually describing the remuneration policy.

[131] Companies Act 2006 ss. 420-421.

[132] Greek Codified Law 2190/1920 does not specify requirements for a remuneration policy, instead only provides that the notes on the accounts must disclose information on the total amounts paid to directors.

[133] For example provisions in regulations of the UK, Ireland, France, the Netherlands, Luxembourg, Denmark, Hungary, Italy (particularly banks' remuneration policy). In accordance with the Commission Recommendation the statement of remuneration policy must include the reasons and criteria on which remuneration is based and give details of the relative importance of the fixed and variable components (including performance-linked bonuses and equity-based remuneration) and of the compensation paid in connection with the termination of service. It must also specify the conditions applied to the contracts of executive directors, among them the terms of contracts, notice periods and any termination payments; the process for setting the remuneration of directors must also be disclosed.

[134] For example the forward-looking approach and the disclosure of external consultants are two conditions stipulated in the EC Recommendation that are implemented in very few national regulations.

policy and with the general guidelines adopted for incentive pay. In 2007, the Commission found that a large majority of Member States had introduced high disclosure standards with regard to the remuneration of individual executives.[135] In most Member States disclosure is required by law on a mandatory basis. Disclosure is also usually required on an individual basis, although a few countries still recommend only aggregate disclosure.

The variations are revealing. In Austria, there are no specific requirements to indicate the individual details of the remuneration paid to the members of the board of directors; the disclosure requirement applies only to the remuneration of the management board. In Germany, which traditionally has a dual-tier governance system made up of a supervisory board and a management board, individual disclosure for both tiers is required, however these requirements are omitted if the general meeting so resolves. Such a resolution, which may be adopted for a maximum of five years, requires a majority of at least three quarters of the share capital represented when the resolution is adopted. Whereas German law requires disclosure to be made in the notes on the financial statements, the Cromme Code recommends, somewhat less precisely, that disclosure with respect to management board members should be made in a remuneration report which, as part of the corporate governance report, describes the remuneration system for management board members in a generally understandable way and that disclosure with respect to supervisory board members shall be made in the corporate governance report. [136]

In Belgium, individual disclosure of remuneration is required for non-executive directors and for the CEO, whilst remuneration of all other senior executives should be presented in aggregate form. If an executive manager is also a member of the board, information on the amount of remuneration he receives in this capacity must be disclosed in the remuneration report.[137] However, details on share-incentive schemes must be disclosed on an individual basis for all directors. Greek law provides only for aggregate disclosure of remuneration of executive and non-

[135] COM SEC(2007) 1022.
[136] Commercial Code, Section 285 sentence 1 no. 9.
[137] Belgian Code of Corporate Governance, Principle 7, 7.10.

executive directors.[138] The Dutch and French recommendations emphasise the importance of disclosure for helping investors obtain a clear view not only of individual remuneration, but also the total cost of directors and of the remuneration policy applied.

Differences also emerge with respect to the specific elements of remuneration that must be disclosed on an individual basis. Most regulations making provisions for individual disclosure refer to fixed and variable remuneration, but are less focused on the details of share-based remuneration schemes. Individual disclosure of remuneration received by directors during preceding years is recommended by only a few national guidelines.[139] Although this may change with the current reform movement, generally we find that the information required on performance targets for share incentive schemes is much more detailed than the disclosure required concerning bonuses. This can be explained by the fact that bonuses are "visible" components and can be judged accordingly, while share incentive schemes can often be opaque and hide the real value being transferred to directors.

Share-based incentive schemes

Disclosure requirements for share-based incentive schemes generally refer to the number of options granted and related shares, the terms of such schemes, in particular the exercise price and how the price is determined, the respective estimated values of the instruments at the time they are issued, the periods during which the options can be granted and exercised and the related lock-up period, and the number of exercised options during the period under review.

Additional requirements are stipulated by a number of Member States. German regulation, for example, requires that stock option plans include the value of the stock options. Similarly, French and Dutch rules require disclosure of the valuations of the shares/options granted. Disclosure concerning vesting periods, lock-up periods and the valuation methods applied (in order

[138] Codified Law 2190/1920, Art. 43a.
[139] For example in France, AFEP/MEDEF (June).

to determine whether performance criteria have been fulfilled) is required in only some Member States.[140]

UK disclosure requirements for share incentive schemes are particularly stringent. In addition to disclosure on performance conditions, listed companies must also give an explanation of why such performance conditions were chosen, a summary of the methods used to assess performance and an explanation as to why such methods were chosen. If a director's entitlement to share options or long-term incentive awards is not subject to performance conditions, an explanation as to why this is the case must also be provided.[141] The remuneration report must also contain a performance graph illustrating the total shareholder return for each class of the company's listed securities over a period of five years and comparing that return with the TSR for a broad equity market index, even if the company does not use TSR as a measure of performance for its share schemes. The performance graph is designed to make it easier to assess whether a company's remuneration arrangements have aligned executives' interests with shareholders' interests. The reports must also show the name of the index selected and outline the reason for selecting it.

Spanish corporate governance guidelines require that the remuneration policy statement be accompanied by an estimate of the total remuneration which is paid following the meeting of performance benchmarks. Remuneration policies should also include technical safeguards to ensure that performance-related awards reflect the professional performance of the beneficiaries and not simply reflect general market or industry performance.

Legislation and best practice guidelines rarely make provision for the ex-post evaluation of performance targets (ex-post evaluation provides a means for remedying faulty variable pay structures). But ex-post valuation is addressed in the French and Dutch recommendations. These stipulate that the disclosure of the criteria on the basis of which variable remuneration is determined

[140] For example in France and the Netherlands.

[141] The detailed disclosure requirements for the Directors' Remuneration Report are set out in the Large and Medium-Sized Companies and Groups (Accounts and Reports) regulations 2008/410. However, it is now rare for a plan to permit new grants which are not subject to performance targets (a limited exception being deferred bonuses that are satisfied in shares). Where a director's historic option grants – e.g. unexercised options from the late 1990s – were not subject to performance targets, this does not need to be explained as the policy statement is forward-looking.

should also include how those criteria were applied as compared to what was forecast during the financial year and an indication as to whether the objectives have been reached.[142] The Spanish guidelines also recommend that firms disclose information on the relation between the remuneration obtained by executive directors and the company's profits, or other measure of enterprise results, for the year in review.[143]

Greater transparency with respect to all remuneration items could be supported by requirements for standardised tabular reporting. But only UK law[144] and French best practice recommendations[145] address the format of remuneration disclosure, although, we suggest, greater standardisation would enhance the clarity of remuneration disclosure.[146] The Commission, however, intends to explore greater standardisation.[147] The standardisation of key definitions would also eliminate confusion and enhance current transparency levels.[148] Furthermore, placing increased responsibility on (supervisory) boards in respect of remuneration matters might decrease the need for additional statutory provisions governing disclosure.[149]

3.5 Remuneration of non-executive directors

The remuneration of non-executive directors deserves specific attention, particularly with respect to performance-related, share-based pay, given possible conflicts of interest and the risk of undermining independence. Member States adopt varying approaches to non-executive director remuneration. The general rule applied by most Member States is that that these directors should not receive share-based remuneration. The Commission has also followed this principle in its 2009

[142] "An ex-ante and ex-post account of the relationship between the chosen performance criteria and the strategic objectives applied, and of the relationship between remuneration and performance", Dutch Code of Corporate Governance (2008), II.2.13.
[143] Spanish Unified Code on Corporate Governance (2006), 57.c.
[144] UK Companies Act 2006 ss. 420-241 and Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008/410.
[145] See French AFEP/MEDEF (October 2008).
[146] While UK regulations do not provide an actual best practice format, the French recommendations do.
[147] COM 2009/3177, 13.
[148] E.g.: remuneration policy, relative importance, severance payments, year's salary, relevant details, sufficient information, independence.
[149] See statement of Gerhard Cromme, Chairman of the Government Commission of the German Corporate Governance Code, Press release, 6 June 2008.

Recommendation.[150] This approach mitigates conflict of interests risks, particularly where non-executive directors are called on to evaluate accounting practices or to take other decisions with a possible bearing on the company's reported earnings, given that such earnings or evaluations could have an impact on their income. Conflicts may arise also in situations where non-executives sit on several boards, sometimes within a peer group, and share incentives are linked to the share performance of these companies. High remuneration for non-executive directors may also jeopardise their independence.

But Member State regulation varies. Some Member States allow performance-based compensation to non-executives. In Germany and Austria the chairman of the board is generally granted double the amount paid to the other members. Differences in remuneration between board members are also allowed, according to the tasks directors carry out. Both countries allow for share-based payment to non-executives, including stock options granted on a contingent capital increase or based on companies' own shares. The German Code recommends that compensation of the members of the supervisory board should include performance-related compensation based on the long-term performance of the enterprise, but it is not clear that this is allowed under company law. The admissibility of so-called phantom stocks (to be paid in cash) as a means of stock price-related remuneration for members of the supervisory board is also questionable. However, failing any pertinent decisions by German courts, most commentators are willing to accept this type of remuneration for members of the supervisory board.

Spanish law stipulates that directors' remuneration should be equal for all directors, unless the opposite is expressly stated in the company by-laws. While it recommends that variable remuneration be confined to executive directors, share-based remuneration is excluded from this limitation, as long as directors are obliged to retain the shares until the end of their tenure.[151] Danish corporate governance recommends that members of the supervisory board do not receive share

[150] COM 2009/3177, art. 4.4 (II).
[151] Spanish Unified Code on Corporate Governance (2006), point 52.

options, but allows for bonus schemes and for remuneration in the form of shares (at their market price). In Hungary, non-executive directors may be awarded share-based remuneration, but they cannot be awarded stock options.[152] But several countries do not address the remuneration of non-executive directors.

Some Member State regulations set limitations on different types of remuneration for board members, especially where remuneration is related to a certain percentage of the company's profits. For example, under Spanish company law, if directors' remuneration is based on a profit sharing scheme, payments can only be made where there are liquid profits and the reserves (by law or in the company by-laws) are fully covered and the shareholders are given a dividend of 4% or higher, where this is fixed in the by-laws. The Portuguese Commercial Companies' Code requires that the global percentage of the profits allocated for directors' variable remuneration, which is set in the articles of association, must exclude the amounts allocated to company reserves as well as any part of the profit that cannot be distributed to shareholders.[153] Similarly, Greek rules provide that payments to board members made out of net profits must be limited to the amount remaining after all reserves have been retained and the "first" (compulsory) dividend amounting of 35% of the net profits has been paid.[154]

The granting of loans to members of the supervisory board, which can generate conflicts of interest, is generally (where such statements are found in regulations) not permitted by regulations, unless on terms applicable to employees as a whole and after approval by the supervisory board. Some Member States, however, permit such loans (e.g. Germany, Luxembourg, Spain and Poland)[155].

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[152] See Answers to Questionnaire on Directors' Remuneration in Listed Companies: Hungary, by H. Andras, available at ECGI: http://www.ecgi.org/remuneration/questionnaire/index_2008.htm.

[153] Portuguese Commercial Companies' Code, Art. 399/2, Art. 429.

[154] Codified Law 2190/1920, Art. 24.

[155] Luxembourgish company law provides that this situation is to be dealt with in the following way: the director involved must abstain from taking part in the board's deliberation on the subject matter, and its conflict and corresponding abstention must be reported specially to the next following shareholders' meeting (Art. 57 LSC 1915). The same rule applies to members of the supervisory board and members of the management board (Art. 60bis-19, LSC 1915). The annual accounts submitted for approval to the shareholders must contain an item (generally a note to the financial statements) which specifies the amount of loans granted to the directors, including the interest, the principal

3.6 Design

Regulation across the Member States includes various guidelines for the design of remuneration packages. Because of their importance in the remuneration process and the significant differences in approach by Member State regulations, this section outlines the provisions related to the terms of contracts of executive directors and the guidelines for incentive pay.

Terms of contracts

The setting of term limits for contracts for executive and non-executive directors is important for linking reward with performance and for controlling rewards for failure. But only some Member States have adopted limits for executive directors' service contracts and limits on termination payments are rare.

UK best practice recommendations (under the Combined Code) provide that notice or contract periods should be set at one year or less; longer periods are unusual. Austrian and German corporate law states that members of the management board are to be appointed by the supervisory board for a period not exceeding five years. The maximum period of the contract is also five years.

In single-tier continental companies, requirements covering terms of contracts for directors theoretically apply to both executive and non-executive directors. At Italian firms, board directors cannot be appointed for a period exceeding three years; the appointment may be renewed where permitted in the articles of association and directors may be removed at any time by the general meeting (as they can be under UK company law), with no loss of entitlement to damages in case of unfair dismissal.[156] French law requires that board directors' service contracts must not exceed six years.[157] The second Viénot report, however, recommends that the duration of the directors' term of office should not exceed a maximum of four years, in order to enable the shareholders to rule upon

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provisions and the amounts which were paid back. These information have to be provided globally (for consolidated accounts, Art. 337 13°, LSC 1915; for annual accounts, Art. 65 (1) 13° of the Law of December 19, 2002 on the Commercial registrar and the accounting and annual accounts of businesses). There is not a specific prohibition in Spain about this subject. The general one is related with the loans directed to acquire the shares of the company.

