The Laws and Regulations Related to Remuneration Practices: a comparative and analytical investigation into legal aspects

Thesis submitted in accordance with the requirements of the University of Liverpool for the degree of Doctor in Philosophy by

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Abstract

This research aims to contribute to the analysis of the laws and regulations related to remuneration practices. It is also intends to offer recommendations and solutions to the problem of setting levels and Structures of remuneration in Saudi Arabia, an area which is currently neglected despite its importance.

Remuneration is a crucial tool in solving the agency problem between shareholders and managers in public companies where the separation of ownership and control exists by providing incentives. However, in Saudi Arabia this practice shows a tendency towards high fixed remuneration and variable remuneration set without any clear links between this and performance, causing variable remuneration to become another salary. Since inadequate laws and regulation have been found to be at least partially responsible for this state of affairs, solving this problem requires careful analysis of the most important jurisdictions which have developed laws and regulations.

Thus, the thesis adopts a comparative legal study of the relevant laws and regulations within a descriptive and analytical framework, presenting a detailed discussion of remuneration regulation in the UK, EU and USA. Moreover, informal discussions have been conducted with individuals in the public sectors of the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA), in order to complement the black letter law analysis of the research, by providing a realistic insight into the nature of the challenges in formulating the policy process in Saudi Arabia. Serious flaws and shortcomings were found in the existing law and regulation regarding remuneration in Saudi Arabia, and recommendations for reform of these are provided.

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Chapter 1 Introduction

1.1 Introduction

The financial crisis 2007 has brought the debate about the role of remuneration in encouraging excessive risk-taking and short-termism behaviour to the attention of politicians and regulators.[1] The crisis has shown that focusing on aligning the diverse interest of managers and shareholders can create problems of excessive risk-taking and short-term focus which can damage the firm in the long term.

The debate has intensified due to the fact that the CEOs of failing banks have walked away with multi-million pound/dollar/euro packages whilst taxpayers have been left to bail out their ailing institutions. However, this is not the first time that remuneration structures have been accused of being one of the factors contributing to a crisis or scandal. The accounting scandal in the USA in the early 2000s occurred partly as a result of options that were granted to executives.[2] Fears regarding losing talented people and money migration caused many regulators to refrain from taking action to curb poor remuneration practices which other regulators of major financial centres would most likely not follow. What was unique about this crisis was its sheer scale and spread, which highlighted the need for international cooperation in taking action against improper remuneration practices to try and avoid similar crises in the future. Therefore, in spite of the debate on the role of incentives in the crisis[3] it is widely felt that specific regulation of remuneration is necessary in the financial services, which is a new development. This initiative has been led by the G20 leaders and the Financial Stability Board (FSB), of which Saudi Arabia, the UK, the EU and the USA are members. They are required to implement the initiatives agreed upon by these bodies in their own jurisdictions.

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[1] See sections: 2.3, 4.2, 5.4, and 6.1.

[2] S Bhagat and R Romano, "Reforming executive compensation: Simplicity, Transparency and Committing to the long-term" (2010) 7(2) *European Company and Financial Law Review* 273, 278.

[3] JC Acrey, WR McCumber, and TT Neguyen, "CEO incentives and bank risk" (2001) 63(5) *Journal of Economics and Business* 456; PO Mulbert, "Corporate governance of banks after the financial crisis: theory, evidence, reforms" (ECGI Law Working Paper No. 130/2009); R Fahlenbrach and RM Stulz, "Bank CEO incentives and the credit crisis" (2011) 99(1) *Journal of Financial Economics* 11.

Thus, problems with remuneration contracts are not only associated with the high level of remuneration but also with the fact that remuneration does not reflect the performance of the executives and their firms. In addition, the 2007 financial crisis has exposed failure in the bankers' remuneration.

One way of dealing with the problem from a social perspective would be to impose a limit on the maximum level of remuneration. This could solve the problem of high levels of remuneration and could be done in the same way as mandating a minimum level of wages. However, this solution is not the one preferred by politicians and regulators in a highly competitive and mobile market for executives.

Instead, the focus is on strengthening the link between remuneration and the financial and non-financial performance of an individual, a business unit and the firm as a whole. This may be achieved by using corporate governance mechanisms which are also designed to remove any conflict of interest from the pay-setting process. These mechanisms are independence (the board of directors or the remuneration committee is tasked with setting the remuneration structure), say on pay (to give shareholders [the owners] the power to vote and hence influence the level of payment), and disclosure (to facilitate shareholder votes and influence "outrage cost" in the media). Rules in company law prohibiting or limiting certain practices as well as guidelines for structuring and negotiation in corporate governance codes have been used. Moreover, there are some new international rules directing financial institutions to structure their remuneration in certain ways to prevent excessive risk-taking and promote financial stability. However, each of these solutions, which has been implemented in different ways in each jurisdiction, suffers from its own drawbacks as will be discussed in the thesis in the context of each jurisdiction.

Therefore, the remainder of the thesis will explore these mechanisms. The strength and effectiveness of each mechanism will be assessed within the context of the chosen jurisdictions. The effectiveness of the various corporate governance mechanisms will be assessed by focusing on their shortfalls. The thesis will also assess and evaluate the current direct law and regulation that controls remuneration in the UK, the EU and the USA. In

addition, it will also analyse and assess the Principles and Standards (P&S)[4] of the FSB with the aim of drawing on lessons learnt from this analysis to contribute to the ongoing debate regarding the law and regulation of remuneration in Saudi Arabia.

1.2 Remuneration Practices in Saudi Arabia

At the end of each accounting year, it is common practice for the board of directors or the remuneration committee to evaluate the results of the company against its stated goals and objectives, whether short-term and/or long-term. The board of directors then grants variable remuneration using pre-defined criteria, taking into account the fact that the award is given only to those who have achieved results which are equal to or exceed targets. Therefore, variable remuneration is not an acquired right for anyone who does not normally meet such criteria. However, listed companies in Saudi Arabia have been accused of a lack of clarity in the objectives and mechanisms behind awarding variable remuneration.[5] This is evident from the continued rewards for members of boards of directors and senior executives without regard to any other considerations of performance until the reward becomes simply another salary to be paid regularly.[6] It is noteworthy that the value of these bonuses has amounted in some cases to more than triple the salary at a time that the performance of the company was either worse than the previous year or had reached the stage of making a loss.[7] During 2007-09 the global financial crisis impacted negatively on the performance of all Saudi banks and the results were much worse than in previous years. The poor perfomance was the result of the presence of serious errors in credit risk management and investment.[8] Loans of this type

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[4] Financial Stability Forum, *Principles for Sound Compensation Practices* (2 April 2009) (FSF Principles for Sound Compensation); Financial Stability Board, *Principles for Sound Compensation Practices: Implementation Standards* (25 September 2009) (FSB Implementation Standards).

[5] MF Alomran, "Misconception of remuneration!" *Aleqtisadiah* (Riyadh, 28 December 2011) Available at: <http://www.aleqt.com/2011/12/28/article_611116.html> accessed 10 July 2013.

[6] ibid.

[7] ibid.

[8] Widespread bank losses caused by the 2009 failure of Al-Gossaibi & Bros Co. and the Saad Group, two large well-established family groups, suggest that there may have been weaknesses in credit risk management. This was specifically because of what is known as the granting of loans based on business reputation that encouraged a loosening of credit conditions. See: International Monetary Fund, *Saudi Arabia: Financial Sector Assessment Program Update—Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision* (July 2013) Available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr13213.pdf> accessed 12 November 2013.

cost billions of Saudi riyals, while the series of rewards for members of boards of directors and top executives continued as if nothing had happened.[9]

These flawed practices can be attributed to the underdeveloped law and regulations in Saudi Arabia, this country not having created the securities regulators (Capital Market Authority [CMA]) until 2004.[10] Since then the CMA as a regulator of the securities sector in a developing country has been charged with the task of working on the development of the market and its laws and regulations.[11] This thesis aims to contribute to the work of the regulator in developing the market, the head of the corporate governance department at the CMA having shown real interest in obtaining a copy of this thesis when the research is finished.

1.3 Research aim and questions

This thesis will contribute to the analysis of the laws and regulations related to remuneration in Saudi Arabia which, to date, has not been subjected to such a detailed examination. The thesis will try to offer solutions to the problem in Saudi Arabia, taking advantage of existing developments in the EU, UK and US, which are amongst the most developed jurisdictions in regulating remuneration practices. The thesis will also provide an analysis of current regulating remuneration practices in the aftermath of the financial crisis. These aims will be achieved by addressing the following questions:

a. How has the regulation of remuneration in financial institutions been internationally affected by the financial crisis?

b. How do the laws and regulations in the UK and US approach this issue in the case of public companies and financial institutions?

c. What is the pan-EU approach to the regulation of remuneration in public companies and financial institutions (as an example of blockholding-dominated company structures)?

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[9] Alomran (n 5).

[10] Only the stock market was operating at that time. For more information see: JW Beach, "The Saudi Arabian Capital Market Law: A Practical Study of the Creation of the Law in Developing Markets" (2005) 41 *Stanford Journal of International Law* 307, 311.

[11] Capital Market Law, Article 5(a)(1).

d. How is remuneration currently regulated in Saudi Arabia?

1.4 Methodology

This thesis takes a comparative descripto-analytical approach to the relevant laws and regulations. Thus, the research strategy adopted for this investigation is legal in nature. Comparative law can help to facilitate legal reform and improvements whilst bearing in mind that what works in one country might not be suitable for another country. However, the main obstacle that the research faced was the ongoing reform of remuneration regulations in the EU, UK and US. However, the law and regulation in Saudi Arabia is currently well behind adequately addressing the issue. So this thesis will offer an analysis of remuneration regulation in the EU, UK and US.

Another obstacle to be faced is the lack of academic literature on the topic of remuneration regulation in Saudi Arabia.[12] This problem was overcome by using journalistic articles and laws and regulations as primary resources. Moreover, informal discussions with senior officers at the Saudi Arabian Monetary Agency (SAMA)[13] and the CMA, which play a crucial role in the policy formulation process, has helped to overcome this obstacle. These discussions aim to complement the black letter law analysis of the research by providing a realistic insight into the nature of the challenges in the policy formulation process in Saudi Arabia.

1.5 Research Plan and Thesis Overview

The thesis is divided into eight chapters.

Following this introductory chapter, chapter two sets the scene for the thesis and is comprised of three sections: section one focuses on the components of remuneration and their relationship with performance and risk-taking; section two discusses the economic theories that surround remuneration practices and how economists interpret remuneration practices in light of these theories; section three looks at international developments in bankers' remuneration after the crisis.

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[12] This is the first time the legal aspects of remuneration have been discussed in such detail in the context of Saudi Arabia.

[13] SAMA is the central bank of Saudi Arabia.

Chapters three and four will be devoted to the discussion of remuneration practices in the UK. Chapter three will examine the issue from the perspective of corporate governance and corporate law while chapter four examines the issue of incentive-based remuneration in financial institutions. These chapters will show how the UK judicial system approaches remuneration and also how the UK regulates conflict of interest by using independence, say on pay, disclosure, and rules and guidelines in the form of hard law, soft law and institutional shareholder representatives recommendations. These chapters will also discuss how the UK implements international principles and standards on remuneration and also EU directives.

Chapter five examines the pan-EU approach to tackling the problem of remuneration regulation since in spite of the dominant blockholding corporate structure of ownership in most EU countries, the Anglo-American[14] approach is evident in EU reforms. The chapter will also discuss how the ambitions of EU leaders (with the exception of the UK) have failed to achieve strict regulation on an international level but have influenced the adoption of the world's strictest regulation of remuneration in the financial system through the adoption of the Capital Requirement Directive IV (CRD IV).

Chapter six analyses the law and regulations in the USA and how these differ from those of the UK in judicial review and approaching independence, say on pay, and disclosure between the two main exchanges. It explores the differences in focus between US corporate[15] and securities law and UK legislation. For example, the UK is stricter in its regulation of exit payments while the USA regulates clawback more severely since corporate scandals have been more evident in the US. The chapter will show the extent to which the USA is less ambitious than the EU or the UK in regulating financial system remuneration. This is evident in the pending regulation proposed by the seven regulators in April 2011 to implement section 956 of the Dodd-Frank Act.

Chapter seven will examine the laws and regulations related to remuneration practices in Saudi Arabia, arguing that as a developing country, the Kingdom has a relatively new securities regulator, meaning that the law and regulation is underdeveloped and reform is needed if the country wants to improve the legal structure of its financial system.

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[14] Ownership in the UK and US is mainly dispersed amongst large numbers of shareholders.

[15] The discussion will be in the context of Delaware corporate law and Federal Securities laws.

Chapter eight will present conclusions in relation to the discussion and will compare the approaches taken by each jurisdiction in tackling the problem as well as offering some recommendations aimed at improving the law and regulation in Saudi Arabia.

Chapter 2 Understanding remuneration and its role in the financial crisis

This chapter will set the scene for the thesis, beginning with an analysis of the components of remuneration and how they are linked to performance and risk-taking. The second section will discuss the economic theories that explain trends in remuneration practices whilst the third section will examine the developments in bankers' pay internationally.

2.1 The components of remuneration

Remuneration can be defined as including all forms of payment or benefit paid directly or indirectly by a relevant institution in exchange for professional services rendered by staff.[1] It can be divided into two main categories: fixed and variable remuneration. Salaries, pension contributions and other benefits (such as cars and medical insurance) mainly represent the fixed elements of remuneration, whereas short-term incentives (such as bonuses) and long-term incentives (such as stock options) are the variable elements. Remuneration can be paid in cash or equity. Thirty years ago, cash-based remuneration was the largest component of manager remuneration. However, since then the use of equity-based remuneration has been increasing in the USA and Europe.[2] This section will analyse the most common elements of management remuneration in more detail, drawing attention to aspects of its relationship with the interests of shareholders, company performance and risk-taking.

2.1.1 Salary

The salary represents the main element of the fixed component of remuneration. It can be defined as the "pay amount given to an employee for performing the daily duties of the defined job".[3] Salary as a fixed component of the remuneration is described as non-

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[1] Committee of European Banking Supervision, "Guidelines on Remuneration policies and practices" (10 Dec 2010) 13 (CEBS Guidelines on Remuneration).

[2] S Pepper, *Senior Executive Reward: Key Models and Practices* (Ashgate, Abingdon 2006) 51.

[3] WH Coleman, "Understanding and Using Long-Term Incentives" (2002) Available at: <http://www.salary.com/docs/resources/salarycom_wp_incentives.pdf> accessed 17 Febrauary 2011.

performance related pay, as it is not directly linked to the company's financial performance.[4] However, Stapledon states that in theory several elements of a remuneration package can be linked to performance, including salary, which can be adjusted on the basis of past performance in the same way as bonuses are, although in practice companies tend to use short- and long-term incentives as performance-based remuneration.[5] Bebchuck and Fried also argue that an increase in salary should be strongly correlated with individual executive performance.[6]

In determining salaries, companies tend to use general industry surveys as a benchmark to set their own, but in the case of financial institutions, they tend to use specific industry surveys.[7] Taking account of other comparable companies in determining the remuneration in general was also recommended by the Greenbury Report.[8] However, this use of surveys in determining the base salary has contributed to a racheting-up effect in salary levels, as each CEO argues for an above-median salary, which results in a rise in the median each year.[9] To resolve this issue, the Association of British Insurance (ABI) recommends communication with shareholders when setting salaries, as well as providing an obligatory justification from the remuneration committee to the shareholders when the committee sets the salary at the median or above.[10] However, the then Financial Services Authority (FSA) maintained that "the fixed component of remuneration remains low relative to the total package of remuneration in investment banking".[11]

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[4] C Pass, "The configuration of long-term executive directors' incentive schemes" (2006) 7(1) *Handbook of Business Strategy* 299, 299.

[5] GP Stapledon, "The Pay for Performance Dilemma" (2004) University of Melbourne Legal Studies Research Paper No. 83. Available at: SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=553061> accessed 17 Febrauary 2011.

[6] L Bebchuk and J Fried, *Pay without Performance: the Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, MA 2006) 122.

[7] KJ Murphy, "Executive Compensation" (April 1998) 9 Available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=163914> accessed 2 August 2011.

[8] Confederation of British Industry, "Directors' Remuneration" (17 July 1995) C2 (Greenbury Report).

[9] Murphy, "Executive Compensation" (n 7) 9; Pepper (n 2) 51; KA Kim, JR Nofsinger and DJ Mohr, *Corporate Governance* (3rd edn, Pearson, New Jersey 2010) 14.

[10] Association of British Insurance, "Executive Remuneration - ABI Guidelines on Policies and Practices" (15 December 2009) 1.1.

[11] Financial Services Authority, *Reforming remuneration practices in financial services* (CP 09/10, March 2009) para 3.23 (FSA, CP 09/10)

The ratio of salary to total remuneration will depend on the performance of the company. It has been found that companies which perform well tend to offer their CEO a very small salary, representing 10-15 per cent of the total package, or even no salary at all, whilst companies with weak performance results provide their CEO with a salary of 50-100 per cent of the total remuneration.[12] Moreover, the size of a company, which is usually measured using the company revenues, tends to influence the level of the salary more than the characteristics of the CEO.[13]

Despite the fact that the level of salary decreases with the length of time a CEO holds a position, in favour of other performance-based remuneration, directors and companies tend to devote substantial amounts of time to discussing the level of their salary. There are a number of reasons for this:[14]

a. A fixed salary represents guaranteed money for directors, whereas other performance-based remuneration does not; this causes directors to prefer an increase in salary to receiving stock options.

b. Other benefits are measured using the base salary. For example, bonuses are defined as a percentage of the base salary, stock options are expressed as a multiple of the salary, and pension benefits and severance arrangements depend on the level of the salary.

2.1.2 Short-term incentives (STIs) or Bonuses

Bonuses, as a flexible method of pay that link pay to performance over the short term, are generally shown in a contract or plan. Along with salary, bonuses represent the annual cash that is given to executives, even though part of the bonuses might be paid in shares.

The criteria for gaining bonuses generally include achieving the company's strategy and goals.[15] Firms prefer awarding bonuses for outstanding performance rather than offering an increase in salary, as bonuses are a flexible method which can be cut in any year the

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[12] J Colley, and others, *What is Corporate Governance?* (The McGraw-Hill Companies, New York 2005) 62.

[13] Murphy, "Executive Compensation" (n 7); Kim (n 9) 14.

[14] Murphy, "Executive Compensation" (n 7) 9-10; Pepper (n 2) 51.

[15] Colley (n 12) 62.

performance falls below the performance thresholds, while an increase in salary can be a permanent increase.

The most important elements in structuring bonuses, which most bonus plans share, are the trigger point, the capping point and performance standards. The trigger point represents the performance threshold which needs to be achieved by executives in order for them to be eligible for the minimum bonus, whereas the capping point refers to the maximum point of performance for the bonus awarded. The zone between the trigger point and the capping point is called the incentive zone. To illustrate this, Murphy gives four common bonus plans which have similarities in terms of the trigger point, capping point and performance standards. One of these examples he calls the 80/120 plan. Under this plan, the payment of a bonus will only occur if the performance falls in the incentive zone between 80 per cent and 120 per cent. In other words, companies will not pay bonuses unless 80 per cent of the performance standard has been achieved and they will stop paying bonus when the performance standard exceeds 120 per cent.[16] However, companies may use different percentages.

The measures of performance which are used depend on the strategy and goals set by companies and might involve single or multiple measures. These measures can be financial, such as profits, earnings per share, revenue growth or economic value added, as well as non-financial, depending on individual performance, customer and employee satisfaction, quality, etc. A company's choice of performance measures is affected by its goals and strategies. For example, companies which follow quality- or innovation-oriented strategies tend to rely more on non-financial measures.[17]

It is argued that most of the thresholds included in managers' contracts for qualifying for bonuses are low and easily met.[18] Moreover, before the 2007 crisis, it was noticed that the regulation of bonuses in the UK was weak, as there were no specific regulations applying to bonus performance conditions and their disclosure.[19] The UK Corporate Governance Code

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[16] Murphy, "Executive Compensation" (n 7) 13.

[17] CD Ittner, DF Larcker and MV Rajan, "The Choice of Performance Measures in Annual Bonus Contracts" (April, 1997) 72(2) *The Accounting Review* 231, 251-52.

[18] Kim (n 9) 15.

[19] A Bruce and others, "Executive Bonus and Firm Performance in the UK" (2007) 40(3) *Long Range Planning* 280, 283.

requires all incentive-based remuneration to be set against "challenging performance conditions" and these performance conditions should be "relevant, stretching and designed to promote the long-term success of the company."[20] The code replaces the phrase "and designed to enhance shareholder value", which were in previous codes, by "and designed to promote the long-term success of the company" as a result of section 172 of the Companies Act 2006. This change should have occurred under the 2008 Combined Code. However, after the crisis, the design of bonuses came under criticism for not being aligned with the interests of shareholders and the long-term success of the banks, as well as being blamed for encouraging executives and traders to take excessive risks and behave recklessly,[21] leading to a change in the regulation of bonuses.

Even before the crisis, the incentives created by bonuses were criticized on a number of counts. For example, as bonuses are usually adjusted using accounting-based standards,[22] this not only has an effect on gearing the focus backwards, but will also promote an overemphasis on short-term accounting returns and a lack of attention to long-term investment.[23] Moreover, these accounting measures can be manipulated by discretionary accruals, which enable executives to shift earnings between periods[24] or even misrepresent the reported accounting performance.[25] Another criticism relates to the standard of performance, namely past year performance, which can encourage executives to reduce productivity in early periods of the year to avoid the setting of a high standard which may result in reducing the firm's value.[26] Bebchuck and Fried also argue that most firms are able to exceed the earnings and profits of the previous year, even if they are the worst in the industry.[27] Moreover, capping bonuses may give executives an incentive to delay actions that will not count towards their bonuses in

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[20] Financial Reporting Council, *The UK Corporate Governance Code*, (September 2014) Schedule A, (UK Corporate Governance Code).

[21] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the city* (HC 2008-09, 519) 3 (Treasury Committee, HC 2008-9, 519).

[22] Murphy, "Executive Compensation" (n 7) 11.

[23] Ittner (n 17) 232.

[24] PM Healy, "The effect of bonus schemes on accounting decision" (1985) 7 *Journal of Accounting and Economics* 85, 89.

[25] RJ Indjejikian and D Nanda, "Executive Target Bonuses and What They Imply about Performance standards" (2002) 77(4) *The Accounting Review* 793, 794.

[26] ibid 795.

[27] Bebchuk, *Pay without Performance* (n 6) 124.

a current year and defer them to the next financial year, which can also, clearly, affect shareholder value.

The move to include non-financial standards and measures in bonus plans was encouraged by the financial regulation, as regulated firms place more emphasis on non-financial performance than other firms;[28] this can offer further evidence in favour of managerial power theory, as executives have a greater ability to manipulate the non-financial measures and no audit is involved in checking such measures. However, some economists have argued in favour of these discretionary measures, believing them to be more accurate and relevant to individual performance than the financial measures which can be affected by the efforts of all the employees in a firm.[29] To reach the correct evaluation under a non-financial measure, a board must be free of any executive influence and genuinely seek to link pay to the executive performance.[30]

Finally, it has been noted that "[t]he rationale and processes behind bonus award, and the impact of bonus on aggregate pay and the pay/performance relationship, have received comparatively little attention from a UK perspective".[31]

2.1.3 Long-term incentives (LTIs)

The aim of long-term incentives is to relate the long-term rewards of executives to the company's long-term performance and results. The payment of these long-term incentives can be in cash or shares. Accordingly, LTIs can be divided into two main groups: cash-based incentives and equity-based incentives.

2.1.3.1 Cash-based incentives (performance unit plans or long-term bonuses)

Performance unit plans (PUPs) are designed to reward executives and top management for achieving long-term financial and non-financial goals over the course of three years or a longer time, as decided by the company; this reward is paid mainly in cash. However,

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[28] Ittner (n 17) 252.

[29] KJ Murphy and P Oyer, "Discretion in Executive Incentive Contracts: Theory and Evidence" (December 2001) Available at: SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294829> accessed 8 August 2011.

[30] Bebchuk, *Pay without Performance* (n 6) 126.

[31] Bruce (n 19) 292.

payment can also be made in shares (performance share plans). A PUP is similar to a bonus plan in principle but there is a difference in the length of maturity.

2.1.3.2 Equity-based incentives

Moving from cash incentives to the equity incentives which are becoming increasingly important in executive remuneration packages, equity incentives are believed to be the most effective tool for aligning shareholder interests and managerial incentives,[32] as managers will gain or lose in the same way as the shareholders. There are a number of issues which have been debated in relation to equity-based remuneration. First, with regard to the quantity of restricted shares and shares options: what quantity should be awarded and how should that be accurately determined? Another issue that has been addressed is that "[p]roviding bank managers with more equity-based compensation (relative to nonbank managers) is perhaps one way to encourage excessive risk-taking in banking".[33] Especially with options, executives can usually gain from excessive risk-taking, whereas any loss will eventually be borne by shareholders, depositors and taxpayers; executives are unsure as to whether they are going to obtain the options, which leads them to take more risks in order to affect the price of shares. The issue of setting long-term objectives and choosing long-term measures poses difficulties for the use of equity-based remuneration.[34]

However, despite the large amount of theoretical and empirical research on the relationship between executives' equity ownership and firm performance, there is no agreement as to how stock ownership affects firm performance.[35] For example, stock prices are not only affected by company performance, but are also influenced by the general economy, as well as speculators and investors' behaviour in the markets. Two forms of equity incentive: share

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[32] Murphy, "Executive Compensation" (n 7) 36.

[33] JF Houston and C James, "CEO compensation and bank risk: Is compensation in banking structured to promote risk-taking?" (1995) 36 *Journal of Monetary Economics* 405, 412.

[34] IT Kay and SV Putten, *Myths and Realities of Executive Pay* (Cambridge University Press, Cambridge 2007) 95.

[35] W Guay, D Larcker and J Core, "Equity incentives" in S Tyson and F Bournois (eds) *Top pay and performance* (Elsevier Butterworth-Heinemann, Oxford 2005) 157, 159.

options and restricted shares will be discussed in detail along with their relationship to company performance and risk-taking.[36]

2.1.3.2.1 Stock options

Stock options were first introduced in the USA in 1970s as a way of accumulating capital to boost executives' retirement pensions.[37] However, stock options then became the most common forms of LTIs. Stock options represent a contract that gives managers the right to buy shares in the future at a predetermined price called the exercise or strike price. These options, which are non-tradable and expire if they have not been exercised, become vested or exercisable over time, either "progressively" (25 per cent each year over four years) or all at one time after three to five years, or even more.[38] This is a market-oriented incentive and rewards stock price appreciation only. Thus, if the price of shares rises, executives will buy them at the predetermined price and receive the difference between the two prices as profit; if the price falls, executives do not exercise their options and these are called "underwater" share options.

Academics have debated the reasons for the popularity of using stock options as incentives and expressed three different views. Most financial economists regard share options as an incentive which provides a direct link between executive pay and the company's future performance.[39] The idea behind options is that managers will increase the value of their firm in order to increase the value of the options and this is aligned with shareholder interests.[40]

Others believe that the popularity of granting stock options in the 1980s and 1990s is evidence of managerial power theory, as stock options allow executives to camouflage and obscure a ten-fold increase in their remuneration by way of pay for performance so as to mitigate and avoid external scrutiny and criticism ("outrage cost").[41] Murphy, on the other

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[36] Performance shares have been discussed under cash-based incentives above.

[37] D McClune, "Designing reward packages" in S Tyson and F Bournois (eds) *Top pay and performance* (Elsevier Butterworth-Heinemann, Oxford 2005) 122.

[38] Pepper (n 2) 10.

[39] KJ Murphy, "Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options" (2002) 69(3) *The University of Chicago Law Review* 847, 857.

[40] Murphy, "Executive Compensation" (n 7) 13.

[41] L Bebchuk, J Fried and D Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensations" (2002) 69 *The University of Chicago Law Review* 751.

hand, opposes this view by stating that 80 per cent of the options were granted to employees in positions below the top five executives.[42] He has also tried to explain the increase as the cost of options to the companies being far below their economic cost, as well as because of their favourable tax and accounting treatment and the benefit of cash inflow that companies gain when executives exercise their options.[43] However, accounting standards in the USA, UK and Europe have changed, affecting the popularity of options, as the figures dropped by seven per cent and 16 per cent in 2004 and 2005 respectively in the USA.[44]

There are many issues which need to be explored further in order to understand the role of options in remuneration packages and whether or not they can really be said to align the diverse interests of managers and shareholders. These issues are as follows: performance measures, reprising options, manipulating the exercise price and time of options, misrepresenting financial statements, dilution, and the difference between options and stock ownership.

Performance measures constitute a real dilemma, as stock price can rise for many different reasons other than the performance of management teams, so executives might be rewarded for doing nothing or they might lose their options for reasons beyond their control.[45] This can affect the role of options as incentives in bull markets, when the price of shares tends to rise, while in bear markets the price of shares tends to decline.

The next issue is that options under the exercised price will have no effect on motivating executives. Therefore, companies may reprise the options. This was seen as removing the initial risk that executives might lose the options and that this would be regarded as a reward for failure and poor performance.[46] Supporters of reprising believe that it is not a reward for failure as, if a board is not happy with an executive's performance, it will terminate the contract; however, if the board is happy with the performance of an executive, it should assist the executive and reprise the options to encourage him or her further. Moreover, options have

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[42] Murphy, "Explaining Executive Compensation" (n 39) 858.

[43] ibid 868.

[44] Kay (n 34) 72; P Norris, "Shareholders' attitude to directors' pay" in S Tyson and F Bournois (eds) *Top pay and performance* (Elsevier Butterworth-Heinemann, Oxford 2005) 41, 48.

[45] Guay (n 35) 162.

[46] ibid 165.

an incentive in retaining talented managers, as they will wait for their option to be vested and it will be difficult for competitors to hire them away from the firm.[47]

The third issue to be considered is that executives could manipulate the time and price of their options. Yermack found that stock price increased significantly at the timing of awards as a result of releasing good news shortly after the reward of options.[48] Aboody and Kasznik have found that stocks are low until the time of grants.[49] Lie has also found, based on a sample of 5,977 CEO stock option awards from 1992 to 2002, that there were negative returns before the grant dates and positive ones after the award. Based on this, Lie concludes that

> *Unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that drive these predicted returns, the results suggest that the official grant date must have been set retroactively.*[50]

Supporting the assumption of backdating suggested by Lie, Heron and Lie have found evidence that backdating is the major reason for the abnormal stock return around the time of awarding the options.[51] Thus, executives are focusing on stock prices rather than maximizing the shareholders' long-term value.

Another problem found to be associated with holding very sizeable options is that this motivates executives to misstate financial statements.[52] It can be noted that executives can manipulate the time and price of their options, which can affect the objective of using options as a tool for incentives and alignment. Executives can also shift earnings between periods in the same way as with bonuses, to affect the granting of options.

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[47] ibid 165.

[48] D Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements" (1997) LII (2) *The Journal of Finance* 449, 474.

[49] D Aboody and Kasznik R, "CEO stock option awards and the timing of corporate voluntary disclosures" (2000) 29(1) *Journal of Accounting and Economics* 73.

[50] E Lie, "On the Timing of CEO Stock Option Awards" (2005) 51(5) *Management Science* 802, 806&810-811.

[51] RA Heron and E Lie, "Does backdating explain the stock price pattern around executive stock option grants?" (2007) 83(2) *Journal of Financial Economics* 271, 294. However, the accounting standards in the USA and Europe have changed following Enron's collapse, making it difficult to backdate options. See: McClune (n 37) 123.

[52] J Efendi, A Srivastava and EP Swanson, "Why do corporate managers misstate financial statements? The role of option compensation and other factors" (2007) 85(3) *Journal of Financial Economics* 667.

Dilution is a normal result of issuing new shares. In the case of options, if executives exercise their options the number of shares in the company will increase and this can, for example, affect the profit per share and voting control. Thus, shareholder activism is concerned with dilution,[53] especially when there is excessive granting of options.

Another important aspect is the difference between options and the granting of real shares. As stated above, options only grant stock appreciation and not total shareholder return, which includes dividends as with stock ownership. This does not align options fully with the interests of shareholders, as managers will focus on risky transactions or transactions that raise the stock price, such as acquisitions, even if they do not increase the dividends. If a share price falls, options will not have any effect on motivating executives, whereas in the case of stock ownership executives will have the incentive to increase the profit and value of the firm, which will be reflected in the share price and dividends. The choice between options and real share grants can be affected by markets. For example, Stapledon argues that between 2000 and 2002 Australia saw a bear market, so executives there preferred restricted shares.[54] However, options have the advantage of not costing a firm as much as the granting of real shares.

From this analysis, it can be noted that despite the advantage of stock options in aligning managers' incentives with shareholder interests in the form of market-oriented incentives, and retaining talented managers, stock options are not fully aligned with shareholder interests as stock price can be influenced by factors other than the performance of the company. Stock options offer the incentive of encouraging managers to conduct very risky investments to affect the price of shares. Executives are more likely to sell their options as soon as they become vested, and then executive incentives are no longer aligned with shareholder interests.

The final point to be made under this subsection is that some firms use another form of option called stock appreciation rights (SARs). SARs reward executives and other employees with cash or stock in the future equivalent to the difference between the market price of shares on

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[53] Kay (n 34) 72.

[54] Stapledon (n 5).

the grant and exercise date.[55] Thus, these are similar to stock options but there is no real purchase of shares involved, and these can be classified as deferred bonuses. Finally as Bill Gates said:

> When you win [with options], you win the lottery […] the variation is huge; much greater than employees have an appetite for […] so what we do now is give shares, not options. [56]

2.1.3.2.2 Restricted stocks

The popularity of options has been affected by the change in accounting standards in the USA, the UK and Europe, as well as shareholder activism concerning dilution, which has resulted in moves towards granting real stock. It has been reported that in spite of the rise in stock prices between 2002 and 2004 the granting of options declined by 30 per cent, while the granting of restricted stocks and performance shares increased by 46 per cent and 51 per cent respectively.[57] Under this type of remuneration, companies grant common stock with restrictions on the ownership. These restrictions preclude managers from selling the shares until a specified length of time has lapsed or specified long-term objectives have been achieved. Thus, this approach can be used to keep executives in a firm waiting for the stock to be vested, as well as encouraging managers to fulfil specified long-term objectives which the company wants to achieve.

Restricted stock has advantages over options as it continues to motivate managers even if it falls, as its value will not go to zero.[58] However, it has the same disadvantages as options with regard to choosing performance measures and setting long-term objectives. Moreover, executives and traders will have the disadvantage of their shares falling for reasons not related to their performance.

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[55] CH Gibson, *Financial Reporting and Analysis: Using Financial Accounting Information* (South-Western Cengage Learning, Mason 2009) 346.

[56] Quoted in: Kay (n 34) 71.

[57] ibid 87.

[58] Kim (n 9) 17.

Some firms which are unable to grant real shares use phantom stock. This is very similar to stock appreciation rights but executives receive cash equivalent to the value of the real shares if they were to be granted.[59]

2.1.4 Other benefits

Apart from the above elements of remuneration, executives also receive other benefits, such as cars (an option which is quite popular in the UK),[60] health care, life insurance or disability cover. This section will briefly analyse the most important and common forms of benefit that can be offered to managers, namely, golden hellos, golden parachutes, golden handshakes and pensions.

Golden hellos are a large initial payment to attract an executive to join a firm from a rival firm. This initial payment can take the form of cash, bonuses, options, restricted shares and pension benefits and is more than such executives were waiting for or expecting to receive from their previous employer. This type of payment can contribute to an increase in the level of executive remuneration as each company will attract executives from rivals and so on, as well as this payment undermining the role of stock options and restricted shares in keeping executives in a company. Moreover, it has been noted that golden hellos cannot be expected to be linked to performance, as most of them are in cash.[61] However, it can be argued that if an executive's performance in the previous firm had not been good enough, he or she would not have been offered this golden hello. However, who can guarantee that an individual's performance in a new firm will be as good as that in the previous one? It can be concluded that golden hellos can benefit shareholders in the short term by attracting talented executives to a company but, on the other hand, this can harm the shareholders and the economy in the long term by increasing the cost of hiring executives to more than they are worth.

Golden handshakes and golden parachutes represent the other side of golden hellos. They are the sums given to executives upon retirement, termination or when a firm is acquired.[62] This

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[59] C Cantrell, *Stock Options: Estate, Tax and Financial Planning* (CCH, Chicago 2009) 14.

[60] Pepper (n 2) 12.

[61] Bebchuk, *Pay without Performance* (n 6) 130.

[62] In the literature, a golden parachute is defined as the sum that is given to the CEO in the case of an acquisition, while a golden handshake is for retirement or termination. For more information see: D

sum is normally linked to the unexpired element of his or her contract, an ex gratia element or, if the executive is old enough, pension payments might be brought forward.[63]

In the UK, in the case of poor performance, golden handshakes are called "payment for failure", as the executives who are asked to leave are the ones who have failed to perform satisfactorily.[64] Thus, when a firm performs badly, an executive may leave with a huge pay package which is not linked to the future performance of the firm, and shareholders will suffer the loss.[65] Supporters of golden handshakes in the case of poor performance allege that the reason behind this grant is the elimination of the problem of some directors who might be reluctant to discuss the dismissal of the CEO and thus prefer to soften the blow with a gift.[66] However, even though this payment is not beneficial to shareholders and not linked to performance, it might be necessary to accelerate and sweeten the replacement of the CEO and benefit the shareholders from this perspective. Therefore, the board should be very strict with this kind of payment and pay as little as possible in order to alleviate the financial impact of the dismissal on the executive.

Golden handshakes in the case of retirement, or golden goodbyes, have been criticized by some for not being linked to the future performance of a firm, whilst other claim they encourage executives to perform well during their tenure.[67] Awarding such payments to executives upon retirement has been criticised for the following reason: if a CEO performs well during tenure, he or she should have been rewarded during the tenure and awarded the deferred remuneration on retirement.

Golden parachutes, which have also been criticized for not being linked to performance, are intended to give executives financial protection in the event of acquisitions or mergers and help them to focus on their work during their tenure rather than being distracted by the need

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Yermack, "Golden handshakes: Separation pay for retired and dismissed CEOs" (2006) 41 *Journal of Accounting and Economics* 237.

[63]Pepper (n 2) 14.

[64] ibid.

[65] DG Johnson, "Executive Pay Trends and Golden Parachute Tax: A Collision on the Horizon" (2004) 1 *Benefit Quarterly* 30.

[66] Bebchuk, *Pay without Performance* (n 6) 88-89.

[67] ibid 93.

to protect their jobs.[68] In addition, golden parachutes can be used to encourage executives to gain a better deal for shareholders in the negotiation of transactions. Besides this, it can help directors to vote in favour of an acquisition that benefits shareholders if the CEO, who might find himself or herself out of work for an extended period, is going to receive a golden goodbye or a golden parachute.[69]

The retirement benefits which are provided to executives come in four forms: the first is a retirement pension, which is different from the typical pension plan;[70] the second is deferred remuneration; the third involves perks in retirement (such as unlimited airline tickets for an executive and his or her family); and the fourth takes the form of guaranteed consultancy fees.[71]

2.2 Economic Theories Surrounding Remuneration

Economists have attempted to explain and justify the need for such high executive remuneration and there are two main theories: optimal contracting (market driven) theory; and managerial power (board capture) theory. Optimal contracting theory sees the incentives created by remuneration as a remedy to the agency problem between executives and shareholders, whilst managerial power theory sees remuneration as part of the agency problem[72] since executives can extract the rent they want. The reform of the regulations and corporate governance principles related to the establishment of remuneration has tried to ensure that they are "fair and competitive"[73] for executives and shareholders. This section will analyse the economic theories surrounding remuneration practice.

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[68] Johnson (n 65) 31.

[69] Bebchuk, *Pay without Performance* (n 6) 90.

[70] Executives are usually provided with a pension plan that is based on their final salary and number of years of service. See: Pepper (n 2) 12.

[71] Bebchuk, *Pay without Performance* (n 6) 95-111.

[72] L Bebchuk and J Fried, "Executive Compensation as an Agency Problem" (2003) 17(3) *Journal of Economic Perspectives* 71.

[73] Financial Reporting Council and London Stock Exchange, "Cadbury Report (The financial aspects of corporate governance)" (1 December 1992) para 4.44 (Cadbury Report).

2.2.1 Optimal contracting theory v. managerial power theory

Optimal contracting, or the official story, as it is called by Bebchuk and Fried,[74]observes that limited liability, a separate legal personality and the stock market have fuelled the dispersed ownership of publicly listed companies. Moreover, this dispersed ownership has created an agency problem between principal (shareholders) and agent (executives), as their interests are not perfectly aligned. A need, therefore, for the alignment of these diverse interests has been seen in a remuneration structure which rewards more when the agents perform better. The underlying assumption of the theory is that the principal will agree to an optimal contract with the agent.[75] However, shareholders do not directly structure the remuneration for executives; this task is delegated to an independent board of directors, which acts as a guardian of the company and shareholder interests to discuss the remuneration of executives at arm's length. Scholars such as Kaplan have defended CEO pay and despite acknowledging that CEO pay is not perfect, they maintain that CEOs are not overpaid. CEO pay is linked to performance, and boards do make efforts to monitor CEO remuneration.[76] He argues that CEO pay is largely driven by market forces, especially the size of the company (when a company grows larger, the CEO receives more pay)[77] and the stock markets, as CEOs' pay reached its peak in the USA in 2000 and declined by 50 per cent by 2006. He asserts that the increase in CEO pay is not unique, as other similarly talented groups have experienced a similar increase, such as hedge fund managers, professional baseball, basketball and football players, and top lawyers. Therefore, unless a board is serving shareholder interests perfectly, remuneration contracts will differ from those predicted by an optimal contracting model.[78]

Bebchuk and Fried argue that there is no reason to assume that directors will serve shareholder interests, as there is no reason to expect executives to maximize shareholder

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[74] Bebchuk, *Pay without Performance* (n 6) 15.

[75] MS Weisbach, "Optimal Executive Compensation versus Managerial Power: A Review of Lucian Bebchuk and Jesse Fried's *Pay without performance: The Unfulfilled promise of Executive Compensation*" (2007) XLV *Journal of Economic Literature* 419, 422.

[76] SN Kaplan, "Are US CEOs overpaid?" (2008) 22(2) *Academic of Management Perspectives* 5.

[77] X Gabaix and A Landier, "Why has CEO pay increased so much?" (2008) 123(1) *Quarterly Journal of Economics* 49.

[78] Weisbach (n 75) 422.

value.[79] They add this because directors also suffer from the agency problem, which undermines their ability to address the agency problem between shareholders and executives effectively. Moreover, they argue that there are many factors pushing a board to consider the interests of the CEO. The CEO has a strong influence on the nomination process to the board, which can cause a director to "go along with the CEO's pay arrangement";[80] otherwise, the director is more likely to lose a well-paid job as well as the opportunity of serving on another company's board as his or her reputation is damaged by going against the CEO. Another factor is the benefits that a CEO can provide for other directors either directly or indirectly. However, one might argue that directors have shares in the company, which encourages them to favour shareholder interests. Bebchuk and Fried refute this argument by stating that the benefit which directors gain from favouring the CEO and other executives outweighs the advantages they gain from their shareholding.