[156] Italian Civil Code, art. 2383

[157] French *Code de Commerce*, Art. L225-18.

their appointment with sufficient frequency.[158] Directors of Spanish listed companies have a maximum term limit of six years, but they can be re-elected without limit.[159] The Spanish Unified Code establishes that independent directors should not stay on as such for a continuous period of more than twelve years.[160]

In Denmark and Portugal members of the board of directors are elected by the general meeting for a period stipulated in the company's articles of association and for a period no longer than four years. In Poland, members of the management board, by law, may serve for a maximum period of five years; there are no specific rules concerning disclosure of contracts. In Member States where directors have an employment contract governed by labour law, termination of the work contract can only be made as provided in the contract and as permitted by law.[161] Most other Member States do not stipulate any specific requirements concerning directors' service contracts with respect to the duration and disclosure.[162]

In the UK, disclosure concerning termination payments policy, notice periods and the duration of directors' service contracts must be made in the Directors' Remuneration Report together with disclosure concerning payments made to directors (for breach of service contracts) in the relevant financial year; termination payments will be related to the director's service contract. Remuneration committees are recommended (under the Combined Code) to 'carefully consider' the impact of early termination in terms of compensation pay-outs and to avoid rewarding poor performance; they are recommended to 'take a robust line' on reducing compensation to reflect the departing director's duty to mitigate losses. Dutch best practice guidelines provide for termination payments that do not exceed one year's fixed salary; however, if this is considered unreasonable for a management board member who is dismissed during his first term of office, the severance pay should not exceed twice the annual salary.

[158] Vienot II Report (1999), available at: http://www.ecgi.org/codes/code.php?code_id=41.
[159] Spanish Companies Act, art. 126.2.
[160] Spanish Unified Code on Corporate Governance (2006), point 40.
[161] For example in Luxemboug and to some extent Italy.
[162] E.g. Greece, Hungary, Sweden.

In Germany, payments to management board members on premature termination of contracts without serious cause must not exceed the value of two years' compensation (the 'severance payment cap') and, in the event of a change in control, payment must not exceed 150% of the severance payment cap. French regulation on termination payments introduces an element that is not found in any other regime. French law imposes total transparency and makes termination payments conditional on performance requirements. [163] Furthermore, it does not allow rewards to be made to failing executive directors. A termination payment cap of two years of compensation, including fixed and variable components, also applies.

According to the Belgian guidelines, severance payments should not exceed one year's basic and variable remuneration. The board may consider higher severance pay but further to a recommendation by the remuneration committee, and such pay should be limited to a maximum of eighteen months remuneration. The contract should specify that the severance package should neither take account of variable remuneration nor exceed twelve months' basic remuneration if the departing CEO or executive manager did not meet the performance criteria referred to in the contract.

Some states do not have any specific rules regarding termination payments. For example, in Austria, contracts signed by the management board's members are so called 'free services contracts' (*Freie Dienstversträge*) and generally neither labour law nor collective agreements are applicable to them. Management board members are explicitly excluded by law from the scope of general agreements. Disclosure of severance payments is not always enforced by regulations. In Germany, the substantive content of severance awards for management board members is disclosed only if, in legal terms, the awards differ significantly from the awards granted to employees.

Capping severance pay to a certain number of years of annual remuneration may create some room within which companies can manoeuvre and remove underperforming directors without excessive cost. Currently, there are significant variations between companies that set limits on

[163] The "TEPA" Act: Act of 21 August 2007 for labour, employment and purchasing power.

severance pay limit. In particular, we suggest that clarity is necessary in Community and Member State regulation as to what annual remuneration (against which termination payments are assessed) refers to, whether: i) fixed annual pay; or ii) fixed + annual bonus; or iii) fixed + bonus + share-based payment. At EU level, the 2009 Recommendations provide for termination payments to be based on maximum two years of the non-variable component of remuneration or the equivalent thereof. Additionally, the Recommendations state that termination payments should be linked with performance.[164]

Incentive pay

An important area of the remuneration framework relates to guidelines for incentive pay. Different approaches have been adopted across the Member States in this area. Share-based remuneration schemes, in particular, tend to attract best practice recommendations.

Schedule A of the UK Combined Code states that, in normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities. Grants under executive share option and other long-term incentive schemes should be phased rather than awarded in one large block. The total rewards potentially available under incentive schemes should not be “excessive”. The Combined Code further recommends that performance criteria for incentive scheme payments should be “challenging”; and that consideration should be given to the use of performance criteria which measure the company’s performance relative to comparator companies in some key variables, including Total Shareholder Return (TSR). Share-based schemes have also been addressed by leading institutional investor organisations. The ABI Guidelines state that remuneration committees should have regard to dilution effects.[165] The

[164] COM 2009/3177, art. 3.5 (II).
[165] ABI Guidelines, *supra* note 99, para 2.3.

NAPF Guidelines state that the board's assessment of the total value of rewards granted to directors should be made available and that directors should ideally only participate in one share based incentive scheme at a time.[166]

In Germany, where extraordinary, unforeseen developments occur it is possible to limit long-term incentives, upon the agreement of the supervisory board. Other requirements include that the grant of new shares to members of the management board is dependent on the nominal value of the contingent capital not being greater than ten percent of the registered share capital available at the time of the relevant resolution. The waiting period prior to the initial exercise of the subscription rights / options is two years.

In France, with respect to share option schemes, boards of directors or management boards should prohibit the immediate resale of all or part of any shares granted for a particular period (the 'custody period'), which period may not exceed three years from the date of exercise of the option. For bonus shares, the minimum term of the vesting period (or period at the end of which the vesting of the shares is final) may not be less than two years, while the minimum term of the custody period may not be less than two years from the final award date. However, the custody period may be reduced or removed by the general meeting if the meeting has also approved a vesting period at least equal to four years for all or part of the awarded shares. The total number of shares awarded free of charge may not exceed 10% of the share capital as of the date of the award made by the board of directors or the management board. Additionally, no bonus share award may be made to employees or officers individually holding more than 10% of the share capital.

In Belgium and Luxembourg the specific rules include that shares should not vest and options should not be exercisable within less than three years. In the Netherlands options should not be exercised in the first three years after the date of granting, and shares granted without financial

[166] The National Association of Pension Funds (NAPF) published their Corporate Governance Policy and Voting Guidelines in November 2007. They can be accessed at the NAPF website www.napf.co.uk. The Guidelines are supportive of the Combined Code and the ABI Guidelines. They contain Global Remuneration Principles that are worth setting out for consideration. NAPF published an update to their November 2007 Guidelines in February 2009. There are no changes as such to Remuneration Policies but the updates give an indication of how Remuneration Reports in 2009 will be viewed.

consideration must be retained for a period of at least five years, or until at least the end of the employment, if this period is shorter.

3.7 New regulatory issues

The financial crisis has led to particular rules being adopted across the Member States for remuneration within banks and has led to regulators and supervisors becoming more involved in the banking remuneration system. As described above in this Section, the Commission has adopted new general principles applicable to remuneration policy in the financial services sector which are designed to ensure that financial institutions have remuneration policies in place for risk-taking staff that are consistent with and promote effective risk management.

Even before the financial crisis deepened in late 2008, however, several banking-specific provisions were already in place in some Member States. For example, according to Luxembourgish company law, the banking supervisory authority could recommend a reduction of the remuneration of the board of a listed bank, as a whole, if it deemed such remuneration disproportionate to the bank's size, activities, profits and to the time directors spent on performing their duties. The Bank of Italy issued specific corporate governance guidelines for banks in March 2008,[167] including with respect to remuneration policy, implementing the EU Recommendations. This is the first such document addressed to the banking sector immediately after the financial crisis hit the markets and as concerns about the health of the financial system were raised.

As the crisis deepened and as remuneration became linked, in the policy debate, to the financial crisis, a series of reforms and reviews were adopted across the Member States and by the EU in an attempt to design a better regulatory framework for director remuneration. Such reforms have been initiated by regulators and politicians with particular regard to financial firms, to prevent a recurrence of the 'credit crunch'.[168] Overall, these reforms seem to impose more responsibility on

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[167] See Bank of Italy *supra* note 126.

[168] For example, efforts for reforming pay in financial firms by the UK Financial Services Authority (FSA), the Institute of International Finance (IIF), the Basel Committee, the Financial Stability Forum (FSF).

the (supervisory) board for directors' remuneration. Whilst measures designed to align remuneration with effective risk management have been required for financial institutions in particular, provisions for an increased role for the board,[169] clawbacks, golden parachutes and compensation's adjustment to risks, all with broader relevance for remuneration policy, have also emerged. All these areas are, for example, covered in the two 2009 EC Recommendations.

Board responsibility

The amendments to the Dutch Code of Corporate Governance in 2008 well illustrate the increased responsibility being placed on the supervisory board. Supervisory boards are given instruments for improving the quality of decision-making on remuneration and the transparency of the remuneration structure. The basic concept is that management board members should earn their remuneration on the basis of performance, but that it is ultimately for the supervisory board to determine how much it would be reasonable for a management board member to earn, taking account of all the circumstances. The active involvement of the shareholders is also essential in this respect. Before determining the remuneration of management board members, the supervisory board should analyse the possible outcomes of the variable components of remuneration. The supervisory board then determines the level and structure of the remuneration by reference to scenario analyses, taking account not only of results and share price but also of non-financial indicators.[170] The Government Commission on the German Corporate Governance Code also made a number of substantive amendments to the Cromme Code in 2008. One of the main reforms was to strengthen the competence and responsibility of the full supervisory board in respect of remuneration.[171]

[169] "Non-executive directors hold particular responsibility for ensuring that executive incentive compensation arrangements are sound. For financial institutions with dual boards, the Supervisory Board must take responsibility for all compensation arrangements, not just senior executive compensation arrangements". FSF Principles, *supra* note 25.
[170] See Dutch Code of Corporate Governance (2008), II.2.
[171] Government Commission, German Corporate Governance Code, Press release, 6 June 2008.

It has also been advocated that non-executive directors should have the discretion to change actual remuneration, ex-post, to ensure that the total pay executive directors receive is 'fair' in relation to the company's results and the personal performance of management[172]; any related adjustment to the operation of established remuneration schemes would be fully disclosed. But only the Dutch corporate governance guidelines empower the supervisory board to adjust variable remuneration downwards or upwards. In support of boards' discretion to change executive remuneration, the role of the remuneration committee needs, however, to extend from making proposals for the remuneration policy, to 'performance reviewing', i.e. carrying out an assessment of the remuneration levels against performance criteria and assessing the appropriateness of the remuneration policy.

Risks of variable remuneration

Variable remuneration may expose the enterprise to various risks. Regulators, as well as banking institutions, are now focusing on the risk which remuneration poses to overall firm financial stability and risk management, and to systemic stability, and are exploring ways to make variable pay better reflect risk and long-term performance. For example, the FSA is concerned with the risks created by the structure, and not with the absolute amount, of remuneration; it regards the latter as a matter for firms' remuneration committees. But its general principle is that a firm should establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.[173] The FSA stance reflects a growing consensus in the industry that pay for bankers should be adjusted for the risks they take when betting their companies' capital.

As yet, EU Member State regulations have not implemented specific measures on the relationship between remuneration and risk-taking. The better alignment of remuneration with a

[172] *Statement of the European Corporate Governance Forum on Director Remuneration*, 23 March, 2009.
[173] FSA, *Draft Code on Remuneration Policies*, February 2009, revised March 2009 (FSA, *Reforming Remuneration Practices in Financial Services*, March, 2009).

firm's risk profile had, however, been raised by the supervisory provisions drawn-up by the Bank of Italy specifically for the Italian banking system in 2008[174], before the deepening crisis woke policy makers up to the issue. The Italian provisions require that remuneration schemes must not conflict with banks' prudent risk management policies or their long-term strategy. In particular, equity-based incentives (e.g. stock options) or performance-linked pay must take account of the risk borne by banks and be structured so as to avoid generating incentives that conflict with their long-term interests.

Across the Atlantic, the Emergency Economic Stabilization Act (2008, so-called "TARP bill") and the American Recovery and Reinvestment Act (2009, so-called "stimulus bill") require firms receiving TARP funds to ban incentives that take "unnecessary and excessive risks". The effectiveness of these measures have been argued.[175]

Remuneration practices can encourage excessive risks across all industries, however, and the reform movement should focus more widely on ensuring that incentives do not induce risk-taking which is in excess of a firm's risk appetite or tolerance.

Clawback provisions

The financial crisis has also seen attention turn to clawing back remuneration.[176] Clawback provisions are rarely found in current Member State regulations. But clawbacks have, nonetheless, become associated with the financial crisis remuneration reform movement.[177] Typically, under a clawback clause, and to the extent possible under applicable employment laws and companies'

[174] See Bank of Italy, *supra* note 126.
[175] Bebchuk and Spamann argue that regulating executive incentives alone is not sufficient to ensure the soundness of financial institutions, while combining traditional regulation approach with the regulation on executive pay could better improve effectiveness of bank regulation. See L. Bebchuk and H. Spamann (2009), *Regulating Bankers' Pay*, Georgetown Law Journal, Forthcoming, Harvard Law and Economics School Discussion Paper No. 641, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072.
[176] One way to align time horizons is to place a portion, and in some cases up to the entirety, of any given year's bonus grant, both cash and equity, into the equivalent of an escrow account. All or part of the grant is reversed if the firm as a whole performs poorly or if the exposures the employee caused the firm to assume in the year for which the bonus was granted perform poorly (a "clawback"). Departure of the employee from the firm should not trigger early payout (hence, for example, many past "golden parachute" arrangements did not conform to this principle); FSF, *supra* note 25.
[177] For example, see Committee of European Banking Supervisors (CEBS), *High Principles of Remuneration Policy*, March, 2009

legislation, the company should reserve the right, at the discretion of non-executive directors, to reclaim performance-linked remuneration elements which were paid to directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice.[178] This requirement currently exists only in the amended Dutch Code, probably thanks to its adoption in the middle of the financial crisis. The Dutch clawback provisions suggests that the supervisory board be able to recover from management board members any variable remuneration which was awarded on the basis of incorrect financial or other data.[179]

4. RESEARCH ON COMPANIES

4.1. Explanation of data

Our dataset consists of Europe's largest 300 listed firms by market capitalisation.[180] 295 firms have been examined; the remaining 5 did not provide the necessary material for the analysis. The firms are situated in 16 European countries, of which 14 are EU countries and 2 are non-EU countries.[181] Table 1 shows the distribution of firm observations across the 16 countries included in our sample.

The analysis was conducted on the annual financial statements or corporate governance reports – where separate from annual reports – for the financial year ending December 2007 or March 2008. The data accordingly reflects firms' remuneration policies for the period just before the crisis occurred.

Our disclosure analysis covers 23 criteria related to the disclosure of directors' remuneration. These criteria are further classified in 8 categories, namely: remuneration committee,

[178] COM 2009/3177.
[179] Dutch Code of Corporate Governance (2008), II.2.11.
[180] FTSEurofirst 300 as November 2008.
[181] EU: UK, France, Italy, Germany, Netherlands, Belgium, Spain, Sweden, Ireland, Austria, Denmark, Portugal, Greece, Finland; non-EU: Switzerland, Norway. Comments in the paper relative to the application of the Commission's Recommendations in practice refer to firms based in EU; nevertheless Swiss and Norwich firms compete on a level playing field with the EU firms, therefore investor requirements are similar.

remuneration statement, terms of contracts, preparatory and decision-making process, remuneration policy information, individual disclosure, emoluments and share-incentive schemes. The criteria were chosen as they provide an insight into the behaviour of firms relating to the disclosure of directors' remuneration across three areas: governance, remuneration policy and individual remuneration disclosure. In setting the criteria we followed the specific provisions stated in the 2004-2005 EC Recommendations and covered in most international best practice guidelines. Annex 1 provides explanations for the evaluation of all criteria. For each criterion we assess whether a firm attains a minimum level of implementation.

The 23 criteria use a *Degree of Conformity (DoC)* measuring the extent to which companies follow international guidelines for the presentation and disclosure of directors' remuneration. We assign a value of "1" to each criterion that a firm complies with and "0" otherwise. All criteria were given the same weight. If the firm does not provide information on a criterion we do not exclude it from the computation but give each missing criterion a score of 0, effectively treating it as if the firm does not conform with the respective disclosure criteria. The DoC can be assessed :

i) at a general level, comprising all firms from our dataset: expressed in percentages, or in number of points (max DoC = 295);
ii) at country level: expressed in percentages or in number of points (max DoC = number of observations (firms));
iii) at firm level: expressed in values assigned (0 or 1 / criteria).

In this section we present an overview of European firms' behaviour in practice with respect to remuneration governance and disclosure. Because the results show homogeneity within countries and variations between firms in different countries, the comments refer to country-specific firm behaviour. Overall, we observe that firms' application of the different disclosure criteria depends on the level of transposition of the Commission's 2004 and 2005 Recommendations in the different Member States and, moreover, on the way these recommendations are applied: through mandatory legislative provisions or through best practice guidelines. Law accordingly 'matters'.

Table 2 provides an overview of the 23 criteria, categories and areas showing firms' overall DoC for each of these. The results show that some criteria are followed by the majority of firms. For example, four of the criteria are fulfilled by over 80 percent of our sample: one of the two criteria in the area of governance, two of the thirteen criteria in the area of remuneration policy and one out of the eight criteria in the area of individual disclosure. The criteria meeting the highest scores are related to general disclosure requirements i.e. disclosure on the presence of a remuneration committee, the existence of a policy statement and the individual disclosure of non-executive directors. The criteria that receive the lowest percentage of conformity relate to detailed disclosure requirements, such as the adoption of a forward-looking approach in the remuneration statement, disclosure of terms of contracts, disclosure of the names of external consultants, information on the link between remuneration and performance and details of the share-incentive schemes.

The empirical distribution of criteria is displayed in table 3. We observe that firms tend to place the highest importance on basic disclosure requirements, represented by criteria such as the existence of the remuneration committee, the existence of a remuneration policy and individual disclosure of emoluments; while requirements for more detailed information relating to directors' terms of contracts and qualitative information regarding the performance-linked compensation generate lower interest. Figures 1 and 2 also reveal the substantial differences in disclosure on remuneration between firms in our sample.

4.2 Remuneration Committee

As part of the analysis of the governance of the remuneration process, we checked for the presence of a dedicated remuneration committee within boards, composed of non-executive, directors, in the majority independent, as required by the 2005 Recommendation on the role of non-executive directors.[182]

Our assessment shows that almost 83% of the firms reviewed have established either separate or joined committees. But only 60% of all firms have remuneration committees composed of non-executive, in the majority independent, directors. Reflecting the pan-EU governance divide, variations occur mostly between jurisdictions, whilst conformity with criteria within each country is quite homogenous. Remuneration committees (either separate or joined) are to be found at all firms from the UK, the Netherlands, Ireland and Portugal. The countries where the lowest number of firms have remuneration committees are Germany, Denmark and Austria. Firms from Belgium, Spain, Sweden, Greece and Norway have the lowest compliance with the requirement regarding committee's composition. Nearly all UK firms reviewed set up dedicated remuneration committees. Several Dutch firms also have separate remuneration committees; some have established joined nomination and remuneration committees. UK and Dutch firms also comply with the composition requirements. In France, most firms have joint nomination and remuneration committees, whilst the majority of Italian firms have dedicated remuneration committees. Greek and Norwegian firms have set up remuneration committees but they do not fulfill the independence criteria. German firms do not have separate remuneration committees; in most cases, other committees (most often human resources committee) have been delegated the responsibility for senior management remuneration and information regarding the independency of their members is not given.

Firms' approach to governance generally follows their national corporate governance requirements. As revealed by our research on regulations and by the Commission's report on implementation of the 2005 Recommendation,[183] the majority of Member States require the creation of remuneration committees; however, not all Member States have implemented the requirements

[182] 2005/162/EC.
[183] COM SEC(2007) 1021.

of the Recommendation on the presence and number of independent directors in the committee and this is reflected in firm practice.

Whether a totally dedicated committee, addressing remuneration alone, ensures optimal remuneration governance is questionable. Committees are supposed to devote full attention to their tasks, whether it is auditing, directors' nomination or remuneration. On the other hand, merging the remuneration and nomination functions may provide co-operation and information efficiencies and provide important inputs to the evaluation and rewarding process. In the end, the corporate governance framework of each firm should be decided by each firm, taking into account its overall responsibility, structure and strategy. The independence requirement, however, is more sensitive, because the remuneration itself is a sensitive argument, prone to conflicts of interest. As the main tasks of the remuneration committee concern the submission of proposals on individual remuneration and on suitable contracts for executive directors and top management, the presence of executive representatives in such committees would undermine its activity. The determination of the independence criteria varies, however, across countries' best practices codes.[184] But whatever the standard adopted, compliance with the independence criterion in practice then becomes essential.

4.3 Remuneration policy

The precise coverage of a company's remuneration policy is not well defined by national regulations. This is also clear from the disclosure practices adopted by firms, which apply local requirements in different ways. The remuneration policy could be understood as a detailed account of individual remuneration, company remuneration principles and the remuneration process. In practice, most regulations and codes that transposed the 2004 Recommendation on directors' remuneration require a clear and comprehensive overview of the remuneration policy, which

[184] See analysis of the composition of remuneration committees in Section 3 of this paper.

enables shareholders to evaluate the company's approach to remuneration and to debate the policy where necessary.

Our analysis assesses the remuneration policy area with respect to four categories: the remuneration statement, contracts terms for executive directors, the preparatory and decision-making process and the information contained in the remuneration statement.

Remuneration statement

Under the 2004 Recommendation, the remuneration policy must firstly contain a statement which provides an overview of the principles governing remuneration for the year in review.[185] Where firms provide an independent remuneration report, the statement is, of course, part of this report. If, as is most often the case, firms do not have a separate remuneration report, the statement can be included in the annual accounts or the respective notes. The statement must provide an overview of the manner in which the remuneration policy has been implemented in the year in review, explaining any changes that have occurred during the year.[186] More than 90% of the firms have a remuneration statement in their report. However, we find great differences in the presentation of the remuneration statement. At the lowest level of disclosure, firms present a rather boilerplate statement, with insufficient bespoke coverage. At the upper level, firms provide clear principles and guidelines on their remuneration policy, including details of any recent changes or future changes. If we were to evaluate the quality and clarity of the statement, we would allocate low scores to the majority of firms from Continental Europe; however this is not an assessment we undertake in the present study.

In addition, the statement should also focus on the company's policy on directors' remuneration for the following year and subsequent years[187]. Although this must be approached with caution because policy evolves over time, this requirement is essential for board

[185] 2004/913/EC, Art. 3.1.
[186] *Id.*, Art. 3.2.
[187] *Id.*

accountability. Nonetheless, few national regulations have transposed this requirement and even fewer firms have applied it. This failure is likely to become the focus of future reforms, considering the risk associated with the remuneration levels of firms' top management. Our research reveals that only UK and Dutch firms achieve a higher than 50% conformity with this criterion. Most other firms do not conform with this criteria at all.

Overall, the remuneration statement category is fulfilled by 70% of the firms.

Terms of contract

The terms of contracts for executive directors, including the duration of contracts, the applicable notice period and details of provisions for termination payments, form part of the remuneration policy and must be disclosed in the statement. Shareholders can take account of these contracts and the way in which they are implemented in considering their vote on the remuneration policy. Best practice guidelines typically provide that when contracts are being negotiated, boards should consider and avoid the reputational risks of being obliged to make large payments to executives who have failed to perform. Contracts should also be reviewed periodically and remuneration committees should consider, and stakeholders assess, whether the contract provisions are in line with their policy and the disclosed statement.[188]

Overall, and despite its importance to effective governance and shareholder voice and the extent of the 'rewards for failure' which the crisis has exposed, this category meets the lowest DoC, approximately 45%. In several cases where only partial information is disclosed, it is provided in sections of the annual report that are not linked to the remuneration statement, and is rather unclear. Nearly all UK firms and most Dutch and Swedish firms, however, consolidate all information relating to the terms of contracts in the remuneration statement. In other cases, the terms of directors' contract are often understood by companies as related to general corporate governance issues and hence are disclosed with board practices generally. However, we argue that service

[188] Best practice guidelines recommended also by ABI/NAPF; *supra* note 99.

contracts disclosure should be linked to remuneration policy and disclosed in the remuneration statement. Accordingly, we assessed all firms on an equal playing field, without penalising the ones that might have this information.

Disclosure of firm policy on termination payments is provided by 61% of all firms and it is often disclosed separately from the duration of contracts. More than 70% firms from Sweden, the UK, the Netherlands and Portugal provide some disclosure on policy on termination payments, while less than 30% of firms from Switzerland, Italy, Austria and Norway provide such information. Because one needs to have an overview of the general policy on termination payments, we penalise firms that only give information on the CEO termination contract instead of a general policy applied to all executive directors.

Preparatory and decision-making process

Information regarding the preparatory and decision-making process used for determining the company's remuneration policy for directors should also be disclosed in the remuneration statement.[189] In line with the Commission's Recommendations, we assess the disclosure of information concerning the mandate and composition of the remuneration committee, disclosure concerning external remuneration consultants and disclosure concerning the role of the general meeting of shareholders in the process. As with disclosure concerning the terms of contracts, disclosure on the process for setting-up remuneration assists shareholders in understanding the company's remuneration policy and in gauging the appropriateness of the levels of compensation. This category is best followed by UK firms and, with significantly lower levels of conformity, by Dutch, Swedish, Irish and Portuguese firms.

With the exception of UK firms, most European firms provide the remuneration statement and the information related to the remuneration committee separately, with the latter often found in the general corporate governance report / section. This reflects national reporting requirements. We

[189] *Id.*, Art. 3.4.

find, however, that process disclosure is an important element of remuneration governance which should be disclosed as part of the remuneration statement, together with the other information which describes the process for setting remuneration. This reform should be made through Member State regulation, even if it requires a duplication of disclosures already required for the corporate governance report. Our research in this area produced two results: the first analysis did not penalise firms that disclosed the information elsewhere in the annual accounts; the second only considered disclosures made in the remuneration statement. In the first situation, 75% of firms disclosed the information, with most countries achieving overall scores higher than 80%.[190] Austrian and Danish firms have the lowest conformity levels. In the second situations, where we penalised firms if the information was dissociated from the remuneration statement; only 30% of all firms (mainly UK firms) conformed.

The names of external remuneration consultants are disclosed by only 33% of firms, mostly UK firms. Several Spanish firms state that they do not use a remuneration consultant. Where the information was missing, we assumed that firms make use of consultants, but do not disclose this information. The role of the general meeting of shareholders in the remuneration process is disclosed by almost 70% of the firms. But less information is provided by German, Austrian, Norwegian and Finnish firms, where the role of shareholders in the remuneration process is weaker. Generally (as noted in section 3 above), the role of the general meeting in the remuneration process consists in setting the remuneration levels for the supervisory board and approving the remuneration policy and the share-based remuneration schemes. But disclosure on shareholders' role is generally unclear across the firms reviewed.

[190] German firms do not have such information because they do not have remuneration committees, but instead they allocate responsibilities for directors' remuneration to human resources or personnel committees undertake the responsibility for the directors' remuneration process.