The other two arguments advanced by Bebchuk and Fried to prove the inadequacy of the optimal contracting model in achieving a fair decision on remuneration are the limitations of the power of market forces and the limitations of shareholder power. The managerial labour market affects the remuneration of executives and the market for corporate control, which puts pressure on executives to serve shareholder interests. The ability of these markets is not effective in imposing constraints on executive remuneration.[81] Shareholders lack the power to intervene and have their say on remuneration arrangements,[82] and other tools which shareholders can use (such as suing the board, voting down long-term incentive remuneration and bringing their own resolution) are unlikely to have an effect on board behaviour unless shareholders have a large holding.[83]

On the other hand, managerial power theory has been proposed by Bebchuk, Fried and Walker.[84] The theory is not intended to replace optimal contract theory completely but to complement it by stating that a remuneration arrangement is designed in accordance with the

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[79] Bebchuk "Executive Compensation as an Agency Problem" (n 72) 73.

[80] ibid 74.

[81] Bebchuk, "Managerial Power and Rent Extraction" (n 41) 778-79.

[82] Their argument here is based on the US regulations and before the UK introduced the advisory vote on remuneration report in 2002 as will be discussed late.

[83] Bebchuk, *Pay without Performance* (n 6) 45-52.

[84] Bebchuk, "Managerial Power and Rent Extraction" (n 41).

managerial power and optimal incentive contract.[85] Moreover, the theory is based on the assumption that executives do, of course, prefer more remuneration as well as having the ability to influence the structure and level of their remuneration.[86] The main difference between the two theories is that optimal contract theory perceives the level of remuneration as enough to keep executives in the firm and motivate them, whereas managerial power theory believes that pay is set at the highest possible level.[87] Managerial power theory claims that the so-called "outrage cost" acts as a constraint on the level of payment that executives receive.[88] Despite the fact that Bebchuk and Fried have also agreed that market forces, the need for board approval and social sanctions place some constraints on remuneration arrangements, they state that the board will be more likely to favour executives in remuneration arrangements unless this provokes negative reactions from outsiders and the public, known as "outrage cost".[89]

In order to get around outrage costs, Bebchuk and Fried explain that executives camouflage their payment by structuring it as if it were optimal and avoiding too many cash payments, as well as appointing remuneration consultants, which can also be explained by the optimal contracting approach as strengthening the relationship between pay and performance. However, the use of remuneration consultants can be undermining if a consultant tries to please the CEO in order to secure reappointment. I would also state that even if consultants are hired by an independent remuneration committee, the consultants who recommend higher remuneration will be more attractive to firms and be hired to justify the rise in remuneration. This is confirmed by studies which show that the use of consultants in the USA and the UK contributed to ratcheting up executive pay and led to more use of equity-based incentives.[90]

Murphy, who opposes managerial power theory, questions the ability of outrage cost to influence executive pay, as although the media have frequently reported on the escalation of

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[85] ibid 755.

[86] Murphy, "Explaining Executive Compensation" (n 39) 851.

[87] Weisbach (n 75) 423.

[88] Bebchuk, "Managerial Power and Rent Extraction" (n 41) 786.

[89] Bebchuk, *Pay without Performance* (n 6) 65.

[90] MJ Conyon, SI Peck and GV Sadler, "Compensation consultants and executive pay: evidence from the United Sates and the United Kingdom" (2009) 23(1) *Academic of Management Perspectives* 43.

executive remuneration, these reports have not led to the imposition of any constraints.[91] In addition, Bebchuk and Fried do not provide the full scope of what they call "outrage cost", failing to examine which factors can cause it, why it should be treated as a constraint and how can it affect and damage a firm?[92]

Bebchuk and Fried have provided evidence to support managerial power theory. Firstly, they point to the failure of optimal contracts to filter out factors beyond executive control when rewarding options based on the movement of the general market price. Secondly, they highlight the ability of executives to unwind their stock-based incentives. These can keep executives motivated as long as they hold them but their ability to unwind them freely at any time can undermine the ability of stocks to play their role in motivating executives. Therefore, camouflage practices to obscure payment, giving executives the ability to gain from their remuneration based on general market price which is beyond executive control and the freedom of executives to unwind their stock, distinguish managerial power theory from optimal contracting theory.[93]

Solutions have been proposed in relation to the structure of payment being linked to performance by filtering out factors beyond executive control when rewarding options, prohibiting the use of hedging or derivative transactions to reduce the risk associated with stock plans, obliging executives to hold their vesting shares for a specified period to keep them motivated, obliging executives to disclose their intentions to sell their shares in advance, avoiding large payments for departing executives, especially if the departure was the result of failure, and having investors assess the non-performance pay given to executives, such as retirement benefits.[94] Other solutions are related to improving transparency, shareholder engagement in remuneration practice, and corporate governance in general.

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[91] Murphy, "Explaining Executive Compensation" (n 39) 855-857.

[92] Weisbach (n 75) 423.

[93] Weisbach (n 75) 423-26.

[94] Bebchuk, *Pay without Performance* (n 6) 189-191.

2.2.2 Sub-theories of market driven or optimal contracting theory

There are five theories that can be classified as sub-theories of market driven theory. These are marginal revenue product theory, tournament theory, opportunity cost theory, bargaining power theory and risk adjustment theory. All of these theories represent attempts to refine our undersyanding of how remuneration of executives is set in accordance with market forces.

2.2.2.1 Marginal Revenue Product Theory

Marginal revenue theory is based on the economic concept that each factor of production, including managerial labour, should be paid the amount of its contribution to the value of the firm.[95] Under this theory the remuneration of the CEO represents his or her contribution to the firm value and is set in accordance with this contribution. Thus the CEO of large organisations is paid more and this theory can offer a possible explanation for the correlation between the level of executive pay and firm size.[96]

2.2.2.2 Tournament Theory

This theory sees top executive pay as the prize that is awarded to the winner of the internal labour market tournament. The tournament is a single elimination tournament similar to those in sports such as tennis. The winners, therefore, advance to the next round of the competition and the prize gets bigger. The winner of the whole tournament becomes the CEO and gets more power and the largest pay.[97] However, in order to maintain the incentive for the CEO further direct financial benefit must be provided as there is no further promotion.

2.2.2.3 Opportunity Cost Theory

This theory is based on the economic concept of opportunity cost as CEO pay represents the amount that would be paid to her/him in the best alternative job. Top executives are in a good position to move from one firm to another in search of a better job and higher pay or they can also take advantage of the capital market to finance their own businesses raising the value of

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[95] RS Thomas, "Explaining the international CEO pay Gap: board capture or market driven?" (May 2004) 57(4) *Vanderbilt Law Review* 1171, 1176.

[96] ibid 1202.

[97] ibid 1176 &1210.

their alternative opportunities.[98] Thus established firms need to offer their skilled employees a large payment to be able to retain them as long as the alternative positions are available to those employees.

2.2.2.4 Bargaining Power Theory

This theory only applied to jurisdictions which give the board of directors the ability to stop hostile takeovers such as in the USA.[99] Therefore top executives demand more remuneration and are given more compensation for agreeing to give up their jobs and approve the takeover. Executives in jurisdictions which do not allow the board of directors and management to determine the sale of the company, do not enjoy this power and theoretically there no need to compensate them for giving up their jobs.[100]

2.2.2.5 Risk Adjustment Theory

This theory applies to executives who are mainly compensated by options and have large holdings in the company they manage. This large holding creates a high risk and can be very costly due to the lack of diversification. Thus companies are forced to pay those executives more to get them to agree to place their eggs in the firm's basket.[101]

After discussing the theories in the context of the divergence between executive remuneration in the USA and the rest of the world, Thomas concluded that:

> *[A]lthough all of the theories may be right to some extent, so that executive pay is determined both for economic reasons and by […] executives' power to obtain a disproportionate share of their firm's rents, more research needs to be done to understand the dynamics of this market before governments rush in and intervene.*[102]

2.3 Remuneration during the Financial Crisis 2007-09

The financial crisis of 2007-09 demonstrated that executive pay structures were contributory factors, fuelling the crisis by encouraging short-term risk-taking at the expense of long-term

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[98] ibid 1177 & 1224.

[99] ibid 1178.

[100] ibid 1251.

[101] ibid 1179.

[102] ibid 1182.

safety, and obliging the governments in many different countries to use taxpayers' money to bail out failing financial institutions. Therefore, remuneration practices are now being re-assessed not only on a national level but also at international level. The attempts to reform remuneration practices are not only aimed at improving the link between remuneration and shareholder interests, but also at addressing other problems, such as excessive risk-taking and aligning remuneration with sustainable and long-term performance. This section will analyse in more detail the international initiatives for reforming remuneration practices. It will briefly discuss the crisis and how political views triggered the international work undertaken by the FSB. Following this, the work of the FSB in introducing the P&S at an international level to reform remuneration practices at significant financial institutions will be assessed together with the supplementary work of the Basel Committee on Banking Supervision (BCBS) which will be referred to henceforth as the Basel Committee.

2.3.1 The Crisis in brief

The crisis started in 2007 following a decline in the US housing market after it had reached its peak in mid-2006. The housing boom before the crisis had been fuelled by low interest rates that had been in place since 2001, which made "cheap money" available both for house purchases and spending generally.[103] The subsequent increase in the interest rate by the US Federal Reserve triggered defaults on the subprime mortgages which had been granted to many people who could not afford a change of this magnitude. The rise in interest rates pushed the price of the existing mortgages up, causing many defaults on subprime mortgages and the number of foreclosures to increase. This loose monetary policy combined with a number of other factors resulted in the financial crisis. These included: high levels of inflation and rising housing prices; complex risk structures with poor risk management in an overestimation of firms' abilities to manage the risk and an underestimation of the capital they should hold; the high rating of AAA for inappropriate financial products by credit rating agencies; mark-to-market accounting principles; poor corporate governance, and regulatory, supervisory and crisis-management failures within the deregulation.

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[103] A Arora, "The 2007-09 Banking crisis and the EU's Regulatory Response" (2010) 21(5) *European Business Law Review* 603.

In the events leading up to the crisis, banks based their business models on the "originate-to-distribute" model of securitization, whereby mortgage loans were repackaged or securitized in different tranches and then sold to investors in capital markets. This was fuelled by savers who had been aggressively searching for high yields on their investments, which in turn led to the innovation and development of market products, some of which were neither fully understood nor regulated.[104]

Banks took advantage of this opportunity as they did not need to keep these debts on their balance sheet and any default would be covered by the credit default swap and loans from other tranches, which proved to be wrong. When it became clear that many of these securitized mortgages were of poor quality, the markets for such assets dried up. Banks that were heavily dependent on the markets for their funding experienced severe liquidity and solvency problems.[105] One might ask why, if the banks were following the "originate-to-distribute" model, did they incur losses? The answer is that they undertook regulatory arbitrage by exploiting credit risk transfers which were used to transfer assets from off-balance sheet to other investors in the markets to circumvent regulatory requirements. As explained by Tomasic and Akinbami, this was conducted by banks in two ways:

a. Banks set up off-balance sheet asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs). ABCP conduits held assets off-balance sheet for banks with banks providing liquidity enhancement and credit enhancement for these conduits. The enhancements implied that investors in the conduits had recourse to the banks in case the quality of assets deteriorated, so investors could return the assets to the bank once they suffered a loss. The enhancements were treated as capital-light in the then existing Basel Committee rules for capital requirements, allowing banks to have five times more leverage ratios off-balance sheet than on-balance sheet.

b. Banks exploited the fact that they could gain capital relief by simply switching away from loans to investments in the form of AAA-rated tranches of collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). As a result, 50 per cent of all AAA-rated asset-backed securities were held within the banking system.

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[104] ibid.

[105] R Tomasic and F Akinbami, "Towards a new corporate governance after the global financial crisis" (2011) 22(8) *International Company and Commercial Law Review* 237, 239.

Consequently, banks which used these mechanisms suffered greater losses during the crisis,[106] as they had to write-down the assets in accordance with mark-to-market accounting standards[107] and reported significant losses.

In the initial response, the central banks injected liquidity in the markets in order to support banks in being able to provide credit to businesses and individual borrowers. However, certain financial institutions that experienced severe difficulties, such as Northern Rock, Bradford & Bingley, Dexia and Hypo Real Estate, were partly or entirely nationalized.[108] In order to receive government bailouts, financial firms with recourse to public funds had to cut their remuneration levels, and comply with other conditions.

2.3.2 The political views of remuneration practices

The financial crisis brought the bankers' remuneration and incentive plans to the close attention of regulators, investors, society and politicians on both sides of the Atlantic. Two problems relating to the remuneration practices have particularly attracted the attention of politicians. The first is the high level of remuneration, which has been the focus of social resentment, particularly when many of the banks needed government support; and the second, which has been the focus of the regulators, is the structure of remuneration which is believed to have encouraged excessive risk-taking and short-termism practices leading to the financial crisis.[109]

In the UK, Gordon Brown, the then British Prime Minister, indicated that excessive remuneration should be cut back as a matter of morality, ethics and justice, and, therefore, this was a key issue from the beginning of the financial crisis on the agenda of reforming the banking industry.[110] A final step for Brown's government before leaving office after the

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[106] V Acharya and P Schnabl, "How banks played leverage games" in: V Acharya and M Richardson (eds), *Restoring Financial Stability: How to Repair a Failed System*, (John Wiley & Sons, New Jersey 2009).

[107] D Martin, O Saba and FG Alogna, "European Response to the Financial Crisis" (2009) Available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1337586> accessed 20 August 2011.

[108] ibid.

[109] G Ferrarini and MC Ungureanu, "Economic, politics and the international principles for sound compensation practices: an analysis of executive pay at European banks" (2011) 62(2) *Vanderbilt Law Review* 431, 453-54.

[110] G Brown, "Beyond the crash: overcoming the first crisis of globalisation", cited in E Ferran, "New regulation of remuneration in the financial sector in the EU" (2012) 9(1) *European Company and Financial Law Review* 1, 9.

general election in 2010 was imposing a one-off bank bonus tax without interfering in the level of remuneration payment.[111]

In the USA, following election, President Obama described the bonuses practices for trading floors, investment banking desks and executive suites in the banking industry as "shameful".[112] He went even further by accusing the bonuses gained by leading executives and traders as forming part of a "reckless culture and a quarter-by-quarter mentality that in turn helped to wreak havoc in our financial system".[113] However, the proposed cap on salary of $500,000 for top executives at firms receiving exceptional assistance was dropped before implementation.[114] This reflects the general direction of the reform in the USA, which was not directed at imposing a limit on the maximum remuneration but on developing principles for the better alignment of remuneration with the interests of shareholders and financial stability, improving the supervisory oversight of financial firms' remuneration, introducing new requirements for independent board remuneration committees, and more shareholder power in the form of the new "say on pay" introduced by the Dodd-Frank Act.[115]

In France the then President, Sarkozy, "placed control of financial sector remuneration within his aspirations for a new style 'moral capitalism'".[116] German political leaders also preferred a tough approach to remuneration practices.[117] The governments of France and Germany, during 2008 and 2009, were presented with the case of regulating bankers' pay at an international level and pressing for strict agreed international rules and principles.[118]

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[111] L Elliot and P Wintour, "Darling announces one-off shock tax to 'break bonus culture'" *The Guardian* (London, 7 December 2009) <http://www.theguardian.com/uk/2009/dec/07/alistair-darling-shock-tax-bankers> accessed 9 August 2014.

[112] A Lucchetti and M Karnitschnig, "On street, new reality on pay sets in: financial firms race to reset compensation policies as US government aims to set some limits", *Wall Street Journal* (New York, 31 January 2009).

[113] Cited in D Solomon and D Paletta, "US eyes bank pay overhaul; administration in early talks on ways to curb compensation across finance", *Wall Street Journal* (New York, 13 May 2009).

[114] D Solomon, "Salaries safe, bonuses hit", *The Wall Street Journal* (New York, 10 June 2009) and Available at: <http://www.maths-fi.com/WSJ-Salaries-Safe-Bonuses-Hit-061009.pdf >.

[115] E Ferran, "New regulation of remuneration in the financial sector in the EU" (2012) 9(1) *European Company and Financial Law Review* 1, 12.

[116] ibid 9.

[117] ibid 9.

[118] T Braithwaite, T Barber and P Smith, "G20 road to the summit: differing agendas may tip meeting off-track", *Financial Times* (London, 13 March 2009).

These views had formed the basis of the discussion of the G20 members who agreed to address remuneration in the financial industry as a fundamental part of the regulatory reform in response to the financial crisis. The report of the Financial Stability Forum (FSF)[119] in April 2008, which diagnosed the implications associated with remuneration practices (among many issues), asserted the need for this to be addressed at the international level and form the basis upon which the subsequent measures of the FSF to tackle the problem would be approached. In this report it was clear that the FSF was not concerned with the level of remuneration or with remuneration practices which align the interests of managers with the interests of shareholders, as its mandate centred on its interest in issues related to the financial stability by addressing vulnerabilities, and developing and implementing strong regulatory, supervisory and other policies to strengthen financial stability. In the report the FSF made it clear that:

> *Compensation arrangements often encouraged disproportionate risk-taking with insufficient regard to longer-term risks. This problem can be mitigated if firms closely relate the incentives in their compensation model to long-term, firm-wide profitability.*[120]

Ferran explains that as the crisis was developing, high-level political support for this view was strengthening, starting at the Washington Summit in November 2008, when there was a call for action, whether voluntary or regulatory, to avoid remuneration schemes which rewarded excessive risk-taking and were based only on short-term returns. The issue continued to be prominent at the London Summit in April 2009 and the Pittsburgh Summit in September 2009. Later Summits (Toronto in June 2010 and Seoul in November 2010) also expressed support for international initiatives to regulate financial sector pay but according to Ferran, these statements increasingly felt like "boilerplate", as the key policy decisions had already been made.[121]

However, full agreement on the detail of what to regulate at the international level was not reached. G20 members said it was not clear whether the intention was to limit the regulation

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[119] The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The Financial Stability Forum (FSF) was established in 1999 by the G7 Finance Ministers and Central Bank Governors <http://www.financialstabilityboard.org/about/history.htm>.

[120] Financial Stability Forum, *Enhancing Market and Institutional Resilience* (April 2008) 20 (FSF, *Enhancing Market*).

[121] Ferran (n 115) 10.

on issues related to remuneration and risk alignment, the structure of remuneration, corporate governance, supervisory oversight and disclosure, or to go further and impose certain limits on overall remuneration. France and Germany were pressing for the inclusion of a limit on the overall remuneration at the international level.[122] However, they did not succeed in obtaining more support from the G20 for their proposal.[123]

2.3.3 The FSB's role in delivering the Principles and Standards on remuneration

The FSB was responsible for designing the P&S which regulate remuneration practices at the international level as the international focus on remuneration practices has been unremitting since 2009.[124] In April 2008 the FSB published its report on the causes and weaknesses that had led to the turmoil, along with its recommendations for increasing the resilience of markets and institutions as it had been asked to do by the G7 Ministers and Central Bank Governors in October 2007.[125] In this report, remuneration was identified as being one of the factors that led to the crisis. This was followed by the FSB publishing the Principles for Sound Compensation Practices in April 2009, which was also followed by the publication of the Implementation Standards in September 2009. The P&S were presented and endorsed by the G20 Summit in London in April 2009 and in Pittsburgh in September 2009.[126] In April 2009 the G20 Finance Ministers agreed that the Basel Committee should incorporate the principles into its risk management guidance.[127] Therefore, the BCBS produced four important publications.

The first of these was the *Compensation Principles and Standards Assessment Methodology* in January 2010 designed to help supervisors in assessing company compliance with the P&S to support a level playing field and avoid a "one size fits all" model by providing different approaches to conducting the review, taking account of the size and complexity of

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[122] J Quinn, "Merkel and Sarkozy in last push on bank reform", *The Telegraph* (London, 25 September 2009).

[123] K Guha, "G20 summit: leaders open the way to wide reforms", *Financial Times* (London, 17 November 2008).

[124] A Arora, "Remuneration practices in banks and other financial institutions: part 1" (2012) 33(3) *Company Lawyer* 67, 73.

[125] FSF, *Enhancing Market* (n 120) 1.

[126] Arora, "Remuneration practices in banks: part 1" (n 124) 74.

[127] ibid.

institutions, the nature of their business model and activities, and level of risk tolerance. This was followed by an updated version of the *Principles for Enhancing Corporate Governance* in October 2010. The third document is the *Range of Methodologies for Risk and Performance Alignment of Remuneration* in May 2011, which is a technical report aimed at enhancing banks' and supervisors' understanding of risk-adjusted remuneration. This report provides clarification concerning the design of risk-adjusted remuneration systems[128] following a recommendation made in the first FSB *Thematic Review on Compensation* linked to the need to raise the standard of risk adjustment to remuneration to ensure that performance-based remuneration is adjusted to take account of all potential risks. [129] The forth document is the *Pillar three disclosure requirements for remuneration* produced in July 2011 which was also recommended by the first FSB *Thematic Review on Compensation* in order to promote greater convergence of disclosure on remuneration after noticing differences across jurisdictions which could hamper the comparability and the effectiveness of disclosure.[130]

The P&S aim at ensuring effective governance of remuneration, alignment of remuneration with prudent risk-taking and adequate disclosure and oversight of remuneration practices by the supervisory authorities. These issues will be discussed[131] starting with the scope of their application.

2.3.3.1 The scope of application

The P&S are intended to apply to significant financial institutions. The FSB has allowed national authorities to apply the P&S proportionately as justified by the business model and risk profile of the firm to avoid a "one size fits all" approach as long as such criteria is defined clearly in the national regulations or in supervisory guidance.[132] However, national

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[128] Basel Committee on Banking Supervision, *Range of Methodologies for Risk and Performance Alignment of Remuneration* (May 2011) 2 (BCBS, *Range of Methodologies*).

[129] Financial Stability Board, *Thematic Review on Compensation: Peer Review Report* (30 March 2010) 3 (FSB, 2010 *Thematic Review on Compensation*).

[130] Basel Committee on Banking Supervision, *Pillar 3 disclosure requirements for remuneration* (July 2011) 1 (BCBS *Pillar 3 disclosure*).

[131] Detailed critical analysis is done in the context of the UK implementation through Remuneration Code, so to avoid repetition this section will not examine this in depth.

[132] Financial Stability Board, *Thematic Review on Compensation: Peer Review Report* (7 October 2011) 5.

jurisdictions may also apply them in a proportionate manner to smaller, less complex institutions.[133] The FSB reported in the first progress report in 2012 that:

> *There is a wide variation among member jurisdictions as to the use of the principle of proportionality as well as the criteria used to support the principle. In some cases, the criteria are not clearly defined.*[134]

Such divergence may give rise to regulatory arbitrage. Another concern is that applying the P&S only to banks or other significant financial institutions will put them at a competitive disadvantage when facing competition from non-regulated industries and will reduce their ability to retain talent.

With regard to the personnel the P&S has not clearly identified the personnel to whom the P&S are primarily directed, as the ultimate objectives of the P&S is to reduce individuals' incentives for excessive risk-taking that may arise from a structure of remuneration.[135] This has led the Basel Committee to state that the P&S should apply at least to senior management, material risk takers (MRTs), and staff performing important risk management and control function, and groups of employees who may together take material risk.[136] However, despite the criteria, there was also divergence in identification of the employees that come under the scope of the P&S.[137] The FSB has stated that there is wide range of practices across jurisdictions and firms due to the differences in the relevant national regulations and supervisory guidance as well as the difference in the size, nature or complexity of firms.[138] Therefore the FSB will survey and compare the practices with the view of identifying good practices taking into account the differences and the need for proportionality.

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[133] Basel Committee on Banking Supervision, *Principles for Enhancing Corporate Governance* (October 2010) 25.

[134] Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Progress Report* (13 June 2012) 8 (FSB, 2012 *Progress Report*).

[135] Basel Committee on Banking Supervision, *Compensation Principles and Standards Assessment Methodology* (January 2010) 2 (BCBS, *Assessment Methodology*).

[136] ibid 3.

[137] FSB, 2012 *Progress Report* (n 134) 9.

[138] Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Second Progress Report* (26 August 2013) 2 (FSB, 2013 *Progress Report*).

2.3.3.2 The governance of remuneration

The P&S assume the responsibility of the board to oversee, evaluate and review the remuneration policy of the firm with the main objective being to align remuneration policy with a risk management framework in mind.[139] However, significant financial institutions are expected to establish a board remuneration committee to oversee the remuneration system's design and operation.[140] The remuneration committee or the body responsible for setting the remuneration should be constituted in a manner which enables it to exercise independent judgement on remuneration policies and practices. This body should also not only be able to produce a remuneration policy that confirms the requirements of the FSB, the BCBS, the International Association of Insurance Supervision (IAIS), the International Organization of Securities Commissions (IOSCO), and the respective rules by national supervisory authorities, but should also be able to understand the effects of incentives created by their designed remuneration policy on risk-taking, capital and liquidity.[141] In doing so the body must have independent and expertise in risk management and remuneration as well as work closely with the firm's risk committee. The body responsible for designing the remuneration should also review and evaluate the policy annually.[142]

The P&S also require that employees with risk and compliance functions should be remunerated independently and not by the business area they oversee to ensure their objectivity and independence in preserving the integrity of financial and risk management. Hence their remuneration should be based primarily on the achievement of the objectives of their functions.

2.3.3.3 The structure of remuneration

This is the area in which the P&S become prescriptive and which forms the major focus, in spite of the FSB's assertion that the P&S were not intended to prescribe a particular structure or level of individual remuneration, as one size does not fit all and firms differ in their goals, activities and culture. The structure of remuneration is seen as being more likely to encourage

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[139] BCBS, *Assessment Methodology* (n 135) 7.

[140] FSB Implementation Standards, 2.

[141] ibid 2.

[142] ibid 2.

excessive risk-taking and work contrarily to a firm's long-term growth. The P&S aim for alignment to be achieved by *ex ante* risk adjustment and *ex post* risk adjustment supplemented by a mix of payment of cash and shares or share-linked instruments, prohibition of guaranteed bonuses and a hedging strategy.

Ex ante risk adjustment represents the initial attempt to risk adjust the remuneration pool and/or individual awards[143] and should take account of all types of risks including those risks which are difficult to measure. For example, two employees who make the same short-term profit but take a different amount of risk on behalf of their firm should not be treated the same by the remuneration policy.[144] *Ex ante* risk adjustment will give supervisors and firms the ability to strengthen their capital base. The FSB recommends that national authorities instruct firms to use net revenue or profit to calculate variable remuneration and to adjust these for risk and prohibit any formula that would prevent firms from strengthening their capital. This is a good recommendation as some company managers may use techniques such as leveraging to boost their return, at the expense of increasing and strengthening capital and liquidity, when the return is mainly measured by earning per share (EPS) or return on capital (RoC) without the use of risk adjustment techniques.

The importance of risk-adjusted remuneration is that at the time when the remuneration is granted, the ultimate performance cannot be assessed without uncertainty.[145] *Ex ante* has the advantage of timeliness, having an immediate impact on risk-taking behaviour. *Ex ante* risk adjustment can be quantitative or qualitative depending on human judgment. However, firms may experience difficulties in finding reliable quantitative measures to cover all sort of risks, thus they are expected to use informed judgments to estimate risks and risk outcomes.[146] However, even qualitative measures or human judgment have shortcomings as they are dependent on estimation; therefore, *ex ante* risk adjustment faces challenges of the limitation of reliable risk measure for all risks.

Ex post risk adjustments aim to achieve symmetry between risk outcome and remuneration outcome by linking the size of the bonus pool to the overall performance of the firm, taking

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[143] BCBS, *Range of Methodologies* (n 128) 29.

[144] FSF Principles for Sound Compensation, principle 2.

[145] BCBS, *Range of Methodologies* (n 128) 23.

[146] ibid 29.

account of individual performance and business unit performance and, therefore, not only reducing or diminishing the pay-outs in times of negative performance, but also operating malus and clawback arrangements.[147] Malus refers to the practice of reducing the amount of unpaid vested remuneration, whereas clawback is reclaiming paid remuneration, although some use them interchangeably.[148]

Malus and clawback allow boards to reduce and reclaim vested or paid bonuses. However, the use of these techniques is still relatively rare in practice.[149] Malus and clawback can be supplemented by deferral of remuneration. This deferral should be on a substantial part of the remuneration, such as 40 to 60 per cent (to increase along with the level of seniority and/or responsibility of the employee) with the payment made on a pro rata basis.[150] Deferment of remuneration is a traditional mechanism of retention, as a "bad leaver" will normally lose unpaid deferred remuneration.[151] However, the FSB wants more use of deferral of remuneration for a period of not less than three years (provided the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question) to prevent finalizing the payment of remuneration based on short-term results, as a clearer result of the activities and transactions will be more apparent over time, giving the firm the ability to reduce or eliminate payment.

The BCBS has clarified that in practice, there is a need for a mix of *ex ante* and *ex post* adjustments. For example, bad-tail risk, which is of low frequency but high impact, is difficult to measure *ex ante* which means deferral is better for reducing such risk-taking incentives. On the other hand, deferral may not be fully effective in controlling the incentives for employees who have the ability to expose the firm to long-term risks as such risks are unlikely to be realised during a reasonable deferred period.

The P&S required that variable remuneration represented a substantial part of the remuneration of senior executives and MRTs. This variable remuneration should be decreased or disappear entirely in the event of poor performance. Payment by shares or share-linked

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[147] FSB Implementation Standards, 3.

[148] FSB, 2013 *Progress Report* (n 138) 18.

[149] Ferrarini "Economic, politics and the international principles" (n 109) 466.

[150] FSB Implementation Standards, 3.

[151] Ferrarini "Economic, politics and the international principles" (n 109) 466.

instruments should constitute more than half of the variable remuneration.[152] Shares and share-linked instruments can be a method of implicit risk adjustment as a result of the change in their value during the deferral or retention period.[153]

Guaranteed bonuses, which are commonly used by banks and regarded as harmless and indeed necessary when hiring new staff in the middle of the year, are described as inconsistent with sound risk management or the pay-for-performance principle (as the concerned employee will receive them regardless of performance) and should not be a part of prospective remuneration plans unless used to hire new staff and should be limited to the first year.[154]

The P&S have covered another two important issues related to severance payment and its effect. The FSB wants firms to re-examine termination payments to avoid payment being made in the event of failure which is contrary to prudent risk-taking. The FSB was careful to direct financial firms to instruct their employees not to take out insurance contracts or use personal hedging to undermine the risk alignment effects embedded in their remuneration contracts.[155]

2.3.3.4 The disclosure of remuneration

The technique of using disclosure of remuneration arrangements has been in existence for a long time and was the major focus used by many national regulators as a method of good governance. However, the enforcement of disclosure did not always meet the relevant standards.[156] The P&S incorporated some of the best practice on the disclosure of remuneration, adding to them new disclosure requirements on the risk adjustment, deferral and share based incentive. However, the requirements are very broad[157] which resulted in

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[152] FSB Implementation Standards, 3.

[153] BCBS, *Range of Methodologies* (n 128) 23.

[154] FSB Implementation Standards, 4.

[155] ibid 4.

[156] Ferrarini "Economic, politics and the international principles" (n 109) 468.

[157] Y Hausmann and E Bechtold-Orth, "Changing remuneration system in Europe and the United States: a legal analysis of recent developments in the wake of the financial crisis" (2010) 11(2) *European Business Organization Law Review* 195, 224.

divergence in implementation between jurisdictions which will negatively affect disclosure.[158]

This led the FSB to recommend detailed disclosure requirements aimed at promoting convergence and uniformity between different jurisdictions to be incorporated into Pillar Three of Basel II/III. The BCBS published a document specifying the qualitative and quantitative disclosures which is believed to "allow market participants to assess the quality of the compensation practices and the quality of support for a firm's strategy and risk posture."[159] The BCBS acknowledges that the requirements will not be relevant to all banks or in relation to all of their business due to the concepts of materiality and proportionality (which already apply to existing Pillar Three disclosure). So some banks will be fully or partially exempt depending on their risk profile or certain requirements may be exempted on the basis that the information is immaterial, proprietary or confidential.[160] Subsequently, the FSB in its second progress report in 2013 stated that disclosure practices had improved as reported by most jurisdictions.

2.3.3.5 The oversight and supervision of remuneration practices

The P&S have emphasized the importance of supervisors' oversight and assessment of firms' remuneration practices against sound practice in their respective jurisdiction. This oversight should be even closer in the event of exceptional government intervention and should include scrutiny, review and approval of remuneration structure.[161] The onus is on financial firms to demonstrate that their remuneration policy is sound and takes into account an appropriate consideration of risk, capital, liquidity and the likelihood and timeliness of earnings.[162] However, failure to do so should trigger and result in:

> *Prompt remedial action and, if necessary, appropriate corrective measures to offset any additional risk that may result from non-compliance or partial*

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[158] *Pillar 3 disclosure requirements.*

[159] ibid.

[160] ibid.

[161] FSB Implementation Standards, 4 and 5.

[162] ibid 5.

compliance, such as provided for under national supervisory frameworks or Pillar 2 of the Basel II capital framework.[163]

However, "supervisors should first exercise suasion on the affected firm, and in the absence of necessary improvement should consider escalation to firmer intervention, which may include increased capital requirements."[164]

2.3.3.6 The assessment of the FSB principles by Ferrarini and Ungureanu

Ferrarini and Ungureanu have assessed aspects of the P&S. They state that the P&S have incorporated some of the traditional corporate governance standards such as the setting of remuneration for executives needing board approval and supervision as part of the board's responsibilities regarding a strategic and supervisory role. The P&S have reflected post-crisis concerns regarding risk management and the alignment of remuneration with prudent risk-taking. Achieving this is recommended by requiring the remuneration committee to work closely with the risk committee to ensure compliance and conformity with the relevant requirement of aligning remuneration with prudent risk-taking.[165]

Ferrarini and Ungureanu state that to a large extent the P&S reflect the best practices which could already be found before the crisis in regard to the role and limits of equity-based remuneration and the effects of short-term incentives which have witnessed increased attention in the last 20 years, especially after Enron in 2001 and other accounting scandals which occurred at the beginning of this century. However, the difference is that before the financial crisis the focus was always on the alignment of executive remuneration with shareholder interests, whereas the P&S have incorporated new development[166] regarding the alignment of executive remuneration with prudent risk-taking.[167]

Even though the principles should be seen as flexible enough to accommodate differences between firms and managers within the same firm, the specification in the standards of the

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[163] ibid.

[164] FSF Principles for Sound Compensation, 14.

[165] FSB Implementation Standards, 2.

[166] In their opinion, aligning remuneration with prudent risk-taking as well as using equity in the remuneration plans and designing these to include long-term incentives were not new, as they had already been discussed in the literature and reflect some of the pre-crisis best practice.

[167] Ferrarini "Economic, politics and the international principles" (n 109) 470.

portion of equity in the variable remuneration as guidance can be problematic as it does not take any account of an executive's actual holding.[168] This can cause problems in the event of large holdings as "[s]tock-based compensation could 'exacerbate' the incentive alignment problems" as observed in the case of US banks.[169] They also note the fact that the P&S do not give detailed requirements for vesting stock options and stock grants. As a result the vesting can be easily conditional on the lapse of time.

However, even if the P&S fundamentally lack originality and innovation, as argued by Ferrarini and Ungureanu, the fact remains that upgrading best practice, which is not widespread, into a form of "soft law" as international regulation is a significant achievement.[170] However, this international achievement was the result of political aspiration, as no country can afford the side effects of a unilateral movement to regulate and impose control over remuneration practices, as this would cause the country to lose talented people to other financial centres given that markets are global, facilitating high mobility. Thus the P&S was also intended to solve the collective action problem.

2.4 Conclusion

An overview of the current situation regarding remuneration in the financial services sector was provided in this opening chapter which began, in section one, by analysing the components which make up remuneration; for although each of these components has its own function, some are not clearly linked to improving company performance or shareholder value. Incentive-based remuneration which links pay to performance can be an effective tool for aligning the diverse interests of managers and shareholders. Short-term incentives can encourage managers to fulfil specific short-term goals, whereas long-term incentives are used to motivate managers to achieve long-term objectives. Equity-based incentives are believed to be the best way of aligning diverse interests by linking executives to company performance in a way that means they may gain or lose as shareholders do, and also help to retain talented executives in a company while they wait for their equity to be vested. Golden hellos used to

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[168] G Ferrarini, "Bankers' compensation and prudential supervision: the international principles" in: RS Thomas and JG Hill (eds), *Research Handbook on Executive Pay*, (Edward Elgar, Cheltenham 2012) 133.

[169] Ferrarini "Economic, politics and the international principles" (n 109) 472.

[170] Ferran (n 115) 15.

compensate executives who forfeit remuneration from their previous firm, are a poor remuneration tool from a long-term perspective. Golden parachutes, may also encourage executives to acquire a better deal for shareholders. Golden handshakes are employed to eliminate the reluctance that directors may feel when firing the CEO. However, payments of this type need to be investigated further, as they may prove to be counter-productive components of remuneration packages, especially in the case of excessive payment. Thus, when a company is structuring a remuneration policy, it needs firstly to set its goals and objectives and specify how these are to be measured, and then design a remuneration policy which will achieve those ends.

Section two discussed how economists have attempted to explain and justify the need for such high executive remuneration, focusing on the two main theories: optimal contracting theory and managerial power theory. The former sees the incentives created by remuneration as a remedy to the agency problem between executives and shareholders, whilst the latter views it as part of the agency problem as executives can extract the rent they want. Optimal contracting theory has been further refined into five sub-theories, all of which were also briefly explored.

The third section discussed the reform of remuneration practices in financial institutions at the international level, led by the FSB, which developed the P&S. Applying risk-adjusted methods to the bonus pool, the P&S focus on aligning remuneration with prudent risk-taking by exposing employees to the negative side of their actions as they might lose some or all of the deferred part of their remuneration. The Principles have recommended measures to ensure a more effective supervisory role by national authorities, boards of directors and other stakeholders. In order to facilitate stakeholder scrutiny of remuneration practices, the P&S have recommended disclosure to make relevant information available to them, and the Basel Committee has published guidelines specifying the minimum information necessary. It is also working with the FSB to inform national regulators and financial institutions how to apply the P&S. The FSB is also involved in ongoing monitoring of the progress of implementation of the P&S in its member states to ensure that international reform will prevent future crises.

Chapter 3 Laws and Regulations Related to Remuneration Practices in the UK: Part One: Corporate Law and Corporate Governance Perspectives

3.1 Introduction

Share options began to be commonly used in the UK during the 1980s.[1] In the 1990s, there were shareholder, public and political concerns about large pay increases, large gains from share options, and the amount of payment being made to some departing directors particularly in the then recently privatised utility industries. What gave these increases a bad image and a hostile reception by the public was that in some cases these were accompanied by staff reductions, pay restraints for other staff and price increases.[2] In response, the Confederation of British Industry (CBI) set up the Greenbury Committee with a remit to identify good practice in determining directors' remuneration and to prepare a code of practice for the UK. The recommendations have since then become part of the series of the combined codes which became the UK Corporate Governance Code in 2010. Kershaw maintains that the guidance that presented in the Greenbury Report which became part of the Corporate Governance Code has resulted in a notable change in terms of the significant increase in the use of long-term incentive plans which provide for share grants upon hitting performance targets, mostly related to EPS and relative total shareholder return and decrease in share options.[3] Kershaw has also attributed remuneration problems over the past 20 years to the fact that overall remuneration has increased at a far higher rate than the increase in the remuneration for other employees. For example, executive pay in the UK has been growing and the gap between executive remuneration and average employee income is widening. The average pay of a Financial Times Stock Exchange (FTSE) 100 CEO increased from £1

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[1] D Kershaw, *Company Law in* Context: Text and Materials (2nd edn, Oxford University Press, Oxford 2012) 284.

[2] Confederation of British Industry, "Directors' Remuneration" (17 July 1995) C2 (Greenbury Report),1.6-1.7.

[3] Kershaw (n 1) 285.

million in 1998 to £4.2 million in 2010.[4] In the period from 1999 to 2010 the average annual increase in FTSE-100 CEO remuneration was 13.6 per cent, although the link between pay and performance is not immediately apparent. CEO pay was 59 times higher than the average pay of a FTSE-100 employee in 1999. This gap rose to its highest level in 2007, some 151 times greater, then declined after the crisis to 115 times in 2009, before starting to rise again to its highest level in 2010 at 120 times more than the average employee's earnings.[5]

The way that the UK is tackling the problem is somewhat similar to the USA by solving the conflict of interests in setting remuneration levels and structure and reaching a fair decision. Therefore, the main tools of corporate governance that are being employed to empower shareholder and expose the practice to the markets. This is clear from the announcement by the Secretary of State for Business, in January 2012, that the government would present a package of measures aimed at addressing failings in the governance framework for director remuneration which would empower shareholders and promote their engagement by means of voting rights; provide greater transparency in director remuneration reports; and facilitate cooperation with investors and business to promote best practice in pay setting.[6] The UK also introduced some specific tools in the Companies Act 2006, the Listing Rules and the UK Corporate Governance Code to help decision makers reach a fair and competitive form and level of remuneration.

It is also important when analysing this issue to take account of the court's position in dealing with shareholder claims against the plans and payment of remuneration. This chapter represents the first part of the discussion of the regulation of remuneration in the UK. It will discuss the issue from corporate law and corporate governance perspectives. The next chapter will discuss incentive-based remuneration in the banking sector.

3.2 Common Law and Remuneration Setting and Practices

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[4] See: Department for Business, Innovation and Skills, *A long-term focus for corporate Britain* (BIS/10/1225) 26; Department for Business, Innovation and Skills, *Executive Remuneration: Discussion Paper* (BIS/11/1287) 8-11.

[5] ibid 26.

[6] Department for Business, Innovation and Skills, *Executive Pay: Shareholder Voting Rights Consultation on enhanced shareholder voting rights: Summary of responses* (BIS/12/918).

A director's remuneration comes from two sources: fees paid for acting as a director and other money and benefits given to them under the service contract as an executive.[7] In the case of the former, a director, based on the trust origin of the company, is not entitled to be remunerated for any services performed for them "as a fiduciary is not entitled to profit from his position"[8] unless it is provided in the articles or a resolution of the company makes provision for such payment.[9] The Court of Appeal stated that

> *A director is not a servant. He is a person who is doing business for the company, but not upon ordinary terms. It is not implied from the mere fact that he is a director that he is to have a right to be paid for it. […] but in some companies, there is a special provision for the way in which the directors should be paid; in others there is not. If there is a special provision for the way in which they are to be paid, you must look to the special provision to see how to deal with it. But if there is no special provision their payment is in the nature of a gratuity.*[10]

This was also affirmed by the Supreme Court (previously the House of Lords) in *Guinness plc v Saunders*.

Unlike the situation in the USA where the board has the authority to set remuneration by virtue of their company law,[11] the directors of a UK company, have no authority to pay themselves from the company's assets unless they are authorised "by the instrument which regulates the company, or by the shareholders at a properly convened meeting."[12] However, if the board is authorised to do so, then it cannot delegate this authority to some of its members or to a committee unless it is authorised.[13]

Executive directors typically have a service contract with the company covering matters related to their remuneration signed by the board of directors which has the power to sign such contracts by the article of association.[14] But in the absence of a service contract and

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[7] P Davies and S Worthington, *Principles of Modern Company Law* (Sweet and Maxwell, London 2012) 400.

[8] *Guinness plc v Saunders* [1990] 2 AC 663, 667.

[9] ibid.

[10] *Hutton v West Cork Railway Co* (1883) 23 ChD 654, 672.

[11] See section 6.2.

[12] *Re George Newman and Co* [1895] 1 Ch 674.

[13] *Guinness* (n 8) 667.