Alignment of remuneration with performance

As outlined earlier, the degree of alignment of remuneration with performance is regarded as an essential measure for evaluating the appropriateness of a company's remuneration policy. Disclosure plays a major role in assisting shareholders (and other stakeholders) in assessing the 'relative importance' of the variable and non-variable components of directors' remuneration. Shareholders and policy makers can use disclosure to evaluate the appropriateness of firms' remuneration policy, linking it to the remuneration process and compensation levels. However, the concept of 'relative importance', frequently used by regulators, is rather vague. Companies often express 'relative importance' as a comparison of the relative values of 'fixed' remuneration (e.g. salary) and variable remuneration (such as bonus, options and LTIS awards). Corporate governance guidelines often recommend a 'proper balance' between base pay and variable pay[191] or that remuneration be linked to performance by means of a relatively low base pay and a higher proportion of variable pay.[192] Approximately 55% of firms provide an explanation as to the balance between the different elements of remuneration, although the depth of disclosure varies.

Most UK firms provide details on the breakdown between fixed remuneration and annual incentives and between fixed remuneration and other long-term incentives, often also disclosing the minimum as well as the maximum levels for these incentives payments. Several UK firms also present these proportionate disclosures, in aggregate form, as part of the total estimated annual pay. This type of disclosure facilitates a clear assessment of the estimated value of incentive payments as a proportion of total annual pay. Most other European firms that disclose the relative importance of fixed and incentive pay usually only refer to the relationship between base pay and annual bonuses. This more limited approach may be linked to the lack of disclosure on the value of share-incentive schemes, which we consider further below. Given that the Commission Recommendation (2004) does not specifically require disclosure of the balance between fixed and the different elements of

[191] See for example, AFEP/MEDEF (October 2008).
[192] See for example UK Combined Code (2006); Italian Corporate Governance Code (2006); Belgian Corporate Governance Code (2009).

the variable remuneration, our assessment awards the DoC to firms which disclose only the relative importance of fixed remuneration and annual incentives (bonus). UK, Dutch, Swedish, Austrian and Portuguese companies rate highest in this criteria, while Spanish, Belgian, Italian, Irish and Danish firms have low conformity.

Understanding the financial state of a firm and its forecasted performance, its strategy and its objectives is essential when evaluating a firm. An accurate assessment of the effectiveness of remuneration policy for directors accordingly must be linked with the financial and non-financial state of a firm. The remuneration statement should therefore set out sufficient information on the linkage between remuneration and performance, through disclosure of the performance criteria on which bonus and share schemes are based, although the need to protect the disclosure of commercially sensitive information must be acknowledged. This, however, should not be an excuse for not disclosing the parameters for the incentive component of remuneration. The low levels of disclosure which are clear from our analysis may be explained by firms considering performance targets to constitute commercially sensitive information. Firms that we assessed as in conformity in this area, by contrast, provided details on performance targets for both annual and long-term incentive schemes; if no information whatsoever is provided on long term-incentive schemes without making it clear whether such schemes are adopted, we assumed that the firm does not disclose this information. The level of disclosure of the link between remuneration and performance cannot be fully objective but, given market concerns, what is important is that an ex-post review of performance against targets is possible.

Disclosure of the performance parameters for bonus schemes is provided by 64% of the firms in our data, while performance targets for share-based incentive schemes is provided by only 56% of the firms. These disclosures are complemented by information (or the lack of it) on the achievement of targets, such that in the end only 30% of firms provide sufficient information on the link between remuneration and performance. The highest levels of disclosure are provided by UK, Dutch and to some extent German firms, while Belgium, Spanish, Italian and Swiss firms are the lowest performers.

Overall, these generally moderate levels of firm disclosure concerning the remuneration policy reflect local transposition of the 2004 Recommendation in the Member States. The EC's assessment showed that implementation was generally variable and that the Recommendation was most often only implemented in part.[193] The Recommendation's detailed requirements have typically been implemented on a 'comply or explain' basis.

4.4 Individual disclosure

Adequate transparency depends on individualised disclosure of executive and non-executive remuneration, including a breakdown of salary/fees and short-term and long-term incentives. This way, shareholders and wider stakeholders can hold individual directors accountable for the remuneration they have earned; but this assessment is accurate only if all the components of remuneration are disclosed individually, relative to the year in review and the preceding years. Our assessment indicates that 58% of all firms conform to all criteria in this area.

We assess the level of disclosure of emoluments, i.e. the total amount of salary or board fees paid to the director under the year in review, the remuneration paid in the form of annual bonus and any additional benefits.[194] We observe that 74% of firms provide both executive and non-executive individual disclosure of emoluments and bonuses. The remuneration of non-executives is disclosed by a greater number of firms; however some companies disclose only with respect to non-executive or executive directors. Generalising firms' behaviour within a country and observing the differences in behaviour between countries, we notice that firms tend to follow domestic regulation. For example, most Swedish and Finnish firms disclose individual remuneration of non-executive directors and do not individually disclose the remuneration of executives. Conversely, Austrian

[193] COM SEC(2007) 1022.

[194] Since pension compensation are often included in the total emoluments, we did not take this criterion into our assessment, assuming that firms that disclose all other components, also include information on pensions.

firms provide individual disclosure of executive remuneration and aggregate figures for non-executive remuneration. In most other countries, firms that only provide aggregate disclosure adopt this practice for both types of directorship.

Disclosure of the remuneration of individual directors of the company, executive and non-executive, in the preceding years can help investors appreciate remuneration in light of the overall performance of the firm.[195] Nearly all UK and Irish firms, and about 71% of Dutch firms, disclose individual remuneration for the previous year. Almost half of French and Italian firms provide this information as well; many French firms also provide information on executive remuneration received in the previous two or even three years. Most often following national regulations, several firms provide this disclosure only for executive directors and are therefore penalised by our assessment.[196] In line with the Commission Recommendation and several national guidelines, we consider that the evolution of non-executive remuneration year-on-year is also important in evaluating board performance, as frequently the non-executive directors receive variable pay based on meeting attendance and, in several cases, based on performance.[197]

We also evaluated the conformity of individual disclosure with respect to share schemes awards, including: share options granted, exercised, unexercised, exercise price, and exercise date. Details on share-incentive schemes are fully disclosed on an individual basis by 46% of firms. The majority of UK, Irish and Dutch firms, and around 40% of firms from Italy and France, provide disclosure on all required information. Companies in other Member States provide low levels of disclosure. Firms that report numerical details also generally provide explanations on the conditions of application of shares granted and exercised rights. Disclosure has, however, expanded following

[195] 2004/913/EC, preamble (9).

[196] For example MEDEF recommends only executive disclosure for the previous years, provision followed by several French companies.

[197] Several German firms pay variable bonus remuneration based on performance to members of the Supervisory Board: dividend-related or based on net profit /share. Spanish board directors receive a certain percentage (e.g. 1%, 2%) of company's net profit. Swiss members of the board receive a base salary in cash dependent on each member's function, an allotment of registered shares (usually 50% cash, 50% shares) and sometimes share options under a LTIP.

the mandated expensing of stock options,[198] nonetheless clarity has not improved. This is mainly because certain details of long-term incentive schemes are not being disclosed.[199]

As with the area of remuneration governance and policy disclosure, individual disclosure of remuneration is a criterion fulfilled by the European firms only in part, reflecting the requirements set by Member State regulation. More stringent requirements have been put in place in this area since the 2004 Recommendation was adopted and, in most States, disclosure is required by law on a mandatory basis. However, where the option for 'comply or explain' applies, many firms still deviate from the rule, providing explanations for their approach (e.g. firms from Spain, Belgium, Austria, Portugal).

In addition to the 23 criteria considered above, we also assessed two criteria which, in our view, could strengthen the regulatory provisions: i) a criterion allowing us to observe the way in which the information related to remuneration is consolidated in the statement; ii) a criterion which analyses the use of benchmarks in the remuneration process.

4.5 Consolidation

Although our results indicate that the majority of firms have a remuneration statement in the annual report, the consolidation criterion was only poorly complied with by European firms; most companies do not provide a consolidated remuneration report. Most Continental European firms do not engage in exhaustive reporting. Elements of the remuneration policy are scattered throughout the annual report. "A clear and comprehensive overview of the company's remuneration"[200] has not been achieved by the majority of firms; this obstructs remuneration governance and assessment of the remuneration system adopted by the firm. UK firms produce remuneration reports; therefore the degree of consolidation is high, with a 94% of firms conforming to this additional criterion. Almost

[198] The introduction of the accounting standards IFRS 2 on January 1, 2005 significantly changed the accounting rules for share-based payments. For listed companies, a new "expected value" charge must be taken to the profit and loss account for all forms of share incentives.
[199] For example, in the case of stock option schemes, individual disclosure of the value realized from the exercising of options is not required, nor disclosed voluntarily by firms.
[200] 2004/913/EC, preamble (5).

80% of the German firms in our data-set produce a consolidated remuneration statement, while all other firms scatter the remuneration information throughout their annual reports. These fragmented remuneration reports may be interpreted as providing opaque and incomplete disclosure. Figure 9 in annex illustrates the degree of consolidation achieved by firms.

4.6 Benchmark peer group

Using a benchmark peer group (related to a business sector and/or the European or global market) to assess remuneration policy and levels is considered best practice, yet it is recommended or required by only a few national regimes.[201]

In practice, benchmarking the level of pay is a criterion found mostly in UK and Dutch remuneration reports; it is not common in other firms. Approximately 78% of UK and Dutch firms disclose a remuneration benchmark in the remuneration statement. An employment market peer group – not limited to national markets – can be an additional element in the process for setting the remuneration for both executive and non-executive directors. It can act as reference for the remuneration levels of the (supervisory) board and support adequate alignment with the relevant market and ensure that remuneration is competitive with that in firms of similar size and complexity. The composition of the comparator group should be reviewed on a periodic basis to assure that its constituents reflect the company's strategic orientation. Most commonly, the peer group used for measuring the TSR is different from the employment market peer group which is used to determine remuneration levels. The TSR performance assessment measure, against a comparator group, is a performance benchmark and is not used to benchmark overall remuneration policy/level of remuneration. Benchmark disclosure poses risks however, in that, aligning directors' remuneration with a peer group, combined with the practice of aiming to reward directors at the

[201] Remuneration benchmarks are, for example, recommended by the French AFEP/MEDEF (October 2008); by the Italian Corporate Governance Code, 2006; by the Dutch Corporate Governance Code, 2008, which also requires disclosure of such benchmarks; and by the ABI Guidelines on Policies and Practices, 3 December 2007 (UK). The old EC Recommendation did not incorporate the requirements for disclosure of the peer group, while the document adopted in 2009 does so: COM 2009/3177, art. 5.2, (g), (II).

median or upper quartile of such peer group, may bring upward pressure ("ratchet effect") to bear on the remuneration market and lead to neglect of the relationship between remuneration and firms' underlying performance. Recent reform proposals suggest that boards should not only benchmark the remuneration of executive directors externally but also internally against the remuneration of other employees within the company, in order to ensure a consistent and 'fair' remuneration policy throughout the company[202], however controversial a requirement this may be.

4.7 Overall analysis

The EC Recommendations allow Member States to adopt different local approaches. This has led to diverse interpretations due to a wide diversity of national transpositions which reflect local traditions, legislation and practices.[203] Our results in the three analysed areas support our observation that firms tend to apply only the basic requirements of national regulations, hence the significant differences in the application of disclosure provisions. Furthermore, they generally conform mainly to legally-binding rules and do not usually go beyond what is required by these rules. Where requirements apply a 'comply or explain' basis, firms tend to follow them only partially.

A further explanation of variations in the application of the governance and disclosure principles reflects the persistent differences in corporate ownership across Europe. Ownership structures have clear effects on corporate governance in general; one of the most striking features of executive remuneration is its reflection of the interaction between remuneration and corporate governance or ownership structures.[204] In the case of concentrated ownership companies, controlling shareholders can monitor management directly without the need for an incentive contract; therefore remuneration controls can be less sophisticated. In dispersed ownership systems,

[202] See for example European Corporate Governance Forum, *supra* note 172.
[203] On similar trends of EC financial regulation in general, see De Larosière Report, supra note 22.
[204] For an analysis of the executive pay as a function of corporate governance, see Ferrarini et al., *supra* note 7; Ferrarini and Moloney, supra note 4; F. Barca and M. Becht (eds.) (2001), "The Control of Corporate Europe", Oxford University Press.

on the other hand, shareholders are less able to monitor management and have more demanding disclosure requirements. Legal controls on pay in these systems tend to be more sophisticated and the responsibility of non-executive directors becomes more acute. In theory, this stimulates better disclosure practices by firms with dispersed ownership structures. Controlling shareholders will, however, continue to play a dominant role in Europe, despite the increase in the number of European firms listing on stock markets[205]; this is reflected in our findings. We note that UK, Ireland, and the Netherlands – traditionally countries with dispersed ownership firms – meet higher levels of disclosure practices, while firms from Belgium, Spain and, to some extent, Italy (traditionally block-holding systems) – achieve lower levels of disclosure.

Table 4 displays individual countries' overall DoC and provides a breakdown of the three areas considered in our analysis. We observe that most countries achieve the highest scores in the governance area, which is represented by the establishment of the remuneration committee. German firms perform better in the individual disclosure area. Firms from the UK, Netherlands, Denmark, Norway and Finland behave similarly within all three areas. Rather surprising is the fact that the lowest levels of conformity occur with respect to individual disclosure. While we find a certain level of homogeneity in disclosure behaviour, there are still some variations in the criteria concerned.

We also calculated the empirical distribution of countries' results. Tables 5-9 provide summary statistics. As the number of observations for each country in our dataset is not proportionate, we considered two alternatives: the first one has values that are independent of the number of observations in each country; the second alternative considers weighted values. The distribution is essentially influenced by the UK results. We also calculate the empirical distribution of results for overall firms from all countries; distribution was also calculated for overall firms from

[205] Thomas, *supra* note 11.

all countries excluding the UK, as this may be considered an atypical case. In the last case the distribution is close to normal. Results are given in tables 10-13.

Many of the Recommendations' provisions have been transposed, although not in full, by national corporate governance codes; implementation in the form of legal requirements is less common. In practice, the basic recommendations identified by our study, within the three areas, are followed; levels of compliance are lower with respect to the more detailed requirements. Some firms, however, still do not comply with even the basic requirements. For example, individual disclosure of directors' remuneration is a fundamental element of adequate disclosure that, in some countries, is only required by soft law.[206] Several firms from Austria, Spain, Belgium and Portugal still provide only aggregate disclosure, giving explanations for non-compliance that seem somewhat unjustifiable. The requirement for a vote on the remuneration policy has also been poorly implemented.[207] This may be explained by the fact that most Member States were late in transposing the Recommendations into national regulations.

Remuneration disclosure, central to effective remuneration governance, should be simple and transparent. But our analysis of the disclosure behaviour of firms from Continental Europe, where there is no legal requirement for a separate remuneration report, in comparison to the disclosure provided by UK companies and by the small number of European companies that produce a separate remuneration report, leads to the conclusion that only a separate remuneration report, providing a bottom line evaluation of the different compensation elements, can provide a consolidated, clear and comprehensive overview of the remuneration policy.[208] It is also essential if shareholders are to receive reasonably full information on which to base their voting decisions.[209] Reform in this area is necessary. The 2004 EC Recommendation on directors' remuneration preserves companies' right to decide internally on remuneration matters; its primary focus is on

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[206] See analysis in Section 3 of this paper.
[207] Provision included in the 2004 EC Recommendation on directors remuneration; see analysis of 'say on pay' in Section 3 of this paper.
[208] See Gordon, *supra* note 14; Gordon had similar recommendations for US companies to adopt a separate remuneration report, named "Compensation Discussion & Analysis".
[209] In the UK; some companies reproduce the full remuneration report in the notice of the AGM.

disclosure and transparency and on the approval of remuneration by the appropriate competent bodies. But it does not make sufficient recommendations regarding the content of remuneration policy. Reforms are necessary if clear and comprehensive disclosure on the remuneration policy is to be provided and if a level playing field is to exist between firms. In particular, greater clarity is needed on the meaning and content of the remuneration policy; this was raised repeatedly in the series of debates we attended on the regulation of remuneration in Europe. The current degree of confusion impacts negatively on the effectiveness of disclosure. It would be desirable for all companies to adopt remuneration policies which address the issue of executive remuneration, non-executive remuneration and share schemes. However, this needs to be clarified at the regulatory level, to facilitate the reporting and assessment of remuneration. The Commission strengthens its disclosure requirements in its 2009 Recommendation; but it leaves disclosure levels essentially to the discretion of the firm, relying on a "sufficient information" formula.[210]

Ultimately, stronger public regulation could lead to higher levels of disclosure given the poor compliance associated with soft law. This is not to argue that harmonisation should be an end in itself and that rules should be identical to achieve consistency. However, minimum core standards could be adopted and enforced at EU level.

5. CONCLUSIONS

The executive remuneration debate has evolved, in this decade, under the influence of two major crises. When the technology bubble blew up and corporate scandals emerged at the beginning of this century, stock options and market manipulation became a major cause of concern, while short-termism was seen as one of the main culprits. The recent financial crisis has revealed that perverse incentives leading to excessive risk-taking and pay for failure are major flaws in executive remuneration. In this study we explored the governance arrangements, the regulatory trends

[210] COM 2009/3177, art. 5.2 (II).

(including best practices) and the policy debate concerning executive remuneration in Europe, with reference to the period leading up to the 2007-2009 crisis. Our main objective was to analyse how remuneration governance and structures emerged from the technology bubble, reacted to the financial crisis and stimulated the remuneration policy debate. Whilst the lessons from the corporate scandals have not been easily applied, the recent financial turmoil will no doubt lead to more incisive reforms.

The current debate on directors' pay is focused on financial institutions, which are at the core of the financial crisis, and on how executive remuneration can deliver better risk management and support systemic stability. The new remuneration models being proposed under the current reform movement include the performance incentives long associated with executive remuneration but they also are designed to penalise failure. Moreover, the proposed models align incentives with corporate strategies but also with risk policies, emphasising the role of enterprise risk management in setting executive remuneration. They suggest a forward-looking approach for sustainable financial performance and recommend periodic reviews of remuneration policies by the board. Attention is increasingly being paid to stakeholder value and the fairness of pay, mainly with respect to financial institutions and, in particular, to those receiving public money. Yet not all considerations valid for financial institutions are applicable to non-financial firms; for instance, the link between incentive pay and risk is more problematic in financial institutions, as their risk structure is subject to rapid change. Therefore the analysis of directors' pay at financial institutions should not be automatically transposed to other companies.

But our study underlines, nonetheless, the importance of sound remuneration governance, including disclosure, board monitoring and shareholder engagement for all companies. If appropriate requirements were foreseen by either public regulation or best practices, detailed mandatory rules with respect to remuneration structure and levels would not be necessary for companies generally. The safety and soundness of financial institutions, however, suggests that prudential regulation and supervision incorporate executive remuneration. Moreover, state-owned enterprises could see governments set their remuneration policies, if not individual directors' pay levels. As for non-financial firms, pay design should be recommended by best practices under a 'comply or explain' regime, for example with respect to vesting periods of stock options and awards, termination payments and the choice of non-performance options.

Despite the importance for non-financial firms of basic governance disciplines with respect to executive remuneration, significant difficulties remain which should not be overlooked amidst the current policy focus on risk management and executive remuneration. As shown by our empirical research, significant differences persist across Europe with respect to remuneration practices, despite the Commission's Recommendations. Variations are generally linked with differences in corporate governance. For instance, corporate ownership may determine the composition of the remuneration committee, which in concentrated ownership firms often includes controlling shareholders, even if the majority of committee members should consist of independent directors. Disclosure varies from country to country, being strongly dependent on national laws and best practice guidelines. Firms tend to focus on basic requirements, such as the existence of the remuneration committee, the adoption of a remuneration policy and the individual disclosure of emoluments. Requirements for detailed disclosure of executives' terms of contracts and performance-based remuneration have lower take-up.

On the policy level, we suggest increased harmonisation of remuneration disclosure, which would reduce information costs to investors and allow comparison of remuneration practices across Europe. Moreover, mandatory disclosure has an impact on remuneration structures and may lead to closer board focus on terms of contracts and severance payments, which currently appear to be overlooked in a number of countries. Disclosure is also indispensable for holding the board and the remuneration committee accountable towards shareholders and other stakeholders. As suggested in this paper, a remuneration report consolidating numerical data and information on the structures and policies of directors' remuneration should be adopted by listed companies across Europe.

Disclosure is also essential for equipping the annual general meeting with the tools necessary to exercise an annual check on remuneration policies, particularly in countries where an advisory or a binding vote is foreseen on those policies. The impact of shareholders' votes on remuneration policy is not yet clear, particularly where the vote is advisory only. Poor disclosure has contributed to this situation. Increased shareholder engagement and market discipline would also be better achieved by adopting, under a flexible 'comply or explain' regime, a binding rather than just advisory vote. Moreover, where a vote is not foreseen, the general meeting can always hold the board accountable by exerting a vote on its election.

As shown by this study, the Commission's efforts to improve standards for the setting and disclosure of directors' remuneration have had limited take-up at national level. Critics of the measures accuse the Commission of lacking ambition by opting to issue Recommendations, which are not legally binding, instead of pursuing direct legislation. The Commission has relied instead on the ethical behaviour of market participants and on Member State enthusiasm for its Recommendations. The 2009 Recommendations may fare better given the current political climate, but their ambition and the timeframe for implementation may well leave some Member States and market participants behind. Whether they will have a positive impact on remuneration policies remains questionable, given the ambition of the current proposals and the limited success of previous reforms. Moreover, history has taught us that companies often find ways to elude limitations on compensation through adjustments of optimal compensation contracts. Ultimately, significant difficulties still remain with basic governance disciplines for all companies, concerning the remuneration committee, disclosure, and the advisory vote, which should not be overlooked as the European economy strives to recover.

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Annex 1. Criteria evaluation

I. Area 1: Governance

Category 1: Remuneration Committee

-Criterion 1: Existence
The existence of a remuneration committee set up within the (supervisory) board, either separate or joined with nomination committee or as appropriate, that has as (among) its main tasks, the process for setting remuneration of directors.
-Criterion 2: Composition
The composition of the remuneration committee made up of all non-executive, majority independent directors.

II. Area 2: Remuneration policy

Category 2: Remuneration policy statement

-Criterion 3: Statement: existent
The disclosure of the remuneration statement as part of an independent remuneration report / annual accounts / notes to the annual accounts.
-Criterion 4: Overview of the policy
Description of the manner in which the remuneration policy was implemented in the financial year in review; policy must be described, apart from numerical information.
-Criterion 5: Forward-looking
Remuneration statement having a focus on the remuneration policy for the following financial year / subsequent years.

Category 3: Terms of contracts of executive directors

-Criterion 6: Duration of contracts
Duration of terms of contracts of executive directors in the remuneration statement / in the tabular format of remuneration details. (If elsewhere in the annual report, we do not consider it as conform, as the details could be missed because of the variety of ways information is presented; hence it would not provide consistency in evaluation.)
-Criterion 7: Notice periods
Disclosure of the applicable notice period in the remuneration statement.
-Criterion 8: Termination payments
Details of provisions for termination payments under contracts for executive directors. The actual amount without description of the policy is not considered as conforming.

Category 4: Preparatory and decision-making process

-Criterion 9: Mandate and composition of the Remuneration Committee
Details presented either in the remuneration statement or in the corporate governance section of the annual report. (Although the EC Recommendation requires this information to be disclosed under the statement, our research shows that most firms in Continental Europe provide this information under a separate section, due to specific countries' reporting requirements.)

-Criterion 10: External consultants
Disclosure of the names of external consultants whose services have been used in determination of the remuneration policy; or statement of not using an external consultant, if such the case.

-Criterion 11: Role of the general meeting
Explanation of the general meeting’s role in the process for setting the remuneration. Conformity is considered also in the situation where no detailed information is provided, but the role of the general meeting in approving the remuneration policy / report can be inferred.

Category 5: Information in the remuneration statement

-Criterion 12: Relative importance fixed-variable
Explanation of the relative importance of the non-variable and variable remuneration understood as the ration between the two components.
-Criterion 13: Main parameters for annual bonus
Disclosure of financial / non-financial performance criteria applied as targets for the annual bonus scheme.
-Criterion 14: Performance criteria share-based remuneration
Disclosure of financial / non-financial performance criteria applied as targets for the share-based remuneration.
-Criterion 15: Information link remuneration – performance
Providing sufficient information on the linkage between remuneration and performance: performance criteria for annual incentives and for share plans evaluation and achievement of performance criteria.

III. Area 3: Individual disclosure

Category 6: Individual disclosure

-Criterion 16: Individual disclosure executives
Disclosure of numerical information for each executive director, in the remuneration report / annual accounts / notes to the annual accounts.
-Criterion 17: Individual disclosure non-executives
Disclosure of numerical information for each non-executive director, in the remuneration report / annual accounts / notes to the annual accounts.

Category 7: Emoluments

-Criterion 18: Salary / fees
Individual disclosure of basic salary paid to executive directors / fees paid to non-executive directors.
-Criterion 19: Bonus & benefits
Individual disclosure of bonuses paid to each executive or non-executive director.
-Criterion 20: Remuneration preceding year
Individual disclosure of the remuneration paid to directors in the preceding financial year.

Category 8: Share-incentive schemes

-Criterion 21: Share / options granted
Individual disclosure of number of share options granted / offered during the relevant financial year, or of the value at grant date.

-Criterion 22: Share / options exercised
Individual disclosure of number of shares exercised during the relevant financial year and the exercise price for each plan.
-Criterion 23: Share / options unexercised
Individual disclosure of number of shares unexercised at the end of the financial year, exercise price, exercise date.