[14] B Hannigan, *Company Law* (3rd edn, Oxford University Press, Oxford 2012) 149.

determination of remuneration, an executive cannot rely on the articles as constituting a contract between him and the company. Instead, the executive may be able to pursue a claim for reasonable remuneration on a *quantum meruit* basis for service accepted by the company.[15] It is difficult for a director to bring a claim on a *quantum meruit* or an equitable allowance as seen in *Guinness*, however, as holding office by a director does not make the director an employee of the company.[16]

In practice, such problems are very rare, as it is usual for the board of directors of public companies, to have the right to be remunerated in accordance with the model articles of association for private and public companies.[17]

Deciding non-executive director fees and executive director remuneration places directors in a situation of conflict of interest. A director has the duty to avoid conflict of interest; however, self-dealing is excluded from this duty.[18] Setting director remuneration is a situation in which a director enters into an agreement with the company, which is referred to as self-dealing. Under the common law default rules, such contracts were void[19] unless shareholder approval was obtained.[20] This default rule for directors' fees was given under the 1985 model articles.[21] The Companies Act 2006 altered this rule, changing the default rule to mere disclosure to the board under section 177 and disabling any common law rule or equitable principles requiring shareholder approval unless provided for in the company constitution.[22] The current model articles of association authorise directors to determine their own remuneration for their services to the company and to pay any reasonable expenses that they may incur in exercising their power and discharging their duties to the company. This could be interpreted to mean that a company is able to allow interested directors to vote on

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[15] *Craven-Ellis v Canons Ltd* [1936] 2 K.B. 403, CA.

[16] D French, S Mayson and C Ryan, *Mayson, French and Ryan on Company Law* (28th edn, Oxford University Press, Oxford 2011) 462.

[17] For private companies, see articles 19 and 20; for public companies, see articles 23 and 24.

[18] Companies Act 2006, section 175(3).

[19] *Aberdeen Railway v Blaikie Brothers* (1854) Macq. HL 461.

[20] See: Kershaw (n 1) 485-89.

[21] Davies (n 7) 401.

[22] Companies Act 2006, section 180(1)(b).

transactions in which they have a vested interest following disclosure.[23] So, unlike the US, there is no clear role for disinterested directors in approving self-interest transactions.[24] However, the model articles of association for both private companies limited by shares and public companies provide a mechanism to prevent interested directors from participating in the decision-making of a self-interest transaction, namely, not counting their votes.[25] However, companies are not obliged to adopt the model article of association.[26] It has become common practice for UK public companies to establish an independent remuneration committee to decide the matter and the model article of association, allowing directors to delegate any of the powers conferred on them under the articles to a committee.[27]

When payment of remuneration is made upon valid authorisation, the court will not inquire into the details of the director's remuneration awarded provided that the payments are genuinely director's remuneration received as "consideration for work done or to be done."[28] The court held that:

> *Where payments were made to a director in pursuance of a company's powers so to do, the competence to award such payments depended on whether they were genuinely director's remuneration and not a disguised capital gift. The court would not inquire as to whether they were reasonable.*[29]

Therefore, the reasonableness test which is usually used by the courts is not applicable in cases related to remuneration. Hence, the court must be satisfied that the payment is real remuneration and not a sham transaction masking an improper return of capital.[30] In times of financial difficulties, however, excessive remuneration payment may be relied on as evidence of unfitness in disqualification proceedings[31] and paying more than companies can afford shows the inability of the board to fix affordable salaries.[32] Excessive remuneration may also

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[23] Kershaw (n 1) 494.

[24] See section 6.2.

[25] For private companies, see article 14; for public companies, see article 16.

[26] Companies Act 2006, section 19.

[27] The Public Companies Model Articles, article 5.

[28] *Currencies Direct Ltd v Ellis* [2002] 2 BCLC 482.

[29] *Re Halt Garage* (1964) Ltd [1982] 3 All ER 1016.

[30] Hannigan (n 14) 150.

[31] *Re Grayan Building Services Ltd. (In Liquidation)* [1995] Ch. 241.

[32] French (n 16) 462.

be challenged by the liquidator[33] or when it is set by the only director according to his or her own interests, as in this case, shareholders can apply to the court for relief from unfairly prejudicial conduct under section 994 of the Companies Act 2006.

This was emphasised in *Maidment v Attwood*.[34] In this case, the majority shareholder, who was the only director of the company, was found to have set excessive remuneration compared to the profitability of the company and its ability to pay such remuneration; accordingly, the remuneration was fixed by him in reference to his own personal interests[35] which is in contradiction to the director's duty to act *bona fide* in the interest of the company. However, the judge, at first instance, held against the only minority shareholder on the ground that such remuneration was declared in the company's accounts and since the minority shareholder did not examine such accounts the action did not constitute unfair prejudice. The Court of Appeal found, however, that the judge's approach at first instance could be interpreted as meaning that there is a danger of minority shareholders losing their rights if they do not read the company's filed accounts which is not consistent with the statutory provisions.[36]

There are not as many cases challenging directors and executive remuneration in the UK as in the US. The reason is likely to be that remuneration in the UK is not as excessive as in the US. When directors decide on their remuneration through the board or a separate committee, they are bound by their duties, particularly the duties to exercise reasonable care, skill and diligence and to promote the success of the company. However, similarly, although different in approach to the well-established US business judgement rule[37] the UK court affirmed that:

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[33] Insolvency Act 1986, section 212.

[34] [2013] BCC 98.

[35] ibid.

[36] C Gannon, "Excessive director's remuneration could amount to unfairly prejudicial conduct" (2012) Available at: <http://www.gannons.co.uk/blog/excessive-director-remuneration-could-amount-to-unfairly-prejudicial-conduct/> accessed 16 April 2013; Company Law Newsletter, "Case Comment: Excessive director's remuneration was unfairly prejudicial although declared in accounts" (2012) 321 *Company Law Newsletter* 7-8.

[37] It should be noted that the Law Commissions refused to introduce a statutory business judgement rule similar to that in the USA as it was felt to be unnecessary in light of the approach taking by courts in dealing with management matters. For more information see: Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of interest and Formulating a Statement of Duties,* (Law COM No 261, 1999) part 5.

> *It would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, on such a question, if bona fide is arrived at.*[38]

3.3 The general approach to regulating remuneration practices

Common Law has little, if any, solution to offer to the problem of making decisions on remuneration and the court will respect a decision made in good faith.[39] However, potential shareholders may refrain from financing companies unless there are sufficient mechanisms to prevent the exploitation of the project and its resources for management interest. Therefore, the reform of remuneration practice in the UK has attempted to prevent managers from intervening in the setting of their remuneration in order to reach a remuneration level and structure at arm's length, which reflects the market value of that manager. These regulations are embedded in the process of establishing remuneration, as the following diagram shows, and will be discussed next.

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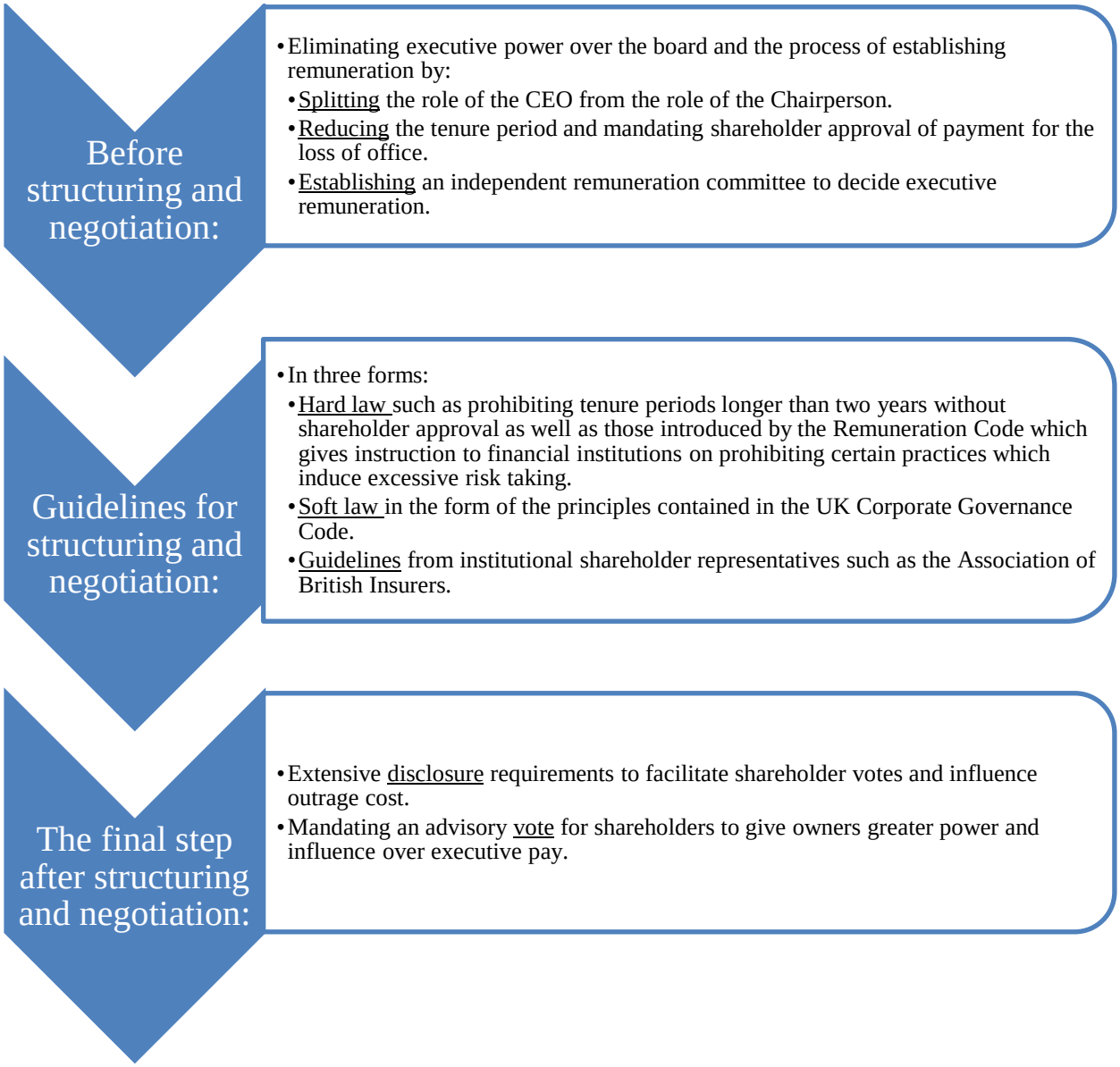
[38] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] A.C. 821, 832.

[39] ibid.



3.3.1 Before Structuring and negotiation

The Splitting, Reducing, and Establishing approach is used in the UK to ensure that managers are not part of the decision-making process and that the process will be carried out by an independent committee that has shareholder interest in their mind.

3.3.1.1 Splitting

Splitting refers to the separation of the leadership of the board and the leadership of the company. The Cadbury Report noted a need to maintain a balance of power and a division of responsibilities at the head of a firm and, subsequently recommended the separation between the role of the chairperson and the role of the CEO to avoid granting any one person a

considerable concentration of power[40] and to enable each of them to concentrate on their own affairs: the CEO running the firm and the chairperson running the board and ensuring its effectiveness.[41] Accordingly, this recommendation has been in the Corporate Governance Code since then, aiming to improve board independence through a clear separation and structuring of the leadership of the board from the leadership of the company. Therefore, this separation was seen to contribute to the board's effectiveness and independence, while in the USA this separation was not widely supported and instead a majority non-executive board was established as the norm to achieve independence and effectiveness for the board. In contrast, public companies in the UK usually have a unitary board, which like their US counterparts, is composed of executive and non-executive directors, among them the chairperson, the chief executive officer, and the senior independent director with an appropriate combination of executive and non-executive directors, which means in practice that the numbers should be similar; otherwise, the presence of the larger group will dominate the board.

A particular emphasis has been given in the Corporate Governance Code to the independence of the non-executive directors.[42] This recommendation has its origin in the Higgs Review, which recommended that half the board members, excluding the chairperson, should be independent non-executive directors.[43] However, Sir David Walker criticised this and the criterion of independence on the grounds that independence can sometimes conflict with the financial experience that is required from the directors of banks and other financial institutions (e.g. former CEOs and non-executives who serve more than nine years), which might force them to increase the board size in order to maintain a balance.[44]

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[40] Financial Reporting Council and London Stock Exchange, "Cadbury Report (The financial aspects of corporate governance)" (1 December 1992) para 4.9, (Cadbury Report).

[41] SW Holden, "Improving Board Effectiveness" (2010) 23(11) *Company Secretary's Review* 86, 87.

[42] Financial Reporting Council, *The UK Corporate Governance Code*, (September 2014) principle B.1.2, (UK Corporate Governance Code).

[43] Department of Trade and Industry, "Review of the role and effectiveness of non-executive directors" (2003), (Higgs Review).

[44] D Walker, "A review of corporate governance in UK banks and other financial industry entities: final recommendations" (November, 2009) para 3.3 (Walker Review).

However, some scholars have argued against the separation on the grounds that the presence of two leaders can lead to conflict and "a dynamic enterprise needs just one leader".[45] In addition, the independence of a board is doubted, as it has been said that directors of public companies are chosen through "the old school tie" approach, which means that existing directors select new directors to make sure they are like-minded people; they are then routinely approved by shareholders.[46] However, this kind of board "does not work and is even dangerous".[47] Others have asserted that even if non-executive directors were independent in their early days of taking a position on the board, this independence will not last.[48] The lack of independence has also been attributed to conflicts of interest in the boardroom, as independent non-executive directors depend on senior executives to provide them with the information needed to make informed decisions. Senior executives might not provide them with the information or might not provide information of the quality required to make informed decisions, as senior executives want the board to be loyal to them and approve their proposals, particularly if they have private interests.[49]

It was also argued that the emphasis on independent directors would not result in optimum performance,[50] which has been confirmed by the financial crisis of 2007-09, as many financial institutions chose independent directors who had little relevant management experience to meet the independence criterion.[51]

3.3.1.2 Reducing

Reducing directors' tenure period is sought to achieve easier termination for underperforming directors by the board without the fear of paying huge termination compensation. The

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[45] B Tricker, *Corporate Governance, Principles, Policies and Practices* (Oxford University Press, Oxford 2009) 58.

[46] ibid 57.

[47] VD Berghe and A Levrau, "Evaluation Boards of Directors: What constitutes a good corporate Board?" (2004) 12 (4) *Corporate Governance: An International Review* 461, 466.

[48] D Dalton and others, "The Fundamental Agency Problem and Its Mitigation" in JF Walsh, *Academy of Management Annals* (2007) 1, 8.

[49] H Mertzanis, "The financial crisis and corporate governance reform" (2011) 6(1) *International Journal of Business Governance and Ethics* 83, 86.

[50] KR Rebeiz, "The two dimensions of corporate governance independence" in M Hirschey and others (eds) *Corporate Governance (Advanced Financial Economics)* (Emerald Group Publishing, Bingley 2005) 11.

[51] Mertzanis (n 49) 86.

Cadbury Report recommended a change to the Companies Act 1985, in line with its recommendation that directors' contracts were not to exceed three years[52] without shareholder approval.[53] This recommendation is intended to restrict director ability to award themselves long-term contracts containing provisions which make it difficult and expensive for firms to terminate under-performing directors.[54] The Companies Act 2006 has, ultimately, reduced this period of a guaranteed term of appointment to two years without shareholder approval.[55] However, the UK Corporate Governance Code has gone even further by recommending that companies set the maximum guaranteed term or notice period to one year;[56] and even if the board offers a longer period for new directors, this should be reduced to one year or less afterwards.[57] As a result, the Listing Rules also require the board to provide the shareholders with:

> *details of the unexpired term of any director's service contract of a director proposed for election or re-election at the forthcoming annual general meeting, and, if any director proposed for election or re-election does not have a directors' service contract, a statement to that effect.*[58]

Moreover, the UK Corporate Governance Code urges the remuneration committee to consider carefully the compensation commitments that directors will be entitled to in the case of early termination with a view to avoiding rewarding poor performance.[59]

The reform in this area was successful in reducing director tenure and the level of compensation for early termination,[60] as setting directors' contracts at a one-year period has become standard practice among companies.[61] The relationship between the reduction of

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[52] The period was five years under the Companies Act 1985, section 319.

[53] Cadbury Report (n 40) para 4.41.

[54] A Calder, *Corporate Governance: A Practical Guide to the Legal Frameworks and International Codes of Practice* (Kogan Page, London 2008) 79.

[55] The Companies Act 2006, section 188.

[56] This was first recommended by the Greenbury Report (n 2) para.7.13.

[57] UK Corporate Governance Code (n 42) provision D.1.5.

[58] Listing Rules section 9.8.8.

[59] UK Corporate Governance Code (n 42) provision D.1.4.

[60] S Thompson, "The Impact of Corporate governance Reforms on the Remuneration of Executive in the UK" (2005) 13(1) *Corporate Governance* 19.

[61] HC Hirt, "Regulation of directors' remuneration: the German approach, the DTI's consultation paper and the way forward" (2004) 15(5) *International Company and Commercial Law Review* 154, 159.

contract or notice period and short-term practices building up to the 2007-09 financial crisis is not totally clear. It appears that reducing the contract or notice period will put executives under pressure to improve the firm's situation over a short period of time to secure their position. This will, in turn, lead them to focus on short-term strategy and results, and also allow them to cash in their variable remuneration on a short-term basis if they are asked to leave office. Thus, it was argued that management tenure should be lengthened and this should be subject to safeguards against incompetence.[62]

However, it appears that this opinion was built on the assumption that directors would not be allowed to serve for a long time. The reform was intended to reduce the guaranteed term or notice period to allow the board and shareholders to terminate under-performing directors without paying a high level of compensation for the dismissal. In addition, lengthening executive contracts will bring practical difficulties with regard to what would amount to incompetence and fair dismissal and could increase the number of litigations, harming shareholder interests.

This reduction of the length of contract was also expected to increase the level of remuneration (as directors would demand higher remuneration to protect themselves against small compensation in the case of early termination).[63] It has been stated that in spite of the reduction in contract or notice period and the requirement of shareholder approval for termination payment, there are still examples of huge payments being made to outgoing directors[64] as a result of the exemption provided under section 220 of the Companies Act 2006, which includes payment in lieu of notice made as part of the director's contract, damages paid for breach of contract and payments which arise pursuant to discretions in bonus or LTIP plans, which do not need the approval of shareholders.

Therefore, the government consulted on how to introduce new regulation which would give shareholders a binding vote on any exit payment exceeding the equivalent of one year's base

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[62] A Sykes, "Overcoming Poor Value Executive Remuneration: resolving the manifest conflicts of interest" (2002) 10(4) *Corporate Governance: An International Review* 256, 259.

[63] Company Lawyer, "DTI consults over compensation for termination of directors' contracts" (2003) 24(9) *Company Lawyer* 271.

[64] BIS/11/1287 (n 4) 22.

salary.[65] However, statutory compensation for unfair dismissal, redundancy or discrimination claims, whether decided by an Employment Tribunal or agreed *bona fide* on termination between the company and director, were to be excluded from the proposed role.[66] This proposal raised considerable concern among businesses because voting will be required in almost all cases which will restrict a company's ability to differentiate between good and bad leavers. Moreover, it has the potential effect of raising base pay and discouraging the use of long-term incentives, resulting in a short-term focus pay setting.[67]

Instead, the Australasian model for exit payments was supported, as this obliges companies to set out their policy for exit payments in the remuneration policy and seek shareholder approval, meaning that a shareholder vote is only needed if the company intends to make exit payments which are greater than company policy permits. Therefore, in a subsequent publication, the Department for Business, Innovation and Skills (BIS) clarified that it intends to include the company approach to exit payment as part of the new remuneration policy[68] which will have shareholder approval through the new binding vote.[69] Once shareholders approve the policy, the company will be bound to make the exit payment in accordance with the policy and publish a statement explaining what the director receives, as well as detailing this in the implementation report.[70] However, it is predicted that companies will try to adopt a broad exit payment policy to retain flexibility in setting the payment.[71]

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[65] Department for Business, Innovation and Skills, *Executive Pay: Shareholder Voting Rights Consultation* (BIS/12/639).

[66] Norton Rose Fulbright, "Executive Remuneration: consultation on voting rights for shareholders" (March 2012) Available at: <http://www.nortonrosefulbright.com/knowledge/publications/64642/executive-remuneration-consultation-on-voting-rights-for-shareholders> accessed 20 March 2014.

[67] BIS/12/918 (n 6).

[68] Department for Business, Innovation and Skills, *Consultation on revised remuneration reporting regulations* (BIS/12/888).

[69] The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, SI 2013/1981, sections 36&37.

[70] Norton Rose Fulbright, "Executive Remuneration: Reforms announced by the government" (June 2012) available at <http://www.nortonrosefulbright.com/knowledge/publications/68047/executive-remuneration-reforms-announced-by-the-government> accessed 16 April 2014.

[71] Norton Rose Fulbright, "Executive Remuneration: Draft legislation published" (July 2012) available at <http://www.nortonrosefulbright.com/knowledge/publications/69044/executive-remuneration-draft-legislation-published> accessed 16 April 2014.

3.3.1.3 Establishing

3.3.1.3.1 The role of the committee

An important tool for eliminating executive power over the remuneration process is the formal and transparent procedure for setting the remuneration package. This is usually interpreted as the establishment of a remuneration committee.[72] As recommended by the Cadbury Report.[73] Therefore, the board will normally establish a remuneration committee and delegate the setting of the remuneration for executives to that committee but the board will still be responsible for the remuneration of the non-executives and other senior managers and the general remuneration policy. However, the Greenbury Report came to the conclusion that a company's broad policy for setting executive packages is the responsibility of the remuneration committee on behalf of the board and shareholders,[74] whilst the Hampel Report asserted that remuneration policy or remuneration packages should be for the whole board to decide and the remuneration committee should only advise the board on this matter.[75]

This difference of opinion is highlighted in the fact that the UK Corporate Governance Code agrees with the Hampel Report,[76] whereas the Walker Review agrees with the Greenbury Report. Indeed, the Walker Review has gone further, than the Greenbury Report, by recommending the extension of the terms of reference of the remuneration committee to include all "high-end" employees,[77] to enable the remuneration committee to focus properly on the risk dimension relevant to performance conditions, as some highly-paid employees can have an influence on the direction and risk profile of a firm.

According to the UK Corporate Governance Code, the remuneration committee's main role is to provide formal and transparent procedures for developing policy on executive

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[72] CA Mallin, *Corporate Governance* (4th edn, OUP, Oxford 2013).

[73] Cadbury Report (n 40) para 4.42.

[74] Greenbury Report (n 2) para 4.4.

[75] The London Stock Exchange and others, "Committee on Corporate Governance (Hampel Report)" (January 1998) para 4.12.

[76] UK Corporate Governance Code (n 42) para D.2.2.

[77] High-end employees were defined by the review to include those who perform a "significant influence function" for the entity or those whose activities have or could have "a material impact on the risk profile of the entity".

remuneration and setting the remuneration packages for individual directors.[78] Therefore, the Cadbury Report, upon noting the shareholders' need for the remuneration of directors to be "fair and competitive",[79] recommended that this should be decided by a committee whose members had no interest in the outcome to enable them to keep shareholder interests in mind when deciding the remuneration of executives.

Thus, a remuneration committee is formed by the board to consider the issue of executive remuneration in greater detail and to solve the conflict of interests that may arise when the board deals with the matter directly. It is also intended to prevent directors from designing their own remuneration by appointing independent non-executive directors to represent shareholders and align executive remuneration with company performance.

The duties of a remuneration committee should be clearly set out in its terms of reference and should include the following: determining the remuneration policy of the firm, setting the targets for performance-based remuneration, determining the remuneration of individual directors, including the pension entitlement and termination payment, appointing an external remuneration consultant if needed, and making sure that the Directors Remuneration Report (DRR) is produced in accordance with the regulations.[80]

The main objective which a remuneration committee should pursue is linking pay to individual and company performance from a long-term perspective. However, the recent financial crisis revealed many shortcomings in remuneration practices, particularly in banks, which attracted greater regulation and scrutiny by the regulators. This new regulation represents a new challenge to remuneration committees. For example, a remuneration committee needs to balance performance with sound risk management when deciding executive remuneration and considering long-term objectives and strategies. Striking the right balance between short-term reward, long-term reward and prudent risk-taking will be a challenging task. Although the UK Corporate Governance Code has provided remuneration committees with help and support,[81] the Code does not suggest any long-term measures that could be used by firms. The Financial Conduct Authority (FCA) and the Prudential

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[78] UK Corporate Governance Code (n 42) para D.2.

[79] Cadbury Report (n 40) para 4.44.

[80] GD Morris and P Dunne, *Non-Executive Director's Handbook* (2nd edn, Elsevier, Oxford 2008) 505-07.

[81] See sections 3.3.1.3.3 and 3.3.2.

Regulatory Authority (PRA) Remuneration Codes[82] have provided remuneration committees with support and guidance in relation to adjusting remuneration policy with prudent risk-taking**.**

3.3.1.3.2 The composition of the committee

The Cadbury Report was the first to recommend the establishment of remuneration committees consisting wholly or mainly of non-executive directors to decide the remuneration of executives. [83] The Greenbury Report[84] and the Hampel Report[85] endorsed and extended the Cadbury Report recommendation on the establishment of remuneration committees and required that all their members should be independent non-executive directors who had no interest in the outcome of the committee and were free from any conflict of interests arising from cross-directorship or the running of the business. The remuneration committee should consist of at least three or, in the case of smaller companies, two, independent non-executive directors[86] who have a sound knowledge of the company and have no personal interest in the outcome, to enable them to keep shareholder interests in mind when they are deciding on the remuneration of executives.[87] A Chairperson who was considered independent on appointment to the Board of Directors can only be a member of the remuneration committee but cannot act as its chair.[88]

Although the BIS asked for views on including an employee representative on the remuneration committee in 2011, it was not convinced that this was suitable for UK companies.[89] This led to the publication of the Executive Pay and Remuneration Bill 2013-2014 (on 6 September 2013) following its presentation in the House of Commons as a Private Members' Bill. The Bill proposed that at least one place on the remuneration committee of a

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[82] SYSC, 19A.

[83] Cadbury Report (n 40) para 4.42.

[84] Greenbury Report (n 2) section A4.

[85] Hampel Report (n 75).

[86] UK Corporate Governance Code (n 42) provision D.2.1.

[87] S Shekh, "The Greenbury Report: fond hope, faint promise?" (1995) *Journal of International Banking Law* 10(11) 471, 474.

[88] UK Corporate Governance Code (n 42) provision D.2.1.

[89] BIS/11/1287 (n 4) 28.

public company should be reserved for a representative of the employees of the company. The company would have determined whether this individual would have had a vote on the committee. However, the Bill failed to complete its passage through Parliament before the end of the session and did not make any further progress.[90]

3.3.1.3.2.1 The purpose of non-executive directors

Non-executive directors are the cornerstone of modern corporate governance. Spira and Bender[91] provided a brief review of the emergence and development of the role of non-executive directors. They state, with reference to another paper co-authored by Spira in 2002,[92] that the earliest appointment of non-executive directors to corporate boards in the UK was in the late nineteenth century, to perform professional tasks and give expert advice in areas related to accountancy and law. It was also the custom to appoint family members of a company's founders and people with useful connections and good reputations who could enhance the company's business.[93] Non-executive director posts could be used to dismiss an executive director.[94]

However, the dispersed ownership and increased complexity of business, which make it difficult for individual shareholders to hold management to account, have contributed to the development of the need for non-executive directors to represent shareholder interests and influence the role of the board in monitoring executives and solving the agency problem. Non-executive directors are expected "to bring wider experience and a fresh perspective to the boardroom".[95] They can also counterbalance the board by not allowing the executive

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[90] Executive Pay and Remuneration Deb (Bill 105) 6 September 2013.

[91] LF Spira and R Bender, "Compare and Contrast: perspectives on board committees" (2004) 12(4) *Corporate Governance* 489, 490.

[92] JA Slinn and LF Spira, "A Jolly Good Lunch: the Evolution of the Role of the Non-Executive Director in the UK" (2006), Oxford Brookes University Business School GARG Research Paper 02/006.

[93] Spira (n 91) 490.

[94] M Sweeney-Baird, "The role of non-executive director in modern corporate governance" (2006) 27(3) *Company Lawyer* 67, 70.

[95] Higgs Review (n 43) para 9.1.

directors to dominate the board and have unfettered power. In the US, non-executive directors can also be appointed to the board to represent certain individual stakeholder interests.[96]

The non-executive director's role in corporate governance has two main dimensions. The first dimension involves monitoring the firm's performance, in the following areas: executive strategy implementation; legal and ethical performance; veracity and adequacy of the financial and other company information provided to investors and other stakeholders; taking responsibility for appointing, evaluating and where necessary, removing senior management; and succession planning for top management positions.[97] The second dimension is their contribution to the overall leadership and development of the company,[98] which involves providing advice and direction to the company's management in the development and evaluation of its strategy and fulfilling their duties in relation to the board's committees.

Therefore, prior to the financial crisis of 2007-09, assessing the independence of a non-executive director had become an important element, if not the most important element, in assessing the suitability of non-executive directors. This was due to the recommendation by Cadbury that non-executive directors should be expected to bring "independent judgment" to the board.[99] As has been noted, solving a conflict of interests between executives and shareholders when dealing with certain issues in the boardroom, such as those related to executive remuneration and audit, or supervising management, has highlighted the need for independent directors. Moreover, independent directors could bring a wider, fresher and more objective perspective into the boardroom and review matters from entirely different angles.[100]

Therefore, after reviewing the position in other countries, e.g. the USA and France, the Higgs Review recommended that half of the members of a board, excluding the chairperson, should be independent non-executive directors.[101] The Higgs Review noted the need for clear

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[96] S Sheikh, "Non-executive directors: self-regulation or codification?" (2002) 23(10) *Company Lawyer* 296, 298.

[97] London Business School, "The Tyson report on the recruitment and development of non-executive directors" (June, 2003) 4, (Tyson Report).

[98] Mallin (n 72) 179.

[99] Cadbury Report (n 40) para 4.11.

[100] S Kiarie, "Non-executive directors in UK listed companies: are they effective?" (2007) 18(1) *International Company and Commercial Law Review* 17, 18.

[101] Higgs Review (n 43) para 9.7.

guidelines to help boards when assessing the independence of their members, as the then Combined Code had offered little guidance on the assessment of the independence criterion and there was disagreement in the consultation responses.[102] However, the final guidance is now in the Code with the ultimate responsibility lying with the board for determining the independence of the non-executive directors not only regarding character but also judgment and any relationships or circumstances likely to affect their independence.[103]

3.3.1.3.3 The operation of the committee

The responsibilities of the remuneration committee and its non-executive members require them to have the necessary skills, experience, independence and knowledge to enable them to fulfil their duties. In addition, they need access to information about the company's business which executives possess as they may only have been shown that information which guarantees executives their support by setting easy targets for variable remuneration. There are five main measures which have been recommended in order to make the role of non-executive directors more effective. These are induction and training programmes; allocating sufficient time for non-executive directors to perform their role; the appointment of a senior independent director (SID); providing access to independent advice; and gaining the information needed to make informed judgements and evaluations.

As Higgs noted, newly appointed non-executive directors need to build their knowledge of the firm to the point where they can use their skills and experience to benefit the organisation.[104] Gaining knowledge of the business and the markets in which the business operates can be a challenging task[105] but is very important for any director wishing to make informed decisions. Non-executive directors who were interviewed for the Higgs Review reported that "visiting company locations and attending company events, together with the informal contact with board and management that this brings, has significantly developed their knowledge of the business and its people".[106] Therefore, firms should structure an induction programme with two main objectives. The first is to offer new non-executive

[102] ibid paras 9.8 & 9.11.

[103] UK Corporate Governance Code (n 42) provision B.1.1.

[104] Higgs Review (n 43) para 11.1.

[105] Morris (n 80) 23.

[106] Higgs Review (n 43) para 11.5.

directors sufficient knowledge to make well-informed decisions, the second is to allow them to build relationships with key players to gain the influence to carry out their role.[107] However, Higgs stated that a survey conducted by telephone showed that less than 25 per cent of non-executive directors received a formal briefing induction after appointment.[108]

Although non-executive directors will be most likely to have the required skills, knowledge and experience, upon noting that two-thirds of non-executive directors and chairpersons had not received any training or development programmes. Higgs recommended training programmes aimed at extending and refreshing the skills and knowledge which non-executive directors already possess,[109] particularly in technical knowledge and risk management. The Walker Review recommended training and development programmes on the basis that a conflict had been noticed between independence and competence.[110]

The other important issue is that non-executive directors should allocate sufficient time for performing their role. This time commitment should be decided by the chairperson and the nomination committee prior to appointment and clearly set out in the letter of appointment.[111] However, it is argued that most non-executive directors are executive directors in another company and, therefore, have a significant workload, which precludes them from devoting sufficient time to their post as a non-executive director.[112] Moreover, being executives in other firms will, by itself, preclude them from being fully effective in their role, as they do not want the other executives to influence the role and scrutinise them closely; this can then become a mutual and tacit agreement between the executives.

The UK Corporate Governance Code recommended a prohibition on executive directors taking more than one non-executive directorship in a FTSE-100 company to allow them to allocate sufficient time to each firm. The Walker Review recommended an increase in the time commitment which non-executive directors allocate for FTSE-100 listed banks and life

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[107] Morris (n 80) 23.

[108] Higgs Review (n 43) para 11.1.

[109] ibid paras 11.6 & 11.7.

[110] Walker Review (n 44) recommendation 1.

[111] UK Corporate Governance Code (n 42) provisions B.3.1-B.3.2.

[112] Kiarie (n 100) 20.

assurance companies, suggesting a minimum time commitment of between 30 and 36 days.[113] However, in its policy statement, the FSA did not support this recommendation, arguing that the time required varies according to the needs of the firm and the candidate. The FSA also confirmed that it would assess a candidate's existing commitments when examining the suitability of the candidate to conduct controlled functions.[114]

Non-executive directors are supported by the SID and an independent consultant. The SID can support the role of the non-executive directors in cases where a close relationship between the chairperson and the CEO prevents non-executive directors from challenging and contributing effectively.[115] Non-executive directors should also be provided with independent advice at the company's expense if they need it to discharge their responsibilities.[116] In the case of the remuneration of executive directors, the consultant should be appointed by the committee and should be identified in the annual report, together with any connection that he or she has with the company.[117] Therefore, the UK approach to the consultant is more relaxed than that of the US, where the law wants a consideration of the independence of any consultant employed against certain criteria.[118] The remuneration committee can obtain advice and support from senior executives in the company provided that care is taken to recognise and avoid conflicts of interest.[119]

Non-executive directors need information to be able to make informed decisions. Therefore, as directors, non-executives have the right to receive timely and clear information.[120] On the other hand, executive directors have an obligation to provide such information and clarify this

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[113] Walker Review (n 44) recommendation 3.

[114] Financial Services Authority, *Effective corporate governance* (PS 10/15, September 2010) 25&26.

[115] Walker Review (n 44) para 4.27.

[116] UK Corporate Governance Code (n 42) provision B.5.1.

[117] ibid provision D.2.

[118] See section 6.3.2.3.

[119] UK Corporate Governance Code (n 42) D.2.

[120] ibid B.5.

if needed.[121] The company secretary, under the supervision of the chairperson, will be responsible for the flows of information between the board and its committees.[122]

In order to strengthen the accountability of the board and the remuneration committee to shareholders, the Greenbury Report[123] recommended the attendance of the Chairperson of the remuneration committee at the Annual General Meeting to answer shareholder questions regarding remuneration policy. In addition, the UK Corporate Governance Code recommends maintaining close contacts with principal shareholders, together with the new disclosure requirement to include a statement of the chairperson of the remuneration committee in the DRR.[124]

3.3.1.3.4 Assessment of the reform on establishing

It has been argued that the success of reform in this area is not supported by evidence, for many reasons.[125] Non-executive directors cannot be expected to be independent of management while working with them and sharing responsibility for the company policy and cannot, therefore, fulfil their monitoring role effectively.[126] For example, non-executive directors are described as "an alien policing influence detached from the rest of the board" when there is an overemphasis on the monitoring role, and an undermining of shareholder confidence in the effectiveness of board governance is predicted when non-executive directors are working closely with executive directors.[127] However, Higgs claimed that there should not be any conflict between the twin roles of non-executive directors, undermining their effectiveness, if mutual respect and a spirit of partnership are established within the unitary board.[128] It appears that the UK Corporate Governance Code focuses more on the non-executive directors' role of contributing to the strategy making of the firm as one of the

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[121] ibid B.5.

[122] ibid B.5.

[123] Greenbury Report (n 2) section A8.

[124] See section 3.3.3 for full discussion on the DRR.

[125] Thompson, "The Impact of Corporate governance Reforms" (n 60) 21.

[126] M Ezzamel and R Watson, "Wearing two hats: the conflicting control and management roles of non-executive directors" in K Keasey, S Thompson and M Wright (eds) *Corporate Governance: Economic, Management and Financial Issues,* (OUP, Oxford 1997) 64.

[127] Higgs Review (n 43) para 6.2.

[128] ibid para 6.3.

main principles, while their role of being the "watchdog" comes under supporting principles.[129]

This lack of independence is reflected in the appointment process. The Corporate Governance Code also fails to solve the conflict of interests that may arise in the appointment of non-executives. Although the independent nomination committee will lead the process of appointment to the board, executives have a strong influence on nominating directors as the ultimate decision on an appointment will be for the board and approved routinely by shareholders. Hence, new directors will feel loyal to the executives.[130] A survey conducted for the Higgs Review on the appointment of non-executive directors found that about half of the non-executive directors surveyed were appointed to their role because of personal contacts or friendship.[131] This can undermine the benefits that a non-executive director is expected to bring to the boardroom and to the economy in general by improving the performance of public companies. There is no doubt that locating a suitable non-executive director is a challenging and difficult job, as non-executive directors need to have the skills, experience, independence and knowledge needed for their posts. Most of those who have the required skills and knowledge are already working in an executive capacity. Moreover, the appointment and recruitment process can contribute to strong corporate governance and the success of non-executive directors can guarantee an effective board by contributing different skills and experience.[132]

It is also argued that non-executive directors are drawn from the same narrow social and business backgrounds as the executives and, as a result, they are not expected to bring any new experience.[133] Companies usually use executive search companies or direct advertising to locate a new non-executive director. However, while using executive search companies can be useful in forcing the existing directors to review the skills that need to be added to the

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[129] UK Corporate Governance Code (n 42) A.4.

[130] Tricker (n 45) 70.

[131] Higgs Review (n 43) para 10.5.

[132] Kiarie (n 100) 19.

[133] Sheikh (n 96) 298.

board,[134] it narrows the pool of non-executive directors and, therefore, the perceptions which they are expected to bring with them because they are "drawn from the same social, educational, business and economic and background as the executives and might have been former executives".[135] A survey conducted by the High Pay Centre between December 15 2011 and January 31 2012 found that 46 per cent of individuals sitting on remuneration committees were current or former lead executive and of the 366 non-executive directors who sit on the remuneration committees, only 37 were not from business or financial backgrounds.[136]

The Tyson Report was published as part of policy reform in 2003, tasked with looking specifically at the issues related to the appointment of non-executive directors. It recommended enhancing board talent and effectiveness by broadening the pool of talent and diversity in the boardroom in terms of background, skills, experience, age, gender, ethnicity and nationality.[137] It argued that this could be achieved by appointing academics, professionals, civil servants and charity representatives who could bring diverse experience and skills. Although these people may lack the required experience and knowledge, their valuable skills can be easily transferred by means of adequate support, training and information.[138]

However, despite the recommendations of the Tyson Report in 2003, in 2009 the Treasury Committee at the House of Commons found that the pool from which non-executive directors in the banking sector were recruited was still far too small.[139] Therefore, the Financial Reporting Council (FRC) made board diversity a new policy issue in the composition of a board. It is not only a concern for diversity in background and gender which is important to ensure that a board does not consist of like-minded individuals, but also the diversity of

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[134] K Keasey and R Hudson, "Non-executive directors and the Higgs consultation paper, review of the role and effectiveness of non-executive directors" (2002) 10(4) *Journal of Financial Regulation and Compliance* 361, 368.

[135] Kiarie (n 100) 19.

[136] High Pay Centre, "The new closed shop: who's deciding on pay?" Available at: <http://highpaycentre.org/files/hpc_dp_remco.pdf> accessed 15 July 2014.

[137] Tyson Report (n 97) 1.

[138] Kiarie (n 100) 20.

[139] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the city* (HC 2008-09, 519) 3 (Treasury Committee, HC 2008-9, 519) 50.

personal attitudes, which include intellect, critical assessment and judgement, courage, openness, honesty and tact, as well as the ability to listen, forge relationships and develop trust.[140]

Moreover, the issue of allowing the executive directors of one firm to serve as non-executive directors of another means that they have a strong interest in raising the average level of remuneration in the market, which would result in a rise in their own remuneration.[141] The survey conducted by the High Pay Centre found that 33 per cent of FTSE-100 companies have a current lead executive on their remuneration committee. Moreover, nine per cent of FTSE-100 companies have a current lead executive from another FTSE-100 company on their remuneration committee.[142]

Recently, the FRC consulted on the issue of executives being on the remuneration committee of other companies, as a response to a request made by the Government in June 2012, when the Secretary of State for Trade stated that when remuneration committee members are executives in another FTSE-350 company:

> *There is a perceived conflict as these individuals have a personal interest in maintaining the status quo in pay setting culture and pay levels. I will ask the Financial Reporting Council to amend the UK Corporate Governance Code to put an end to the practice of serving executives sitting on the remuneration committees of other large companies.*[143]

The consultation presented statistics showing that in 2003, 45 per cent of the FTSE-100 remuneration committees included executives of other companies. This figure declined to 23 per cent in 2009 and then started to increase again, to 31 per cent, in 2012. The consultation presented the percentages of voting against the remuneration report in companies that have an executive on its committee and companies that do not. The figures show no clear correlation between votes against the remuneration reports of the FTSE-350 and the presence of executives on the remuneration committees.[144] Thus, when the FRC released its proposal to

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[140] Financial Reporting Council, *Guidelines on Board Effectiveness*, (March 2011) 10.

[141] MB Hemraj, "Spotlight on executive remuneration" (2005) 26(5) *Company Lawyer* 149, 150.

[142] High Pay Centre (n 136).

[143] Financial Reporting Council, *Directors' Remuneration: Consultation Document* (October 2013), (FRC, *Directors' Remuneration*).

[144] ibid 4 & 5.

make changes to the UK corporate governance code, it maintained that it did not intend to take this proposal any further.[145]

Another issue that can be said to undermine the success of the reform in this area is allowing the Chairperson to serve on the remuneration committee. This will have a negative impact on the procedure for setting executive remuneration, because even if the Chairperson was considered independent in the appointment, he or she will work closely with executives and this close relationship can affect the objectivity of establishing the remuneration by favouring the executives.[146] Moreover, it is argued that non-executive directors not only lack the incentive to go against the executives, but also depend on executives for their appointment, remuneration, and acquiring information.[147]

Finally, even if there is a truly independent director, such a director may lack the competence and the experience required for the post. Walker has criticised the overemphasis on the independence of directors, the argument being that experience can sometimes infringe on independence, particularly in the case of former executives who have served five years in the same firm. [148] It is thought that executives who have served five years will have a close association with the firm, preventing them from bringing sufficient objectivity to their role.[149] However, the complexity of setting a risk strategy and controlling risk, as well as the potential massive externalities involved in the failure of major financial institutions, shows there is a greater need for industry experience to be represented on the board of banks and other financial institutions than for non-financial businesses.[150]

Evidence for this argument was presented in the Treasury Committee report. The Treasury Committee at the House of Commons doubted the ability of non-executive directors to act and check the performance of executives in the way specified in the UK Code.[151] The Committee has reported that non-executive directors in general, including those in financial

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[145] Financial Reporting Council, *proposed revision to the UK corporate governance code: consultation document* (April 2014).