Annex 2. Tables and figures

Table 1. Overview of countries included in the sample

Country	**Observations (no. of firms)**
Austria	7
Belgium	11
Denmark	5
Finland	5
France	55
Germany	34
Greece	7
Italy	20
Ireland	5
Netherlands	14
Norway	8
Portugal	5
Spain	21
Sweden	14
Switzerland	20
UK	64
Total	*295*

Table 2. Overview of criteria

Analysis	**% of firms meeting criteria**
Area: GOVERNANCE	71.1%
Catgory: Remuneration Committee	71.1%
1. RC: existence	82.7%
2. RC: composition	59.7%
Area: REMUNERATION POLICY	56.3%
Category: Remuneration policy statement	70.4%
3. Statement: existent	92.8%
4. Overview of the policy	91.8%
5. Forward-looking	26.4%
Category: Terms of contracts	45.9%
6. Duration of contracts	39.6%
7. Notice periods	36.6%
8. Termination payments	61.3%
Category: Preparatory and decision-making process	59.4%
9. Mandate and composition RC	75.9%
10. External consultants	32.8%
11. Role of the general meeting	69.5%
Category: Policy information	51.3%
12. Relative importance fixed-variable	55.6%
13. Main parameters annual bonus	64.0%
14. Performance criteria share-based remuneration	56.0%
15. Information link remuneration-performance	29.9%
Area: INDIVIDUAL DISCLOSURE EXEC. & NON-EXEC.	58.1%
Category: Individual disclosure	73.6%
16. Individual disclosure executives	66.8%
17. Individual disclosure non-executives	80.3%
Category: Emoluments	59.3%
18. Ssalary/fee	67.1%
19. Bonus & other benefits	66.8%
20. Preceding year	44.0%
Category: Share-incentive schemes	46.7%
21. SO granted	59.0%
22. SO exercised	42.0%
23. SO unexercised	39.0%

Table 3. Distribution of criteria: summary statistics

Country	***No. Firms***	**Average DoC (M)**	**Variance**	**Std. Deviation (σ)**
Overall (per total)	*295*	171.87	3121.33	55.87

M-2σ	**M-σ**	**M-σ**	***M***	***M***	**M+σ**	**M+σ**	**M+2σ**
60	116	116	*172*	*172*	228	228	284
-Forward looking -Notice periods -External consultants -Sufficient info linkage remuneration-performance -Share options unexercised		-Duration of contracts -Relative importance fixed-variable -Performance criteria share-based remuneration -Information preceding year -Share options exercised		- RC: composition - Termination payments -Mandate and composition RC -Role of the AGM -Parameters annual bonus -Individual disclosure executives -Individual salary/fee -Individual bonus & other benefits - Shares/Share options offered/granted		-RC: existence -Statement: existent -Overview of the policy -Individual disclosure non-exec	
Low interest criteria				*Interested criteria*			

Figure 1. Firm compliance with each criteria (grouped under categories and areas)

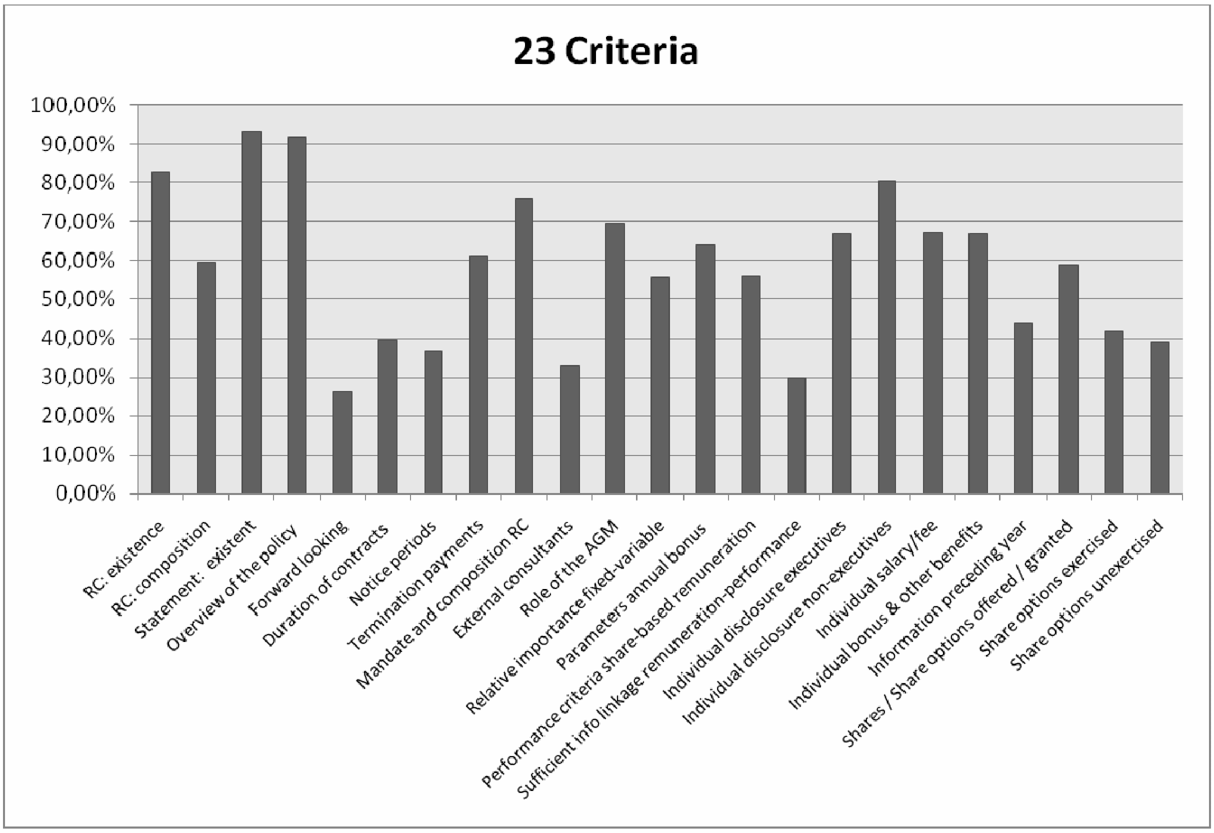

Figure 2. Firm compliance with each criteria (in descending order)

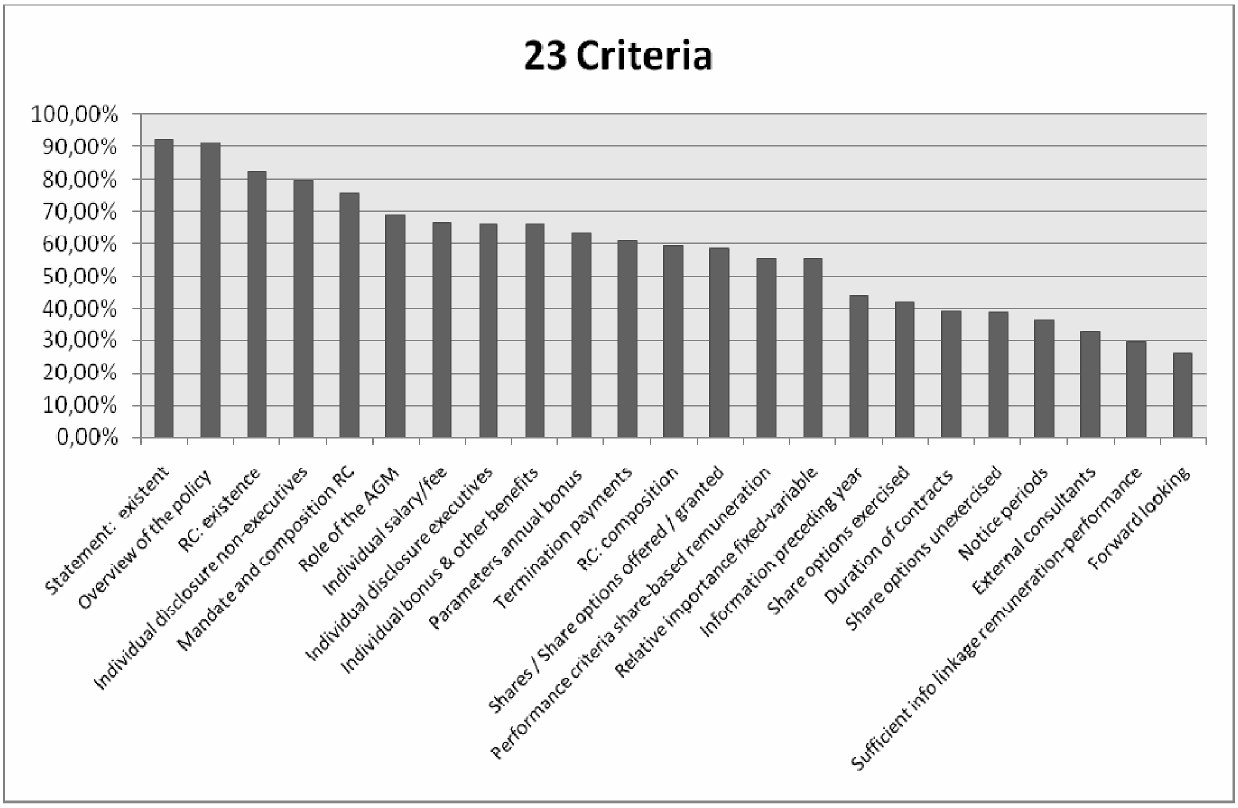

Figure 3. Firm compliance with criteria in the 3 main areas

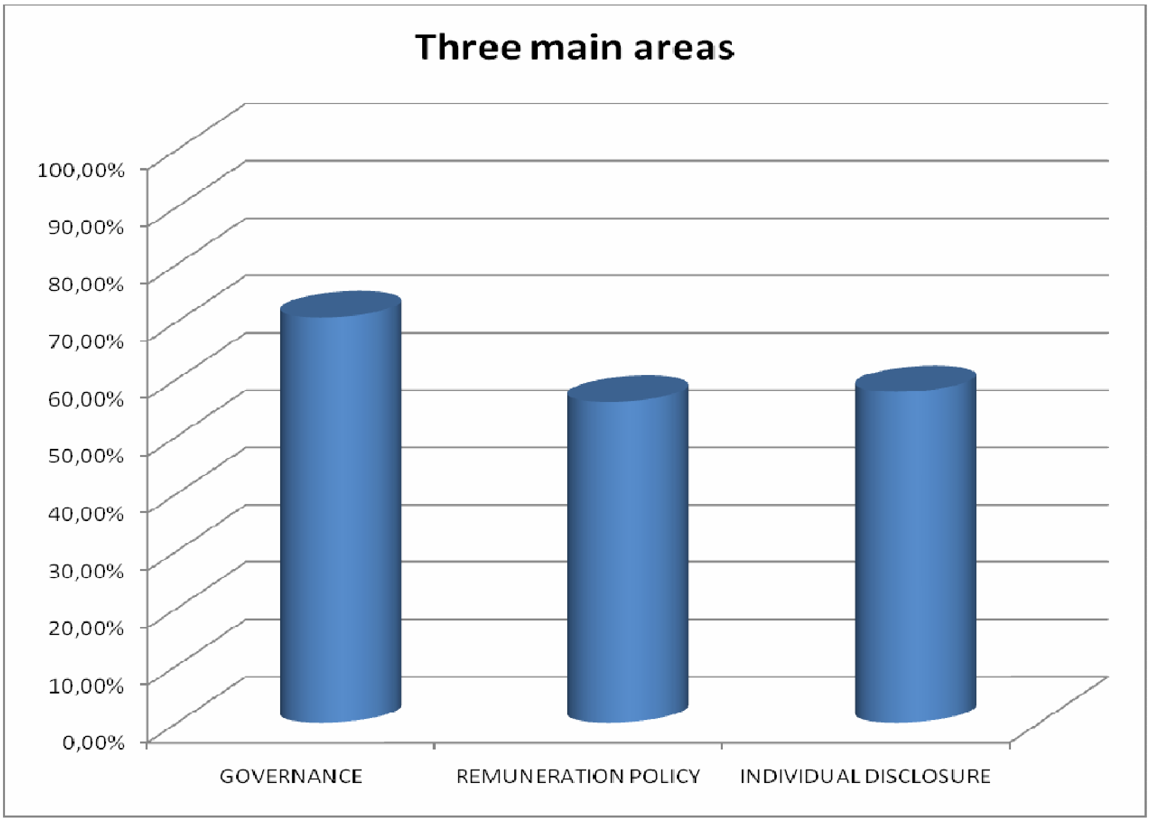

Figure 4. Firm compliance with criteria in the 3 main areas (breakdown on countries)

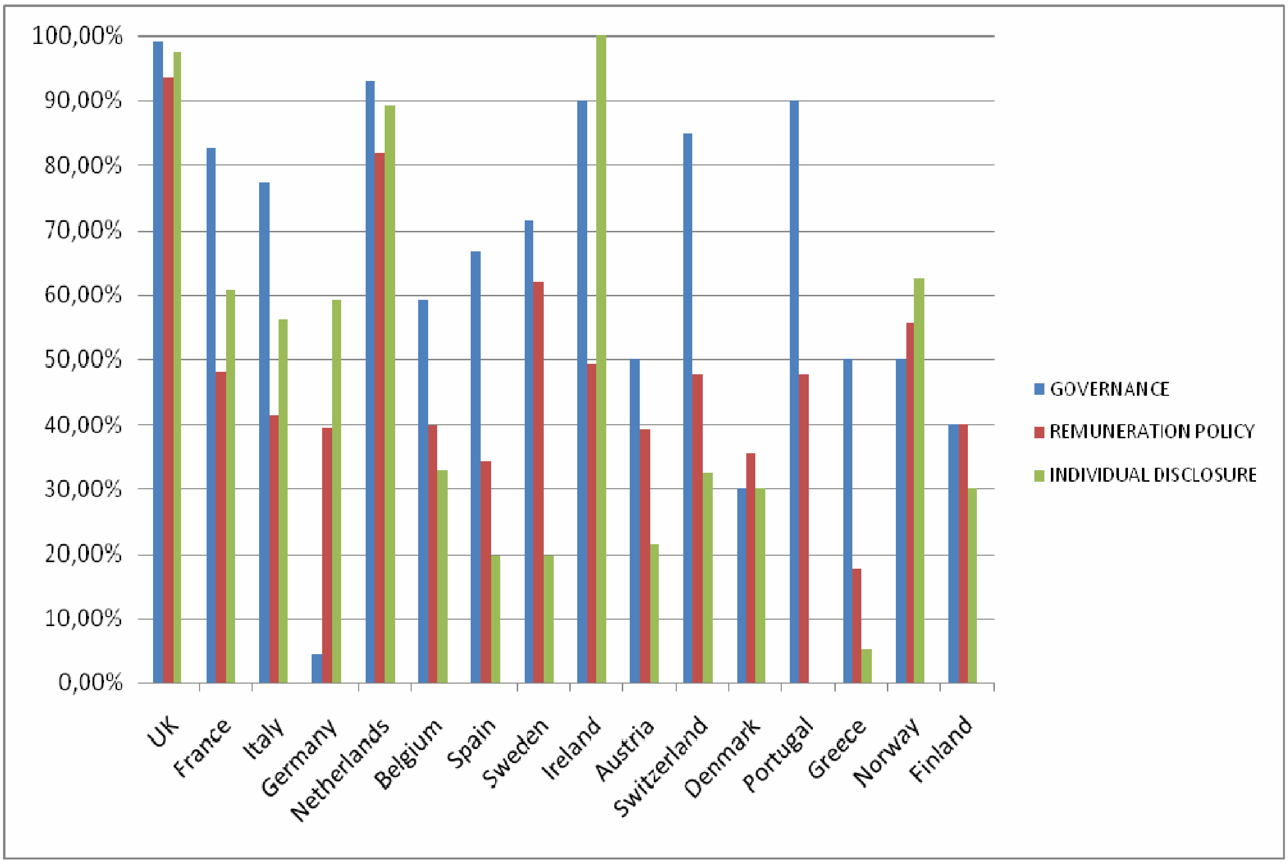

Figure 5. Firm compliance with criteria in the 8 categories

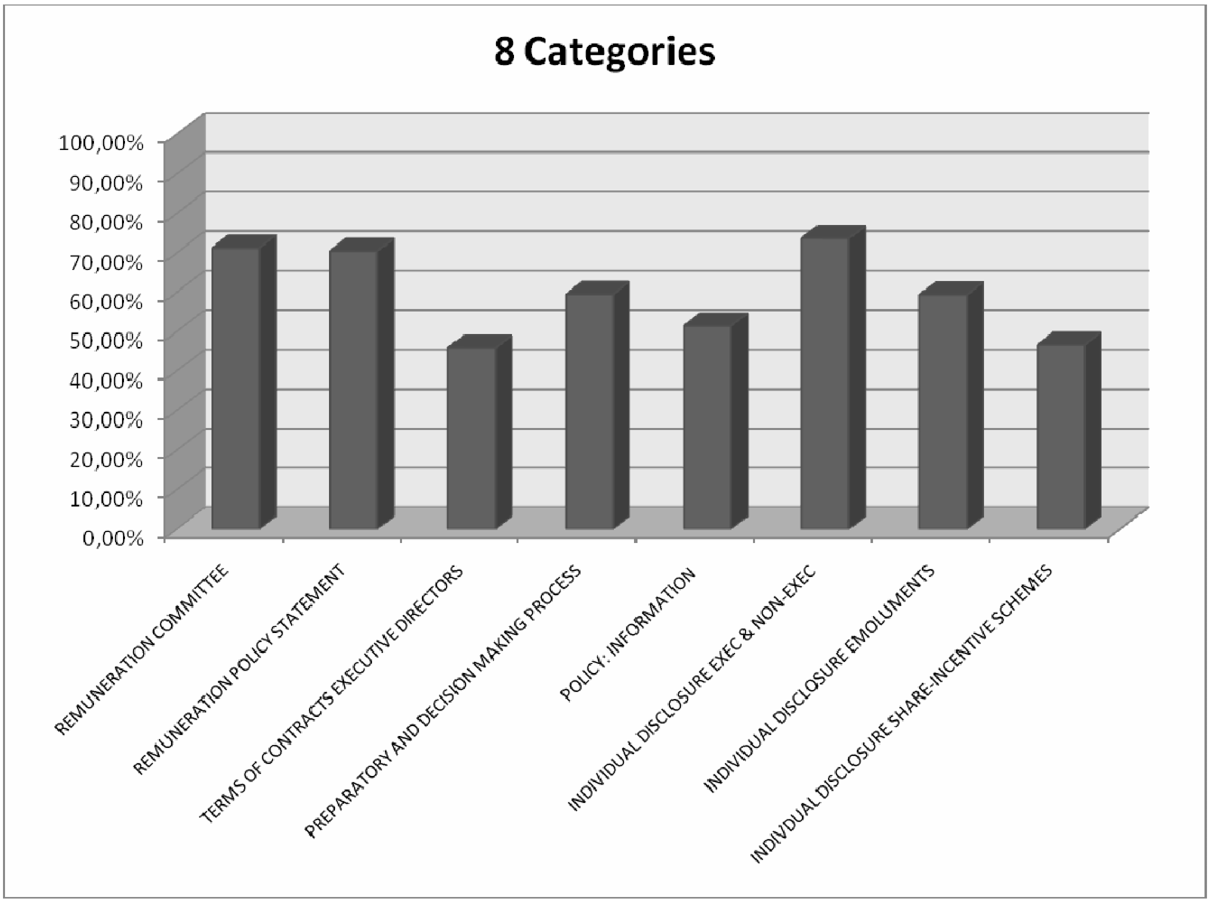

Figure 6. Firm compliance with criteria in the Governance area

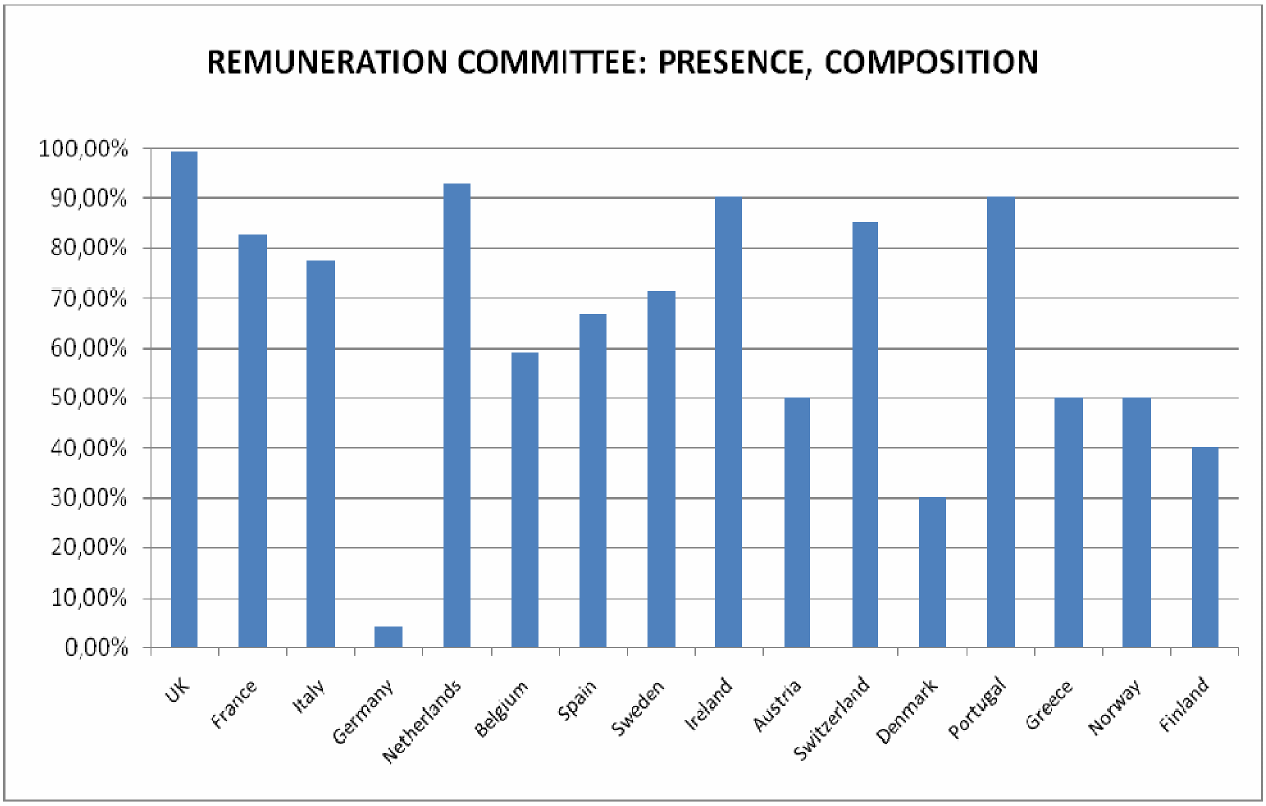

Figure 7. Firm compliance with criteria in the Remuneration Policy area

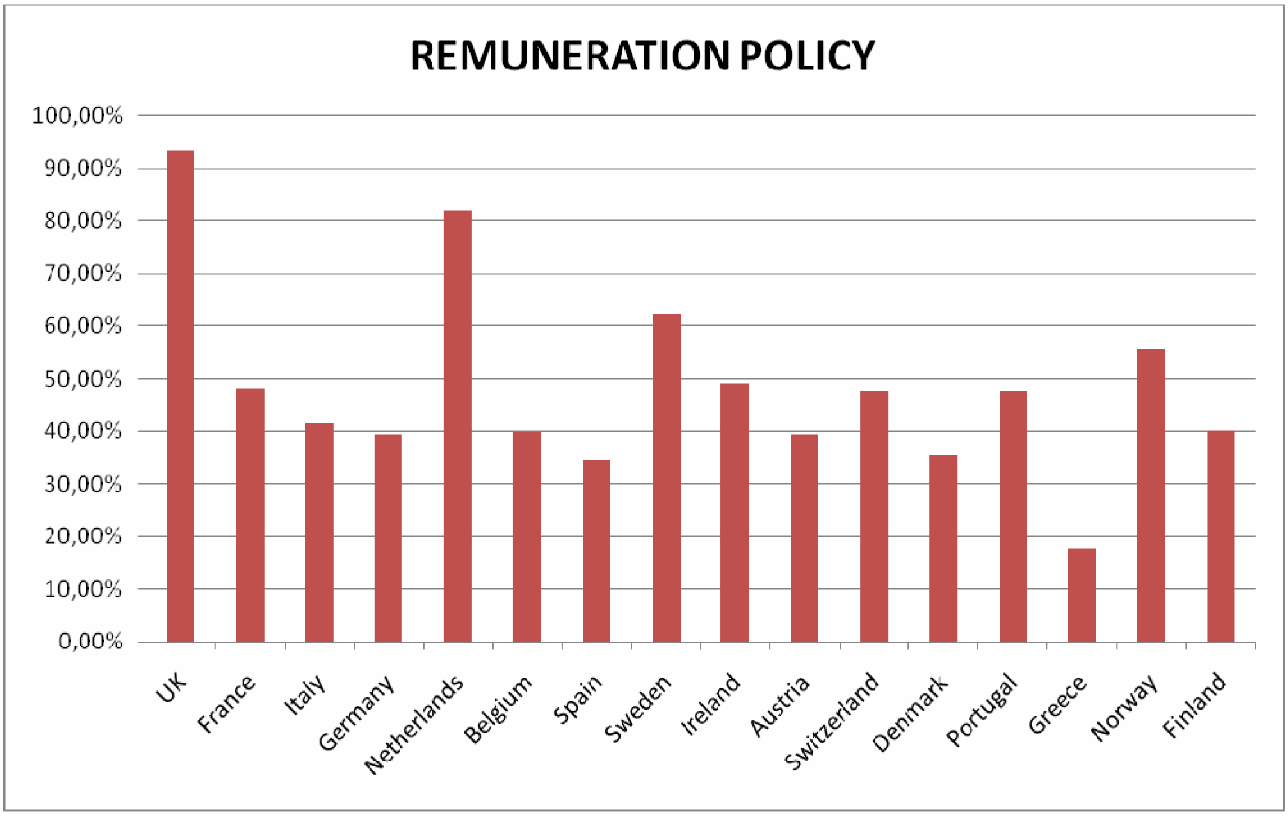

Figure 8. Firm compliance with criteria in the Individual Disclosure area

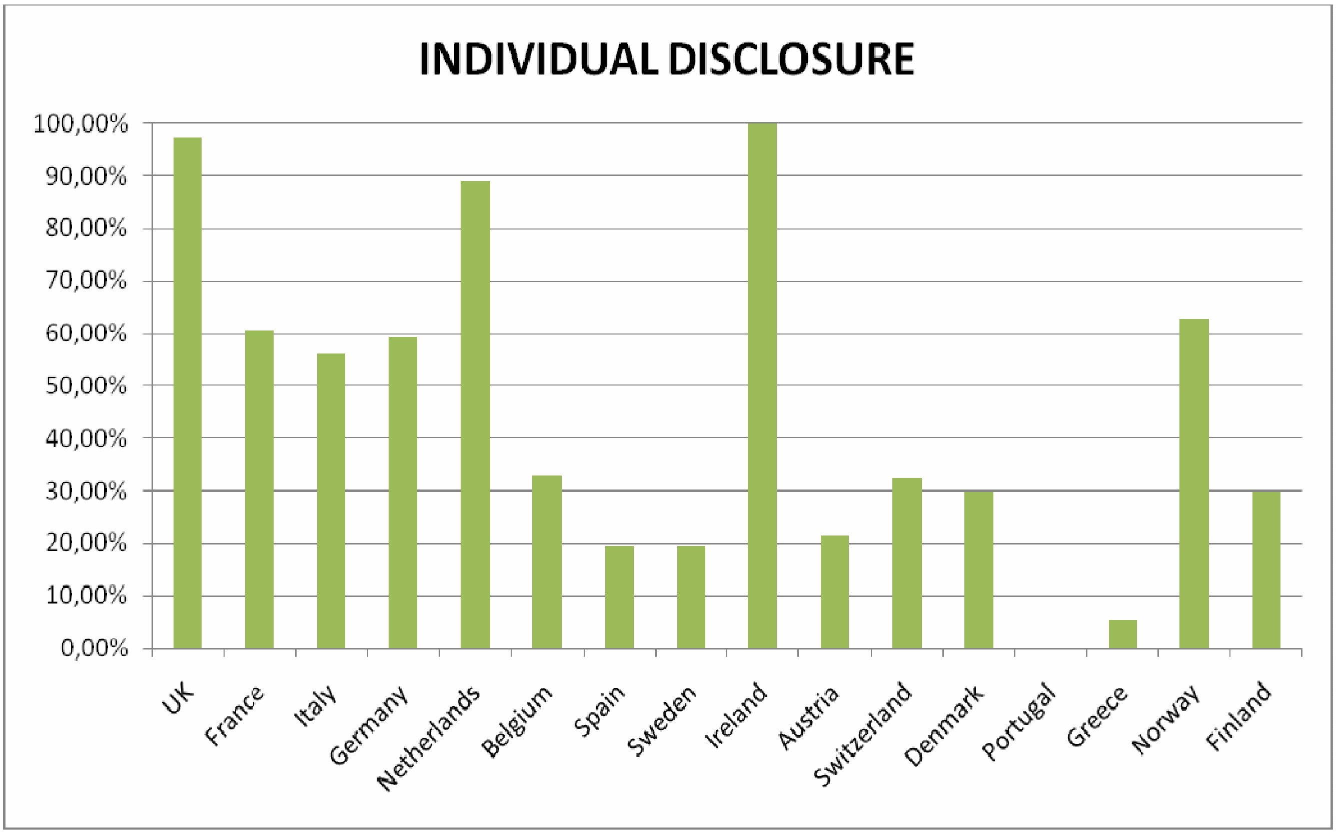

Figure 9. Firm compliance with the Consolidation criteria

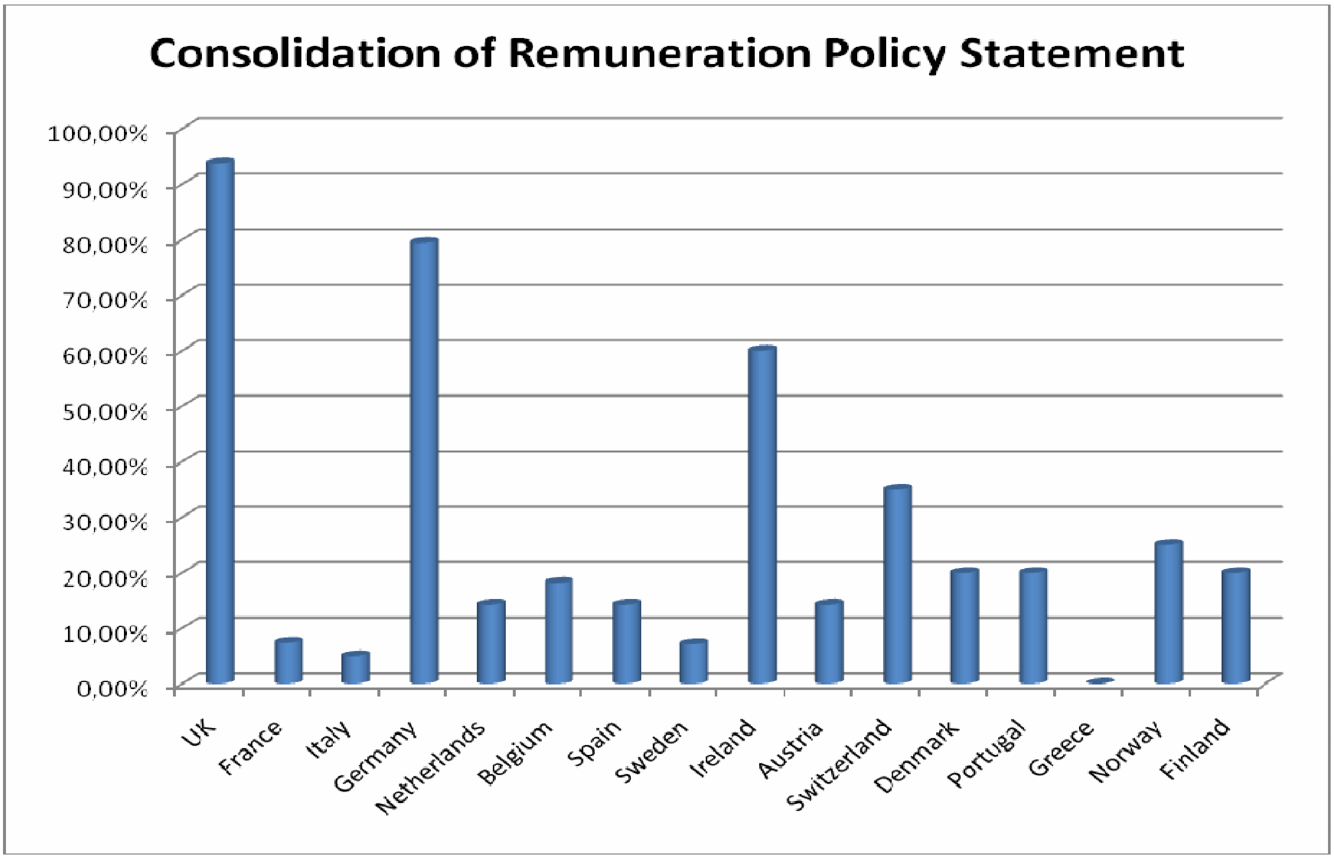

Figure 10. Firm compliance with the Benchmark Disclosure criteria

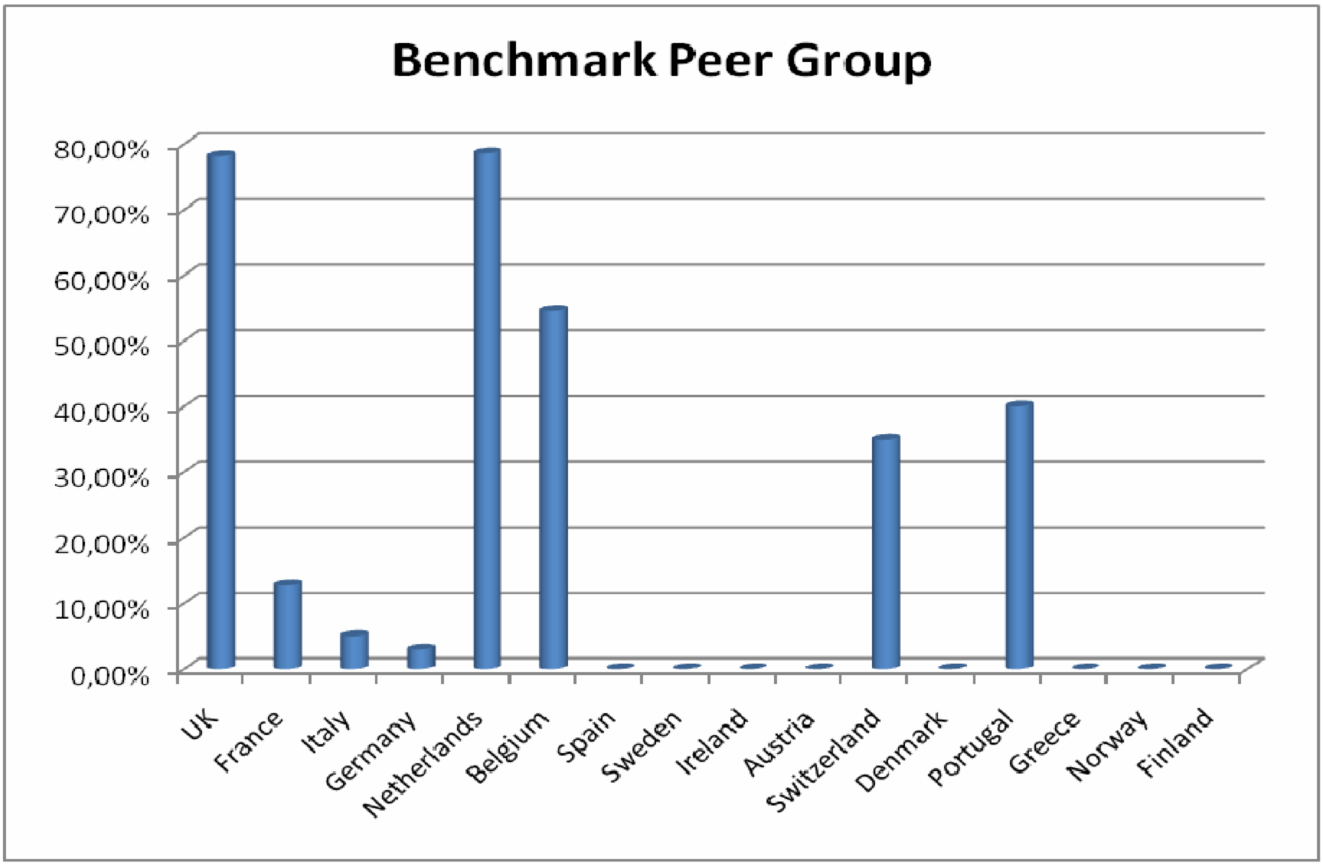

Table 4. Degree of conformity per countries

Country	Overall	Governance	Remuneration policy	Individual disclosure
Austria	32.3%	50.0%	39.2%	21.4%
Belgium	39.1%	59.1%	39.9%	33.0%
Denmark	33.0%	30.0%	35.4%	30.0%
Finland	36.5%	40.0%	40.0%	30.0%
France	55.6%	82.7%	48.3%	60.7%
Germany	43.2%	4.4%	39.4%	59.2%
Greece	16.2%	50.0%	17.6%	5.4%
Ireland	70.4%	90.0%	49.2%	100.0%
Italy	49.8%	77.5%	41.5%	56.3%
Netherlands	85.4%	92.9%	81.9%	89.3%
Norway	57.6%	50.0%	55.8%	62.5%
Portugal	34.8%	90.0%	47.7%	0.0%
Spain	32.1%	66.7%	34.4%	19.6%
Sweden	48.1%	71.4%	62.1%	19.6%
Switzerland	45.7%	85.0%	47.7%	32.5%
UK	95.4%	99.2%	93.5%	97.5%

Table 5. Distributions of criteria per countries: averages

Country	Observations	Maximum DoC	Actual DoC	DoC (%)	Firms' Avg DoC	Weighted Avg
Austria	7	161	52	32.3%	7.429	52.000
Belgium	11	253	99	39.1%	9.000	99.000
Denmark	5	115	38	33.0%	7.600	38.000
Finland	5	115	42	36.5%	8.400	42.000
France	55	1265	703	55.6%	12.782	702.999
Germany	34	782	338	43.2%	9.941	337.997
Greece	7	161	26	16.1%	3.714	25.999
Ireland	5	115	81	70.4%	16.200	81.000
Italy	20	460	229	49.8%	11.450	229.000
Netherlands	14	322	275	85.4%	19.643	274.999
Norway	8	184	106	57.6%	13.250	106.000
Portugal	5	115	40	34.8%	8.000	40.000
Spain	21	483	155	32.0%	7.381	154.999
Sweden	14	322	155	48.1%	11.545	161.636
Switzerland	20	460	210	45.7%	10.500	210.000
UK	64	1472	1404	95.4%	21.938	1404.000
	295	6785	3953		178.772	3959.629

Table 6. Distributions of criteria per countries: deviations