[146] Kershaw (n 1) 292.

[147] Keasey (n 134) 365.

[148] Walker Review (n 44) para 3.9.

[149] ibid.

[150] ibid para 3.7.

[151] Treasury Committee, HC 2008-9, 519 (n 139) 50.

services companies, banks, and in major UK-listed companies are ineffective because they lack the experience in the company's business and have insufficient time in which to fulfil their scrutiny and oversight functions.[152] Lord Stevenson, the former Chairman of HBOS, said there had been "a lot of talk about not enough bankers being on boards", but he justified this by commenting that it was "very difficult to get non-executives with banking experience on boards".[153]

However, Lord Turner denied that there were people without the required expertise on the boards of leading UK banks, asserting that the problem lay with the time which non-executive directors needed to devote to their tasks.[154] Lord Myners refuted this argument by citing a job advertisement for Citibank, which was seeking non-executive directors without focusing on financial experience when recruiting for the post. He believed that this indicated that there was a problem in the competence of non-executive directors as they had failed to understand the risk and complexity involved in the financial instruments which caused the financial crisis.[155]

3.3.2 Instructions and guidelines for structuring and negotiation

The assistance which is provided to the remuneration committee comes in two forms: support and guidelines. Support to ensure the effective operation of the remuneration committee has been discussed[156] and further assistance, consisting of instructions and guidance, is intended to help committees decide on the level and form of the remuneration. These come in the form of hard law, for example the Companies Act 2006 regulates exit payments and loans to directors; soft law, for example the Corporate Governance Code, as well as guidelines from institutional shareholder representatives such as the ABI and the National Association of Pension Funds (NAPF) designed to assist remuneration committees in reaching a fair decision for shareholders and executives. In this sub-section, the most important issues

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[152] ibid.

[153] ibid 52.

[154] ibid 53.

[155] ibid 53 & 54.

[156] See section 3.3.1.3.3.

arising from the Companies Act 2006, the Corporate Governance Code and the Listing Rules will be highlighted. Instructions to banks are discussed in the next chapter.

The most notable instructions from the Companies Act 2006 are related to exit payment and loans. The former has already been discussed;[157] loans to directors will be addressed here. Loans can be used to avoid the rules on the disposal of assets and to remunerate directors by providing them with a gift in the form of loans, particularly as the position of directors will enable them to affect such transactions to suit their own interests. Unlike the US approach, the UK has changed the law from a blanket prohibition, subject to minor exceptions, on company loans to the requirement of shareholder approval, subject to certain exceptions.[158] This change was a result of a recommendation from the Company Law Review.[159] There is also a requirement for disclosure in the notes to the company's accounts of the details of advances and credits granted by the company to its directors and of guarantees of any kind entered into by the company on behalf of its directors.[160]

The UK Corporate Governance Code contains some guidance on structuring remuneration. It does not specify any set limit on the level of remuneration, providing flexibility to enable firms to attract, retain and motivate directors. However, at the same time, the Code discourages firms from paying more than is required for this purpose, as this would be incompatible with the fiduciary duties of directors. The Greenbury Report[161] recommended that a remuneration committee should take account of a number of issues, such as remuneration at other comparable firms via surveys, and the firm's own strategy for determining executive remuneration level. However, the remuneration committee should be cautious when wishing to position the company relative to others, as this can contribute to a ratcheting up of the general level of remuneration.[162] When determining remuneration

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[157] See section 3.3.1.2.

[158] Companies Act 2006, section 197.

[159] Company Law Review Steering Committee, *Modern Company Law for a Competitive Economy: Completing the Structure* (November 2000) para 4.21.

[160] Companies Act 2006, section 413.

[161] Greenbury Report (n 2) section C2.

[162] UK Corporate Governance Code (n 42) provision D.1.

packages, the remuneration committee should be "sensitive to pay and employment conditions elsewhere in the group, particularly when determining annual salary increase."[163]

In relation to pension entitlements, due to their complexity and importance, the Greenbury Report recommended that a committee should seek professional advice.[164] Moreover, the report recommended that bonuses and other long-term incentive plans should not be pensionable and the pension should be calculated based on salary. However, the report warned firms of the consequences of using final salary or average salary over a certain period to calculate pensions, as the manager concerned may increase his or her salary during the pensionable period in order to gain a higher pension, which, as a result, would be costly for the pension fund and the company.[165]

The structure of remuneration, which is becoming increasingly complex, particularly in the largest companies in the UK,[166] should be designed to link pay to performance. Therefore, it is recommended that incentive-based remuneration should form a significant part of an executive's total remuneration, as the variable part of remuneration can be used to align the interests of directors and shareholders, and to incentivise directors to perform at the highest levels.[167] In the wake of the financial crisis of 2007, it is recommended that financial firms should have a sufficient level of fixed pay to allow them to operate a flexible variable policy on remuneration, including reducing or cutting the variable components in any given year.[168] This recommendation has also been reflected in the new version of the UK Corporate Governance Code.[169] Moreover, as a result of the short-termist practices in the run-up to the crisis, the UK Corporate Governance Code recommends that incentive-based remuneration should not only be relevant and stretching but should also be designed to promote the long-

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[163] ibid provision D.1.

[164] Greenbury Report (n 2) para 6.42.

[165] ibid 6.44, 6.45 & section C12.

[166] BIS/11/1287 (n 4) 31.

[167] Greenbury Report (n 2) section C4.

[168] FCA Handbook, SYSC, 19A.3.44; PRA Handbook, SYSC, 19A.3.44.

[169] UK Corporate Governance Code (n 42) Schedule A.

term success of the company. However, the Code did not introduce any performance metrics which could be used to assess long-term success.[170]

All incentive plans should be subject to financial and non-financial metrics and their performance conditions should be relevant, flexible, designed to promote the long-term success of a company and compatible with risk policies and systems.[171] For example, guaranteed bonuses should be stopped, share options should not be offered at a discount, and the granting of shares should not be vested or exercisable in less than three years and should be phased in over time to ensure that executives are kept motivated and are not receiving a reward for doing nothing. Moreover, to ensure that directors promote the long-term success of their firm, a significant part of the short-term remuneration should be paid in shares and held for a designated period. To protect shareholder interests, any remuneration that has been granted to directors should be subject to provisions which allow the firm to reclaim it if the grant was a result of misstatement or misconduct. This provision on clawback, as it is known, was first inserted in the UK Corporate Governance Code in 2010. Unlike the US, where clawback is a matter of law,[172] the UK approach is to encourage companies to use it as part of the requirements of the Code.

The FRC consulted on several issues related to the terminology used by the code and whether this should be similar to those used in the Large and Medium-sized Companies and Groups (Accounts and Reports) 2013. This is also related to whether it should specify situations under which payments could be recovered and/or withheld, and the legal considerations that may restrict the ability of the firms to do so.[173] Therefore, in the new version of the Code the FRC has added that:

> *Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which it would be appropriate to do so.*[174]

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[170] Mertzanis (n 49) 92.

[171] UK Corporate Governance Code (n 42) Schedule A.

[172] See section 6.4.4.

[173] FRC, *Directors' Remuneration* (n 143).

[174] UK Corporate Governance Code (n 42) provision D.1.1.

3.3.3 The final steps after structuring and negotiation

The final steps for establishing executive remuneration involve shareholder engagement and the disclosure of the remuneration practices to shareholders and the markets to facilitate shareholder voting and media coverage.

3.3.3.1 Disclosure

Disclosure is always seen as the cost of having the benefit of limited liability, which separates the wealth of shareholders from that of the company, so that creditors cannot sue shareholders directly. Transparency and the disclosure of remuneration can play an important role in ensuring the accountability of directors to shareholders as well as alleviating public concerns about remuneration practices.[175] This can also play an important role in gearing the focus and affecting the structure of remuneration in terms of it being more performance linked and preventing directors awarding themselves a large non-performance linked payment.[176] Disclosure can be a useful tool in reducing the cost of informing shareholders and the market about the firm's remuneration policy and practices in establishing whether a policy is designed to attract and motivate executives or if it is non-performance linked. Disclosure will also facilitate shareholder action and media coverage of pay in general and excessive pay in particular, to enable the "outrage cost" mentioned by Bebchuk and Fried to control remuneration.[177]

However, it is argued that disclosure can also have a negative impact on increasing the level of remuneration, as each company benchmarks the others in setting a competitive remuneration policy which attracts, retains and motivates executives, with the focus on being in the upper quartile range.[178] This negative impact has been shown by the continuing increases in executive pay, despite the measures that have been taken.

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[175] Greenbury Report (n 2) para 5.2.

[176] JA Craighead, "The Impact of Mandated Disclosure on Performance-Based CEO Compensation" (2004) 21(2) *Contemporary Accounting Research* 369.

[177] Kershaw (n 1) 294.

[178] BIS/11/1287 (n 4) 10.

The Cadbury Report recommended disclosure of director remuneration as best practice. [179] However, the then Labour Government did "not believe that the best practice framework [was] successful in achieving adequate levels of compliance".[180] Therefore, in 2002, the Directors' Remuneration Report Regulations 2002, which is a statutory instrument, was enacted and sections were inserted into the Companies Act 1985 requiring the directors of quoted companies to prepare a DRR each financial year containing certain information specified in an accompanying Schedule, and to submit this DRR for an advisory vote of the shareholders.[181]

As a result of this regulation, the disclosure rules have been removed from the Combined Codes since the 2003 version, but not from the Listing Rules. Subsequently, these sections have become part of the Companies Act 2006.[182] These sections require any (quoted) company which is listed in the UK, included in the official list as a Member of the European Economic Area, or has been admitted to dealing on the New York Stock Exchange or NASDAQ, to produce a DRR and present it to the shareholders for voting. This report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company. Therefore, companies must comply with these sections as failure to do so is a criminal offence.[183] The Companies Act 2006 also broadens the definition of quoted companies to remove any incentive for British companies to list their securities in other countries and escape the new regulation.[184] The Secretary of State for Business has the power to change the definition of quoted companies by limiting or extending its application[185] and may wish to extend the application to prevent British companies listing their securities on other official lists not mentioned in section 385 in order to escape the

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[179] Greenbury Report (n 2).

[180] Patricia Hewitt, the Secretary of State for Trade and Industry, cited in: R Maharaj, "Fat Cat Scan – director pay under the microscope" (2002) 152 *New Law Journal* 1302, 1304.

[181] Companies Act 1985 sections 234B(1), 241A and Schedule 7A.

[182] Companies Act 2006 sections 420-422, 439 and 385.

[183] Companies Act 2006, sections 420-422.

[184] Davies (n 7) 405.

[185] Companies Act 2006 section 385.

burdens of the regulation.[186] Alternatively the application may be limited if the host state regulation is stricter than that of the UK.

The Companies Act 2006 gives the Secretary of State the powers to draw up regulations regarding the information that must be included in the DRR, its layout, and which information in the report needs to be audited and which does not. On February 19 2008, the Secretary of State signed the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 which amended the 2002 regulations by inserting a new paragraph 4.[187] However, these regulations were replaced in 2013[188] following an announcement in January 2012 by the Secretary of State for Business concerning failings in the corporate governance framework for executive remuneration.[189] The Enterprise and Regulatory Reforms Act 2013 requires a separation and elaboration of the part containing information about the company's forward-looking remuneration policy as well as approval of that part by shareholders at least every three years.[190] If payment of remuneration did not conform to the approved remuneration policy or had not been approved by resolution of the company's members, any directors who had authorised the payment would be jointly and severally liable for any losses suffered by the company.[191]

The 2013 Regulation requires the DRR of quoted companies to consist of three parts, from October 1 2013. Part one is a statement made by the chairperson of the remuneration committee; part two is the company remuneration policy and part three is information on how the remuneration policy has been implemented during the financial year, including actual payments made.

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[186] Companies Act 2006 section 385.

[187] A Judes and E Hauder, "Disclosure and Shareholder Approval of executive Remuneration Packages" (2011) 40(8) *Benefit and Compensation International* 11, 12.

[188] SI 2013/1981 (n 69).

[189] Department for Business, Innovation and Skills, *Executive Pay: Shareholder Voting Rights Consultation* (BIS/12/639).

[190] Enterprise and Regulatory Reform Act 2013, section 79.

[191] ibid section 80.

The annual statement of the chairperson must summarise the major decisions on director remuneration, any substantial changes to director remuneration made during the year, the context in which those changes occurred and any decisions that have been taken.[192]

The regulation also sets the minimum requirements concerning the contents of the remuneration policy. This includes a table presenting and explaining key elements of pay with supporting information on how each element supports the achievement of the company's strategy, the potential value and performance metrics. It must contain information on the company's approach to recruitment remuneration and loss of office remuneration, service contracts, and remuneration scenarios dependent on company and individual performance. It must also contain statements regarding how the company's pay and employment conditions were taken into account when setting the policy for director remuneration as well as whether or not any shareholder views were expressed and if these were taken into account.

The third part must contain the annual implementation report, which is equivalent to past annual reporting requirements for director remuneration and is sub-divided into two sections. One is subject to audit and includes the new single figure of total remuneration for each director. The BIS has requested that the Financial Reporting Lab conduct a short-term project to obtain the views of the investment community on how the single figure should be calculated and presented to assist the BIS in developing the disclosure requirements.[193] The BIS aim to have a single figure that is both comprehensive, covering all types of reward and reflecting actual payment earned rather than potential pay awarded, and consistent across companies to facilitate comparison.[194] This single figure must be in the form of a table shown in the regulation which is divided into seven columns. These columns are headed as follows: salary and fees, all taxable benefits, annual bonuses, LTIP, pension, and total. The implementation report must contain information about the total pension entitlement, scheme interests awarded during the financial year, payment to past directors, payment for loss of office, statement of directors' shareholding and share interest.

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[192] SI 2013/1981 (n 69).

[193] Financial Reporting Lab, "Lab Project report: A single figure for remuneration" (June, 2012).

[194] BIS/12/888 (n 68).

The second part of the implementation report which is not subject to audit, must contain information on performance, graphs and tables, the percentage change in the CEO remuneration, relative importance of spend on pay, statement on implementation of the remuneration policy in the following year, consideration by directors of matters relating to pay, and a statement of voting at the last general meeting.

By introducing the new regulation and the single figure, the BIS has responded to past criticism that despite the extensive information which must be disclosed, there was little information regarding how this data was to be presented, which could prove confusing and time-consuming[195] for shareholders if a company provides extensive or very technical information.[196]

The Listing Rules previously required all listed companies incorporated in the UK to attach a statement containing certain information about director remuneration to their annual financial report to shareholders. Calder believes that there should only be one DRR containing all the information which meets the requirements of both the Listing Rules and the Companies Act 2006.[197] The FCA has finally realised this, as the BIS indicated this issue during the consultation phase of the new disclosure requirements.[198] In December, the changes were finalised and the FCA kept only the requirement that listed companies need to provide information about unexpired terms of service contracts of any director proposed for election/re-election at the general meeting.[199] The FCA has kept the Listing Rules which require shareholder approval of any long-term plan[200] as it believes that there is not much overlap between the two sets of rules as the FCA rules are wider than the BIS regulation.[201]

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[195] BIS/11/1287 (n 4) 16.

[196] L Roach, "The Directors' Remuneration Report Regulations 2002 and the disclosure of executive remuneration" (2004) 25(5) *Company Lawyer* 141, 145.

[197] Calder (n 54) 85.

[198] Financial Conduct Authority, *Consequential Changes to the Listing Rules resulting from the BIS Directors' Remuneration Reporting Regulations and Narrative Reporting Regulations* (CP13/7, August 2013).

[199] Financial Conduct Authority, *Consequential Changes to the Listing Rules resulting from the BIS Directors' Remuneration Reporting Regulations and Narrative Reporting Regulations* (PS13/11, December 2013).

[200] Listing Rules section 9.4.1 & 9.4.4.

[201] Linklaters, "Listing Rules amended to take account of new rules on directors' pay" (28 August 2013) available at <http://www.linklaters.com/Insights/Employment-and-Incentives/Disclosure/Pages/Listing-Rules-amended-take-account-new-rules-directors-pay.aspx> accessed 12 December 2013.

3.3.3.2 Shareholder engagement and vote

The reason for allowing shareholders to vote is to give the owners greater power and influence over executive pay. The so-called "say on pay" can also be useful in ensuring that executives are not setting their own pay and rewarding themselves an excessive payment level which is not connected to performance and, if they did so, the shareholders could vote against this.[202] Therefore, shareholder votes can be a useful tool in obliging companies to liaise with shareholders before setting remuneration, hence eliminating excessive levels of remuneration and ensuring this is aligned with shareholder interests. However, it is not clear whether this vote would make any real difference.

3.3.3.2.1 Engagement

Public listed companies can help people with low and middle incomes to invest, as well as giving them protection against bankruptcy through limited liability if the company goes into liquidation. The total return on equity in public listed companies should be higher than that of saving accounts and bonds. Moreover, they are easier to understand compared with other financial instruments such as derivatives. These companies and the capital markets can play a major role in distributing wealth in society. On the one hand, they allow many people who would not otherwise be able to set up a business to participate in large-scale projects in order to gain profit on the capital they have employed. On the other hand, they provide the funds and liquidity needed by the founders of the company to set up a firm which, as a consequence, provides thousands of jobs for people in the community.

Many people become shareholders in companies in the hope of obtaining a fair return. However, the behaviour of individual investors has shifted over the past 50 years, from investing in shares, to receiving dividend payments, to expecting large capital gains.[203] Therefore, if the return is not fair and/or not high enough, people will prefer to invest in savings accounts which are very low risk.

Governments and financial regulators scrutinise the markets and listed firms to ensure that they comply with the regulations and best practice, so that investors can have confidence in

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[202] M Conyon and G Sadler, "Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK" (2010) 18(4) *Corporate Governance: An International Review* 296.

[203] Mertzanis (n 49) 99.

the markets. However, a recent trend in the UK shows an increase in the number of institutional shareholders and a decrease in the number of ordinary shareholders which, as a result, has pushed policymakers to give a greater role for them to play in solving the agency problem and improving company performance.

There are many factors which have contributed to placing institutional shareholders in a better position to monitor the executive directors of a company. The first is that institutional shareholders have an advantage over individual shareholders in having the ability to understand the information which the markets disclose to them, as well as having greater knowledge and experience. The second is that institutional shareholders can easily monitor their investee company as they can cooperate with each other due to their geographical situation in the City of London and their trade associations, such as the ABI and the NAPF.[204] The third reason is cost, as institutional shareholders can monitor companies for less cost than individual shareholders. Another important reason is that the number of institutional shareholders has increased over the past 30 years in the UK whilst the number of individual shareholders has decreased. In 1963, individual shareholders in the UK represented 54 per cent of all shares.[205] However, since then the number has been decreasing, as the Hampel Report noted in 1998:

> *Sixty per cent of shares in listed UK companies are held by UK institutions – pension funds, insurance companies, unit and investment trusts. Of the remaining 40 per cent about half are owned by individuals and half by overseas owners, mainly institutions. It is clear from this that a discussion of the role of shareholders in corporate governance will mainly concern the institutions, particularly UK institutions.*[206]

This increase in and concentration of share ownership was seen as a solution to the agency problem, as institutional investors could display a more proactive and effective governance role.[207] Moreover, this increase was seen as a potential way to reunite ownership and control

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[204] L Roach, "CEOs, chairmen and fat-cats: the institutions are watching you" (2006) 27(10) *Company Lawyer* 297, 298.

[205] Mallin (n 72) 105.

[206] Hampel Report (n 75) para 5.1. However, after Hampel the number of shares held by institutional shareholders has decreased, due to an increase in shares held overseas. See: Mallin (n 72) 105.

[207] L Roach, "The UK Stewardship Code" (2011) 11(2) *Journal of Corporate Law Studies* 463, 464.

and a new era of board accountability.[208] For example, Conrad stated that "the holdings of these institutions are now so large that a manageable number of funds could feasibly join hands to supervise managers in a new system of control".[209]

However, this optimism was short-lived. In the early 1990s, a study by the ABI and NAPF showed that the level of voting among institutional investors was very low, around 20 per cent.[210] The main solution suggested to tackle this problem was the publication of voluntary codes and guidelines of best practice, starting with Cadbury until the most recent UK Stewardship Code in July 2011. Noting the increase in institutional shareholders and the common interests between individual and institutional shareholders, the Cadbury Report presented three principles in response to an earlier report by the Institutional Shareholders' Committee (ISC) on the responsibilities of institutional shareholders.[211] Section E of the first Combined Code in 1998 contained three similar principles. However, despite the fact that the Myners Report in 2001 provided a detailed analysis of how to improve institutional shareholder engagement with their investee firms, the updated versions of the Codes, in 2003, 2006 and 2008, did not contain any change to the three principles presented in the original Code of 1998.

However, the financial crisis of 2007-09 revealed a number of problems with regard to the engagement of institutional shareholders with their investee company. After meeting with some of the institutional shareholder representatives, the Treasury Committee of the House of Commons identified four reasons for the ineffectiveness of institutional shareholders. Firstly, they needed more power and tools, such as the ability to subject all directors to yearly re-election. Secondly, some institutional shareholders and their representatives lacked the resources, interests and capacity to engage effectively with their investee company. Thirdly, institutional shareholders were not obliged to disclose their voting rights to the public. Fourthly, institutional shareholders were facing information barriers compared with what was

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[208] Roach, "CEOs, chairmen and fat-cats" (n 204).

[209] F Conrad, "Beyond Managerialism: Investor Capitalism?" (1988) 22 *University of Michigan Journal of Law Reform* 117, 119.

[210] Cited in: Roach, "The UK Stewardship Code" (n 207) 465.

[211] Cadbury Report (n 40) para 6.11.

available to the regulators and non-executive directors. This final point was explained to the Committee by Peter Chambers, who maintained:

> *Of all outside people the regulators have the first line of sight in seeing what goes on in the banks. They have information that is not accessible by the rest of us as investors in the public domain. The other group of people who have line of sight are the banks themselves and their executive directors and above that the non-executive directors. One would have to conclude that the non-executive directors were not effective in controlling the activities of the executive directors; otherwise, we would not be where we are now.*[212]

Roach[213] has identified a number of barriers which can be said to prevent or minimise institutional shareholder activism. The first is the cost of coalition formation, as some institutional shareholders may refuse to share the costs of an action, as happened in the removal of the board of Tace plc in 1991, which can affect shareholder activism. The second barrier is that the cost of information relating to corporate governance can be high, which may prevent small shareholders from acquiring information as they do not want to incur such costs if they are not able to make any changes. The third barrier is the conflict of interests, particularly in the case of pension fund managers who are usually affiliated with merchant banks. A conflict of interests can arise when a merchant bank represents a company in the fund manager's portfolio. Moreover, fund managers are always seeking new corporate business and a reputation as a trouble maker can threaten their future career. The fourth barrier is the fear of losing "soft information". A good relationship between management and institutional shareholders will result in executive directors passing on what is called "soft information", which is not available to the market, and any trouble in this relationship means that the institutions will be at risk of losing such information and subsequently any abnormal profit they are making.[214]

Having considered the factors which place institutional shareholders in a better position in monitoring and engaging with their investee companies and the potential barriers which may minimise the effectiveness of such engagement and monitoring, it is important to analyse the options which are available to institutional shareholders in controlling remuneration

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[212] Treasury Committee, HC 2008-9, 519 (n 139) 63.

[213] Roach, "CEOs, chairmen and fat-cats" (n 204).

[214] ibid 299.

practices. These two options are the same as the general options available to all shareholders, identified by Hirschman as: exit or voice.[215] In the former case, institutional shareholders may prefer to exit from a firm when they are not happy with their investee company's management. This choice might be preferable, as engagement can lead to lengthy discussions and procedures which will affect the share price if such dissatisfaction leaks to the market. For example, in 1991 the institutional shareholders succeeded in removing the CEO of Brown & Jackson, which was seen as a victory for them; the action took over a year and the company's share price declined.[216] Therefore, each institutional shareholder may be involved in a "race to exit" before the others.

However, some argue that considering their large holdings, they are more likely to try to engage in company affairs, and therefore should have the necessary tools for this engagement, such as dialogue with the company, voting, and bringing resolutions. The Cadbury Report stressed the importance of regular contact between institutional shareholders and senior executives, a recommendation which was welcomed and endorsed by the Hampel Report. All subsequent reports and codes have also endorsed this recommendation. Section E of the Combined Code, 1998, 2003, 2006 and 2008, contained recommendations concerning the engagement of institutional shareholders with their investee company. The Institutional Shareholders' Code of Activism provides that institutional shareholders have a responsibility to discharge to their client by intervening objectively in investee companies when necessary.[217] The Walker Review was of the opinion that the Combined Code principle and the ISC Code on the responsibilities of institutional investors provided a sound foundation for the engagement policy.[218] The review recommended that "[t]he Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and become the Stewardship Code".[219]

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[215] AO Hirschman, *Exit, Voice, and Loyalty* (Harvard University Press, Cambridge, MA 1970).

[216] See: Roach, "CEOs, chairmen and fat-cats" (n 204) 300 for more examples.

[217] Institutional Shareholders' Committee, "The Responsibilities of Institutional Shareholders and Agents: Statement of Principles" available at <http://www.ecgi.org/codes/documents/isc_statement_of_principles.pdf> accessed 12 December 2013.

[218] Walker Review (n 44) para 5.37.

[219] ibid recommendation 17.

In January 2010, the FRC, in response to the Walker Review, published a consultation document on a stewardship code for institutional investors. As a result, section E was removed from the UK Corporate Governance Code and in July 2010 the FRC published the UK Stewardship Code. The Stewardship Code has seven principles and is applied on a "comply or explain" basis. The Code aims to enhance the quality of engagement between institutional shareholders and companies to help improve long-term success and comply with corporate governance codes. However, analysing the Code principles is outside the scope of this thesis,[220] which will now turn to considering the tools of engagement.

3.3.3.2.1.1 Dialogue

This is the first tool which institutional shareholders may use in their engagement with their investee company. However, companies will not hold one-to-one meetings with individual shareholders. One-to-one meetings between institutional shareholders and the company's senior management focus on issues relating to the firm's strategy and how it is planning to achieve its objectives.[221] Any disputes will be kept behind the scenes, as everyone will lose if a dispute becomes public. Institutional shareholders may choose to sell their shares quietly when they fail to change the policy of their investee company, rather than using the voting power or the power to bring their own resolution. Dialogue with an investee company can trigger insider trading problems when institutional shareholders act in accordance with the information they receive.

3.3.3.2.1.2 Shareholder resolutions

This is one of the main tools for shareholders. Shareholder resolutions are widely used in the USA, with some 800-900 proposals or resolutions each year.[222] The UK Companies Act allows shareholders to bring their own resolutions when they are requested by i) members who have five per cent of the voting power of the company or ii) 100 or more shareholders who have the right to vote and the value of the share of each one is not less than £100.[223] Mallin reports that the practical difficulties of complying with this section of the Companies

[220] For full analysis of the Code principles see: Roach, "The UK Stewardship Code" (n 207).

[221] Mallin (n 72) 117.

[222] ibid 122.

[223] Companies Act 2006, section 314(2).

Act are the reason for the low number of shareholder resolutions in the UK, which do not usually exceed 10 each year. [224] She also expected the number to increase due to shareholder dissatisfaction with executive remuneration.

3.3.3.2.1.3 Re-election

Regardless of a director's term of appointment, shareholders can remove a director of public companies in the UK from office at any time by ordinary resolution before the term expires.[225] To facilitate the exercising of this right the UK Corporate Governance Code recommends that all FTSE-350 directors be subject to election by shareholders.

3.3.3.2.1.4 Other useful tools

Mallin[226] mentions two other useful tools which can be used by institutional shareholders to discipline underperforming listed companies.[227] The first is the "focus list", whereby institutional shareholders target underperforming companies, companies which did not respond to institutional shareholders appropriately or did not take their views into account, and include them on a list. As a result, institutional shareholders might target the company and change its board members. The second tool is the "corporate governance rating system", in which the corporate governance standards of listed companies are assessed against several factors of good corporate governance practice. Companies with good corporate governance will be more attractive to investors and will more easily raise capital if needed.

3.3.3.2.1.5 Assessment of Engagement

This section considers the aims and objectives of shareholder engagement and activism and the extent to which this improves their investee company's performance. Typically, shareholders become engaged and get involved in activism because they wish to make sure that their investment is growing and that their investee company's management is doing its job properly. With relation to their engagement in remuneration policy, there has been some debate about whether they can be expected to take the interests of other stakeholders such as

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[224] Mallin (n 72) 123.

[225] Companies Act 2006, section 168.

[226] Mallin (n 72) 123.

[227] ibid.

the depositors of the bank and society into account when they assess the firm's remuneration policy and the extent to which they really care about long-term success. It could be argued that there another conflict of interests between the interests of the executives of the institutional shareholders and their own shareholders.

Shareholders in general and institutional shareholders in particular, are concerned with the link between pay and performance and are likely to focus more on the level of remuneration rather than its structure as shareholders are more likely to vote against the DRR when remuneration is regarded as excessive. This is not to suggest that shareholder activism has no role to play as a tool of corporate governance, but it is not expected to control the excessive risk-taking of financial institutions. The financial crisis of 2007-09 supports this conclusion. Some scholars argue for aligning the financial interests of shareholders with those of society from the start and leaving shareholders to design individual contracts with the right incentives.[228] However, it is not clear to me how this would be achieved, as no practical means of doing this have yet been suggested.

3.3.3.2.2 Voting

3.3.3.2.2.1 Voting in general

This is the second and most important tool for shareholder control of their company. The voting system in listed companies has evolved from being "one person, one vote" to "one share, one vote".[229] Thus, when shareholders vote on a resolution at the Annual General Meeting (AGM), the rule of the majority will be applied, giving the shareholders who own the majority of shares control over the company. Moreover, shareholders are not obliged to vote or exercise their voting right in any particular way. As Lord Lowry has observed, "the shareholder may lock away his paid up shares and go to sleep".[230] For the institutional shareholders, the situation of voting might be different, as the issue can be said to form part

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[228] J Carpenter, T Cooley and I Walter, "Reforming Compensation and Corporate Governance" in: V Acharya, T Cooley, M Richardson and I Walter (eds), *Regulating Wall Street*, (John Wiley & Sons, New Jersey 2011) 501.

[229] A Rahmani, "Shareholder control and its nemesis" (2012) 23(1) *International Company and Commercial Law Review* 12, 13&14.

[230] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 A.C. 187, 220.

of their accountability to their clients, which is not required in law but has become accepted in practice.[231]

The argument for mandatory voting is to oblige shareholders, particularly institutional shareholders, to monitor their investee company. They have previously been accused of being "absentee landlords who are happy to collect 'rent' in the form of dividends but who do not seek to monitor management with the result that sub-optimal managerial performance goes unchecked".[232] However some are against this, believing that the mandatory vote might become an exercise in "box ticking". Therefore, the UK has chosen to make voting a requirement for institutional shareholders as part of its corporate governance under the approach of "comply or explain", and now comes under principle six of the Stewardship Code. The Myners Report found that in 1999 the voting levels by institutional shareholders had risen to 50 per cent, compared with 20 per cent in 1990.[233]

There have been efforts to facilitate voting and increase its levels. The NAPF Report in 1999 identified some impediments to voting, the most notable being the problem of outdated paper-based voting systems, which led to the recommendation to facilitate an electronic voting system, which was introduced in 2003. Another issue was the communication problem between pension fund managers, fund managers, custodians, registrars, and companies. The Shareholder Voting Working Group issued a number of reports, stating in its fourth report in 2007 that the voting level had risen from 50 to 60 per cent.

3.3.3.2.2.2 Voting on the Remuneration Report

The Greenbury Report and the Hampel Report recommended that shareholder approval should be required for any long-term incentive plans; however, this can be seen as a clear encouragement of short-termism as boards may avoid designing long-term remuneration plans which reward long-term performance in order to avoid shareholder voting and focus on short-term incentive plans which might not be in shareholder interests. However, the reports failed to find a workable way for shareholders to vote on a remuneration report as a whole,

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[231] Roach, "CEOs, chairmen and fat-cats" (n 204) 301.

[232] ibid 301.

[233] Department of Trade and Industry, "Institutional Investment in the United Kingdom: A Review" (DTI, London 2001) para 5.84 (Myners Review).

and delegated this to the board to decide whether the board wished to have shareholder approval of the remuneration report. This was due to the belief that recommending the establishment of a remuneration committee comprising non-executive directors as the indirect voice of shareholders could have positive effects on remuneration practices, as well as allowing the shareholders to put forward their own resolution if they were not happy with the remuneration report.

The most important development in this regard is the Directors' Remuneration Report Regulations 2002, which require quoted companies to prepare an annual DRR and allow shareholders to vote on it as a whole, but not on each director's remuneration. This requirement now comes under sections 439 and 439A of the Companies Act 2006.

However, when it was introduced in 2002, this vote was classed as mandatory but not binding. It was an advisory vote because remuneration matters are extremely complicated and even remuneration committees sometimes need to employ professional remuneration consultants.[234] Thus, a company was not obliged to take any notice of the outcome, as "[n]o entitlement of a person to remuneration is made conditional on the resolution being passed by reason only of the provision made by this section."[235]

The vote currently applies to the two main parts of the DRR; a binding vote on the future remuneration policy and an advisory vote on the implementation report. The binding vote must be taken at least once every three years unless the company wishes to change its policy.[236] Once the remuneration policy has been approved, the company will only be allowed to make payment which conforms to the policy unless separate shareholder approval is obtained.[237] The advisory vote will remain as it was for the implementation report.

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[234] Roach, "The Directors' Remuneration Report Regulations 2002" (n 196) 145.

[235] Companies Act 2006, section 439(5).

[236] Enterprise and Regulatory Reform Act 2013, section 79.

[237] Enterprise and Regulatory Reform Act 2013, section 80.

3.3.3.2.2.3 Assessment of the Voting on the Remuneration Report

The introduction of the advisory vote in 2002 aimed to make executive pay arrangements subject to the direct approval of the shareholder vote.[238] It was rejected by some institutional shareholders as they saw it as a way of sharing accountability and responsibility with directors for the pay level, which should be the responsibility of the board.[239] Moreover, it has been argued that institutional shareholders receive abnormal returns as they have access to what is called "soft" information, which is unknown to the market, and, due to the importance of this knowledge, institutional shareholders will not take the risk of losing the advantage of having such information as a result of voting against a directors' remuneration report.[240]

Although the advisory vote will not bring any change to a company's remuneration report from the legal point of view, it may do so in practice. Davies and Hannigan believe that the vote is a good opportunity for shareholders to express their views on directors' remuneration, which they would not be able to do without section 439.[241] They state that companies which have faced a negative vote have reconsidered their remuneration report and entered into discussion with their shareholders, particularly institutional shareholders, to amend the remuneration report and obtain shareholder support and agreement.[242] Carter and Zamora found evidence that shareholders usually vote against a remuneration report when the salary is high; the payment of bonuses is not then sensitive to performance and to greater potential dilution from stock-based pay. They also found evidence that a board responded to a negative vote by controlling a salary increase and the dilution of stock options, as well as strengthening the link between pay and performance.[243]

However, companies must now have a separate section on the report stating their policy on future remuneration and since shareholder representatives in the UK such as the ABI and

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[238] S Thompson, "Executive pay and corporate governance reform in the UK: what has been achieved?" in: RS Thomas and JG Hill (eds), *Research Handbook on Executive Pay*, (Edward Elgar, Cheltenham 2012) 67.

[239] J Solomon, *Corporate Governance and Accountability* (3rd edn, Wiley, West Sussex 2010).

[240] Roach, "The Directors' Remuneration Report Regulations 2002" (n 196) 145.

[241] Davies (n 7) 406; Hannigan (n 14) 128.

[242] Davies (n 7) 406; Hannigan (n 14) 127.

[243] ME Carter and V Zamora, "Shareholder Remuneration Votes and CEO Compensation design" (2007) MAS Meeting Paper Available at: SSRN <http://ssrn.com/abstract=1004061> accessed 15 December 2013.

NAPF are well organised and able to produce guidelines on executive remuneration, this will lead to general consensus on the policy. This binding vote on the future remuneration policy is believed to strengthen communication and engagement between companies and their shareholders over the long term.[244] Furthermore, if a remuneration committee ignores shareholder views, the report will be voted against and the company will have to change its policy, as happened to GlaxoSmithKline in 2003.[245] Therefore, remuneration committees are now spending more time with investors to explain their remuneration policies and their relationship with business strategies.[246]

A sensible company will do its best to satisfy its shareholders in relation to the remuneration report, as, even if a shareholder vote on the implementation report does not affect the remuneration report, shareholders can vote negatively on other issues, particularly if they have brought their own resolution in accordance with section 338 or on the re-election of directors. Finally, the FRC consulted on a requirement for companies to report to the market in circumstances where a company fails to obtain at least a substantial majority in support of a resolution on remuneration in addition to what is in the regulations. This is suggested to be in excess of 20 per cent voting against the report, following the guidance of the GC100 and Investor Working Group.[247] This now forms part of the UK Corporate Governance Code:

> *When, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.*[248]

However, a study published in 2010 found that the average level of dissent was very small, averaging between six and nine per cent of the votes cast since 2002.[249] It remains to be seen if the binding vote on the remuneration policy will close doors to debate and discussion on remuneration payments. Companies will rely on the policy for payment and if institutional shareholders do not take care when casting their votes on the policy, even they find

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[244] BIS/12/888 (n 68) 13.

[245] Judes (n 187) 12.

[246] ibid.

[247] FRC, *Directors' Remuneration* (n 143).

[248] UK Corporate Governance Code (n 42) principle E2.2

[249] S Thompson, "Executive pay" (n 238) 67.

themselves caught out by an extremely complex pay policy that they may not be able evaluate accurately, as happened with credit rating agencies when evaluating complex financial instruments in the financial crisis.

3.4 Conclusion

This chapter focused on the regulation of remuneration in the UK from corporate law and corporate governance perspectives. It argued that courts are ill-equipped to deal with problems in this area, as the test for declaring remuneration and other self-dealing transactions is insufficiently stringent, and interested directors can be involved in the decision making. The chapter then analysed how the UK approaches the conflict of interest arising from remuneration contracts, identifying the tools which are generally advocated, namely independence, disclosure to the market and shareholders, and shareholder votes.

The reform of the regulations and codes regarding the establishment of remuneration stems from attempts to solve the agency problem between shareholders and executives by trying to control remuneration practices by imposing extensive disclosure requirements to facilitate shareholder say in the outcome. It is also directed at aligning diverse interests through the greater use of performance-based remuneration. The reform has been heavily influenced by managerial power theory, reflected in attempts to reduce and eliminate executive power over terms of remuneration. This entails reducing their power over the board by splitting the role of CEO and chairperson, reducing guaranteed tenure and delegating remuneration decision making to an independent committee who are given support and guidance to assist them to reach fair and competitive decisions in relation to remuneration policy. As specified in the regulations, remuneration committees must also prepare a detailed remuneration report and present this to shareholders who make their opinions known via binding or advisory votes.

Chapter 4 Laws and Regulations Related to Remuneration Practices in the UK: Part Two: Incentive-Based Remuneration in the Banking Sector

4.1 Introduction

In the UK reform measures started with the FSA issuing the "Dear CEO" letters in 2008, which was followed by the first Remuneration Code in February 2009. A consultation paper was produced in March 2009 with a Code intended for the largest and most significant financial institutions (26 in all). The Code was adopted in August 2009. The Turner Review[1] and the Walker Review[2] were published with analyses and recommendations for fixing remuneration practices in the City of London. However, Turner urged the reforms to be in line with international development to preserve the position of the City of London as a major financial centre. The Financial Services Act 2010[3] was passed in April with three sections concerning remuneration reform.

In August 2010, and as a result of Capital Requirements Directive III (CRD III), the FSA revisited the Code to bring it into conformity with the requirements of the directive. The final rules were published in December 2010 and incorporated into the Handbook, Senior Management Arrangements Systems and Controls Sourcebook (SYSC 19A). In the same month, the FSA had also published the final rules on disclosure which were intended to implement the disclosure requirements regarding remuneration under CRD III.[4] However, in April 2013, a new regulatory infrastructure system involving a triple peak model has formally replaced the FSA. The Financial Policy Committee (FPC), responsible for macro-prudential

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[1] Financial Services Authority, *The Turner Review: a regulatory response to the global banking crisis* (March, 2009) (Turner Review).

[2] D Walker, "A review of corporate governance in UK banks and other financial industry entities: final recommendations" (November, 2009) (Walker Review)..

[3] Financial Services Act 2010.

[4] Financial Services Authority, *Implementing CRD3 requirements on the disclosure of remuneration* (PS 10/21, December, 2010) (FSA, PS 10/21).

regulation, and the PRA, responsible for micro-prudential regulation for systemically important firms, within the Bank of England. The FCA, responsible for conduct of business regulation for all firms and prudential regulation for other firms that are not in the scope of the PRA. The two regulators, PRA and FCA, have maintained the Remuneration Code which comes under SYSC 19A of both regulators. However, changes at EU level by the Alternative Investment Funds and the CRD IV along with the report of the Parliamentary Committee on Banking Standards (PCBS) have led to changes. This chapter will analyse these issues and the measures that the UK introduced to tackle the problem of the mis-alignment between reward and risk in the financial sector and implementing the international and EU regulations. The chapter then look at the future of incentive-based remuneration with the PRA and FCA.

4.2 Various Reports examining Remuneration since the crisis

4.2.1 Remuneration in the Turner Report

In his review Lord Turner distinguished between the two problems concerning the remuneration of top executives and traders: the level and the structure of remuneration. Lord Turner has insisted that the long-term concern should be about the structure of remuneration,[5] which can create incentives for excessive and inappropriate risk-taking. He also noted that calculating profits on a mark-to-market basis during a rise of markets created illusory profits on which bonuses were decided, as well as incentives being created for traders and management to take more risk.[6] He also stated that in the past neither regulators nor financial institutions focused on remuneration structure, which was wrong as remuneration structures have created inappropriate incentives for encouraging reckless behaviour and contributed to the financial crisis.

However, Lord Turner was not sure of the extent to which the structure of remuneration had contributed to the 2007-09 crisis as he believed that excessive risk-taking, especially at management level, is linked more with broad behavioural and cultural factors than incentives inherent within remuneration contracts. He added that "dominant executive personalities have

[5] The issue of the structure of remuneration was not examined properly by financial regulators or firms before the crisis as the focus was mainly on the high level of remuneration, as Lord Turner affirmed. Regulating banking and other financial institutions is a new issue.

[6] Turner Review (n 1) 47.

a strong tendency to believe in their own strategies".[7] It could be said that he underestimated the role played by remuneration structure. This was also noted by the Treasury Committee at the House of Commons, which was very concerned by this underestimation and its consequences for the FSA in tackling inappropriate remuneration practices.[8] Finally, Lord Turner highlighted the need for international alignment in regulating remuneration and mentioned the work which was being undertaken by the FSB to achieve such alignment.[9]

4.2.2 The Treasury Committee Report on reforming corporate governance and pay in the City

In contrast to the Turner Report, the Treasury Committee concluded that the structure of remuneration had played "a key role in causing the banking crisis".[10] The Committee highlighted bonus-driven remuneration structures as encouraging reckless and excessive risk-taking, in addition to the fact that these were not aligned with the interests of shareholders and the long-term sustainability of the banks.[11] The Committee asserted that cash bonuses calculated on the basis of short-term results and paid out immediately meant that individuals often paid little or no regard to the overall long-term consequences and future profitability of the transactions.[12] The Committee agreed, with Lord Turner, that there should not be regulation limiting the level of remuneration but that there was a legitimate concern in the way the structure of remuneration might create incentives for excessive risk-taking, and it stated that strong measures were needed to ensure that "discredited practices of the past do not creep back".[13]

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[7] ibid 81.

[8] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the city* (HC 2008-09, 519) 3 (Treasury Committee, HC 2008-9, 519) 3.

[9] Turner Review (n 1) 81.

[10] ibid 16.

[11] ibid 3.

[12] ibid 12.

[13] ibid 16 & 27.

4.2.3 Remuneration in the Walker Review

Sir David Walker was appointed by the then Prime Minister, Gordon Brown, to undertake a review of corporate governance structures in UK banks and other financial institutions in the light of the financial crisis. A key focus of the review was the management of incentives in remuneration policy. Walker published his consultative review in July 2009, but international developments led by the FSB and the FSA Remuneration Code had overtaken many of the relevant recommendations in the review.[14] However, Walker kept his recommendations on remuneration in the final report published on 26 November 2009, as he described them "as tough, or tougher, than anything to be found anywhere else in the world".[15] However, the review was not so tough as to suggest a cap on the level of remuneration.

The recommendations regarding remuneration covered: the scope of remuneration committees, disclosure, measures for aligning remuneration with appropriate risk-taking, shareholder influence, and remuneration consultants. To empower the remuneration committee to oversee and control any inappropriate risk associated with remuneration policy, Walker recommended an extension to the remit of remuneration committees to include a firm-wide remuneration policy. Moreover, he recommended that remuneration committees oversee the remuneration of "high-end" employees and stated in the report that the remuneration committee should be satisfied with the way in which performance objectives and risk adjustments are reflected in the remuneration structure for high-end employees.[16]

Enhancement of disclosure was not covered by the FSA in its first Remuneration Code because it did not fall under its policy objectives. Walker recommended that the power to request disclosure should be given to the Treasury[17] and this was granted under the terms of the Financial Services Act 2010. Walker recommended that anonymous disclosure should be made by a number of high-end employees (whether board members or not) of FTSE 100-

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[14] Walker Review (n 2) para 7.2.

[15] S Filder, "UK review reins in risk reward" *The Wall Street Journal* (New York 17 July 2009) <http://online.wsj.com/article/SB124773114690549933.html> accessed 6 March 2014.

[16] "High-end" employees were defined in the July consultation as those whose total remuneration was in excess of the executive board median. However, the definition was changed to be consistent with the FSA approach in its Remuneration Code. The new definition of 'high-end' refers to an employee who performs a "significant influence function" for the entity or whose activities have or could have "a material impact on the risk profile of the entity".

[17] Walker Review (n 2) para 7.17.

listed banks and comparable entities in three bands. The first band would range from £1 million to £2.5 million, the second from £2.5 million to £5 million, and the third over £5 million, with details of the main elements of the salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution having to be disclosed. The review also recommended disclosure in the remuneration report of any enhanced benefits beyond those already disclosed in the DRR given to executives or high-end employees in any circumstances (upon termination, resignation, retirement, change of control, continued employment, etc.) and whether the remuneration committee had exercised its discretion during the year to enhance the benefits as a means of controlling the benefits. The reason behind this recommendation is that Walker was not persuaded that the then control of exit payments in the Companies Act 2006[18] which required shareholder approval had secured satisfactory enforcement due to its details and complexity. The final point is that the Walker Review recommended disclosure of the sources advising the remuneration committee and whether this consultant had another advisory role with the firm.

The Walker Review went further than the Remuneration Code in respect of the alignment between risk and remuneration structure. As with the Remuneration Code, Walker was of the view that the bonus pool should be adjusted to cover current and future risk and should be based on profit rather than revenue. This represents an *ex-ante* measure to control inappropriate risk-taking combined with Walker's other recommendation that the remuneration committee should seek advice from the board's risk committee on adjusting performance objectives to risk, and that in the case of a difference of opinion on appropriate risk adjustments, the final decision should be made by the Chairperson and the non-executive directors of the board. However, Walker recommended a tougher *ex-post* measure than that recommended by the FSA as guidance to Principle eight of the evidential provisions of the then Remuneration Code, believing that the deferral of incentive payments should provide the primary risk adjustment mechanism for aligning rewards with sustainable performance. However, this is not going to reduce the risk-taking as the risk takers will still be taking excessive risks in the hope they will receive their bonuses in a few years' time and, if they lose these, it is not going to harm them as they will simply not get what they were hoping for.

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[18] Companies Act 2006, sections 215 to 217.

The review was more prescriptive and intrusive than the then FSA Code in its rules of deferral as it recommended that at least half of the variable remuneration in the financial year should be in the form of a long-term incentive scheme with vesting, subject to a performance condition, with half of the award vesting after not less than three years and the rest after five years. Moreover, short-term bonuses should be phased over a three-year period with a maximum of a third paid in the first year. Walker also recommended clawbacks to be operated as a means of reclaiming payment made in circumstances of misstatement and misconduct. It was recommended that these prescriptive rules were incorporated into the then FSA Remuneration Code on a comply or explain basis, due to the fact that these prescriptive rules were believed to be the toughest in operation at that time.[19] The review also urged the importance of high-end employees, including executive members of the board, holding shares in or retaining a portion of vesting awards equal to their total compensation and being able to build up this holding over time.

To increase shareholder influence on the outcome of the remuneration committee and encourage the committee to discuss and communicate with shareholders, especially institutional shareholders, the review recommended that if the advisory vote on the director's remuneration report failed to gain 75 per cent support, the Chairperson of the remuneration committee should seek re-election in the following year, regardless of his or her normal appointment term. This proposal would encourage the Chairperson of a remuneration committee to communicate with shareholders to reach an agreeable proposal. However, the recommendation fell short in not including all the members of the committee, as the other members might not necessarily support the Chairperson of the committee in his or her communication.

Moreover, despite the fact that Walker had used re-election as a means of punishment to solve the agency problem between shareholders and the remuneration committee (which can be classified as an *ex-post* solution), he did not recommend any incentive to be provided to the remuneration committee, such as if the advisory vote succeeded in achieving 95 per cent support, the remuneration committee should receive extra remuneration (this is an *ex-ante*

[19] Walker Review (n 2) recommendation 33.

solution to encourage remuneration committees to communicate effectively with shareholders).

Walker was the first to recommend measures regarding the work of remuneration consultants. He recommended that remuneration consultants have a formal constitution with an emphasis on independent oversight and a review of the Remuneration Consultancy Code. Remuneration committees can, therefore, use the Code as the basis for determining the contractual terms of the engagement of their consultants.

The FSA believed that its Code was already generally aligned with the Walker recommendations.[20] However, the FRC experienced problems in its attempts to integrate the Walker Review in its review of the then Combined Code. The FRC took the view that the UK Corporate Governance Code should remain unitary in its nature and not contain sector-specific provisions and, as a result, the recommendations which were applicable generally were included in the UK Corporate Governance Code.[21]

4.2.4 Remuneration in the FSA report on the failure of the RBS

This report was published after a public outcry ensued in December 2010, following the FSA's announcement that it had closed the investigation into the problems at the Royal Bank of Scotland (RBS) without taking action against anyone[22] in spite of the liquidity injection and part nationalisation which cost the tax payer £45 billion.[23] Remuneration was not among the six key factors that the report identified as the reasons for the failure of RBS. The report also indicated a possible seventh factor as being the "underlying deficiencies in RBS management, governance, and culture which made it prone to make poor decisions".[24]

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[20] Financial Services Authority, *Revising the Remuneration Code* (CP10/19, July 2010) para 2.19 (FSA, CP10/19).

[21] I MacNeil, "The trajectory of regulatory reform in the UK in the wake of the financial crisis" (2010) 11(4) *European Business Organization Law Review* 483, 521.

[22] J Treanor and S Bowers, "RBS failure caused by "multiple poor decisions" *The Guardian* (London, 12 December 2011) <http://www.theguardian.com/global/2011/dec/12/royal-bank-of-scotland-fsa-report> accessed 9 March 2014.

[23] Financial Services Authority, *The failure of the Royal Bank of Scotland* (December, 2011).

[24] ibid.

However, instead of drawing up firm conclusions regarding this seventh factor, the Report raised some questions regarding the effects of remuneration on the failure of the bank. The Report stated that it was difficult from the available evidence to be certain of the extent to which the CEO had been overly focused on revenue, profit and EPS rather than capital, liquidity and asset quality, particularly in relation to the growth of assets in many sectors such as commercial real estate and structured credit and the acquisition of the ABN AMRO via debt to increase EPS and strengthen RBS's competitive position against peers. This was due to the fact that the board set incentives which made it rational for the CEO to behave in this way as his annual remuneration was heavily influenced by operating profit, EPS growth and RoE with less regard for non-financial performance.[25] The FSA maintained that this is similar to the situation at other large banks, stating that remuneration practices of this type can produce similar results focusing on increasing revenue, profit, and leverage at the expense of the quality of capital, assets, and liquidity.[26]

4.2.5 Remuneration in the Parliamentary Commission on Banking Standards (PCBS) report

Published in June 2013, the report examined a range of topics, including remuneration. The Commission's view was that, in spite of the Remuneration Code having been in force for four years, remuneration still lay at the heart of some of the banks' biggest problems. In many cases, remuneration was still higher than performance justified and incentives for top bankers were linked to inappropriate measures that incentivised short-termism distorted the approach to risk-taking and encouraged poor conduct in retail banks.[27] Interestingly, the Commission described the widespread claim that increasing regulation would position UK at a competitive disadvantage, causing banks to relocate or expand abroad and/or bankers to relocate abroad thereby affecting the pool of talent in the City and tax revenues, as "overstated", advising regulators to disregard "the risk of an exodus".[28] However, the Commission warned that

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[25] ibid 27, 58, 225, 226 & 234.

[26] ibid 226 & 287.

[27] Joint Committee on Banking Standards, *Changing banking for good* (2013-14, HL27-II, HC175-II) 377 & 389.

[28] ibid 408-10

increased regulatory oversight might lead banks to outsource their remuneration practices in the same way they had outsourced risk management before the financial crisis.[29]

Consequently the Commission made a number of recommendations to address the misalignment between risk and reward, noting the need to expose executives to the downside risk of their decisions by reducing the extent to which remuneration increases the likelihood of misconduct and of taxpayer bailout without preventing reward when duly merited.[30] The Commission wanted to see a new Remuneration Code on the basis of a new statutory provision, including additional provisions regarding *ex post* measures to adjust remuneration, the payment of remuneration, the measure of remuneration, new powers for the regulators, and increased disclosure.

With regard to the *ex post* adjustment of remuneration to risk, the Commission noted that bonuses are awarded on the basis of annual performance while profits and losses can take a long time to be realised beyond the deferral requirement of the Code, demonstrating the need for an increased deferral period. However, the Commission did not specify any period as it believed that flexibility in approach was required to align risk and rewards. It also recommended that regulators should be given the power to require a substantial part of bonuses to be deferred for up to 10 years.[31] This power is not new and it is already vested in the regulators by the Remuneration Codes[32] which require this deferral to be in line with the business cycle, the nature of the business, its risk and the activities of the employee in question which the regulators choose not to enforce.[33] The Commission also wanted regulators to be granted the power to render void or cancel all deferred compensation, all entitlements for payments for loss of office or change of control and all unvested pension rights when a bank is in receipt of direct taxpayer support.[34]

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[29] ibid 412.

[30] ibid 390.

[31] ibid 405.

[32] SYSC, 19A.3.49.

[33] PwC, *Changing for better but not entirely for good: PCBS publishes recommendations on bank remuneration* (19 June 2013).

[34] Joint Committee on Banking Standards (n 27) 406.

The Commission noted that it was common practice for banks attracting employees from competitors to compensate them by buying-out their contracts with an amount equivalent to their award (a golden hello) and whilst this was in accordance with the Remuneration Code it can blunt its intended effect.[35] Thus, the Commission urged regulators to come up with a domestic proposal to solve this problem and wanted this to be transformed from a retention tool to a risk tool by obliging the former employee to leave deferred remuneration in place or to give regulators the power to recover from the new employer pay that would have been clawed back by the previous employer.[36] In spite of its practical difficulties this second proposal could serve to balance risk and retention while the first leans more towards risk, undermining the retention effects of deferral.

In terms of the payment of remuneration, the Commission was right to warn that overuse of equity can produce perverse incentives for leverage and for short-termism to drive share price as seen during the crisis. Lehman Brothers' senior executives held large amounts of stock and Andy Hornby, CEO of HBOS in the UK, had invested his entire cash bonus for his final eight years in the bank's shares, but this did not prevent excessive risk-taking or company failure.[37] Thus the Commission's view was that there is a merit in using debt instruments such as bail-in bonds in deferred compensation to ensure that senior staff are liable to lose their deferred pay if a bank goes bust. However, the Commission did not discuss the difficulties associated with the creation of such instruments and their marketability. Moreover, their effects on risk-taking behaviour is not clear especially since their value is hardly affected compared to equity as share values had fallen significantly during the crisis before the value of the debt instrument was materially affected.[38]

The Commission's recommendations also addressed the measures for calculating remuneration, raising concerns about the widespread use of RoE to measure the profitability of banks as it can create perverse incentives for leverage through greater use of debt finance. Using return on assets can solve this problem but creates another problem, encouraging bankers to increase profits via holding riskier assets to increase return which the measures

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[35] ibid 406.

[36] ibid 406.

[37] ibid 402.

[38] PwC (n 33).

based on risk-weighted return can do little to address.[39] Thus, the Commission recommends that the remuneration committee should disclose in the annual report how remuneration has been affected by the range of measures used to determine it, along with an explanation of how measures of risk have been taken into account and how they have affected remuneration. The Commission, therefore, placed the onus on regulators to assess if banks are striking an appropriate balance between risk and reward.[40]

Another problem in measuring profitability relates to the accounting standards on revenue recognition. The Commission warned that unrealised profits from thinly traded or illiquid markets which are usually recorded as a profit are inappropriate for the purpose of calculating bonuses and need to be changed even if accounting standards which underpin reported profits and losses is not changed.[41] The Commission also recommended that sales-based incentives for staff should be restricted, with regulators being granted the power to limit or even prohibit such incentives which can persist informally even if they have been formally removed. Such schemes contributed to industry problems including the mis-selling of payment protection insurance (PPI).[42]

Finally the Commission recommended expanding the banks' statutory remuneration reports by requiring the inclusion of a disclosure of expected levels of remuneration for the forthcoming year by division, assuming a central planning scenario and, in the following year, an account of any differences from the expected levels of remuneration and the reasons for those differences. The disclosure should also include all elements of remuneration and the methodology underlying the decisions on remuneration as well as a summary of the risk factors that were taken into account in reaching decisions and how these have changed since the last report.[43]

4.3 Introduction and updating of the Remuneration Code by the FSA

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[39] Joint Committee on Banking Standards (n 27) 397.

[40] ibid 398.

[41] ibid 397.

[42] ibid 398.

[43] ibid 412.

4.3.1 Introducing the code

4.3.1.1 FSA's powers to control remuneration practices before the crisis

Despite the fact that regulating remuneration was not the main part of the agenda for regulating financial markets before the crisis, the FSA had the power to regulate remuneration practices at regulated firms.[44] This power was in addition to the general control of remuneration, which takes the form of soft and hard laws as discussed in the previous chapter. The pre-crisis FSA Handbook contained some provisions related to the risk posed by remuneration practices. However, these were not sufficient, as they were very broad provisions, not specifically focused on remuneration in the context of excessive risk-taking.[45]

The provisions are contained in the Principles for Businesses and the SYSC. Principle three of the Principles for Businesses in the FSA Handbook required all firms to take reasonable care to organize and control their affairs responsibly and effectively, using adequate risk-management systems. Principle eight, which required firms to manage conflicts of interest between a firm and its customers as well as between a customer and another customer, is also relevant to the extent that the structure of remuneration encouraged staff to act contrary to customer interests.[46] A similar more detailed provision under SYSC 10 required firms to identify conflicts of interest between the firm and its clients created by incentives from the remuneration structure and to deal with them fairly. SYSC 4.1.1 required firms to "have robust governance arrangements", including "effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms". SYSC 7.1.16 required BIPRU firms, which include banks, building societies and certain investment firms, to "implement policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high severity events". SYSC 6.1.4 required common platform[47] firms and management companies to ensure that the methods of determining the remuneration of a person involved in a compliance function does not compromise or is likely to compromise his or her objectivity. The FSA relied on some of

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[44] A Arora, "Remuneration practices in banks and other financial institutions: part 2" (2012) 33(5) *Company Lawyer* 131, 131.

[45] ibid.

[46] ibid.

[47] This includes banks, building societies and investment firms.

these provisions when it concluded that the Alliance & Leicester's advisors and team managers were encouraged to employ inappropriate selling methods by a remuneration structure which rewarded them on the basis of the number of PPI policies sold, and exploited employee desire to exceed bonus targets, without regard to customers' interests.[48] However, these provisions were described as "light touch"[49] and not enough to deal with an inappropriate remuneration structure, as there is no express requirement for firms to ensure consistency between remuneration strategy and sound risk management. Moreover, the fact that the FSA was described as being a consumer protection agency rather than a financial and market stability regulator[50] due to the fact that its dominant focus was on consumer protection has also prevented it from recognizing the risk side of remuneration structure.

4.3.1.2 "Dear CEO" letter

Before the publication of the Turner Review, the FSA had already started taking steps to tackle inappropriate remuneration practices. On 13 October 2008, the FSA sent its "Dear CEO" letter to 20 of the major banks and building societies, stating its concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have been inconsistent with sound risk management and, therefore, may have contributed to the present market crisis.[51] The letter urged financial institutions to reconsider their remuneration practices, especially in the light of recent market developments, and to make sure these were aligned with sound risk management. The annex to the letter sets out the initial thinking in the form of a set of criteria for what the FSA considered to be the good or bad practices of remuneration policies. The criteria focus on good and bad practices in four areas related to the determination and payment of remuneration: the measure of performance and calculating bonuses; composition of the remuneration; being performance-adjusted for deferred compensation; and governance.

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[48] Letter from the FSA to Alliance & Leicester, *Final Notice* (6 October 2008) Available at: <http://www.fsa.gov.uk/pubs/final/alliance_leicester.pdf> 9 accessed 12 August 2011.

[49] P Snowdon, S Lovergrove and K Wicks, "Remuneration and Regulation" (2011) 91(Nov*) Compliance Officer Bulletin* 1, 3.

[50] M Blair, *Financial Services Law* (2nd edn, OUP, Oxford 2009) 22.

[51] Letter from the FSA to CEO, *Remuneration Policies* (13 October 2008) Available at: <http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf> accessed 13 August 2011.

With regard to measuring performance and calculating bonuses, the FSA wanted to see firms using profits instead of revenue for this purpose, using a multi-year performance average instead of basing remuneration on current year performance, using other performance measures and not only financial measures, and using a measure of risk-adjusted returns and taking the cost of capital into account. In relation to the composition of the remuneration, the FSA thought it necessary for firms to ensure they have a balance between fixed and variable pay, and to make more use of non-cash payments and the deferral of a major proportion of a bonus. In addition, the FSA wanted the deferred element of a bonus to be adjusted to future performance on moving average years. Finally, the FSA thought that remuneration should be decided by an independent remuneration committee, ensuring separation between the remuneration of staff from the business area in terms of risk and compliance, and that risk reports should be subject to independent verification. The FSA expected firms to use these criteria as a benchmark for reviewing their remuneration schemes. It also announced its intention to visit firms to check their remuneration policies and discuss what constituted good remuneration practice and at the time of writing had already conducted some of these visits.[52]

4.3.1.3 Findings of the FSA review (2008)

The FSA published the findings from its review of remuneration practices in 2008 in its Consultation Paper 09/10, based on bilateral review meetings held with 22 firms.[53] The FSA found good practice in many firms, and examples of companies who were changing their practices in response to the crisis. In the opinion of the FSA these changes were generally in the right direction.[54] The FSA noted that almost all of the firms had welcomed its criteria for good and poor remuneration practices. Concern was mainly expressed with regard to the fear that the FSA would adopt a "one size fits all" approach to regulation. Another concern related to companies being deprived of using their judgement in awarding remuneration and having to apply a formulaic approach instead. Objections were focused on the need to differentiate between investment banking and retail banking and it was thought that the scope of the review should only cover the latter.

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[52] Arora, "Remuneration practices in banks: part 2" (n 44).

[53] Financial Services Authority, *Reforming remuneration practices in financial services* (CP 09/10, March 2009) 14 (FSA, CP 09/10).

[54] ibid.

However, the FSA did also find some poor practices, which were as follows:

a. In the area of measuring performance:

- The FSA was not happy with the use of unadjusted revenue or net revenue, as this can provide an incentive for employees to pay insufficient regard to the quality of the business undertaken or the services provided. Therefore, firms should use adjusted profit to measure employee performance.
- The FSA found insufficient use of risk adjustment in both investment and retail banking.
- Due to practical complications, firms generally did not use a moving average for performance measurement.
- The FSA expressed concern about the increasing use of non risk-adjusted metrics for measuring performance as these can easily be used to drive short-term performance targets, such as EPS and total shareholder return (TSR).
- Non-financial measures of performance were given insufficient weight and there was a lack of clarity in the process.

b. In the area of remuneration composition:

- The FSA voiced concern that the low level of fixed components of remuneration has implications for encouraging excessive risk-taking since in terms of quantity, bonuses can be ten-fold or more.
- The FSA found that most firms deferred between 25 and 55 per cent of total bonuses awarded to middle-ranking to senior executives in investment banking, the higher proportion generally being awarded to senior executives with the remainder paid upfront in cash at the end of the year.
- The FSA found that a large part of bonuses was paid in cash and the deferred part was not linked to future performance.

c. In the area of governance:

- The FSA found that all the firms have remuneration committees staffed by non-executive directors, but the majority of them were not involved in determining the remuneration policies across the firm as a whole.

- The FSA found that remuneration committees have not regarded the assessment of the risk of remuneration policies as a significant part of their terms of reference, and the FSA wanted to change this.
- The FSA found that compliance functions had an input to remuneration decisions in nearly all firms, but risk management functions had less input and played no role at all in some cases.
- The FSA found that most compliance and risk staff were independent from line units, both in their ability to challenge decisions and in the way they were remunerated, but there were few firms where these staff were embedded in front-line units, which meant they lost their ability to challenge decisions.
- It was found that in some investment banks, bonuses for risk and compliance staff were paid from the same pot as for other staff in the business unit, which creates a conflict of interest.

4.3.1.4 The need for the Code

Following the work the FSA undertook in 2008, the first Remuneration Code was published on 26 February 2009 with a view to being applied to all FSA-authorized firms.[55] The FSA revised the Code and published a revised version along with its consultation paper in March 2009.[56] This publication reflected the groundswell of opinion in the UK and Europe that inappropriate remuneration practices had contributed to the financial crisis and this failure needed to be addressed by further regulation.[57]

The FSA decided to introduce the Code following its findings from the review of financial practices, as shortcomings in the remuneration structure are unlikely to be reformed by the markets. This conclusion was reached because the FSA believed that there was a market failure and a need for government intervention. It observed that remuneration among financial institutions has a short-term focus and is not adjusted for risk as a result of the pressure from labour markets, as firms stand to lose their key employees if they take

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[55] ibid para 5.2.

[56] ibid.

[57] Snowdon (n 49) 7.

unilateral action and introduce a long-term and risk-adjusted remuneration focus.[58] It also based its conclusion on the fact that bonuses cannot be lower than zero, which gives an incentive to executives and traders to raise short-term profits without fully considering the potentially negative consequences of their actions on their firms and on society which will bear the losses.[59]

Losses in the banking sector in general tend to spread outwards as in the recent financial crisis when losses spread out to the rest of the economy as banks were not able to provide the necessary credit. Therefore, these externalities justified intervention, as the market was unlikely to come up with a solution which would address this problem due to pressure from shareholders focusing on short-term perspectives. Missing quarterly earnings benchmarks are associated with a higher chance of executives being dismissed or receiving lower variable remuneration. These follow a market standard and any firm which tries to be the first to introduce a remuneration policy which takes risk into account and focuses on long-term incentives will be more likely to lose some of its key employees. Risk-taking behaviour is affected by the low probability of high risk when a market is booming in addition to the mentality which encourages employees to "ride the herd" to prove their decisions are right and to receive variable remuneration which is decided relative to peer performance. Finally the FSA asserted that there was a gap in the regulation of remuneration as neither its Handbook nor the Corporate Governance Code and the Companies Act 2006 had filled this gap as these focus mainly on remuneration at executive level and in listed companies.[60] Moreover, the regulation of remuneration in general tends to focus on its link to performance without taking risk factors into account.

Therefore, the FSA wanted to impose constraints, which could counteract shareholder short-termism and pressures in the labour market for short-term variable remuneration, to mitigate excessive risk-taking and other associated externalities.[61] The FSA also articulated several times in its documents that its initiatives related to reforming remuneration practices are not concerned with the level of remuneration, as this is a matter for the board of the firm. Both

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[58] FSA, CP 09/10 (n 53) para 4.3.

[59] ibid para 4.4.

[60] ibid paras 4.12-4.31.

[61] ibid para 4.10.

the FSA and its Chairman Lord Turner, had also made it clear that there is a need for general alignment on an international level and that the implementation of the Code will depend on this alignment, as it does not want to put UK firms at a disadvantage compared to other international financial institutions.

4.3.1.5 The First Code

The first Remuneration Code was aimed at large financial institutions as many of their inappropriate remuneration practices had contributed to the financial crisis. As the FSA acknowledged, smaller financial institutions face different problems in their remuneration structure. Their key problem is mainly associated with the risk of conflicts of interest between employees and customers and at that time, the FSA was not prepared to introduce measures to address this.[62]

The first Code was applied to 26 financial institutions after the FSA amended the scope in the final version.[63] However, it made it clear that in its supervisory role it would be taking steps to increase the focus on the potential risks posed by inappropriate remuneration structures in all FSA-authorized firms.[64] This focus would take the form of incorporating an assessment of remuneration into ARROW (Advanced Risk Response Operating FrameWork) programmes, capital adequacy assessment, supervisory reviews and evaluation processes, and the Pillar 2 process. It would also take a risk-based, principle-based and proportionate approach.[65]

Although the FSA had introduced the Code for large firms, the FSA would not exclude smaller firms from taking steps to tackle inappropriate remuneration practices. In the Code the FSA introduced an element of proportionality[66] to avoid a "one size fits all" approach, and this was developed and extended in the new Code. Concerns were raised as the Employment Appeal Tribunal which reiterated that, even though a bonus scheme is described as

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[62] ibid para 5.4.

[63] N Smith, "Reforming the bonus culture" (2010) 25(1) *Journal of International Banking and Financial Law* 37.

[64] FSA, CP 09/10 (n 53) para 1.17; Financial Services Authority, *Reforming remuneration practices in financial services* (PS 09/15, August 2009) 5.

[65] FSA, CP 09/10 (n 53) para 1.18.

[66] SYSC 19.2.2(4) stated that "the *Remuneration Code* will vary according to the nature, scale and complexity of the *firm* and its activities".

discretionary, employees have a contractual right to such a bonus if their institution has consistently paid this.[67] The employment tribunals were to scrutinize an institution's bonus plans to decide which factors were absolute and which were merely discretionary.[68]

There was concern that this first Code, along with the then new bank payroll tax, would place the UK at a competitive disadvantage since an agreed international standard was still to be introduced.[69] This was combined with the risk that multinational institutions would try to avoid the tougher regulatory requirements in the UK by locating key employees elsewhere.[70] However, the agreement of the UK subsidiaries and branches of leading overseas banks to apply the Code to their key employees, as well as their endorsement of the P&S, alleviated these fears to a certain extent. However, some US financial groups with operations in London expressed concerns that the FSA's approach was more restrictive than the more flexible approach of the Federal Reserve, which did not have specific principles for remuneration, which could lead to a two-tier pay scale applying to UK and US employees.[71]

Mindful of these concerns, the FSA highlighted its collaboration with the FSB and the Committee of European Banking Supervisors (CEBS), and asserted that it would maintain the competitive position of the UK before finalizing the Code in the summer of 2009. Its implementation of the Code would also be subject to satisfactory alignment of implementation plans by the authorities in the major financial centres.[72]

Most of the criticism of the Remuneration Code in the consultation phase focused on the need for flexibility and allowing firms to implement a remuneration policy which suited their business model together with the need to take international development into account and to not go further than the international standards, as this would have anti-competitive consequences for the UK.

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[67] R Moulton and J Quinn, "FSA Bonus code puts spotlight back on banks" (2009) 23(27) *Lawyer* 6.

[68] ibid.

[69] Smith (n 63).

[70] ibid 38.

[71] ibid.

[72] FSA, CP 09/10 (n 53) para 2.14, 2.19 & annex 5 para 11.

4.3.2 Updating and revising the code

The FSA decision to revise the Remuneration Code, released in a consultation paper in July 2010.[73] This revision was prompted by the new powers provided by the Financial Services Act 2010, the results of Walker's review, lessons learned from the previous Code, regarding its scope and the need to extend this to other financial institutions, and finally international developments in this area, especially the Implementation Standards published by the FSB, as well as the Capital Requirements Directive III (CRD III) passed by the European Parliament and the Council. We will now examine the new powers under the Financial Services Act 2010 and the experience of implementing the earlier Code and deal with the new Code in more detail.

4.3.2.1 New Powers to control remuneration under the Financial Services Act 2010

The Financial Services Act 2010 was passed, and received Royal Assent on 8 April 2010. Among the diverse issues addressed by the Act was the conferring of new powers on the Treasury and the FSA to regulate remuneration in the financial system. These powers concerned executive remuneration reports and imposed restrictions on firms in relation to certain remuneration arrangements.

The Act gave the regulator powers, instructing it to make rules which require all or certain authorized firms to have a remuneration policy and to ensure compliance. This power was inserted into the Financial Services and Markets Act 2000 as section 139A. The Act defines a remuneration policy as "a policy about the remuneration by the authorised person of (a) officers, (b) employees, and (c) other persons, of a specific description".[74] The Act has restricted the rules which the FSA makes to be consistent with effective risk management and relevant international standards.[75] However, the Act stopped short of including any prohibition of remuneration structures or arrangements which are related to consumer protection, even though increasingly financial scandals have been related to the mis-selling of PPI which was at least partly encouraged by the bonus or commission structures of the employees in the retail banks.

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[73] FSA, CP10/19 (n 20).

[74] Financial Services Act 2010, section 6(2).

[75] Financial Services Act 2010, sections 6(3), (4), (12) & (13).

The Act provides a solution to the problem which the FSA faced with its earlier Code when it tried to prohibit certain methods of remuneration, as some firms had long-term commitments to some of their employees which were contractually binding but, at the same time, constituted a breach of the Remuneration Code. The solution was that any provision of an agreement that contravened a prohibition of the FSA was void and such payments could be claimed back.[76] This eased firms' concerns that they would become exposed to legal suits if they refused to honour their contractual obligations to apply FSA rules.[77] This section allowed the FSA unprecedented power to interfere in privately-arranged and freely-negotiated contracts.[78]

4.3.2.2 Lessons learned from the previous Code

In its consultation paper *Revising the Remuneration Code*[79] which reviewed the implementation of the Remuneration Code, the FSA noted that following the financial crisis remuneration policies and awards had been influenced by several factors, including political and media pressure. Therefore, it acknowledged that there was a need for more time to assess the full impact of the Code and its contribution to effective risk management. The FSA stated that there had been a general improvement in the work of the remuneration committees among firms within the scope of the Code with greater attention being paid to risk when setting remuneration policies and signing off bonuses. Nevertheless, the FSA concluded that further improvement was needed, especially in the area of risk adjustment.

The FSA was happy with the way in which firms within the scope of the Code had paid their bonuses for January 2010 compared to 2008 and 2009. In 2010, in accordance with the Remuneration Code, firms increased the payment of bonuses in shares and LTIP, while decreasing payments in cash. Firms had also agreed to defer 40 to 60 per cent of the remuneration of employees who are classified as principle 8 (P8) employees, with the majority increasing the level of deferral and the rest just meeting the minimum requirements

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[76] Financial Services Act 2010, sections 6(9)(b) and (c).

[77] N Willmott and others, "Equipping the modern regulator: assessing the new regulatory powers under the Financial Services Act 2010" (2010)78 (Jul/Aug) *Compliance Officer Bulletin* 1, 6.

[78] Arora, "Remuneration practices in banks: part 2" (n 44) 136.

[79] FSA, CP10/19 (n 20).

of 40 per cent. However, with regard to the vesting period of the deferred remuneration, all firms inclined towards the minimum requirement of three years.

Firms did not quite meet the FSA's expectations with regard to performance adjustment. Despite the fact that most firms have policies regarding performance adjustment in relation to deferred remuneration, these were limited to the incidence of misconduct by employees. The FSA wanted performance adjustment to cover those circumstances in which a firm, or a smaller unit within it, faces substantial deterioration in its financial performance, or situations where losses arise as a result of significant failures in risk management. To avoid this shortfall, the FSA set a target for firms to award 75 per cent of deferred remuneration for P8 employees in shares, which most have done.[80] For banks and building societies which are not able to award shares because of their legal structure, the FSA ensured that appropriate deferral schemes and malus arrangements were in place to comply with the Code.

Implementing the prohibition on guaranteed bonuses has given an advantage to firms outside the scope of the Code in terms of attracting talented employees.[81] The FSA had asserted that, when implemented, CRD III will help to end this shortcoming. However, some employees of firms within the scope of the Code were paid guaranteed bonuses and were asked by the FSA to renegotiate these contracts where possible or impose additional risk monitoring. The FSA also reported a slight increase in fixed pay and, as a result of developments at EU level in this area of the ratio between fixed and variable pay, the FSA decided to wait for an agreed outcome.

Finally, the FSA was happy with the fact that most firms have satisfactory governance arrangements in place, which included an independent remuneration committee comprising non-executive directors who meet regularly to consider their firm's remuneration practices. It concluded that risk functions have generally been well incorporated into firms' remuneration policies. However, there was still room for improvement in the method of calculating bonus pools and adjusting them for current and future risk.

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[80] FSA, CP10/19 (n 20) Annex 3.

[81] FSA, CP10/19 (n 20) para 2.27.

4.3.2.3 The Revised Code

4.3.2.3.1 The scope of the Code and the proportionality principle

On 17 December 2010, the FSA published its policy statement on revising the Remuneration Code,[82] containing the final rules and incorporating feedback from the July 2010 consultation. This policy statement was delayed until December so that the FSA could take account of the CEBS guidelines[83] on remuneration.[84] The new Code was set out in Chapter 19A of the FSA's SYSC. The aims of the Remuneration Code are to force boards of directors to focus more closely on the consistency between the distribution of remuneration and effective risk management and sustainability as well as ensuring that individual remuneration practices provide the right incentives.[85] The most important features of the Code will be discussed here, and thus will not feature in the later discussion of the Remuneration Codes in the context of the new regulators and what they inherited from the FSA.

The FSA defined the scope of the Code in relation to the elements of the remuneration as follows:

> *[T]he Remuneration Code covers all aspects of remuneration that could have a bearing on effective risk management including salaries, bonuses, long-term incentive plans, options, hiring bonuses, severance packages and pension arrangements.*[86]

Unlike the previous Code, which only applied to about 26 of the larger financial institutions, the new Code was expected to be applied to over 2,500 firms as a result of implementing CRD III.[87] This extension, which is maintained under CRD IV, has helped to reduce lobbying by large financial institutions, as they had claimed that they were at a competitive

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[82] Financial Services Authority, *Revising the Remuneration Code: Feedback on CP10/19 and final rules* (PS10/20, December 2010), (FSA, PS10/20).

[83] Committee of European Banking Supervision, "Guidelines on Remuneration policies and practices" (10 Dec 2010) 13 (CEBS Guidelines on Remuneration).

[84] Arora, "Remuneration practices in banks: part 2" (n 44) 132.

[85] ibid 133.

[86] SYSC, 19A.2.2(2).

[87] FSA, CP10/19 (n 20) paras 2.16 & 3.6.

disadvantage and would lose their employees to competitors unaffected by the scope of the Code.[88]

However, as with the previous Code, UK branches of the EEA are not required to apply the Code as they will be required to comply with their home state regulation, which will have similar provisions to those under CRD. Moreover, UK groups and UK subsidiaries of a third country need to apply the Code globally,[89] regardless of whether they are required to apply similar provisions under other jurisdictions or not. In the case of divergence in implementing the P&S, this will increase the burden on those firms if they have to conform to two different sets of rules and might put them at a competitive disadvantage if the other state has a more lenient set of rules which also encourages talented staff to leave and benefit from the regulatory arbitrage. Moreover, they might find themselves in a position where it is impossible to comply with two different sets of rules in addition to the employment law of a third country if there is a conflict between them.

All the principles of the new Code will be applied to defined personnel known as "Code Staff". This represents a shift from the previous Code, which was applied to the firm generally except for P8, which was aimed at a specific group of employees. However, this does not mean that non-Code Staff will not be subject to any principles, as the Code urges firms to give consideration to the remuneration principles on a firm-wide basis in the light of the general rule and in accordance with proportionality. The Code requires firms to specifically consider Principle 12(c), which is related to guaranteed variable remuneration, and Principles 1-4, 8-10 and 12(e) and (g) on a firm-wide basis.[90]

The term "Code Staff" refers to the group of employees to which the Remuneration Code is applied. Code Staff are linked to those individuals who have a material impact on a firm's risk profile, as the main objective behind the Code is to achieve effective risk management.[91] Firms were expected to set their own metrics in order to identify their risk takers.[92] The

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[88] ibid para 2.26.

[89] Note that a UK subsidiary need only apply the Code in relation to its activities from an establishment in the UK and its global subgroup.

[90] SYSC, 19A.2.3(2) & (3).

[91] FSA, CP10/19 (n 20) para 3.17.

[92] SYSC, 19A.3.6(e).

guidance from CRD III stated that the Remuneration Code is to apply to the persons who perform significant influence functions (SIF), the senior managers and all staff whose total remuneration takes them into the same bracket as senior management and risk takers, and whose professional activities could have a material impact on a firm's risk profile. However, since it was not clear on what basis an employee falls into "the same bracket" as senior management,[93] the FSA stated that it expected individuals who perform a role as a head of a significant business, line, or a support and control function, to be part of the Code Staff. It provides a non-extensive list of who might be considered "Code Staff" to ensure consistency between firms in applying the Code.[94] Under the CRD IV the European Banking Authority (EBA) is charged with identifying the persons to whom the Remuneration provisions apply as will be discussed later in the context of the chapter concerning the EU.

Secondees and employees who become Code Staff for part of a year, and consultants or advisors of authorized firms are also subject to the terms of the Code. However, this will only apply if the secondees' performance involves material risk-taking regardless of which firms are paying their remuneration. If they are work-shadowing or training and do not have a material impact on a firm's risk profile, they will not be considered as Code Staff.[95] A person who has been considered as a Code Staff member for any part of the year will be treated as Code Staff for the whole of the year. However, the regulator will have regard for proportionality and decide whether the provisions regarding the remuneration are to be disapplied or applied to only a proportion of variable remuneration depending on the length of service as a Code Staff member. The regulators differentiate between someone who becomes Code Staff for no more than three months and someone who becomes Code Staff for more than three months.[96] Firms also need to consider whether their consultants and advisors fall within the definition of Code Staff. As the regulators' definition of "employee" is quite broad, it could also incorporate personnel if they are classified as an "employee receiving total remuneration that takes them into the same remuneration bracket as senior management

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[93] Arora, "Remuneration practices in banks: part 2" (n 44) 135.

[94] FSA, CP10/19 (n 20) paras 3.12, 3.14 & 3.16.

[95] FSA, PS10/20 (n 82) 15.

[96] ibid, paras 3.3-3.5.

and risk takers, whose professional activities have material impact on the firm's risk profile".[97]

Proportionality is used to avoid a formulaic "one size fits all" approach to the regulation of remuneration policies, meaning that the implementation of the rules can be tailored to institutions according to their nature, scale, scope, internal organization and the complexity of their activities[98] and, accordingly, the level of supervision will be different in each case. The aim is to match remuneration policies and practices with an individual institution's risk profile, strategy and risk appetite.[99] This is in addition to the proportionality approach regarding employees which limits the application of the Code to Code Staff and exempts certain employees from having Principle 12 applied, as it contains provisions with regard to the structure of remuneration, when they meet the *de minimis* concession under principle 12. The reason for this is that the FSA recognized that applying the full Code to all firms might be inappropriate and burdensome for some companies.[100] A proportionality principle will allow for differences between firms in applying the Code.

However, some large banks have highlighted the risk of losing their key staff to their competitors as a result of this approach, whilst some investment firms have emphasized that they will be at a competitive disadvantage in comparison to non-CRD or international peers if they apply the full Code.[101] Therefore, the FSA asserted that it would make sure that similar firms will be treated in a similar fashion and prepared a four-tier system. The FSA focused on the systemic importance and risks posed by different firms and their business models when formulating the metrics and thresholds for the four tiers.[102]

The FSA relied on capital resource as a threshold in determining the tiers. However, due to the difficulties in applying this threshold to third-country BIPRU firms, total branch assets were used. This guidance on proportionality was updated in December 2011 and again in September 2012. The latter update has created a three-tier rather than a four-tier division.

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[97] Snowdon (n 49) 26.

[98] SYSC, 19A.3.3(2).

[99]FSA, PS10/20 (n 82) para 3.11.

[100] FSA, CP10/19 (n 20) 7.

[101] FSA, PS10/20 (n 82) para 2.55.

[102] ibid, paras 3.13 & 3.15.

This approach will "allow the [regulator] to focus its resources on the firms who pose the most significant risks to financial stability".[103] Moreover, the FSA used total assets as a measure for the three levels in relation to all the firms in the scope of the Remuneration Code and stopped using capital resource for local firms, as was its previous approach.

Due to the significant increase in total assets, many third-country firms which used to be in tier one are most likely to be in level two under the new guidance. However, if a firm is part of a group, then each Remuneration Code firm must determine its own level; if they then fall into different levels, each firm in the group will be placed at the level of the highest overall. However, individual guidance is still available as a firm can be classified as being upper or lower level as identified by the guidance depending on its characteristics. Therefore, the guidance is not comprehensive and firms on the same level may require different responses to the Remuneration Code.[104] The Proportionality levels now form part of the work of the new regulators in monitoring compliance with the Remuneration Code.

Level one firms include banks, building societies, investment firms and IFPRU 730k firms (which are investment firms regulated by the FCA)[105] with total assets exceeding £50 billion on the relevant date. However, if the total assets of these firms are in the range from £15 billion to £50 billion, they will be generally classified as level two firms. Level three will apply to firms with total assets of up to £15 billion on the relevant date and to IFPRU limited licence and limited activity firms.

Level one and two firms have to apply the Remuneration Code in a similar manner. However, the supervisory approach is less intensive for level two.[106] Level three firms can disapply the remuneration principles related to retained shares or other instruments, deferral and performance adjustment. Full scope IFPRU regulated by the FCA and IFPRU limited licence

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[103] Financial Services Authority, "Proposed review of general guidance on proportionality for remuneration" (26 July 2012) Available at: <http://www.fsa.gov.uk/library/policy/guidance_consultations/2012/gc1210> accessed 4 May 2014.

[104] Fincial Conduct Authority, "General guidance on proportionality: the remuneration code (SYSC19A)" (December 2013) paras 26 & 27.

[105] This has changed according to the new classification of the FCA in applying the CRD IV.