	Country	**Avg**	**Deviations**
i	UK	21.938	-10.764
ii	Netherlands	19.643	-8.470
iii	Ireland	16.200	-5.027
iv	Norway	13.250	-2.077
v	France	12.782	-1.609
vi	Sweden	11.545	-0.372
vii	Italy	11.450	-0.277
viii	Switzerland	10.500	0.673
ix	Germany	9.941	1.232
x	Belgium	9.000	2.173
xi	Finland	8.400	2.773
xii	Portugal	8.000	3.173
xiii	Denmark	7.600	3.573
xiv	Austria	7.429	3.745
xv	Spain	7.381	3.792
xvi	Greece	3.714	7.459

Table 7. Distributions of criteria per countries: summary statistics

Avg (M\`)	11.17
Weighted Avg (M\`\`)	13.42
Variance	21.33
Std deviation	4.62
Weighted Variance	28.10
Weighted Std deviation	5.30

Table 8. Distribution of results for all countries (values independent from the number of observations within each country)

<table>
<tr><td></td><td>M`-2σ</td><td>M`-σ</td><td>M`</td><td>M`+ σ</td><td>M`+2σ</td><td>M`+3σ</td></tr>
<tr><td>0.00</td><td>1.93</td><td>6.55</td><td>11.17</td><td>15.79</td><td>20.41</td><td>25.03</td></tr>
<tr><td colspan="7">0 xvi (1) viii-xv (8) iv-vii (4) ii-iii (2) i (1)</td></tr>
</table>

Table 9. Distribution of results for all countries (values considering the number of observations within each country)

<table>
<tr><td></td><td>M``-2σ</td><td>M``-σ</td><td>M``</td><td>M``+ σ</td><td>M``+2σ</td><td></td></tr>
<tr><td></td><td>2.82</td><td>8.12</td><td>13.42</td><td>18.72</td><td>24.02</td><td></td></tr>
<tr><td colspan="7">xii-xvi (5) iv-xi (8) iii (1) i-ii (2)</td></tr>
</table>

Table 10. Distribution of criteria per overall companies in all countries: summary statistics

Avg (M)	13.41
Variance	33.89
Std deviation	5.82

Table 11. Distribution of results per overall companies in all countries

	M-2σ	M-σ	M	M+ σ	M+2σ	
	1.77	7.59	13.4	19.23	25.05	
	48	118	61	68		

Table 12. Distribution of criteria per overall companies in all countries, except for UK: summary statistics

Avg (M)	11.03
Variance	21.45
Std deviation	4.63

Table 13. Distribution of results per overall companies in all countries, except for UK

	M-2σ	M-σ	M	M+ σ	M+2σ	M+3σ
0	1.77	6.40	11.03	15.66	20.29	24.92
5	40	78	73	29	6	

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