[106] Linklaters, "FSA Remuneration Code: consultations on proportionality tiers and remuneration data collection" (3 August 2012) Available at: <http://www.linklaters.co.uk/Publications/Employment-and-Incentives/Corporate-governance/Pages/FSA-Remuneration-Code-consultations-proportionlity-tiers-remuneration-data-collection.aspx> accessed 14 February 2014.

and limited activity firms may also disapply rules related to the ratios between the fixed and variable components of total remuneration:[107] "Such firms may also take into account the specific features of their types of activities in applying the requirement on the multi-year framework".[108]

4.3.2.3.2 The Code's general requirement and principles

4.3.2.3.2.1 The Code's general requirements

The general rule has not been changed in the new Code, which states that "[a] firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management",[109] as this represents the central tenet of the Remuneration Code. The Code wants firms to avoid remuneration structures that could create incentives for employees to take excessive risk to increase bonuses and endanger the firm's sustainable growth. A firm's remuneration proposals would be measured against this rule and firms are expected to use the general rule as the first point of consideration and apply it to all staff in the firm.[110] Firms are also advised to have regard for the guidelines on remuneration and corporate governance published by other bodies, such as the ABI and the NAPF.[111] Despite the fact that the regulators asserted that the ABI and NAPF guidelines are valuable, they are not binding and are limited to the remuneration of executive directors.[112] This did not support the regulators' aim to extend the remit of remuneration committees to cover remuneration practices on a company-wide basis.

The general rule is supplemented with principles to assist firms to comply with this. These principles are mainly intended to prevent remuneration structures that encourage decision making on a short-term basis or without due regard to risk, and to encourage those that take

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[107] FCA, "General guidance on proportionality" (n 104) para 29.

[108] Financial Services Authority, "General guidance on proportionality: the remuneration code (SYSC19A) and pillar 3 disclosures on remuneration (BIPRU 11)" September 2012.

[109] FSA, CP 09/10 (n 53) para 5.8.

[110] ibid para 3.29.

[111] SYSC, 19A.2.2.G(2).

[112] FSA, CP 09/10 (n 53) Annex 3 para 11.

into account long-term effects on the business.[113] The principles have rules and sometimes evidential provisions which can show whether a firm is applying the general rule or not. However, the principles under the FSA updated Code are more prescriptive and intrusive than those of the previous Code, and they rely more heavily on rules rather than evidential provisions. In other words, the principles will be used to assess the quality of a firm's remuneration policies and whether they encourage excessive risk-taking as the means of determining their compliance with the general rule. The principles are also supplemented with guidance to help firms with implementation.

The principles deal with risk management, governance, capital, government intervention, risk adjustment, pensions, hedging and avoidance, remuneration structures, and the effects of breaching the principles.

4.3.2.3.2.2 Risk management and control function

Firms must ensure that their remuneration policy is consistent and promotes effective risk management, aligns with business strategy, objectives and long-term corporate value and does not lead to conflicts of interest at any level, encourage excessive risk-taking, or exceed the firm's tolerated level of risk.[114] To ensure effective risk management overseeing, the Code urges firms to separate the remuneration of those employees in a control function from the remuneration of the business area they oversee to allow them to be independent and focus on long-term growth.[115]

Moreover, the Code obliges firms to ensure that the remuneration of senior officers in risk management and compliance functions is overseen by the remuneration committee or the governing body directly.[116] However, achieving the right balance between risk-taking and risk management will represent a difficulty for firms, especially with the separation of the remuneration between front and back offices. More risk-taking translates to more financial growth in the short-term but this may or may not be the same case in the long term. Judging

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[113] Y Hausmann and E Bechtold-Orth, "Changing remuneration system in Europe and the United States: a legal analysis of recent developments in the wake of the financial crisis" (2010) 11(2) *European Business Organization Law Review* 195, 203 & 204.

[114] SYSC, 19A.3.7-19A.3.9.

[115] SYSC, 19A.3.14.

[116] SYSC, 19A.3.16.

precisely what leads to long-term growth in the absence of an accurate long-term measure[117] is a very challenging task; adopting a very conservative risk management policy will result in less financial growth in the short term but not necessarily encourage greater growth in the long term. Therefore, this separation should be re-examined in more detail to ensure objectivity and involvement, as the proposed separation and increase in base pay might serve to ensure the detachment of risk management and compliance officers from the business.

4.3.2.3.2.3 The governing body

The principles are also concerned with aspects of governance. The Code only requires significant firms to have remuneration committees. The remuneration committee or governing body in smaller firms is responsible for adopting and periodically reviewing the general principles of the remuneration policy. The members of the remuneration committee must be members of the board who do not perform executive functions. They must be independent, skilled and experienced enough to exercise competent and independent judgement in preparing the decision for the board, taking account of the implications for risk management, capital, and liquidity as well as the long-term interests of shareholders, investors, and other stakeholders in the firm and in the public interest.

However, the Code states this rule without suggesting any solutions in the case of a conflict of interests between these interests.[118] For example, what might be in the interests of shareholders might not be in the interests of other stakeholders and since the Code does not suggest any hierarchy, firms may not be able to give proper consideration to other interests, especially when common law favours shareholder primacy.[119] Concerns were also raised that there might be a shortage of non-executive directors with the relevant experience to sit on remuneration committees given this increased responsibility, which would make it difficult for firms to comply with this principle.[120] The Code also urged firms to allow risk management and compliance functions to have appropriate input into the setting of

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[117] Note that share price is suggested as an indicator of long-term growth. However, share prices are affected by a number of factors, some of which are beyond a firm's control, especially in inefficient markets.

[118] SYSC, 19A.3.10-19A.3.12.

[119] The Companies Act 2006, section 172.

[120] Snowdon (n 49) 9.

remuneration policies to help the remuneration committee or the governing body to align the remuneration policy with effective risk management.

4.3.2.3.2.4 The relationship between the firm's capital and variable remuneration

The Remuneration Code tries to restrict the effect of variable remuneration on the ability of a firm to build its capital. The Code also has some rules which relate to institutions receiving government aid. The Code requires institutions which receive exceptional government intervention to limit variable remuneration as a percentage of net revenues and to stop paying variable remuneration to any members of senior management who were in office at the time of the intervention unless it is justified.[121] This rule can be seen as a way of terminating the existing contracts of the existing senior management of a firm which has received exceptional government intervention, as they are more likely to transfer to another firm where they can have variable remuneration; however it does not prevent firms which have received government intervention from hiring new talented managers and paying them a variable remuneration. However, the principle did not differentiate between managers as all of the existing managers will be precluded from receiving variable remuneration when their firm receives government aid while some may be in some departments which did not cause the loss to the firm and they will be precluded from variable remuneration due to errors made by other people.

4.3.2.3.2.5 Risk adjustment of remuneration

The updated Code focuses not only on the *ex-post* measure of aligning remuneration outcome with risk outcome, but also pays attention to the *ex-ante* measure. This means that when measuring performance for the purpose of determining the variable remuneration to adjust the remuneration to those risks, firms need to take account of all types of current and future risks, especially the cost and quantity of capital, and the liquidity required.[122] The Code leaves firms to decide which risk adjustment measure is appropriate to use depending on the firm's risk profile. However, firms will be asked to provide the regulators with details of all adjustments that are used by the firm under a formulaic approach as well as applying

[121] SYSC, 19A.3.20.

[122] SYSC, 19A.3.22.

qualitative judgements in the final decision about performance-related components of variable remuneration.

4.3.2.3.2.6 Discretionary pensions and avoidance

The Code has also introduced a rule for discretionary pensions. A discretionary pension is different from a standard pension entitlement and a firm's financial contribution schedule, being a non-standard one-off payment on an individual basis that is deemed to be of a variable nature.[123] The Code obliges firms which grant discretionary pensions to leaver or retired employees to be paid in specified instruments[124] and held by the firm for five years.[125]

The updated Code has introduced provisions to cover avoidance and hedging. Hedging and insuring the risk of deferred remuneration or using it as collateral for a non-recourse loan could undermine the effect of deferral. The Code urges firms to ensure that their employees do not take out an insurance contract on their remuneration to transfer the risk to a third party in exchange for payment. However, the Code has simply placed the onus on firms to ensure that they have effective arrangements to ensure compliance, which can be very difficult to implement.

4.3.2.3.2.7 The structure of remuneration

Principle 12 is concerned with the structure of remuneration and covers a range of issues related to performance assessment and adjustment, deferral, guarantees, retention, leverage, and payment related to early termination. The Code restates the main objective that the structure of remuneration must be consistent and promote effective risk management.[126] However, rules covering guaranteed variable remuneration, payment of remuneration in shares or other capital instruments, deferral and performance adjustment do not apply to Code Staff who fulfil two conditions. The first is that his or her variable remuneration is less than 33 per cent of total remuneration and the second is that his or her total remuneration does not exceed £500,000.[127] As part of introducing the new remuneration provisions of CRD IV into

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[123] FSA, CP10/19 (n 20) para 3.53.

[124] SYSC, 19A.3.47.

[125] SYSC,19A.3.29.

[126] SYSC, 19A.

[127] SYSC, 19A.3.34.

the Code the regulators have required firms to make a clear distinction between criteria for determining fixed and variable pay.

The Code wants a departure from using revenue to measure performance to using profit for a number of reasons. The most important is to force employees to pay sufficient regard to the quality of business undertaken and services provided and their appropriateness for clients.[128] The Code urges that when calculating the bonus pool current and future risk adjustment should be included. In addition, the cost of capital employed and liquidity required should be taken into account. Moreover, long-term performance should be a significant part of the performance assessment process, based not solely on financial measures but also non-financial measures (especially those related to risk management and compliance). The Code emphasises that long-term performance should be assessed using a moving average of results or by using a deferral technique. It also stresses that some measures of performance, such as EPS and TSR, have a short-term focus and are risky, even if they are based on a two- to four-year period as firms tend to increase leverage to ensure a higher return.

The Code wants firms to move away from only using financial measures to assess performance. Assessment of performance in the Code's view must be based on the performance of the individual, the business unit and the overall results of a firm in a multi-year framework, and should include non-financial criteria related to the adherence to effective risk management and compliance with the regulatory system.[129] However, this provision might be challenged by shareholders who are granted a binding vote regarding remuneration policy. Shareholders, especially those with short-term prospects, are more likely to vote against a policy which favours such non-financial criteria.

Another important issue is that the Remuneration Code instructs firms to stop payment of variable remuneration when financial performance is poor. However, the payment of such variable remuneration is unlikely to be justified by non-financial performance because Principle 12(h) asks firms to reduce unvested remuneration in the case of a downturn in the financial performance of a business unit.[130] The relationship between determining employee

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[128] FSA, CP 09/10 (n 53) 32.

[129] SYSC, 19A.3.36-3.39.

[130] SYSC, 19A.3.52.

remuneration and the use of non-financial measures is not completely clear in the Code even it has recommended the use of balanced scorecard. Moreover, despite the importance of using non-financial measures to assess performance, it is unclear how it can be verified if firms overuse these.

The use of surveys or the benchmarking of other firms is based on current financial performance or, in other words, it is a short-term comparison between firms which will be more likely to put a firm with more effective risk management at the bottom of the table but the same company might be at the top after a few years as a result of taking a longer-term perspective. However, shareholders are generally short-sighted and will demand more change in a firm, which will put pressure on directors to meet shareholder demands to avoid being removed from office. The Code did not place any responsibility on shareholders to adhere to the Code's principles when exercising their voting power. For example, Carpenter, Cooley and Walter argue that the solution to the remuneration problem in financial institutions should be based on solving the agency problem of risk-shifting between shareholders and society, rather than the traditional view of solving the agency problem between shareholders and management; the Code fails to address this issue.[131] However, the PCBS has raised this point, recommending that the Government consult on a proposal to amend section 172 of the Companies Act 2006 to remove shareholder primacy in respect of banks, requiring directors of banks to ensure the financial safety and soundness of the company ahead of the interests of its members.[132]

The Code prohibits firms from awarding Code Staff a guaranteed variable remuneration unless the company has a sound and strong capital base and the award is consistent with the Code requirement that this is exceptional in the case of hiring new remuneration Code Staff, is limited to the first year only, is not more generous than the award made by the previous employer, and is subject to performance adjustment and deferral.[133] Firms are also required to maintain a balance between the variable and fixed components of remuneration, which will be achieved through raising the fixed component of remuneration. However, as part of

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[131] J Carpenter, T Cooley and I Walter, "Reforming Compensation and Corporate Governance" in: V Acharya, T Cooley, M Richardson and I Walter (eds), *Regulating Wall Street*, (John Wiley & Sons, New Jersey 2011).

[132] Joint Committee on Banking Standards, *Changing banking for good* (2013-14, HL27-I, HC175-I) 42.

[133] SYSC, 19.3.40-3.43.

introducing the CRD IV the regulators have incorporated the rules on the ratio between fixed and variable payment by inserting the relevant sections from the CRD IV into the Code and making them applicable to level-one and level-two firms.[134]

These two rules regarding guaranteed variable remuneration and the balance or maximum ratio contradict each other, as the Code requires firms to stop paying guaranteed variable remuneration but allows them to raise employee salaries which can be a form of guaranteed remuneration or, even worse, may lead to an increase in salary for everyone without the need for a corresponding rise in performance. Having a flexible defined guaranteed variable remuneration is better than having a guaranteed fixed component. The reason given by firms is that the rise in salary increases the fixed cost of running the business whereas variable remuneration can be reduced or increased. So, this will not give firms the flexibility to implement a remuneration policy which rewards success and punishes failure even if the punishment were solely a reduction in the expected variable remuneration. Thus, the rules on balance and guaranteed variable remuneration need to be revised in order to give firms more flexibility to implement their remuneration policy and reduce their fixed costs. Firms should not be asked to have a balance but to provide a rationale for any payment, ensuring this is determined on financial and non-financial performance.

These rules, together with the deferral rule, will have the effect of raising the hiring bonus, which is not prohibited but is limited to the first year, as the firm hoping to attract employees needs to compensate them for the forfeiture of the deferred part of their remuneration. In addition to this, the current employer will not be able to counter an offer if it is made to a key member of staff, despite the regulators' assertion that they would consider retention bonuses, as there are no clear rules and guidelines about their application in the Code, meaning employers who offer a retention bonus will be in breach of the rules.[135] Therefore, this rule will increase the mobility of talented staff as well as making it very expensive and as a result firms facing failure will not have the ability to attract new staff because they would not be able to offer them more than they could expect from their previous employers and they would not be likely to find talented employees who will take such risks to move to a new firm.

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[134] Prudential Regulation Authority, *Strengthening capital standards: implementing CRD IV, feedback and final rules* (PS7/13, December, 2013), (PRA, PS7/13).

[135] FSA, PS10/20 (n 82) paras 2.42 and 2.43.

Principle 12(e) obliges firms to ensure that payment for early termination reflects performance achieved over time. This area is also controlled by section 215 of the Companies Act 2006 for directors. This raises the following issue: given that the regulators have no power to amend the Companies Act and this rule contains an indirect amendment of the Companies Act, if the payment was approved by a member of the company or is consistent with the Companies Act 2006, will the firm be considered as being in breach of the rules or will it be exempt given that it had met the Companies Act requirement? If the answer is that payment is exempt from this requirement, then the rule is not enforceable and, therefore, is not fit for purpose.

As a means of promoting a long-term focus and prudent risk-taking by Code Staff, the Code introduced rules for the greater use of shares and capital instruments (non-cash instruments) in remunerating staff as well as deferral techniques. These together with the use of retained shares and capital instruments are intended to help *ex-post* measures of malus and clawback be used for controlling excessive risk-taking. However, as far as the Code is concerned the main *ex-post* measure is performance adjustment, which is used to determine the actual outcomes after a period of time to make sure that they were correctly counted the first time.[136] Firms are required to pay 50 per cent of the variable component upfront or deferred remuneration in shares and other capital instruments and are subject to a retention period in accordance with the firm's retention policy, which is designed to align incentives with the long-term interests of the firm.[137] Moreover, firms are required to have a policy on deferral which applies to Code Staff for three to five years and is aligned with the nature of the business and its cycle as well as being vested on a *pro rata* basis. This deferral must be at least 40 per cent of a total remuneration under £500,000 and at least 60 per cent for more than that.[138]

In this case the Code has determined part of the long-term remuneration by using deferral and paying the remuneration in shares or other capital instruments, without any regard to the requirements of shareholder approval of this kind of remuneration, claiming that this will closely align the remuneration of staff with company performance. However, this will only be

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[136] FSA, CP10/19 (n 20) para 3.88.

[137] SYSC, 19A.3.47.

[138] SYSC, 19A.3.49.

effective in efficient markets, where the price of shares reflects the available information and the real situation of a firm and is also reliant on closely monitoring of insider trading. Moreover, this might have a significant effect on raising the market in the run-up to the time when the shares of executives are vested and exercisable, as studies discussed in Chapter Two found that executives have an incentive to defer the announcement of good news until the time when their shares are vested and/or exercisable. In addition, several studies have found that a large holding of shares increases risk-taking.[139] This will also encourage fund managers to consider this as the time to speculate on the shares concerned. All of these issues will affect the efficiency of the market and in the future the aim of using more shares will prove ineffective.

Principle 12 also outlines the rules regarding the payment and vesting of variable remuneration including any deferred part. Firms are required not to pay or allow vesting unless it is sustainable according to the financial situation of the firm as a whole, and is justified on the basis of performance.[140] Under the updated code, firms are required to apply clawback and malus. Enacting malus and clawback is subject to the firm's criteria regarding these which should include those situations in which the employee has participated in conduct which has resulted in significant losses to the firm, or has failed to meet appropriate standards of fitness and propriety. However, the Code has not specified any detailed rules on the application of clawback making it difficult for firms to recover payment. As a means of implementing the provision on clawback in the CRD IV and covering this in the Code, the PRA obliges firms to subject variable remuneration to clawback for a period of seven years from the date of award.[141] As with malus, the operation of clawback is also subject to the firm's criteria but it must make all reasonable efforts to recover an appropriate amount if there is reasonable evidence of employee misconduct or material error, and if the firm or relevant business unit suffers a material failure of risk management. However, in applying the latter scenario, the firm must consider the employee's proximity to the failure of risk management and his/her level of responsibility and seniority.[142] It has been argued that the

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[139] See sections 2.1.3.2.1 and 4.2.5.

[140] SYSC, 19A.3.51.

[141] Prudential Regulation Authority, *Clawback* (PS7/14, July, 2014).

[142] ibid.

Code is unlikely to result in improved risk management outcomes unless changes are made to the corporate governance framework at a more systemic level.[143]

4.3.2.3.3 Disclosure requirements and supervisory approach

UK companies are under an obligation to disclose their remuneration arrangements. However, the requirements are more detailed in the case of quoted companies which, in addition to disclosure, are obliged to hold a shareholder vote on the remuneration report. However, these requirements are focused on the remuneration of directors and, as Walker points out, in the financial industry many senior management are not board members but they could have an impact on a firm's risk-taking and their remuneration reaches or exceeds that of some of the board members.

The FSA also considered provisions of disclosure in its work to implement CRD III which introduced requirements for firms to make disclosures regarding remuneration. The FSA used the guidance of the CEBS as the basis for its approach.[144] In November 2010, the FSA consulted on a proposal to implement the disclosure requirements for remuneration under CRD III, the final rules being published in December 2010. The FSA believed that the CRD III requirements will help to improve market transparency and discipline as well as creating a level playing field within Europe.[145]

The FSA published the following requirements in its handbook.[146] Firms are required to disclose, at least annually, information regarding their remuneration policy and practices. This disclosure applies to the remuneration of those employees whose professional activities have a material impact on a firm's risk profile.[147] Companies are obliged to disclose the following data: information related to the decision-making process for determining remuneration policy (including the composition and the mandate of the remuneration committee); the use of external consultants and the role of any relevant stakeholders. This disclosure must contain information regarding performance measures, risk adjustment and the

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[143] E Shear, R Moulton, B Price and N Kay, "Corporate governance in financial institutions" (2010) 74(Mar) *Compliance Officer Bulletin* 1.

[144] FSA, PS10/21 (n 4) para 1.2.

[145] ibid, para 1.13.

[146] BIPRU, 11.5.18-11.5.21.

[147] BIPRU, 15.5.18.

link between pay and performance. The disclosure must include aggregate quantitative information on remuneration broken down by business area and aggregate quantitative information on remuneration for senior management and members of staff whose actions have a material impact on the risk profile of the firm must be included in the disclosure (a reference must be made to the level of senior personnel in the case of significant firms). This data must include the sum of remuneration for the financial year presented as fixed and variable components along with the number of beneficiaries. The latter component must be clearly indicated and split into cash, shares, share-link instruments and other types. Information is also required for vested and unvested deferred remuneration and whether this was adjusted downwards or not due to performance. Welcome bonuses and exit payments must also be included, along with the number of beneficiaries.

The provisions of disclosure have been increased and carried over to the CRD IV but not into the directive. It forms part of the Capital Requirement Regulation (CRR) and is directly applicable to the EU member states.[148]

The regulators will be more involved in scrutinizing the remuneration policies of authorized firms and their influence on risk-taking. Firms within the scope of the Code will be required to submit annual data setting out information on their remuneration policies and certification to show that their remuneration policies are compliant with the Code. Regulators will assess compliance against requirements but the level of scrutiny will vary according to the proportionate level as well as the risk profile of the firm.[149] Firms can be classified as lower or upper, according to their characteristics and risk profile. The regulators will also use the principles to assess the quality of a firm's remuneration policy and whether it encourages excessive risk-taking.[150] Regulators may ask firms to provide evidence that their remuneration scheme meets Code requirements, together with plans for improvement if there is a shortfall.[151] Firms are expected to use Code principles in their internal capital assessment process.[152] In addition, firms within the scope of the Code are required to prepare a

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[148] See section 5.5.2.5.

[149] Arora, "Remuneration practices in banks: part 2" (n 44) 134.

[150] SYSC, 19A.2.2(4).

[151] SYSC, 19A.2.2(5).

[152] Arora, "Remuneration practices in banks: part 2" (n 44) 133.

Remuneration Policy Statement (RPS) which reports the firm's self-assessment of compliance with the Code. The RPS must be reviewed and approved by the firm's remuneration committee and revised annually to take account of any changes in policies, practices or procedures and the changes should be approved by the firm.[153]

4.4 The new regulators and the remuneration codes

4.4.1 The remuneration code in the regulators' handbook

Following the passage of the Financial Services Act in December 2012, the FSA was replaced as a unified regulator and new regulatory supervision structure came into force in April 2013, with separate authorities for macro-prudential policy, micro-prudential supervision and conduct of business supervision.[154] The FPC now sits within the Bank of England, its aim being to identify and take action to remove or reduce systemic risks.[155] The PRA is established as a subsidiary of the Bank of England and tasked with the prudential supervision of all "systemically important firms"[156] including banks, building societies, insurers, credit unions, and major investment firms (currently nine investment firms are jointly regulated by the PRA and FCA)[157] with the aim of ensuring that any failure would not undermine the stability of the financial system.[158] The FCA will replace the FSA, taking responsibility for prudential and conduct of business regulation. Prudential regulation is for firms that do not fall within the scope of the PRA and will be conducted in partnership with PRA while the conduct of business regulation will be for all firms.[159]

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[153] FSA, PS10/20 (n 82) para 4.10.

[154] Financial Stability Board, *Peer review of the United Kingdom: Review Report* (10 September 2013) 12.

[155] Financial Services Act 2012, section 6.

[156] The Chartered Insurance Institute, "Policy briefing: the UK's new financial services regulatory landscape" (April 2013) available at <http://www.cii.co.uk/knowledge/policy-and-public-affairs/articles/the-uk's-new-financial-services-regulatory-landscape/25460> accessed 18 April 2014.

[157] PRA and FCA, *Strengthening the alignment of risk and reward: new remuneration rules* (PRA CP15/14 and FCA CP14/14, July 2014), (PRA&FCA, Joint consultation).

[158] National Audit Office, *Regulating financial services: Report by the Comptroller and Auditor General* (24 March 2014).

[159] J Kirk and J Ross, *Modern Financial Regulation* (Jordan Published Limited, Bristol 2013) 28.

The Remuneration Code has been inherited by the PRA and the FCA as part of the prudential regulation and is now under chapter SYSC19A of the Handbooks for both regulators[160] with identical principles and rules. However, the FCA has other two codes under chapters 19B and 19C. The 19B code is for Alternative Investment Funds (AIFs) and 19C covers BIPRU firms. However, this thesis will not focus on the categorisation of investment firms[161] that the FCA introduced by amending the BIPRU firm definition and introducing a new IFPRU investment firm definition[162] as the focus is going to be on the Remuneration Code under SYSC 19A which implements the CRD IV and the P&S which is aimed at significant financial institutions.

4.4.2 Implementation of remuneration provisions in the CRD IV

CRD IV reproduces to a large extent the remuneration provisions introduced by CRD III. However, the maximum ratio between fixed and variable pay has been approved and become part of the CRD IV with other changes as will be discussed under the EU chapter. In implementing CRD IV, both regulators PRA and FCA have copied out the relevant sections into SYSC 19A Remuneration Code.[163] However, the FCA has amended the definition of the BIPRU firm and introduced a new term "IFPRU investment firms" in order to exempt BIPRU firms from the requirements of the CRD IV and SYSC 19A and subject them to the BIPRU Remuneration Code under the new chapter 19C of the SYSC which reflects the then existing Code. So these firms do not need to apply the rules on CRD IV including the ratio between fixed and variable pay.[164] Rules on the CRD IV are incorporated into SYSC 19A which contains the Remuneration Code for both regulators. However, level one and two firms are expected to apply the ratio but not level three firms. FCA has clarified that all of the current investment firms that are subject to CRD IV and prudentially regulated by the FCA are at

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[160] The PRA is in the process of replacing its Handbook with a Rulebook.

[161] For a brief explanation see: Alternative Investment Management Association (AIMA), "Categorisation of investment firms under the FCA's proposals to implement the CRD IV legislation" (October, 2013).

[162] For more information see: Financial Conduct Authority, *CRD IV for Investment Firms: Feedback and final rules for CP13/6, CP13/9 (Chapter 16) and CP13/12* (PS13/10, December 2013), (FCA, PS13/10).

[163] ibid; PRA, PS7/13 (n 134).

[164] SYSC 19C BIPRU Remuneration Code.

level three.[165] The PRA and FCA will also address the recommendations on remuneration in the PCBS report via consultation on a revised Remuneration Code in 2014.[166]

4.4.3 The future of remuneration

In July 2014, the PRA and FCA published a joint consultation paper to address the PCBS recommendations.[167] The PCBS has made recommendations designed to improve remuneration practices among financial institutions. However, PRA and FCA are consulting on how to incorporate these recommendations into the Remuneration Code by requiring firms to defer payment of variable remuneration for a minimum of five or seven years depending on their seniority. For senior managers this is a minimum of seven years with vesting starting no earlier than the third year after the award and no faster than pro rata between years three and seven. Five years for other MRTs with vesting would be pro rata. The idea behind increasing deferral is to capture the business cycles thus exposing employees to the downside of their decisions. However, it will be difficult to use deferral as the only method of capturing the cycle which can run for a period of 20 years. Thus, to improve *ex ante* measures for risk adjustment it is probably better to take such risks into account, particularly those arising from long-term securities (for example ABS & CDOs) and mortgages.

In addition to the newly introduced measure of allowing PRA firms to recover payment even if this has been paid out or vested for seven years in certain circumstances which the FCA is also consulting on,[168] it is proposed to further enhance this to ten years for senior management when risk management or conduct failings come under internal or external investigation (including from an overseas authority). The purpose of this extension is to allow firms to recover payment beyond seven years when a regulatory investigation or internal investigation is conducted into incidences related to remuneration that has been awarded or paid. Increasing deferral may contribute to a rise in the level of remuneration as a compensation for the length of waiting. Moreover, it is unclear what will happen if the investigation starts after seven years or if the extended period has elapsed and the

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[165] Financial Conduct Authority, *CRD IV for investment firms 2 - implementation* (CP13/12, October 2013) 13.

[166] FCA, PS13/10 (n 162); PRA, PS7/13 (n 134).

[167] PRA&FCA, Joint consultation (n 157).

[168] ibid.

investigation is still under process. Although it is rare for an investigation to last for that length of time, it is possible.

The proposal sets out options for addressing the fact that employees sometimes avoid the application of malus by changing firms. The options are that former employers should maintain unvested awards, applying malus to bought-out awards, banning buy-outs, or using the new clawback rules as an alternative. Thus the regulators are inviting views on the best way of dealing with the problem stating the advantages and disadvantages of each option.

The proposal also deals with the issue of revenue recognition and accounting rules on fair value when it is used to calculate variable remuneration as well as the limits of some performance measures. The PRA and FCA want firms to calculate profit for the purpose of determining the size of bonus pools by deducting a prudential valuation adjustment figure from fair value accounting profit in line with the requirement that banks need to report their prudent valuation adjustment of fair value positions quarterly. However, this proposal did not deal directly with the issue of revenue recognition as firms will continue to realise revenue before it is paid in accordance with accounting standards which are based on accrual but adjustment to the fair value of those revenues will be required. The full effect of such a proposal remains to be seen. In addition, the regulators want to introduce rules that simple revenue-based measures such as RoE, EPS and TSR may not be relied on to determine variable remuneration at aggregate or individual level unless they are used as a part of a balanced and risk-adjusted scorecard.

Finally, in keeping with the PCBS recommendation on this matter, the regulators are intending to make it an explicit requirement that non-executives do not receive variable remuneration.

4.5 Conclusion

The development of regulation of incentive-based remuneration in the UK was discussed in this chapter, which began by analysing the issue of incentive-based remuneration as it has been addressed in various reports since the financial crisis. It then proceeded to examine the work done by the FSA before it ceased to exist. Following that, the chapter considered potential future developments relating to incentive-based remuneration which may be suggested by the new regulators, the PRA and FCA.

The reports discussed in this chapter all agreed on the need for control of incentive-based remuneration, but express different views on how this should be done. In the Turner review, the case was made for the need for alignment with international developments to preserve the City of London as a major financial centre.[169] Walker introduced what was regarded as the strictest code at that time,[170] recommending that the FSA incorporate its recommendations into its own Remuneration Code on a comply or explain basis.[171] The PCBS described the widespread claims that increasing regulation would position UK at a competitive disadvantage as "overstated".

The Remuneration Code was introduced to tackle the problem of excessive risk taking being encouraged by remuneration structures. When the FSA was replaced in April 2013 by three separate bodies, the FPC, PRA, and FCA, the Remuneration Code was retained by both the PRA and FCA under SYSC 19A. However, EU-level changes in the form of the Alternative Investment Fund Managers Directive and CRD IV, together with the PCBS report, led to further changes. These are discussed in this chapter which analysed the measures introduced in the UK to tackle the problem of mis-alignment between reward and risk in the financial sector and explored how international and EU rules on remuneration in the financial industry have been implemented.

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[169] Turner Review (n 1) 81.

[170] Filder (n 15).

[171] Walker Review (n 2) recommendation 33.

Chapter 5 European measures to control remuneration practices

5.1 Introduction

In 1998 the EU started to take steps aimed at the integration of financial services. Issues related to corporate governance at that time were believed to be of limited relevance. However, corporate scandals in Europe and the introduction of the Sarbanes-Oxley Act in the USA changed the direction of the integration process and corporate governance became part of the pan-EU agenda. The starting point was the Recommendations made by the Winter Report of 2002,[1] which were followed by an Action Plan[2] for implementing these Recommendations. Later, Recommendations in 2004[3] and 2005[4] respectively from the European Commission (EC) were aimed at removing core conflicts in the decision-making process by setting up an independent body to decide the level and make-up of the remuneration of executive directors. This initiative was enhanced by defining and strengthening the role of independent directors and giving shareholders a "say on pay" in the remuneration-setting process. Disclosure requirements were recommended to facilitate shareholder involvement and influence the media's ability to embarrass executives. Therefore, it can be seen that pre-crisis reform refrained from intervening directly in the structure of remuneration, even in the form of a non-binding recommendation.

The financial crisis of 2007 affected the regulation of remuneration. Excessive remuneration caused public outrage with people facing wage cuts or even job losses, whilst bankers were enjoying large bonuses. Therefore, the EC issued three communications to assist Member States to safeguard their financial systems when bailing out companies, which included

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[1] The High Level Group of Company Law Experts, *Report on a Modern Regulatory Framework for Company Law in Europe* (4 November 2002) 9 (Winter Report).

[2] Commission, "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward" (Communication) COM (2003) 284 final, (Commission, Communication on Modernising Company Law).

[3] Commission Recommendation 2004/913/EC of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies [2004] OJ L385/55 (Commission Recommendation 2004/913).

[4] Commission Recommendation 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L52/51 (Commission Recommendation 2005/162).

aspects of the direct control of excessive remuneration in the ailing banks. The High-level Group[5] was set up and tasked with offering proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision. The report issued by the Group, known as the de Larosière Report, included remuneration among the issues it covered and explicitly accused remuneration practices of running counter to effective risk management.

Shortly after the de Larosière Report was issued, the CEBS published its High-level Principles for Remuneration Policies, in April 2009, which were repealed in a later publication of the EBA, in 2011.[6] In the same month, the EC also published two Recommendations,[7] dealing with the remuneration of directors of listed companies, and the second on remuneration in the financial sector. These Recommendations represented a turning point in the EC's approach to tackling remuneration practices. While the EC refrained from intervening directly in the structure of remuneration, these Recommendations explicitly designed the remuneration for listed companies and financial institutions through non-binding recommendations. However, the financial sector Recommendation is more demanding.

Another turning point was mandating the structure requirements as a result of the need to implement the P&S and the unsatisfactory and non-uniform implementation of financial sector recommendations by the Member States. The EC pressed for the inclusion of remuneration regulation in the CRD III.

In July 2011, the EC introduced a proposal for two European legislative instruments.[8] The proposal referred to as CRD IV contains a directive[9] and regulation.[10] The regulation or the

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[5] Commission, *The High-level Group on Financial Supervision in the European Union*" (25 February 2009), (de Larosière Report).

[6] European Banking Authority, *EBA Guidelines on internal governance* (GL 44, September, 2011) 48 (EBA, GL 44).

[7] Commission Recommendation 2009/385/EC of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies [2009] OJ L120/28, (Commission Recommendation 2009/385); Commission, Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector, [2009] OJ L120/22, (Commission Recommendation 2009/384).

[8] BP Joosen, "Further changes of the Capital Requirements Directive: CRD IV – major overhaul of the current European CRD legislation to adopt Basel III Accord (part 1) (2012) 27(2) *Journal of International Banking Law and Regulation* 45, 47.

CRR, which is directly applicable with immediate effect in all Member States, contains provisions relating to disclosure of remuneration, the "single rule book" and the Basel III prudential reforms. The directive, which needs to be enacted by Member States, includes provisions related to remuneration, corporate governance and transparency, and the introduction of buffers. CRD IV carries out all the remuneration provisions in the CRD III and adds to them. The most notable modification is the introduction of the capping of variable remuneration to a ratio of the fixed pay. Principles related to corporate governance which are usually applied on a soft law basis have been upgraded by the directive to become a hard law which needs to be implemented by member states.

This chapter will analyse these issues in the sections which follow.

5.2 Pre-crisis measures for reforming remuneration

5.2.1 The Winter report

> *Harmonisation of the rules relating to company law and corporate governance, as well as to accounting and auditing, is essential for creating a Single Market for Financial Services and products.*[11]

The motivation for urgent action to achieve the integration of financial services throughout the EU came from the Cardiff European Council in June 1998. It had become clear that the integration of financial services was a prerequisite for the accomplishment of the EU's economic potential following the introduction of the euro. The Financial Services Policy Group, made up of ECOFIN (Economic and Financial Affairs Council) ministers and representatives of the European Central Bank, under the Chair of the EC, was given the task of identifying priorities for action. In October 1998, the EC published a Communication setting out a Framework for Action on Financial Services, followed by the Financial Services Action Plan (FSAP) itself in May 1999.

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[9] Council Directive 2013/36/EC of 26 June 2013 on access to the activity of credit institutions and prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, [2013] OJ L176/338. (CRD IV).

[10] Council Regulations 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1. (CRR).

[11] Commission, "Company law and corporate governance". Available at: <http://ec.europa.eu/internal_market/company/index_en.htm> accessed 15 August 2013.

The FSAP was aimed at opening up a single market for financial services in the EU. Started in 1999, it comprises 42 measures designed to harmonize Member States' rules on securities, banking, insurance, mortgages, pensions, and all other forms of financial transaction.[12] However, efforts to harmonize corporate governance structure and control were blocked by Member States, as each wanted to pursue its own interests.[13] Moreover, the EU had explicitly refrained from taking any initiatives in the area of corporate governance as differences in standards were not seen to distort the free movement of goods or services, and the subsidiarity clause came into play. This attitude changed as a result of corporate scandals in the EU and the Enron affair that led to the adoption of the Sarbanes-Oxley Act in the USA.[14] The EC was eager to have a unified European code for corporate governance, like the Organisation for Economic Co-operation and Development code, which would replace the existing individual codes in the European states.

The EC launched a review of existing codes of corporate governance and in July 2001 the High-level Group of Company Law Experts[15] was set up to advise the EC on a modern EU framework for company law which would include corporate governance.[16] Headed by Jaap Winter, the Group presented its report in November 2002. The Winter Report represents the starting point in the debate on corporate governance at a pan-European level. It was not in favour of a single European code of corporate governance, as this would not achieve full information for investors and would not contribute significantly to the improvement of corporate governance in Europe.[17]

The report's recommendations were based on the concept of "shareholder democracy". As Lannoo and Chaturyan have stated, the report focused on efficiency measures to mitigate the agency problem associated with dispersed ownership, which is in the view of some is not

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[12] EurActiv.com, "Financial Services Action Plan" (18 December 2004). Available at: <http://www.euractiv.com/financial-services/financial-services-action-plan/article-132874> 15 August 2013.

[13] K Lannoo and A Khachaturyan, "Reform of Corporate /governance in the EU" (October, 2003) *Centre for European Studies*, CEPS Policy Brief No.38.

[14] ibid.

[15] This group issued two reports. The first was in January 2002 and related to issues of takeover bids.

[16] EurActiv.com, "Corporate governance" (26 October 2005). Available at: <http://www.euractiv.com/euro-finance/corporate-governance-linksdossier-188335?display=normal> 15 August 2013.

[17] Winter Report (n 1) 9

effective in mitigating the agency problems associated with concentrated shareholder structures in most of the EU Member States.[18]

5.2.2 The 2003 Action Plan

The then EU Internal Market Commissioner Frits Bolkestein promised an Action Plan to take forward the recommendations of the Group. The plan was published in a Commission Communication on 21 May 2003, entitled "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward". The Communication endorsed fully and unconditionally the recommendations made by the Winter Report. The then Commissioner stated that:

> *Company law and corporate governance are right at the heart of the political agenda, on both sides of the Atlantic. That's because economies only work if companies are run efficiently and transparently. We have seen vividly what happens if they are not: investment and jobs will be lost; and in the worst cases, of which there are too many, shareholders, employees, creditors and the public are ripped off. Prompt action is needed to ensure sustainable public confidence in financial markets. The Action Plan provides a clear and considered framework combining new law where necessary with other solutions. It will help deliver the integrated and modern company law and corporate governance framework which businesses, markets and the public are calling for. The Commission is shouldering its responsibilities: Corporate Europe must shape up and do the same. Working in partnership, we have a unique opportunity to strengthen European corporate governance and to be a model for the rest of the world.*[19]

The Action Plan outlined the reasons why initiatives to reform company law and corporate governance needed to be taken at the EU level as follows: the growing trend of European companies to operate cross-border in the Internal Market; the integration of European capital markets; the rapid development of new information and communication technology; the forthcoming enlargement of the EU to encompass 10 new Member States; and the impact of recent financial scandals on promoting new debate. The Action Plan also outlined two main

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[18] Lannoo (n 13).

[19] Global Corporate Governance Forum, "The EU approach to corporate governance: Essentials and Recent Developments" (February 2008). Available at: <http://www1.ifc.org/wps/wcm/connect/f515ff804af4fc7da869b9b94e6f4d75/IFC_EUApproach_Final.pdf?MOD=AJPERES> accessed 10 July 2013.

objectives: strengthening shareholder rights and third party protection, and fostering efficiency and competitiveness in business.[20]

5.2.3 Assessment of the effectiveness of the Action plan and the Winter report in dealing with remuneration

The main concern of the Action Plan and the Winter Report with regard to remuneration was the conflict of interest caused by the remuneration-setting process combined with awareness of the different ownership structures (dispersed and blockholding) in different European Member States. The Winter Report, however, provided the same solution for both types of ownership. It acknowledged that blockholding ownership structures, with controlling shareholders, have the benefit of closely monitoring executives, but noted that this kind of ownership creates another agency problem between the minority shareholders and controlling shareholders. This requires monitoring by non-executive directors or supervisory directors on behalf of minority shareholders.[21] Both the Action Plan and the Winter Report described executive remuneration as a key conflict of interest and called for it to be set by non-executive directors or the supervisory board who are, in the majority, independent.[22] However, the Winter Report noted the existence of different board structures among European states, in which some have controlling shareholders and employees sitting on the board and, therefore, reject the Anglo-American requirement that remuneration committees should consist entirely of independent directors.[23] The Winter Report was of the view that despite the fact that executive remuneration represents a key area of conflict of interest, tackling the problem should not be based on prohibiting certain types of remuneration, as the level and form of remuneration should be left to the companies and their shareholders. In the view of the Winter Report, reform should be based on governance control and adequate information rights to facilitate this.[24]

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[20] Commission, Communication on Modernising Company Law (n 2).

[21] Winter Report (n 1) 59 & 60.

[22] ibid para 3.1.3; Commission, Communication on Modernising Company Law (n 2).

[23] Winter Report (n 1) 61.

[24] ibid chapter 3, para 4.2.

This approach, adopted by both the Winter Report and the EC in its Action Plan, was also aimed at improving individual disclosure as a further control on remuneration, and not by structural requirements as to the form of remuneration. It was recommended that the remuneration of executive, non-executive, or supervisory directors, should be disclosed in detail in the annual financial statement of the company. The disclosure was expected to cover financial and non-financial benefits derived from the company, including golden parachutes and pension rights and other perquisites. The report also called for effective accounting and shareholder approval of shares granted and share option plans, with costs to the company resulting from these plans being accounted for in the annual accounts.[25]

The Winter Report and the Action Plan did not, however, fully address the monitoring mechanism by shareholders of remuneration practices. Although it was suggested that a remuneration report should form part of the annual financial statement, there were no voting rights recommended by the Winter Report equivalent to those in the UK at that time. The Winter Report did not believe that "a shareholder vote on the remuneration policy generally should be an EU requirement, as the effects of such a vote can be different from Member State to Member State". [26] Instead, the report recommended that remuneration policy be debated on the basis of a comprehensive disclosure of the policy, without having to go through the process of tabling shareholder resolutions.[27] However, the Winter Report recommended prior approval by shareholders to the granting of shares, options plans, other share incentive schemes, and any substantial changes. This approval relates to schemes and not to the individual remuneration of directors under these schemes.[28] The approval which this required was introduced in most Member States and was seen as approval of the change in capital structure and not a form of shareholder control over executive remuneration.[29]

Therefore, the Commission's pan-EU approach to remuneration appears to have been designed to remove core conflicts from the pay-setting process via the remuneration

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[25] ibid 65 & 66.

[26] ibid 65.

[27] ibid 65.

[28] ibid 66.

[29] G Ferrarini and N Moloney, "Executive Remuneration in the EU: the Context for Reform" (2005) 21(2) *Oxford Review of Economic Policy* 304, 315.

committee.[30] Reform was expected to proceed via the remuneration committee, which provides a visible form of control, and a strengthening of the role of independent directors, which is the approach adopted by the EU and by many Member States. Given the rise in shareholder activism, it could also address the nature of the role played by shareholders by formally strengthening the role they play in the remuneration-setting process.

5.2.4 Two important recommendations in 2004 and 2005

Reflecting on the above, two important recommendations on directors' remuneration and the role of non-executive directors or the supervisory board resulted from this Action Plan. Measures to improve remuneration governance and disclosure were adopted by the EC in 2004 and 2005.[31] The reform proposed by the two recommendations covers the same three areas: disclosure, shareholder voice, and the composition of the remuneration committee.

The recommendations covered the four key disclosure requirements proposed by the Winter Report,[32] which are seen as following Anglo-American best practice.[33] The recommendations require companies to disclose in their annual report, or in a separate report, general information on remuneration policy as well as giving as an overview of the manner in which the remuneration policy was implemented in the previous financial year. This serves to allow evaluation of incentive effects and facilitate assessment of the remuneration policy by shareholders. The emphasis is on providing information on the following: the relative importance of the variable and non-variable components of director remuneration; performance criteria; the link between pay and performance; the parameters and rationale for cash or non-cash bonus schemes; any supplementary pension or early retirement schemes for directors; and details of the duration and terms of executive contracts as well as the notice period and any provision for termination payments and other payments linked to early termination. The report on remuneration policy should also provide information concerning the decision-making process of the remuneration policy, including the mandate and

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[30] G Ferrarini and N Moloney, "Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives" (2004) 3 *European Company and Financial Law Review* 251, 288.

[31] Commission Recommendation 2004/913 (n 3); Commission Recommendation 2005/162 (n 4).

[32] Winter Report (n 1) 65 & 66.

[33] Ferrarini "Executive Remuneration in the EU" (n 29) 318.

composition of the decision-making body, the names of external consultants whose services have been used in determining the remuneration policy, and the role of the shareholders.[34]

Individualized disclosure of executive director remuneration was also recommended. This includes details of total remuneration, which covers fixed pay, including salary, bonus and profit sharing, togather with the reasons why this was granted. Any additional payment for special services, termination payments, and other non-cash benefits should also be disclosed. Additional information is required for any share-based remuneration and any supplementary pension schemes. For shares and share options, information regarding the number of shares or share options offered, exercised and unexercised, and any change to the terms and conditions of the plans occurring during the year should be disclosed. With regard to pension schemes, this depends on the scheme. If it is a defined-benefit, changes in the director's accrued benefits during the relevant year are to be disclosed; if it is a defined-contribution, information on the contributions paid or payable by the listed company for each director during the relevant financial year is to be disclosed.[35] This disclosure requirement was only a recommendation to achieve harmonization across the EU Member States via minimum standards, and was not as high as the disclosure requirements introduced in the UK by law in 2002.

Shareholder voice became an element in the European reform of remuneration regulation following the 2004 recommendation although this was not supported by the Winter Report. This has probably been influenced by the different ownership structures in different European states (as it is not likely to have any significant effect on blockholding structure ownership) and by the so-called "rational apathy", which was seen as a disadvantage by the Winter Report whereby shareholders would prefer to sell out their holdings rather than monitor and influence corporate performance. However, a shareholder vote would not have the desired effect without tabling a detailed remuneration policy at the AGM with clear accurate clarification regarding the link between remuneration and performance on a multi-year and peer comparison basis. In this way shareholders would be able to assess the remuneration level and form. The EC recommended submitting the remuneration policy to the AGM for

[34] Commission Recommendation 2004/913 (n 3) Section II.

[35] ibid section III.

either an advisory or mandatory vote.[36] However, the EU is in the process of including new voting requirements similar to those introduced in the UK, and such requirements will form part of the updated Shareholders' Rights Directive.[37]

Another reform applies to a vote on share options, a reform which has been introduced in many European countries and is linked to a change in capital structure rather than a vote on remuneration policy. Moreover, share granting and any long-term incentive plans as well as any change to the schemes' main terms would require shareholder approval.[38] Information regarding dilution and how the firm plans to provide the shares should also be provided.[39]

The third element in the reform relates to the effective governance of the body that decides the remuneration policy. This body can be the supervisory board (in a two-tier board system) or the remuneration committee (in a one-tier board system). This recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board was set out in the 2005 recommendation and stems from the Anglo-American convention, as noted by Ferrarini and Moloney. They add that at the heart of this recommendation is the Commission's view that independent board oversight, provided this independent board has the essential resources and ability to challenge management decisions, will protect the interests of shareholders and reduce the agency cost across both structures of ownership.[40] Therefore, the assumption is that non-executive directors will play a vital role in protecting the interests of shareholders against management in dispersed ownership, ensuring that the interests of minority shareholders are considered in blockholding ownership.

The Commission Recommendation states that a remuneration committee in both governance structures (dispersed and blockholding) is essential for solving the conflict of interest that is inherent in the remuneration-setting process.[41] If a remuneration committee is set up, the EC wants it to be composed exclusively of non-executive or supervisory directors with the

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[36] ibid section II, 4.2.

[37] Commission, "Proposal for a Directive of the European Parliament and of the council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement COM (2014) 213 final.

[38] ibid section IV.

[39] ibid section V.

[40] Ferrarini "Executive Remuneration in the EU" (n 29) 319.

[41] Commission Recommendation 2005/162 (n 4) Recital 9.

majority of its members being independent. However, the Commission refused to offer a precise definition of "independent" owing to the different situations and circumstances which affect the independence of a director from one Member State to another and the rapidly evolving best practice in defining this term.[42] Instead, the Commission listed the threats affecting a director's independence, providing the general view that "independence" refers to a director who is "free of any material conflict of interest".[43] To help national regulators define independence for their own purposes, the Commission listed some general criteria.

The Commission's Recommendation divided the role of the remuneration committee into four main areas. The first related to executive or managing directors' remuneration. The remuneration committee's role is to propose a remuneration policy for executive directors detailing all forms of remuneration − fixed, variable, pension, and termination payments− for the board's approval, explaining the objectives and evaluation criteria for achieving alignment between executive pay and the long-term interests of shareholders. This represents support from the Commission for firms in adopting performance-related payment with clarification of the objectives of the plan and its evaluation criteria.[44] In addition to proposing individual remuneration for executive directors, the remuneration committee should also provide suitable forms of contracts for executive directors.

The second aspect of its role is related to making general recommendations to the board with regard to the level and structure of senior management remuneration, as well as monitoring the level and structure of senior management remuneration based on the information provided by executive directors.

The third area which it covers is share options and share grant schemes. The committee should debate the general policy regarding the granting of such schemes, review the information provided on this topic in the annual report and to the shareholder meeting, where relevant, and make proposals to the board concerning the choice between granting options or subscribing shares, specifying the reasons for the choice as well as the consequences that this choice has.

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[42] ibid Annex II.

[43] ibid recital 8.

[44] Ferrarini "Executive Remuneration in the EU" (n 29) 319.

The fourth area regards the operation of the remuneration committee. This should consult the chair and/or chief executive about their views relating to the remuneration of other executive or managing directors. Moreover, the remuneration committee should be able to seek help from external consultants in obtaining the necessary information on market standards for remuneration systems with sole responsibility for establishing the selection criteria, and selecting, appointing and setting the terms of reference for any remuneration consultants. However, the Recommendation did not ask for disclosure concerning any relationship between the firm and the external consultant. Such consultancy firms usually offer a variety of services to their clients which might trigger a conflict of interests, as the external consultant might choose to support what executives want in order to secure a contract for other services.

Thus, these reforms can be seen as less interventionist and more flexible than those which were introduced regarding disclosure and shareholder voice.[45] This flexibility comes from the fact that there is no requirement for the remuneration committee to be wholly composed of independent directors. Moreover, the function of the remuneration committee can be performed by a small supervisory board in a two-tier board structure if this board meets the requirement of having an independent majority. The recommendation of shareholder voice did not take into account the relative weakness in relation to the dominant position of large shareholders in the blockholding system. The dominant position suggests a greater need for independent non-executive directors to help balance the power between the management and the large shareholders on the one hand and the minority shareholders on the other. However, independent directors need to have the knowledge, skills, resources and information, commitment and experience to engage effectively, which the Recommendation sets out, while delegating the responsibility of monitoring and assessing the independence, competence and commitment of a director on the board to shareholders and the markets via the disclosure requirement.[46]

In 2006, a review of the Action Plan resulted in prioritization of the strengthening of shareholder rights, but also acknowledged that there was a growing sense of regulatory fatigue and the need to pause and allow both businesses and investors more time to digest

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[45] ibid.

[46] Commission Recommendation 2005/162 (n 4) Section III.

recent legislation.[47] In July 2007, the Commission published two reports which reviewed the extent to which Member States had implemented the 2004 and 2005 Recommendations.[48] The two reports found that all the Member States had issued corporate governance codes and most codes were to be applied on a comply-or-explain basis. However, the reports identified certain areas in which the Recommendation's principles had not been adequately followed and implemented.

5.3 Measures taken during the first phase of the crisis

The thesis will now provide an overview of the measures taken by the EU to impose limits and restrictions on remuneration for institutions which received state aid and the Communications issued by the EC to those institutions which recapitalized and received state aid.

European financial markets were deeply affected by the US sub-prime crisis.[49] The financial crisis demanded a governmental response at the national level[50] to safeguard the integrity of domestic banking markets; however, any domestic response also had to be set against the context of the EU measures to allow Member States to intervene in order to stabilize their respective banking sectors. Recapitalization of financial institutions, guaranteeing schemes for certain type of activities such as inter-bank lending, asset disposals and "bad bank" solutions, and the nationalization of distressed institutions might have been in breach of established EU state aid rules intended to prevent selective economic intervention by the Member States liable to distort competition and trade within the EU.[51]

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[47] Global Corporate Governance Forum (n 19).

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

[49] G Ferrarini and MC Ungureanu, "Executive pay at ailing banks and beyond: a European perspective" (2010) 5(2) *Capital Markets Journal* 197, 199.

[50] For a full review of Member States' rescue measures see: A Petrovic and R Tutsch, "National Rescue Measures in Response to the Current Financial Crisis" (July 2008) *European Central Bank Working Paper No.8*.

[51] A Arora, "The 2007-09 Banking crisis and the EU's Regulatory Response" (2010) 21(5) *European Business Law Review* 603; European Commission, "State Aid Control—overview", available at: <http://ec.europa.eu/competition/state_aid/overview/index_en.html> accessed 12 April 2013.

Owing to the exceptional nature of the unfolding crisis, however, the Commission made it clear in its Communication of 13 October 2008 that it would apply state aid rules flexibly and purposively, and recapitalization schemes were one of the key measures that Member States could take to preserve the stability and proper functioning of financial markets.[52] A similar statement made by the ECOFIN Council on 7 October 2008 and the Eurogroup meeting on 12 October 2008 concluded that:

> *Governments commit themselves to provide capital when needed in appropriate volume while favouring by all available means the raising of private capital. Financial institutions should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non-beneficiaries… [and] … legitimate interest of competitors must be protected, in particular through the state aid rules.*[53]

This Communication was followed by others: on 5 December 2008 there was a Communication on Recapitalization of Financial Institutions;[54] followed on 25 February 2009 by the Impaired Assets Communication.[55] These recommendations were aimed at preserving financial stability by introducing measures to guarantee schemes, recapitalization, and winding up or nationalization.

However, the intervention by Member States to rescue financial institutions came at a cost, such as a restrictive policy on dividend payment (as seen with Northern Rock and the Lloyds TSB takeover of HBOS, which followed the condition that no dividends were to be paid to private shareholders until the government's preference shares had been repaid),[56] an increased solvency ratio and limits on executive remuneration. These limits provided in the ECOFIN Council and the Communications referred to "the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis"

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[52] Commission Communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C 270/8.

[53] Cited in: Commission Communication on the recapitalization of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C 10/2.

[54] ibid.

[55] Commission Communication on the treatment of impaired assets in the Community banking sector [2009] OJ C 72/1; See also: Commission Report on State Aid Scoreboard, Spring 2009 Update, Special edition on State Aid Interventions in the Current Financial and Economic Crisis, COM (2009) 164.

[56] Arora, "The 2007-09 banking crisis" (n 51).

and stressed, *inter alia*, that the management of rescued banks should not retain undue benefits and that governments could have the power to intervene in remuneration.[57]

The Communication on "The recapitalization of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition" was intended to set standards for bank recapitalization in order to ensure adequate levels of lending to the real economy and stated limits and restrictions on the remuneration of the recapitalized banks.

Finally, the third Communication on "The treatment of impaired assets in the Community banking sector" presented the framework for removing toxic assets and underperforming loans requiring a cap on executive remuneration to be considered. It is clear that these measures for curbing bankers' remuneration were conditions for accessing state aid. However, as a result of lessons learned from the financial crisis, public outcry and political pressure, regulation of remuneration has been extended to all banks permanently. However, the start of the permanent regulation of remuneration in the EU came with the de Larosière Report.

5.4 The de Larosière Report and remuneration

Following the financial crisis, the High-level Group on Financial Supervision in the EU published its report in February 2009. In its report, the Group, chaired by Jacques de Larosière, identified a number of failures in corporate governance.[58] Incentive contracts were considered to be an important aspect of the failure in corporate governance. In a similar way as that seen in the Turner Review, the report identified two dimensions to this problem: one was the often excessive level of remuneration in the financial sector; the other was the structure of this remuneration, notably the fact that it induced risk-taking at a level considered to be too high, encouraging short-termism to the detriment of long-term performance. The report explained that:

> *[S]ocial-political dissatisfaction has tended recently to focus, for understandable reasons, on the former. However, it is primarily the latter issue which has had an adverse impact on risk management and has thereby*

[57] Cited in: Commission Communication C 270/8 (n 52).

[58] de Larosière Report (n 5).

contributed to the crisis. It is therefore on the structure of remuneration that policy-makers should concentrate reforms going forward.[59]

However, although the report asserted the need to re-align the incentives of remuneration contracts with the interests of shareholders and long-term profitability, it was silent on the agency problem between shareholders and society or taxpayers. The view of the report on reforming remuneration practices centred around full disclosure, paying bonuses based on multi-year assessment, no guaranteed bonuses, and financial institutions being overseen closely by supervisors.[60]

5.5 The post-crisis measures adopted by the EU

5.5.1 The EC Recommendations 2009

Building on the recommendations of the de Larosière Group, the CEBS published its High-level Principles for Remuneration Policies on 20 April 2009. However, these principles were repealed by its successor, the EBA, following the publication of its Guidelines on Internal Governance in September 2011.[61] These High-level Principles were shortly followed by two sets of Recommendations from the Commission regarding 1) the remuneration of directors of listed companies,[62] and 2) remuneration policies in the financial services sector,[63] which were also aimed at endorsing the P&S. The EC became the first to implement the FSB principles with more detail than the principles.[64] These two Recommendations sought to contribute to the long-term viability of companies and reduce risks to financial stability.[65] However, the Recommendations are non-legally binding guidance and provide best practice. Those Recommendations were the first steps in the Commission's plan to improve the regulation of remuneration by aligning incentives with risk management and the long-term sustainable performance of companies, as they were followed by the CRD.

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[59] ibid.

[60] ibid.

[61] EBA, GL 44 (n 6) 48.

[62] Commission Recommendation 2009/385 (n 7).

[63] Commission Recommendation 2009/384 (n 7).

[64] E Ferran, "New regulation of remuneration in the financial sector in the EU" (2012) 9(1) *European Company and Financial Law Review* 1, 17.

[65] Arora, "The 2007-09 banking crisis" (n 51).

5.5.1.1 Listed company directors' pay

The Commission issued a Recommendation, in April 2009, to complement its two previous Recommendations of 2004 and 2005. The Recommendation of 2009 regarding the regime of remuneration for directors of listed companies focused on the structure of directors' remuneration and the process of the design and operation of the remuneration policy for directors of listed companies.[66] The Commission recognized that "remuneration structures have become increasingly complex, too focused on short-term achievements and in some cases led to excessive remuneration, which was not justified by performance".[67] Therefore, the Recommendation on the regime for the remuneration of directors of listed companies has focused on six main areas.

The Recommendation asserted the need for the structure of remuneration to promote long-term sustainability of the company with the variable elements being linked to predetermined and measurable performance criteria which should include non-financial criteria relevant to the long-term success of the company. The limit on fixed components of remuneration should be sufficient to allow companies to stop paying the variable component in underperforming year(s) when the performance criteria are not met and the variable component should be limited. To promote long-term performance, the Recommendation advised using deferral techniques for a major part of the variable component for three to five years in order to enable firms to take account of long-term implications and reduce the unpaid parts accordingly. Companies should also be able, through contractual agreements, to reclaim variable components of remuneration that were paid on the basis of data which proved to be manifestly misstated.

The Commission allowed termination payments on three conditions. The first is that they do not reward failure or are not to be paid if the termination is due to inadequate performance. Secondly, they must be used for the primary purpose of providing a safety net in the case of early termination of a contract and not when a director leaves on his or her own account. The third is that termination payments should be set at a pre-determined limit in terms of amount or duration, which, in general, should not be more than two years' annual remuneration and

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[66] ibid.

[67] Commission Recommendation 2009/385 (n 7).

should only be on the basis of the non-variable component of the annual remuneration. However, this does not preclude termination payments in situations of early termination of a contract due to changes in the strategy of the company or in merger and/or takeover situations.

Schemes which award shares, share options or any other rights to acquire shares or be remunerated on the basis of share price movements also feature in the Commission's recommendation. The Commission believes that this kind of scheme should be linked to the performance and long-term value creation of the company and wants to impose a minimum period of three years for vesting and another three years for exercising after the vesting and award. This division between vesting and exercising along with the requirement to retain a number of shares until the end of a director's mandate is a way of preventing directors from making short-term profits and employing market manipulation,[68] which is similar to what Bebchuk and Fried called for in their book *Pay without Performance*.[69] In addition, the Commission wants these schemes to be subjected to predetermined performance conditions and not simply linked and awarded based on share price movements.

The final point is that the remuneration of non-executive directors should not include shares in order to prevent conflicts of interest. However, it is possible that this prohibition of awarding shares to non-executive directors might detach them from the company they oversee. Thus, the way that executive directors are provided with incentives to align their interest with shareholders should also be used with non-executive directors. Remunerating non-executive directors with shares or share profits equivalent will make them think like shareholders and act effectively. The current practice of remunerating non-executive directors with a payment based on their time does not help to ensure that they make a valuable contribution in the interests of shareholders.

The 2009 Recommendation aims at improving the structure of remuneration in the three aforementioned areas, and at strengthening the 2004 and 2005 Recommendations with regard to disclosure, shareholders, and remuneration committees. The Commission felt it was necessary to ensure that the remuneration statement recommended in 2004 should be clear

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[68] Arora, "The 2007-09 banking crisis" (n 51).

[69] See section 2.2.1.

and easy to understand, and should contain: an explanation of how the chosen performance criteria contribute to the long-term interests of the company and which methods have been applied to determine whether those criteria have been fulfilled; sufficient information on deferment periods which are applied to the variable components of the remuneration; information on the policy regarding termination payments; information on vesting periods and retention periods after vesting for share-based remuneration; and information on the composition of peer groups by whom the remuneration has been examined.

The Recommendation also went on to strengthen the role of shareholders by reinforcing the remuneration statement and urging that it should appear clear and easy to understand. It also asserted that shareholders, and in particular institutional shareholders, should attend general meetings where appropriate and should make considered use of their votes regarding directors' remuneration.

The Commission wants evidence that at least one member of the remuneration committee has knowledge of and experience in the field of remuneration policy, and also that members are exercising independent judgement and integrity. When using the services of a consultant, the remuneration committee should ensure that this individual does not also advise the human resources department or executive or managing directors of the company involved. The committee's role should include: reviewing the remuneration policy for executive or managing directors, including the policy regarding share-based remuneration and its implementation; reporting on the exercise of its functions to the shareholders; being present at the AGM for this purpose, and ensuring that the remuneration of various individual directors was proportionate.

5.5.1.2 Financial services' pay

The other Recommendation made on 30 April 2009[70] concerned remuneration practices in the financial services sector. The Commission agreed with the de Larosière Group[71] that excessive risk-taking in the financial services industry and in particular in banks and investment firms had contributed to the failure of financial undertakings and to systemic problems both in the Member States and on a global scale. Staff were encouraged by

[70] Commission Recommendation 2009/384 (n 7).

[71] ibid Recital 1.

incentive arrangements to pursue unduly risky activities which provided higher income in the short term, while exposing financial undertakings to higher potential losses in the longer term. Therefore, the Commission believed that the limitations in risk management and control systems had failed to deal with the risks created by inappropriate incentives due to the increasing complexity of these risks and the range of ways in which risk may be controlled. [72] If the risk-taking incentives provided by remuneration practices were strong and effective, it would be consistent with the risk tolerance of a financial undertaking. Moreover, creating appropriate incentives within the remuneration system itself should reduce the burden on risk management and increase the likelihood that these systems would become effective.[73] The Commission's view is that the failures in remuneration practices lay in the remuneration policies, corporate governance arrangements and supervision.

Against this background, the Commission adopted the Recommendation to be applied by Member States to all financial undertakings that include deposits and other repayable funds; provide investment services and/or undertake defined investment activities; are involved in insurance or reinsurance business; or perform business activities similar to any of the above, irrespective of their size and legal status, if they have a registered office or their head office is in the territory of a Member State.[74] This was to avoid loopholes and prevent regulatory arbitrage between different sectors and institutions. It also applies to the remuneration of those categories of staff whose professional activities have a material impact on the risk profile of a particular financial undertaking.[75] The reason for this extension in application to personnel beyond directors is to preserve incentives in remuneration schemes.[76] However, fees and commissions received by intermediaries and external service providers in the case of outsourced activities lay outside the scope of the Recommendation, since they are covered by different legislation.[77]

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[72] ibid Recital 4.

[73] ibid Articles 4 & 5.

[74] ibid Articles 1.1.

[75] ibid Articles 1.2.

[76] Arora, "The 2007-09 banking crisis" (n 51).

[77] For more details see: Commission Recommendation 2009/384 (n 7) Recital 9.

The Recommendation covers the structure of pay, governance, disclosure and supervision of remuneration practices. The policies of payment for risk-taking staff should be consistent with and promote effective risk management.[78] In the Commission's view, achieving this is to strike an appropriate balance between core and variable pay, with the latter being set at a maximum limit to enable financial institutions to reduce or stop paying bonuses when performance criteria are not met by individuals, business units or the whole institution.[79] When a significant part of remuneration is awarded in bonuses, a major part of those bonuses should be deferred to take account of future risk.[80] As well as this, financial institutions should use a multi-year assessment of performance to ensure that outstanding risks are taken into account throughout the business cycle, with a financial entity having the right to reduce or withdraw unpaid bonuses when calculations have been proven to be wrong as well as claiming back bonuses already paid based on data which later proved to be manifestly misstated.[81]

As a means of using *ex ante* risk alignment between remuneration and risk, the Commission wants performance measures to include an adjustment for current and future conditions related to underlying performance which should take into account the cost of capital employed and liquidity required.[82] Moreover, there should not be rewards for failure, especially in the case of early termination, even if such payment is based on a contract, as the Commission wants employment contracts of this type to be altered to link an early payment to the performance achieved over the period in office.[83] Performance criteria should be transparent and staff should be informed in advance of the criteria that will be used to determine their remuneration and also about the appraisal process.[84]

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[78] ibid Article 3.1.

[79] ibid Articles 4.1 and 4.2.

[80] ibid Article 4.3.

[81] ibid Articles 4.6 and 5.2.

[82] ibid Article 5.3.

[83] ibid Article 4.5.

[84] ibid Article 6.7.

The remuneration committee of a financial institution should be independent and have relevant expertise to avoid conflicts of interest.[85] Moreover, the procedure for setting remuneration policy should be clear and documented with control functions involved in the design of the policy, but it should not be remunerated based on the success and failure of the business they oversee to avoid conflicts of interest.[86] If appropriate, human resources departments and external experts can also be involved in the design of the remuneration policy.[87] However, the ultimate decision concerning the policy and its oversight is left to the board.[88]

The remuneration policy and any change to it should be disclosed by the financial undertaking in a clear way, which is easily understandable to relevant stakeholders. This disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements or any other form.[89] The disclosure should contain information on the decision-making process; the composition and mandate of the remuneration committee, if used; the name of the external consultant, if consulted; the link between pay and performance; the criteria used for performance and risk adjustment; the performance criteria on which the entitlement to shares, options or variable components of remuneration are based; and the main parameters and rationale for any annual bonus scheme and any other non-cash benefits.[90]

Supervisors in EU Member States should take account of the size of the financial undertaking and the nature and complexity of its activities when addressing the question of proportionality.[91] Authorities in the Member States should have the power to request and gain access to all the information needed for the purposes of evaluating and assessing an institution's compliance with the Recommendation.[92] At the same time, to facilitate the work of the authorities in the Member States, financial undertakings should communicate their

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[85] ibid Article 6.1.

[86] ibid Articles 6.3 and 6.6.

[87] ibid Article 6.3.

[88] ibid Article 6.2.

[89] ibid Article 7.

[90] ibid Article 8.

[91] ibid Article 10.

[92] ibid Article 12.

remuneration policy to the authorities and confirm their compliance with the principles set out in the Recommendation.[93]

However, the Recommendations have no direct binding effect unless and until they are enacted into domestic legislation and Member States are unlikely to implement stringent rules which may place their own financial services at a competitive disadvantage. Moreover, Member States may interpret rules differently.[94] Therefore, the Commission intended to examine and evaluate the application of the Recommendations by Member States.

5.5.2 The Capital Requirements Directive IV

In July 2009, the EC issued a proposal for a directive amending Directive 2006/48/EC relating to the strengthening of prudential regulation, and introduced a capital requirement for trading books and resecuritization as well as strengthening the prudential regulation of the remuneration structure and empowering supervisors to impose capital sanctions on financial institutions. The Commission's report on the application of the 2009 Recommendations found that they were not being applied in a uniform or satisfactory manner.[95]

The Commission Green Paper of 2 June 2010, on corporate governance in financial institutions and remuneration policies, identified a series of failures in corporate governance in financial institutions that needed to be addressed. Among the solutions identified, the Commission refers to the need to significantly strengthen requirements relating to persons who effectively direct the business of an institution, indicating that they should have appropriate experience and also be assessed as to their suitability to perform their professional activities. The Green Paper also underlines the need to improve shareholder involvement in approving remuneration policies.[96] The European Parliament and the Council

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[93] ibid Article 11.

[94] Arora, "The 2007-09 banking crisis" (n 51).

[95] G Ferrarini and MC Ungureanu, "Economic, politics and the international principles for sound compensation practices: an analysis of executive pay at European banks" (2011) 62(2) *Vanderbilt Law Review* 431, 476; Commission Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector (2009 Recommendation on remuneration policies in the financial services sector), COM(2010) 286 final.

[96] Commission Green Paper, "Corporate governance in financial institutions and remuneration policies" COM (2010) 284.

noted the Commission's intention to make legislative proposals, where appropriate, on those issues.[97]

As the Commission was not happy with the implementation of the 2009 Recommendations, it suggested the inclusion of principles on remuneration in the proposal for CRD III. The reason for this inclusion was to strengthen the prudential regulation of the remuneration structure and empower supervisors to impose capital sanctions on financial institutions whose remuneration policies encouraged excessive risk.

Moreover, the Commission wanted to implement increased EU compliance with the P&S by using a combination of enforceable regulation and supervisory oversight, as opposed to the USA, which chose to use a supervisory approach.[98] However, the FSB had no preference for one approach over another, as FSB members may implement the approach they prefer.[99] The way in which these requirements in the Directive should be implemented by Member States is explained by the guidance published by the CEBS.[100] The rules contained in the CRD III are different from those in the previous Recommendations since they are now binding rules.

The CEBS has been charged by the CRD III with issuing guidelines on sound remuneration policies in the banking sector to promote supervisory convergences in the assessment of remuneration policies and practices.[101] In December 2010, the CEBS published the final version of the guidelines, which are intended to help national supervisors in the EU in implementing the CRD III requirements. However, in July 2011, the EC introduced a proposal for two European legislative instruments.[102] The proposal is referred to as CRD IV and consists of a directive and regulation. The regulation or the CRR, which is directly applicable with immediate effect in all Member States, contains provisions relating to disclosure of remuneration, the "single rule book", and the Basel III prudential reforms. The

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[97] Council Directive 2010/76/EC of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies, [2010] OJ L 329/3. (CRD III).

[98] Ferran (n 64) 18.

[99] Financial Stability Board, *Thematic Review on Compensation: Peer Review Report* (30 March 2010) 3 (FSB, 2010 *Thematic Review on Compensation*) 17.

[100] Committee of European Banking Supervision, "Guidelines on Remuneration policies and practices" (10 Dec 2010) 13 (CEBS Guidelines on Remuneration).

[101] CRD III, Article 19.

[102] Joosen (n 8) 47.

directive, which needs to be enacted by Member States, includes provisions related to remuneration, corporate governance and transparency, and the introduction of buffers.

CRD IV carries out all the remuneration provisions in the CRD III and adds to these. The most notable modification is the re-introduction of the capping of variable remuneration to a ratio of the fixed pay awarded.[103] Principles related to corporate governance, which are usually applied on a soft-law basis, have been upgraded by the directive to a hard law which must be implemented by member states. However, as with the Recommendations, binding regulatory intervention has failed to meet the expectations of those who wanted an immediate crackdown on the levels of pay in the financial sector.[104] The main features of the new remuneration requirements are detailed below.

5.5.2.1 The main requirement

The Directive's main objective is implementing "international principles and standards at Union level". It seeks to implement this by:

> *introducing an express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose professional activities have a material impact on the risk profile of credit institutions and investment firms, remuneration policies and practices that are consistent with effective risk management.*[105]

This main requirement represents the Commission's intention that remuneration policies and practices should supplement risk management functions and control excessive risk-taking in the case of those staff whose professional activities have a material impact on the firm's risk profile.

"Excessive risk-taking" is a vague term, as what might be judged excessive for some firms might not be for others. Therefore, this thesis adopts a similar point of view to the Commission which has indicated that excessive risk-taking is any risk level that is taken beyond the tolerance level of a firm's risk profile.[106] Achieving this requirement needs

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[103] The ratio was first introduced in March 2010 and formally recommended in June 2010 but was dropped on 30 June 2010 from the text of the CRD III. See: KJ Murphy, "Regulating Banking Union: a case study in unintended consequences" (2013) 19(4) *European Financial Management* 632, 643.

[104] Ferran (n 64) 16.

[105] CRD IV.

[106] ibid Article 92(2)(a)

financial institutions to align risk with the risk appetite, values and long-term interests of the credit institutions or investment firm.[107]

Another term that is not clearly defined is the "long-term interest of the credit institutions or investment firm". However, instead of defining the term, the Commission has recourse to the use of *ex-ante* and *ex-post* measures to align remuneration with the long-term interests of the institution to ensure sustainable growth exists and is maintained. The CRD IV has added a new requirement that the remuneration policy must take account of national criteria on wage setting and make a clear distinction between fixed and variable remuneration which will help to reduce the ability of institutions to circumvent the ratio rules.

5.5.2.2 Scope and proportionality

CRD IV[108] applies to all EU credit institutions (banks and building societies)[109] and investment firms (other financial institutions including certain fund and investment management firms) within the meaning provided by the Markets in Financial Instruments Directive (MiFID).[110] Asset managers who are not regulated by the Undertakings for Collective Investment in Transferable Securities Directive (the UCITS Directive)[111] or by the Alternative Investment Fund Managers Directive (the AIFMD)[112] will be considered as investment firms in accordance with the meaning in MiFID. AIFMD contains similar but not identical provisions for remuneration[113] and UCITS V, as introduced in July 2014, contains

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[107] ibid.

[108] ibid Article 3.

[109] As defined in point 1 of Article 4(1) of Regulation (EU) No 575/2013, this refers to a credit institution "the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account".

[110] Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, [2004] OJ L 145/1, Article 4.

[111] Council Directive 2014/91/EU of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, [2014] OJ L 257/186.

[112] Council Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, [2011] OJ L 174/1.

[113] ibid Article 13 and Annex II. The provisions of the AIFMD are heavily influenced by the Guidelines of the CEBS.

provisions on remuneration which are similar but not identical to those on CRD IV.[114] However, given the potential overlap which exists amongst the three directives it is not totally clear which should take precedence when more than one apply.

The regulations have a wide scope of application, as EU parent institutions must ensure that all of their subsidiaries, including those located in non-EU jurisdictions, apply EU remuneration requirements and are at the same time subject to local jurisdiction requirements.[115] EU subsidiaries and branches of a third or non-EU country are subject to the requirements in the CRD IV as well as staff performing services for an EU institution. The EU requirements are wider in application than the P&S, which are mainly aimed at significant financial institutions. However, the principle of proportionality might assist in avoiding the "one size fits all" problem and could aid different firms in applying the requirements in accordance with their size, internal organization, and the complexity and nature of their activities. However, certain requirements are applied on a firm-wide basis without differentiating between staff, such as those regarding guaranteed bonuses and personal hedging.

As with CRD III, CRD IV is applied to those staff whose professional activities have a material impact on a firm's risk profile. Those categories of staff should include at least senior management, risk takers, staff engaged in control functions and any employees whose total remuneration takes them into the same remuneration bracket as senior management and risk takers.[116] Institutions are required to identify individual staff members to whom the requirements apply. However, unlike CRD III, CRD IV has charged the EBA to produce regulatory technical standards (RTS) specifying qualitative and quantitative criteria to identify categories of staff to whom particular provisions apply and submit them to the Commission for adoption.

The EBA identified qualitative criteria based on the role and decision-making of staff members as specified in the RTS. Staff identified under the qualitative criteria cannot argue that they do not have a material impact on the institution's risk profile. The quantitative

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[114] Council Directive 2014/91/EU (n 111), Articles 14a and 14b.

[115] CEBS Guidelines on Remuneration (n 100) para 29.

[116] CRD IV.

criteria are based on the total remuneration in absolute terms or in relative to other staff in the institution.[117] Staff should be identified based on the quantitative criteria if their total remuneration exceeds EUR 500,000 per year; if they are included in the 0.3 per cent of the staff with the highest remuneration in the institution; or if their total remuneration is equal or greater than the lowest remuneration of certain staff who are identified under the qualitative criteria. The reason for using both quantitative and qualitative criteria is that an employee's remuneration is an indicator of his/her responsibilities. However, an employee can be excluded when he/she is only identified based on the quantitative criteria but does not have a material impact. The institution must notify the authority about employees awarded EUR 500,000 or more. However, for staff receiving remuneration of EUR 750,000 or for staff included in the 0.3 per cent of the highest earners, prior approval of these exclusions is required and when the total remuneration reaches EUR 1,000,000 or more the authority need to notify the EBA before granting the exclusion. The exclusion must meet certain conditions to show that on the basis of the business unit where they work or on their duties and activities such employees have no material impact on the institution's risk profile.

The CRD IV allows institutions to apply the CRD IV provisions in different ways according to their size, internal organization, and the nature, scope and complexity of their activities. Size is determined by taking different factors into account. Acccording to the CEBS, these are the value of assets; liabilities or risk exposure; level of capital; and the number of staff or branches in the institution. Internal organization is related to the legal structure, being listed on regulated markets, the authorization to use internal/advanced methods for the measurement of capital requirements, or the corporate goals. The nature, scope and complexity of business activities are related to factors such as the type of licences involved, the category of clients, the proportion of riskier activities or clients to the total activities or clients, the national or international nature of the business activities, the measurability and predictability of the risks of the business activities, and the complexity of the products and contracts. Examples of this might be that "limited licence" and "limited activity" institutions (being institutions that are deemed to be lower risk as they do not provide certain services,

[117] European Banking Authority, *Final draft regulatory technical standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile under Article 94(2) of Directive 2013/36/EU* (EBA/RTS/2013/11, 16 December 2013).

such as dealing on own account or underwriting) may be given a certain flexibility in their application of the requirements.

That is not to say that such principles of proportionality will allow these institutions to avoid any of the minimum obligations as set out in the CRD IV (such as the minimum portion of deferral of the variable remuneration or the minimum deferral period). However, certain requirements may be "neutralized"[118] by the decision of the institution if this is reconcilable with the risk profile, risk appetite and the strategy of the institution (amongst other things).[119] Neutralization can be applied to the CRD IV requirement to establish a remuneration committee which is only applicable to significant financial institutions and disclosure requirements. The CEBS guidelines maintain that neutralization can be applied at institution level or in relation to specific staff.[120] Proportionality and neutralization can serve as methods for facilitating industry efforts to find ways to circumvent the rules[121] and thwart efforts to close all the loopholes by introducing the strictest regulation of remuneration practices.

5.5.2.3 Governance of remuneration

The EU requirement in this instance is that the company must ensure the design of remuneration policies is integrated in the risk management of the institution. The management body should adopt, and periodically review, the remuneration policies in place.[122] This was interpreted by the CEBS guidelines which state that the management body in its supervisory function should act to design, approve and provide oversight for the remuneration policy of a firm.[123] However, this management body should include non-executive directors who collectively have sufficient knowledge of remuneration policies and structures to ensure alignment between remuneration and prudent risk-taking. The CEBS guidelines recommend remunerating the members of the management body who are

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[118] Neutralization is the disapplication of certain requirements.

[119] Morrison & Foerster, "Financial sector remuneration in the UK and the EU" (*Morrison & Foerster*, January 2011) <http://www.mofo.com/files/Uploads/Images/110124-Financial-Sector-Remuneration-in-the-UK-and-the-EU.pdf> accessed 14 May 2013.

[120] CEBS Guidelines on Remuneration (n 100) para 20.

[121] Ferran (n 64) 20.

[122] CRD IV.

[123] CEBS Guidelines on Remuneration (n 100) para 42.

responsible for the supervisory function using fixed remuneration to avoid conflicts of interest.

The CRD IV was silent on the issue of "say on pay" which is covered by the Commission Recommendation in 2009, regarding the remuneration of directors in listed companies; the CEBS guidelines stated that remuneration policy should also, where appropriate, be approved by the shareholders and reviewed annually by the board of directors at least. The revision should involve the close participation of internal control functions as well as external review when appropriate according to the proportionality principle to ensure that the remuneration policy is operating as intended and it is compliant with national and international regulations.

Significant institutions in terms of their size, internal organization and the nature, scope and complexity of their activities should establish a remuneration committee. The committee should consist of non-executive members in the supervisory function, the majority of whom should qualify as independent. One member at least should have experience in aligning remuneration structure to institutional risk and capital profiles. The committee should prepare recommendations on remuneration for management and highly paid staff members to advise the board on the overall remuneration policy to the board; have access to internal and external advice; review the appointment of external remuneration consultants; help oversee the remuneration system's design and operation; support in the assessment of the mechanisms designed to ensure that remuneration systems take account of all types of risks and are consistent with long-term sound and prudent management of the institution; and test how the remuneration system will react to future external and internal events by formally reviewing a number of possible scenarios.

Staff engaged in control functions must be provided with appropriate authority to participate in the design, oversight, and review of the remuneration policy for other business areas. Attention should be paid to their remuneration so as not to compromise their independence by providing them with a variable remuneration that is directly linked to the financial performance of the business unit they oversee or to the institution-wide performance. Their variable remuneration should be contracted in favour of fixed pay and if it is provided should be based on function-specific objectives.

5.5.2.4 The structure of payment and risk-alignment measures

The statements that the EU remuneration rules are "the strictest rules in the world on the bonuses paid to bankers"[124] and that the rules are "world leading" are the result of the way the rules have regulated the structure of remuneration. The current design of the regulation has limited the ability and flexibility of financial institutions to structure their own remuneration, as it has described in extensive detail the components of remuneration and permits institutions very little room to manoeuvre within the structure, which could put them at a competitive disadvantage globally as well as with non-financial institutions in spite of the fact that there is no direct competition between financial and non-financial institutions.

The CRD IV urges financial institutions to have a remuneration policy that is consistent with and promotes sound and effective risk management and does not encourage excessive risk-taking. Such a policy should be in line with the business strategy, objectives, values and long-term interests of the institution, and incorporates measures to avoid conflict of interest.[125]

5.5.2.4.1 General prohibitions

As with CRD III, CRD IV has prohibited and limited certain remuneration practices. These are guaranteed variable remuneration, severance pay, and personal hedging. As with CRD III, the CRD IV has limited the payment of guaranteed variable remuneration to the case of the exceptional circumstances of hiring new staff for the first year only. However, the CRD IV has added such guaranteed variable remuneration is only allowed if the institution has a sound capital base. In spite of allowing exceptional guaranteed variable remuneration the CRD IV states that "guaranteed variable remuneration is not consistent with sound risk management or the pay for performance principle and shall not be a part of prospective compensation plans".[126] However, these rules will give an advantage to firms in attracting talented employees by offering welcome or signing bonuses, whereas the current employer will be prohibited from countering the offer and offering a retention bonus as discussed in Chapter Four. However, if countering is allowed, as the UK regulator mentioned that it might

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[124] L Zingales, "The bonus risk" (project syndicate, 18 August 2010). Available at: <http://www.project-syndicate.org/commentary/the-bonus-risk> accessed 9 April 2013.

[125] CRD IV.

[126] ibid.

be in some cases, then there is no guarantee that firms will not use it to circumvent and escape the application of the CRD IV.

Severance payment made without regard to performance can create a situation where the employee is encouraged to take excessive risk as they will get the bonus if they win the deal or transaction, or receive severance payment if they fail and are asked to leave. So, such payment must reflect performance achieved over time and does not reward failure or misconduct. However, the CEBS has clarified that termination payment for change in control or strategy is not precluded as well as termination payment that is required by employment law, such as payment related to the duration of a notice or redundancy, or contract law such as non-competition clause in the contract.

Since the principles of remuneration are designed to expose employees to the downside of their conduct by reducing or cutting remuneration according to the performance, personal hedging and insurance contracts which transfer the downside risks to another party is prohibited.

5.5.2.4.2 The balance between variable and fixed pay

Unlike the P&S which recommended variable remuneration form a substantial part of the total remuneration,[127] CRD III rules required firms to have a balance between fixed and variable pay to allow firms to operate fully flexible variable payments, which can be reduced or cut at any time when performance falls without specifying certain rules.[128] However, CRD IV has amended this requirement by introducing a maximum ratio of variable remuneration to fixed pay. This ratio must not exceed 1:1 (i.e. variable bonuses are equal to fixed pay).[129] The maximum this can go is 2:1 if 50 per cent of shareholders participate in the vote and it is approved by 66 per cent or 75 per cent of the attending shareholders.[130] A discount rate may be applied to a maximum of 25 per cent of total variable remuneration provided that it is paid in instruments that are deferred for a period of not less than five years.[131] The present value of

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[127] FSB Implementation Standards, 3.

[128] CRD III, Annex I.

[129] CRD IV, Article 94(1)(g).

[130] ibid Article 94(1)(g).

[131] ibid Article 94(1)(g)(iii).

future cash flow can be discounted by the interest rate taking into account the number of year(s) in which the cash will be received.

However, the EBA has published guidelines on the applicable notional discount rate taking account of all relevant factors which are interest rate for EU government bonds, inflation rate of the Member State or third country, incentive factors for the use of long-term deferral of 10 per cent for five years deferral, plus a further 'add-on' factor of four per cent for each additional year of deferral, and the number of deferred years.[132] At least 40-60 per cent of variable remuneration must be deferred and 50 per cent of the total variable will paid in instruments. Remuneration is most likely to be divided into four parts provided that 50 per cent is deferred and 50 per cent paid in instruments. The half that is paid upfront will consist of cash and instruments and the other half which is deferred for a minimum of three to five years will also consist of cash and instruments. Thus, a discount rate of a maximum of 25 per cent will apply to the deferred part that is paid in instruments or some of it provided that it is deferred for a period not less than five years.[133]

The argument of having a balance or ratio is not a convincing argument. Firms can operate fully flexible variable remuneration without having that balance. Having a balance between fixed and variable remuneration is going to raise the fixed cost of running a business. The increase in fixed cost can make banks more vulnerable to business cycles and downturns which can significantly increase the risk of bank failure.[134]

The other argument in favour of such a balance is that this can serve to reduce the amount of risk and, hence, prevent the firm from exposure to excessive risk-taking. This argument is convincing to a certain extent as it is true that traders might reduce the amount of risk when they have high fixed pay, but this is also related to their behaviour and satisfaction, as there are many factors which influence their risk-taking and a bonus is only one of them. When the variable pay is equivalent to a year or two of fixed pay they might even dislike losing that, and still be taking more risk until they reach the point of guaranteeing the upper limit of their bonus; then they might reduce or even stop taking any risks, as there would be no point in

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[132] European Banking Authority, *Guidelines on the applicable notional discount rate for variable remuneration* (EBA/GL/2014/01, 27 March 2014).

[133] ibid.

[134] Murphy, "Regulating Banking Union" (n 103).

taking extra risk which is not rewarded and might cause them to lose some of their accumulated bonus if they lose.

At the same time as asking institutions implicitly to raise fixed pay to achieve the balance, the CRD IV prohibits guaranteed bonuses unless these are exceptional and for hiring new staff for the first year. These two rules contradict each other, as at the same time as wanting firms to stop paying guaranteed variable remuneration, the CRD IV also wants firms to raise salaries which are similar to guaranteed variable remuneration or an even worse form. Having a flexible guaranteed variable remuneration is better than having a guaranteed fixed component. The reason, as discussed in Chapter Four, is that the rise in salary will increase the fixed costs of running the business, whereas variable remuneration can be reduced or increased. The ratio will be likely to reduce the competitiveness of the EU banks to non-EU banks and non-bank financial services providers that are not subject to the rule.[135]

5.5.2.4.3 Alignment with risk and long-term performance

The alignment between the payment of remuneration and risk-taking and long-term performance follows the path of ensuring that payment is adjusted for all types of risk and designed to capture any ramifications in the future to ensure sustainable performance. Achieving this is possible using *ex-ante* and *ex-post* measures. *Ex-ante* measures, which have immediate effect on risk-taking behaviour, require institutions to adjust remuneration to all types of risk afterwards when assessing the performance of their staff (which should be based on defined objectives and financial and non-financial criteria related to the business strategy and risk appetite of the firm).[136] This adjustment is done by using risk measurement methods based on quantitative and qualitative measures which require judgement and are less transparent and less accurate than the quantitative measures. This adjustment is also encouraged for periodic re-assessment to ensure a multi-year performance framework which is also encouraged for the payment of a deferred part of the remuneration.[137]

Since the *ex-ante* risk-adjustment using risk measures has its own shortcomings as not all risks can be fully taken into account, the *ex-post* measures of malus and clawback also apply.

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[135] ibid 650.

[136] CEBS Guidelines on Remuneration (n 100) paras 86 & 95.

[137] ibid para 86.

Deferral of at least 40 to 60 per cent of remuneration depending on the seniority and responsibility of the staff for at least three to five years or more depending on the future risk and business cycles is introduced to help in operating the *ex-post* measures.

In addition to that, the payment of variable remuneration should be divided and at least 50 per cent should be paid in shares, share-linked instruments, and equivalent non-cash instruments for non-listed firms or other instruments which reflect the credit quality of the institution as a going concern. These instruments apply to the payment of deferred and upfront parts of the variable remuneration.[138] However, these instruments must be retained after vesting for both the upfront and deferred instruments[139] to ensure their effectiveness as a mean of aligning reward with performance and exposing executives and traders to the downside of their decisions.

Therefore, institutions need to use a back-testing or performance adjustment to ensure that the *ex-ante* risk adjustment was correct and accurate. When the actual risk outcome is different from the initial calculation, institutions are expected to reduce the value of the deferred part of the remuneration.

Institutions are encouraged to set specific criteria for applying malus and clawback. These criteria apply to when the staff member participated in or was responsible for conduct which resulted in significant losses to the institution and/or failed to meet appropriate standards of fitness and propriety. The CEBS already recommended some criteria under the CRD III which should include the following: evidence of misbehaviour or serious error by staff; significant downturn in the business unit and/or the institution; significant failure of risk management in the institution and/or the business unit; or significant changes in the institution's economic or capital base.[140] However, a new feature of the CRD IV is that 100 per cent of variable remuneration is subject to malus and clawback. It is worth mentioning that malus cannot be applied to the vesting part of instruments even if they are subject to the retention period, and staff cannot sell them as the vested part in the view of the CEBS belong to the staff and in this situation the institution can apply clawback.[141] However, clawback is

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[138] ibid para 122.

[139] ibid para 128.

[140] ibid para 137.

[141] ibid para 132.

very limited in application and is relevant only in cases realting to fraud or misleading information.

5.5.2.5 Disclosure

The disclosure requirement in the CRD IV is included in the regulation so it is directly applicable to member states and there is no need for implementation.[142] In order to ensure greater transparency, a remuneration report is required on at least an annual basis. The required report must include detailed information of any remuneration policies relating to staff whose activities have a material impact on their risk profile. This information includes matters concerning the decision-making process; information on the link between pay and performance; the most important design characteristics of the remuneration system; information on the performance criteria on which entitlement to shares is based; the ratios between fixed and variable remuneration set in accordance with the directive; aggregate quantitative information broken down in two ways: by business area as well as senior management and members of staff whose actions have a material impact on the risk profile of the institutions. The latter type of aggregate information must include: the amount of fixed and variable remuneration and the number of beneficiaries; the amount and forms of variable remuneration; the amount of outstanding deferred remuneration indicating what has been vested and what has not; and any signing-on and severance payments made during the year along with the number of beneficiaries specifying the amount and the highest award of severance payment.

Unlike CRD III, CRR has included a new requirement to disclose the number of individuals receiving EUR one million or more per financial year, for remuneration between EUR one million and five million broken down into pay bands of EUR 500 000 and for remuneration of EUR five million and above broken down into pay bands of EUR one million.[143]

In accordance with the proportionality principle, institutions may comply with the disclosure requirement which is appropriate to their size, internal organization and the nature, scope and complexity of their activities. For example, small or non-complex institutions are only expected to provide "some qualitative information and very basic quantitative information

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[142] CRR.

[143] ibid Article 450(1)(i).

where appropriate". Certain types of information may also be exempt from disclosure on the basis of materiality, their proprietary nature or confidentiality.[144]

Presently, however, there are no specific requirements as to how such information is to be disclosed, although the CEBS Guidelines make it clear that the information must be "easily accessible".[145] There is a similarity between the requirements of the FSB and the CRR with regard to disclosure requirements. However, both sets of requirements have failed to incorporate the most demanding disclosure requirements, as there is no requirement for the disclosure to be individualized.[146]

5.5.2.6 Capital base and supervisory oversight

Similar to the P&S, the CRD IV urges firms to ensure that the total variable remuneration does not limit their ability to strengthen their capital base. Moreover, supervisory authorities must ensure that they have the ability to impose corrective measures as well as financial and non-financial sanctions when an institution breaches the requirements of the CRD IV. Measures can be quantitative, such as increasing the capital requirement, or qualitative, which takes priority over the quantitative, and contains actions taken by the institution to remedy the deficiencies in its remuneration policy.[147] Supervisory authorities should be able to require a reduction of the variable remuneration or even a cap on the overall payment if it is inconsistent with the requirement of having a sound capital base. Supervisors should also be able to limit variable remuneration to a percentage of total net revenues or net profit to strengthen the capital base. However, contractual arrangements between staff and the institution must not limit the institution's ability to comply with requirements regarding the capital base.

5.6 Conclusion

EU regulation of remuneration was discussed here since most of the ownership structures in its member states are classified as block-holding rather than dispersed ownership. In 1998 EU

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[144] Morrison & Foerster, "Financial sector remuneration in the UK and the EU" (n 119).

[145] ibid.

[146] Ferran (n 64) 22.

[147] CEBS Guidelines on Remuneration (n 100) para 33.

leaders believed that integration of financial services was essential to the introduction of the euro but Member States blocked the inclusion of measures to harmonize corporate governance practices in the financial services Action Plan. However, corporate failure in the EU and the USA, and the introduction in the USA of the Sarbanes-Oxley Act, persuaded the Commission of the need for harmonization of corporate governance in a single code, a proposal which was rejected by the Winter Report. Remuneration remains a core issue in the corporate governance reform at the EU level and the Commission's pan-EU approach to this issue aims to remove core conflicts from the pay-setting process by using remuneration committees and strengthening the role of independent directors and shareholders in the remuneration-setting process, supplemented by disclosure requirements. Pre-crisis reform thus eschewed direct intervention in the structure of remuneration, even in the form of non-binding recommendations.

Following the financial crisis of 2007, remuneration practices were accused of being a contributory factor, rather than the primary factor, to the build-up to the crisis. During the first phase of the financial crisis, the Commission had issued three Communications intended to assist Member States to safeguard the financial system, all of which asserted the need to control any direct intervention by the state in the remuneration practices of the bailed-out banks. Later, a High-level Group was tasked with devising proposals to strengthen European supervisory arrangements across all financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision. The group's de Larosière Report explicitly accused remuneration of running counter to effective risk management.

Following the de Larosière Report, in April 2009 CEBS published its High-level Principles for Remuneration Policies (repealed in 2011) and the Commission published two Recommendations: the first regarding remuneration in listed companies, and the second and more demanding recommendations relating to remuneration in the financial sector. These Recommendations, which explicitly tackle remuneration practice in listed companies and financial institutions, represented a turning point in the Commission's previous hands-off approach to this issue.

The Commission also pressed for the inclusion of remuneration regulation into the CRD III, partly as a result of its dissatisfaction with the lack of uniformity in implementation of the financial sector Recommendation in Member States and partly due to the need for

international alignment, which produced the P&S. The CRD III contained the world's strictest rules, going beyond the FSB requirements, and has since been replaced by even more stringent requirements on remuneration under the CRD IV.

Chapter 6 The regulation of remuneration practices in the USA

6.1 An overview of the US remuneration story

Despite the fact that both the USA and UK corporate governance structures are classified as market-based and have broad similarity in pursuing shareholder-oriented models, there are differences between the two in approaching corporate governance issues. These differences have become more evident since the enactment of Sarbanes-Oxley in 2002. The US system is based largely on hard law and a regulatory state, while the UK system is mainly founded on soft law. Therefore, the US approach of mandatory rules causes the system to follow a "one size fits all" approach.[1] With regard to corporate law, this is a matter for state rather than federal regulation in the USA. However, securities law is regulated on the federal level[2] and the Securities Exchange Commission (SEC) usually emphasizes disclosure rather than substantive provisions regarding company structure.[3]

The regulation of remuneration in the USA, developed after companies started to use golden parachutes and performance remuneration. This development in the 1980s was a response from business communities to alleviate pressure within the market for corporate control, and calls from academic, and institutional shareholders to tie rewards more closely to company value through increases in share options and other forms of equity-based incentives. In the 1960s and 1970s, an era described as one of managerial capitalism,[4] no regulation existed regarding remuneration committees. The reason is that most of executive remuneration took the form of fixed pay and bonuses tied to the annual performance of the company. Salary was strongly correlated to the size of the company revenue and not to wealth creation.[5]

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[1] G Jackson, "Understanding corporate governance in the United States: an historical and theoretical reassessment" (*boeckler*, October, 2010) <http://www.boeckler.de/pdf/p_arbp_223.pdf> accessed 12 November 2012.

[2] ibid.

[3] ibid.

[4] ibid

[5] MC Jensen and KJ Murphy, "Remuneration: where we've been, how we got to here, what are the problems, and how to fix them" (2004) ECGI Finance Working Paper 44/2004(July), 26 & 27.

In the 1980s, this power started to shift towards shareholders as a result of the emergence of institutional investors.[6] Shareholder activists and academics were increasingly demanding that executive pay be tied more closely to company value through increases in share options and other forms of equity-based incentives.[7] These were introduced but without a direct requirement for say on pay under corporate law, which gave the board the power to influence the size and form of the schemes, and led to the explosion of managerial remuneration in the 1990s.[8] Moreover, many hostile takeovers took place, targeting companies with excess cash, which indicated that incumbent managers did not know how to invest such cash.

During this time, golden parachute agreements emerged to award payments to incumbent managers who lost their jobs following a change in control, and as a takeover defence to make it more costly to acquire a firm.[9] The US government responded to the generous payment of golden parachutes by enacting the Deficit Reduction Act of 1984, which imposed a special tax on payments exceeding three times the executive's average recent remuneration. Jensen and Murphy insist that the Act had a negative effect. Rather than curbing the practice of golden parachutes, many companies introduced the change in control agreements and used the three times average remuneration as standard.[10] Moreover, companies even went so far as to introduce comprehensive employment agreements designed to protect executives from termination for reasons other than a change of control, even if the termination was for the incompetence of the executive.[11]

The 1990s witnessed an explosion in levels of executive remuneration supported by a shift in senior executive remuneration towards being primarily based on stock rather than cash. This movement was also encouraged by tax and accounting incentives. Tax law provided favourable tax treatment for certain types of incentive stock options, describing non-performance remuneration in excess of $1 million as "unreasonable" and, therefore, not

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[6] Jackson (n 1).

[7] Jensen (n 5) 28.

[8] Jackson (n 1).

[9] Jensen (n 5), 28.

[10] ibid 28 & 29.

[11] ibid 29.

deductible as an ordinary business expense for corporate income tax purposes.[12] However, the rule was restricted to the top five executive officers.[13] Performance-based remuneration was exempt from the rule, provided the plan had been determined by a remuneration committee comprising outside directors, who had to certify that the performance goals and any material terms had been satisfied and shareholder approval obtained, especially for the plan and its terms, before making the payment.[14] These rules have restricted the use of qualitative performance measures and board discretion.[15]

Accounting treatment for stock options was advantageous, as a corporation issuing stock options was able to avoid expenses for the fair market value of these options in its financial statements.[16] This change caused management to become focused on market price and the likely future performance of their firm's shares over the short term.[17] This short-termism was also fuelled by the change to section 16(b) of the Securities Exchange Act 1934, as it had previously required executives to hold their exercised options for six months. In 1991 the SEC changed the section to allow executives to exercise stock options and sell their stock at the same time, provided there were at least six months between granting and exercising.

During this era new forms of executive pay, greater executive turnover and golden parachutes, so that remuneration became part of the political agenda and legislation was introduced to the House of Representatives disallowing deduction for remuneration exceeding 25 times the lowest-paid worker. The Corporate Pay Responsibility Act was introduced to the Senate to disclose the total of remuneration rather than the details and components and to give shareholders more rights to propose remuneration-related policies.[18] However, the SEC pre-empted the pending Senate Act by announcing regulations, which took

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[12] ibid 30.

[13] KJ Murphy, "The politics of pay: a legislative history of executive compensation" in: RS Thomas and JG Hill (eds), *Research Handbook on Executive Pay*, (Edward Elgar, Cheltenham 2012) 25.

[14] Internal Revenue Code, Section 162(m).

[15] NL Rose and C Wolfram, "Regulating executive pay: using the tax code to influence CEO Compensation" (2002) 20(2) *Journal of Labour Economics* S142.

[16] SW Suchan, "Post-Enron: US and German corporate governance" (June 2004) *Cornell Law School Graduate Student Papers*. Paper 4, 7 &8.

[17] JC Coffee, "What caused Enron? A capsule social and economic history of the 1990s" (2003) Columbia Law School: Centre for Law and Economic Studies Working Paper No. 214.

[18] KG Salwen, "Shareholder Groups Cheer SEC's Moves on Disclosure of Executive Compensation" *The Wall Street Journal* (14 February 1992).

effect in the 1993 proxy season, requiring substantially greater disclosure of executive remuneration awards[19] and expanding the definition of allowable topics for shareholder proposals to include issues related to executive remuneration.[20]

Jensen and Murphy maintain that government intervention worsened the situation, as executive remuneration continued to rise above $1 million[21] due to the greater use of options that met the requirement of tax rules with regard to deduction. However, whilst many companies lowered salaries to $1 million following the legislation[22] others increased cash payments to $1 million and added on top of that other performance-based pay.[23] Jensen and Murphy show in their article that CEO annual pay in Standard & Poor's (S&P) firms increased from an average of $2.7 million in 1992 to $14 million by 2000. Base salaries represented 38 per cent of the total remuneration in 1992 and decreased to 17 per cent in 2000, while options increased to 49 per cent in 2000 from 24 per cent in 1992.[24] The initiatives of the 1990s are best described by Rose and Wolfram, who assert that "[w]hile the initial rhetoric concerned pay levels, the final legislation targeted reforming the compensation process with an emphasis on performance-based pay".[25]

The collapse of Enron and the high profile accounting scandals in 2001 showed how executives had been incentivized to adopt high-risk strategies, shifting future revenues to the present and current expense to the future, even manipulating their accounting statements and committing fraud to maintain the value of their stock options. Firms were allowed not to report the expenses for options, which, according to Ferri and Sandino, led to excessive use of options in executive contracts.[26] A proposal relating to the mandatory expense of options

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[19] Jensen (n 5), 30.

[20] MF Johnson, S Porter and MB Shackell, "Stakeholder pressure and the structure of executive compensation" (1997) SSRN <http://ssrn.com/abstract=41780> accessed 12 November 2012.

[21] The level which was seen as acceptable in the legislation, see: Jensen (n 747), 30.

[22] T Perry and M Zenner, "Pay for performance? Government regulation and the structure of compensation contracts" (2001)62(3) *Journal of Financial Economics* 453.

[23] Rose (n 15).

[24] Jensen (n 5) 30.

[25] Rose (n 15).

[26] F Ferri and T Sandino, "The impact of shareholder activism on financial reporting and compensation: the case of employee stock options expensing" (2009) 84(2) *American Accounting Association* 433.

was removed from Sarbanes-Oxley.[27] However, since shareholders were allowed to propose issues related to executive remuneration, more than 150 shareholder proposals requesting the expense cost of executive options were submitted during the 2003 and 2004 proxy seasons.[28] Later in December 2004, the Financial Accounting Standards Board (FASB) released a revised rule that required all firms to include the expense of options based on the fair value at the grant date,[29] leading to a decline in the use of options among companies.

The outcomes of the analysis of officials in the USA of the role of remuneration practices in the financial crisis are no different from those in the FSB, EU and UK reports. A report on the causes of the financial crisis maintained that:

> *[C]ompensation systems designed in an environment of cheap money, intense competition, and light regulation too often rewarded the quick deal, the short-term gain without proper consideration of long-term consequences. Often, those systems encouraged the big bet where the payoff on the upside could be huge and the downside limited. This was the case up and down the line from the corporate boardroom to the mortgage broker on the street.*[30]

The scholarly debate over executive pay in the USA is well documented.[31] The explosion of executive pay in the USA was mainly driven by the increased use of options in the 1980s and 1990s[32] combined with the stock market boom of the end of the 1990s to 2000.

Against this backdrop, this chapter will develop as follows. The next section will review how remuneration is dealt with under state law and the judicial system. The general approach to regulating remuneration practices on the federal level in the USA will then be discussed, followed by an examination of the aspects of federal law that affect remuneration directly, and a consideration of the regulation of incentive-based remuneration.

6.2 Remuneration under state corporate law and the judicial system

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[27] Jackson (n 1).

[28] Ferri (n 26).

[29] ibid.

[30] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011).

[31] RS Thomas, "Explaining the international CEO pay Gap: board capture or market driven?" (May 2004) 57(4) *Vanderbilt Law Review* 1171.

[32] L Bebchuk, J Fried and D Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensations" (2002) 69 *The University of Chicago Law Review* 751, 791.

Delaware corporate law provides that "[u]nless otherwise restricted by the certificate of incorporation or bye-laws, the board of directors shall have the authority to fix the compensation of directors".[33] The law also provides that "[T]he business and affairs of every corporation […] shall be managed by or under the direction of a board of directors". The court explained that when directors are carrying out their roles, they are charged with an unyielding fiduciary duty to the corporation and its shareholders.[34] Remuneration is considered within the "business and affairs" and is, therefore, subject to the business judgement rule.

In *Campbell v. Potash Corp. of Saskatchewan, Inc.,* the court ruled that "evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts".[35] In *Brehm v. Eisner,* the court ruled that "directors have the power, authority and wide discretion to make decisions on executive compensation".[36] This ruling is grounded on section 122(5), which states that "[e]very corporation […] [has] power to: […] (5) [a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation".[37]

The business judgement rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.[38] Underpinning the Rule is the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and the honest belief that the action taken was in the best interests of the company".[39]

Therefore, the court acknowledges that in most cases directors are more capable of making business decisions than judges.[40] Bebchuk and Fried have also claimed that courts are ill-

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[33] Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code) section 141(h).

[34] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[35] *Campbell v. Potash Corp. of Saskatchewan, Inc*., 238 F.3d 792, 800 (6th Cir. 2001).

[36] *Brehm v. Eisner* 746 A.2d 244 (Del. Sup. 2000).

[37] Delaware General Corporation Law (n 33) section 122(5).

[38] *Smith* (n 34).

[39] *Aronson v. Lewis* 473 A.2d 805 (Del. 1984).

[40] *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 (lth Cir. 1989). Cited in: LJ Barris, "The overcompensation problem: a collective approach to controlling executive pay" (1992) 68(1) *Indiana Law Journal* 59, 81.

equipped to judge the desirability of remuneration packages and policies.[41] In the absence of wrongdoing, courts will refrain from examining the decision on remuneration matters, allowing directors broad discretion to set the level and kind of remuneration and "under such circumstances will not substitute its own notions of what is or is not sound business judgement".[42]

However, for such a decision to enjoy the protection of the business judgement rule, it must be made "on an informed basis, in good faith and the honest belief that the action taken was in the best interests of the company".[43]

Barris reviewed the cases that involved challenging remuneration issues for the period from 1900 to 1992 and came to the conclusion that, in every case, courts had either applied the business judgement rule and endorsed the compensation practice, or simply thrown in the towel and refused to deal with the problem.[44] It was acknowledged in *Heller v. Boylan* that

> *[C]ourts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province. Courts are concerned that corporations be honestly and fairly operated by its* [sic] *directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders. This does not mean that fiduciaries are to commit waste, or misuse or abuse trust property, with impunity. A just cause will find the Courts at guard and implemented to grant redress.*[45]

In *Rogers v. Hilt,* the court ruled that "[i]f a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority".[46] In *Zupnick v. Goizueta*, the court acknowledged that

> *[T]he plaintiff does not claim that the board failed to act in good faith, or that it had a disqualifying self-interest or lack independence […] [but] he claims that the option grant itself was wasteful and not protected by the business*

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[41] L Bebchuk and J Fried, *Pay without Performance: the Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, MA 2006).

[42] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717(Del. 1971).

[43] *Aronson* (n 39).

[44] Barris, (n 40) 82.

[45] *Heller v. Boylan*, 29 N.Y.S.2d 653, 680 (Sup. Ct. 1941).

[46] *Rogers v. Hill*, 289 U.S. 582 (1933).

> *judgement rule […] [He needs to show then] that the directors were interested or that shareholder ratification was improperly obtained, the well-pleaded allegations of the complaint must support the conclusion that "no person of ordinary, sound business judgment would say that the consideration received for the options was a fair exchange for the options granted".*[47]

Therefore, it can be said that approaching a compensation case will involve the courts routinely looking first to whether the corporation made a proper "business judgement". If the corporation followed a reasonable course of action in adopting a compensation plan, the courts will then look to whether the payments constitute corporate waste.[48] However, before bringing a derivative suit, shareholders must overcome the procedural obstacle, as will be examined below.

6.2.1 Procedural obstacles

There is a difficulty in bringing a derivative suit before a court due to the "demand requirement",[49] by which shareholders are not allowed to raise the matter with the court unless a formal demand is made to the board to investigate the problem. When the demand is made, the board can take full control of the problem and can decide not to pursue the litigation.[50] The court will generally respect such a decision if the board appears to have acted independently and conducted reasonable investigation of the allegations in the plaintiff's complaint.[51]

In order to bypass the demand requirement, a shareholder must show that making the demand to the board would be futile. This means that the plaintiff must present to the court "particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgement".[52] However, since it is difficult for the plaintiff to

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[47] *Zupnick v. Goizueta*, 698 A2d 384 (Del. Ch.1997).

[48] Barris, (n 40) 82.

[49] *Grimes v. Donald*, 673 A.2d 1207, 1216-17 (Del. 1996).

[50] *Scattered Corp. v. Chicago Stock Exchange, Inc*., 701 A.2d 70 (Del. 1997).

[51] ibid; See also RS Thomas and KJ Martin, "Litigating challenge to executive pay: an exercise in futility?" (2001) 79(2) *Washington University Law Quarterly* 569, 576-77.

[52] *Aronson* (n 39).

achieve this in the early stages of a case without discovery, the best hope is to show that a majority of the board of directors are financially interested in the compensation decision.[53]

6.2.2 Business judgement rule or substantive obstacles

A remuneration plan that is decided by an interested board of directors and does not have the approval of disinterested directors can be challenged as a voidable self-interested transaction, shifting the burden of proof to the directors to establish affirmatively that the remuneration is fair and reasonable to the corporation.[54] Thus, based on the judgment in *Zupnick v. Goizueta,* it can be said that if the recipient does not vote on the remuneration plan, and the plan is approved by the shareholders or disinterested directors upon disclosure of all material facts, the decision will be protected by the business judgement rule under the presumption that the amount and type of pay awarded is in the best interests of the corporation, unless it can be shown that the independent directors breached their duty of loyalty or care, or that the remuneration plan amounts to corporate waste.[55]

6.2.2.1 Duty of care and corporate waste

At the heart of the duty of care is "a director's duty to exercise an informed business judgment".[56] This exercise must be in good faith[57] after the directors "inform themselves of all information reasonably available to them and relevant to their decision".[58] To meet this requirement, the board must exercise a "degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances".[59] However, the court will not hold directors liable under the protection of the business judgement rule unless the directors' action reaches the level of "gross negligence". This was made clear when the court in *Aronson v. Lewis* stated that "while the Delaware cases use a variety of terms to describe the applicable standard of care, […] under the business judgment rule director liability is

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[53] Thomas, "Litigating challenge to executive pay" (n 51) 576-77.

[54] *Cohen v. Ayers*, 596 F.2d 733 (7th Cir. 1979).

[55] Barris, (n 40) 83.

[56] *Smith* (n 34).

[57] *Aronson* (n 39).

[58] *Smith* (n 34).

[59] RC Clark, cited in: Thomas, "Litigating challenge to executive pay" (n 51) 581.

predicated upon concepts of gross negligence". [60] This standard was also confirmed in *Smith v. Van Gorkom*, when the court stated that "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one".[61]

However, under the duty of care directors are not precluded from relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person, as to matters the member reasonably believes are within the professional or expert competence of an individual who has been selected with reasonable care by or on behalf of the corporation.[62]

If the requirement that directors must inform themselves of the information available to them before making a decision is the procedural part of the duty of care, corporate waste is considered as the substantive part of the duty of care.[63] To win a waste claim, the plaintiff must illustrate that the company failed to undertake reasonable consideration (even slight consideration) of the remuneration rewarded.[64] The waste test in *Saxe v. Brady*, which was affirmed by the Supreme Court, stated that the plaintiff must show that "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid".[65]

The reasonableness requirement can easily be met by purporting the award of the remuneration is for an appropriate purpose, such as to reward and retain executives.[66] Therefore, the court will deem the consideration reasonable if the corporation deems it adequate,[67] especially if the decision is made by an independent remuneration committee.[68]

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[60] *Aronson* (n 39).

[61] *Smith* (n 34).

[62] Delaware General Corporation Law (n 33) section 141(e).

[63] Thomas, "Litigating challenge to executive pay" (n 51) 581.

[64] JA Kreinberg, "Note, reaching beyond performance compensation in attempts to own the corporate executive" (1995) 45 *DUKE Law Journal* 138, 171.

[65] *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962); *Zupnick* (n 47).

[66] Kreinberg, (n 64) 171.

[67] Barris, (n 40) 83.

[68] ibid.

However, if the corporation receives no benefit, then corporate waste is easily found and this can stem from the ruling in *Rogers v. Hilt* mentioned above.

6.2.2.2 Duty of loyalty

The duty of loyalty requires directors to act in the best interests of the company and to refrain from action that might injure the shareholders.[69] The personal financial interest of the board of directors in dealing with a transaction creates a situation of a conflict of interests. In this case, directors must either remove this conflict of interests through appropriate ratification by a disinterested decision maker, or the directors must bear the burden of demonstrating that the transaction is entirely fair to the corporation.[70] However, compensation agreements are negotiated between managers and the board's remuneration committee. This committee comprises mostly, if not entirely, disinterested outside directors, which makes its decisions generally immune from being attacked on duty of loyalty grounds.

6.2.2.3 The Walt Disney Case

A landmark case involving the Disney Company received a great deal of attention since it demonstrates the difficulties of holding directors liable for decisions related to remuneration. In this case, the CEO of Disney, Michael Eisner, wanted to appoint his personal friend, Michael Ovitz, to the position of president and possible successor. Before joining Disney, Ovitz headed the powerful CAA Hollywood talent agency.[71]

Ovitz had no experience for the Disney position but was sought after by other companies due to his successes in the entertainment business.[72] Eisner exclusively negotiated an employment agreement with Ovitz and this was approved by the board.[73] Ovitz was given a five-year employment contract, described by the court as "extraordinarily lucrative".[74] This contract included $1 million annually as the base salary, a discretionary bonus, and two sets of stock options. The "A" option contained three million shares and could be vested immediately if

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[69] Thomas, "Litigating challenge to executive pay" (n 51) 584.

[70] ibid.

[71] SM Bainbridge, *Corporate governance after the financial crisis* (OUP, Oxford 2012) 121.

[72] *Brehm* (n 36).

[73] ibid.

[74] ibid.

Disney granted Ovitz a non-fault termination of the employment agreement. Option "B" consisted of two million shares. Terminating this agreement could be done in three ways: serving the five years; terminating with good cause (only if Ovitz committed gross negligence or malfeasance), or if Ovitz resigned voluntarily. If termination were with good cause, Disney would not owe Ovitz any additional remuneration, while termination without cause would entitle Ovitz to the present value of his remaining salary payments, a $10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first three million stock options from plan "A".[75] After 14 months, it was obvious that hiring Ovitz had been a mistake. As a result of the deterioration of the company's situation, Eisner negotiated with Ovitz his exit from the company and agreed to arrange for him to leave Disney on the non-fault basis. The board acted as a rubber stamp for Eisner's decision. As a result, Ovitz walked away with about $130 million, a sum which would have been much smaller if the contract had been terminated for cause or had Ovitz resigned.

The board, according to the plaintiff, one of the shareholders, failed to inform itself about the total costs and incentives of the Ovitz employment agreement, especially the severance package. Therefore, the plaintiff alleged that the contract gave Ovitz an incentive to find a way to exit the Company via a non-fault termination as soon as possible, because doing so would permit him to earn more than he could by fulfilling his contract. The derivative suit argued that the board had breached its fiduciary duties in hiring and firing Ovitz and committed waste. The plaintiff alleged that there were grounds to terminate Ovitz's agreement for cause, as his performance and lack of commitment met gross negligence or malfeasance standards, citing media reports about the situation of Disney after Ovitz's appointment.

The court held that Disney directors had not violated their duty of care or acted in bad faith in connection with their handling of the hiring and subsequent no-fault termination of Ovitz's contract nor committed waste.[76] The court held that the business judgement rule protects directors' decisions, even if the "informational and decision-making process used […] was

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[75] ibid.

[76] In re The Walt Disney Co. Derivative litigation, 906 A.2d 27 (Del. 2006).

not so tidy".[77] The court found that the remuneration committee had exercised due care in approving Ovitz's remuneration and had the power to approve it without referring the matter to the board. The court also further held that the board was entitled to rely on Eisner and the remuneration committee.

The court rejected the argument that Ovitz's remuneration gave him an incentive to get fired and was, therefore, wasteful. The reason for this rejection is that the court asserted that "Ovitz had no control over whether or not he would be fired, either with or without cause".[78] The deal, as the court stated, "had a rational business purpose: to induce Ovitz to leave CAA, at what would otherwise be a considerable cost to him, in order to join Disney".[79]

This case, as Bainbridge has stated, makes it clear that in the absence of evidence of self-dealing, Delaware corporate law will focus on the process by which executive remuneration is set rather than the amount or form of such remuneration. To support his argument, he cites from the case: "[c]ourts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is process due care only."[80] Moreover:

> *Directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.*[81]

Bainbridge concludes that by using shareholder money, directors can buy themselves litigation insurance, hire competent legal advisors to advise on the appropriate decision-making process, and hire an expert remuneration consultant to advise on the setting of an appropriate level and form of remuneration.[82]

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[77] ibid.

[78] ibid.

[79] ibid.

[80] *Brehm* (n 36).

[81] ibid.

[82] Bainbridge, (n 71) 122.

6.2.3 The impact of the advisory vote on court assessment of remuneration

The Dodd-Frank Act was enacted on 21 July 2010. This Act introduced the requirement for US public companies to hold an advisory non-binding vote from their shareholders on executive remuneration in the prior fiscal year, to determine how often the vote should be held, and to approve so-called "golden parachute payments" triggered by an acquisition, merger or other similar corporate transaction. In January 2011, the SEC adopted the Final Rules on "say-on-pay" under Section 951 of the Dodd-Frank Act.[83] From the 2011 proxy season, over 90 per cent of the Russell 3000 companies received 70 per cent shareholder approval, with 70 per cent of the total number of companies receiving over 90 per cent shareholder approval. Only 37 companies failed to receive at least 50 per cent shareholder approval.[84]

Following the 2011 votes, at least 10 of the Russell 3000 companies have faced shareholder derivative lawsuits that were filed against their board of directors and executive officers, and, in some cases, the independent compensation consulting firms that advised them.[85] Of these 10 lawsuits filed in 2011, one has been dismissed, one has survived a motion to dismiss, two have settled and the remaining six are pending.[86] Shareholders argued that the "disapproval" of a company's executive compensation plan supports claims that the directors breached their fiduciary duties when they accepted the plans, and that the directors are personally liable for damages to the company for approving such excessive compensation payments.[87]

Andreozzi and Murray have reported on some cases. In the cases, with minor variances, the plaintiff alleged that the company advises shareholders that it maintains a "pay for performance" remuneration philosophy. The board relied in part on the advice of a remuneration consultant to approve an executive compensation plan, pursuant to which non-executive directors receive an increase in remuneration, despite the company's arguably poor

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[83] BJ Andreozzi and DC Murray, "Lawsuits in the wake of say-on-pay" (2011), 19(5) *Corporate Governance Advisor* 20.

[84] T Asmer and S Gadd, "Recent development in say-on-pay in the US and UK" (*Lexology*, 15 July 2012) <http://www.lexology.com/library/detail.aspx?g=da7b61df-e3a2-42c5-9872-f59e06e29d01> accessed 12 November 2012.

[85] ibid.

[86] ibid.

[87] Andreozzi (n 83).

financial results. A majority of the shareholders vote "no" in the say-on-pay vote. The board failed to rescind the pay increases following the shareholder vote. Based on this combination of factors, the plaintiffs alleged that the directors' approval of (and refusal to rescind) the remuneration plan was irrational, unjustified, a profligate waste of corporate assets, and could not have been the product of valid business judgement.[88]

The claims were based on several causes. However, the most important argument was that the fact that the shareholders declined to support the executive remuneration plans in their say-on-pay votes demonstrates that the remuneration plans were contrary to the best interests of the shareholders and, therefore, that the directors breached their fiduciary duties when they approved such plans or when they failed to rescind them following the shareholder vote.[89]

The success of the cases is highly doubtful. The plaintiffs in these shareholder derivative lawsuits faced substantial hurdles, both procedurally and substantively. The procedural obstacle requires shareholders either to make a pre-suit demand to the company's board of directors or to plead with particularized facts that such a pre-suit demand should be excused because it is futile. Having been successful in overcoming this obstacle, plaintiffs must then overcome the obstacle of the application of the "business judgement rule".

Section 951 of the Dodd-Frank Act will not be of much help since the section clearly articulates that "the [advisory] vote shall not be binding on the issuer or the board of directors of the issuer". The section adds that the advisory vote is not to be construed "as overruling a decision by such issuer or board of directors" and does not "create or imply any change to the fiduciary duties of such issuer or board of directors", nor does it "create or imply any additional fiduciary duties for such issuer or board of directors". However, the lawsuit used a negative vote to support the argument that the directors were not acting in the best interests of the company. If accepted by the court, this argument would make shareholder votes binding on the company rather than advisory. Thus, section 951 can offer a safe harbour to the defendants in these cases.

6.3 The general approach to regulating remuneration in the USA

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[88] ibid.

[89] ibid.

The US federal government has used tax to control excessive remuneration practices. Indirectly, by using tax law and accounting principles, the US government shifted the focus of US companies to considering the use of equity incentive in executive contracts which led to the explosion in the level of US executive remuneration. Along with tax law, the Internal Revenue Code,[90] has encouraged companies that want to enjoy the benefit of tax deduction to establish an independent remuneration committee to decide and oversee the practice of performance as well as obtain shareholder approval of such plans. The SEC, through its historic role of using disclosure as the main mechanism of regulating financial markets, has tightened its disclosure rules.

Unlike in the UK, it seems that there is no limit on the length of an executive contract.[91] However, the shareholder approval requirements are diluted with significant exceptions, as the Listed Company Manual of the New York Stock Exchange (NYSE) requires companies to obtain shareholder approval for "equity compensation plans", which would include plans providing for option grants or grants of actual shares.[92] However, shareholder approval on granting options and shares serves to give the owners power over the change of the capital structure rather than giving them a say on pay. Therefore, influenced by its corporate governance model which is market-based and the general preference in the USA for director rather than shareholder primacy,[93] US remuneration has generally been regulated by using disclosure and establishing a remuneration committee of outside directors. The following section will analyse the general approach to regulating remuneration in public companies in the US.

6.3.1 Disclosure requirements under Regulation S-K

6.3.1.1 Disclosure concerning decision making or the remuneration committee

These requirements fall under section 407 of Regulation S-K which is divided into five subsections. The first requires companies without a remuneration committee to state their

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[90] See section 6.1.

[91] D Kershaw, *Company Law in* Context: Text and Materials (2nd edn, Oxford University Press, Oxford 2012) 286- 287.

[92] NYSE Listing Manual, Rule 303A.08.

[93] L Bebchuk, "The case for increasing shareholder power" (2005) 118 *Harvard Law Review* 833.

view of the appropriate reasons for not having such a committee and identify each director who participates in the consideration of director and executive remuneration.[94] The second requirement obliges companies to provide specific information regarding the remuneration committee charter if they have one or to state the fact that they do not have one.[95] Under the terms of the third requirement, companies must provide a narrative description of the company's processes and procedures for the consideration and determination of executive and director remuneration, including the authority of the remuneration committee or the decision-making body and the extent to which the remuneration committee or the decision-making body can delegate any authority, specifying the authority that can be delegated; the role of any executive in determining or recommending the amount or form of executive and director remuneration; and the role of any remuneration consultant in determining or recommending the amount or form of executive and director compensation[96]. Fourthly, under the heading "compensation committee interlocks and insider participation," companies are also required to identify each member of the remuneration committee or the decision-making body during the last completed fiscal year, indicating the members who acted as an officer or employee of the company during the fiscal year, those who were formerly an officer of the company, or had any relationship requiring disclosure by the company under any paragraph of Item 404 of Regulation S-K.[97] The company is also required to describe the specific relationship when there is cross directorship between the company and another company when both or one of the directors serve on the remuneration committee.[98] Finally, under the heading "compensation committee report" companies are required to state whether the remuneration committee or the decision-making body has reviewed and discussed with management the Compensation Discussion and Analysis (CD&A) and that, based on this review and discussion, it recommends its inclusion in the company's annual report, proxy statement, or information statement and their names must appear under this statement.[99]

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[94] 17 C.F.R. 229.407(e)(1).

[95] 17 C.F.R. 229.407(e)(2).

[96] 17 C.F.R. 229.407(e)(3).

[97] 17 C.F.R. 229.407(e)(4)(i).

[98] 17 C.F.R. 229.407(e)(4)(iii).

[99] 17 C.F.R. 229.407(e)(5).

6.3.1.2 Disclosure of the actual remuneration policies and practices

Before the disclosure rules were tightened in 1992, the SEC allowed companies to report their remuneration practices in the format of their choosing. Thus, Bebchuk and Fried were not surprised that companies took full advantage of this freedom in discretion to obscure the level and structure of their pay.[100] In 1992, the SEC extensively revised its disclosure rules by providing standards for how the information regarding remuneration must be presented. This was also followed by further amendments in 1993. The requirements of 1992 were welcomed by shareholders but the corporate community raised concerns regarding undue intrusion into the internal affairs of a company, claiming that it interfered with the operation of the state law business judgement rule, as well as deterring people from serving as directors.[101] On 8 September 2006, the SEC published new rules on the disclosure of remuneration.[102]

The rules on remuneration disclosure, in the USA, provide differential treatment for foreign private issuers, smaller issuers and issuers. However, since the rules on disclosure for issuers are the most comprehensive, only these rules will be discussed here. The rules can be divided into three parts:[103] tabular disclosures regarding the remuneration of executives and directors;[104] a narrative description of other types of remuneration and any information material to an understanding of the tabular information;[105] and a CD&A.[106]

There are eight different standardized tables that companies must provide, detailing information regarding their executive remuneration. These tables start with the summary remuneration table, the grants of plan-based awards table, the outstanding equity awards at fiscal year end table, option exercise and stock vested table, pension benefits, non-qualified defined contribution and other non-qualified deferred remuneration plans, potential payments

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[100] Bebchuk, *Pay without Performance* (n 41) 67.

[101] 57 Fed. Reg. 48138, cited in: WA Effros, *Corporate governance: principles and practices* (2nd edn, Wolters Kluwer, New York 2013) 482.

[102] 71 Fed. Reg. 53158.

[103] The disclosure requirements are under Regulation S-K.

[104] 17 C.F.R. 229.402(c),(d),(f),(g),(h),(i),(j),(k) & (t).

[105] 17 C.F.R. 229.402(e).

[106] 17 C.F.R. 229.402(b).

upon termination or change in control, and golden parachute remuneration.[107] A table is also required showing the remuneration of directors, but in much less detail.[108]

These tabular disclosures must be accompanied by narratives providing a description of any material factors necessary for understanding the information disclosed in the tables of the summary compensation and grants of plan-based awards, including the material terms of each named executive's employment agreement.[109] These must also be a narrative disclosure of the company's remuneration policies and practices as they relate to the company's risk management to the extent that risks arising from the company's remuneration policies and practices for its employees are reasonably likely to have a material adverse effect on the company.[110]

The third part is the CD&A, which was included with effect from 2006. Here the SEC wants companies to provide information on how and why the company arrives at specific executive remuneration decisions and policies.[111] Therefore, the CD&A is intended to provide investors with a clearer and more complete picture of the remuneration practices of the company. The SEC has indicated that a company must address seven items in its CD&A: (i) the objectives of the company's remuneration programmes; (ii) what the remuneration programmes of the company are designed to reward; (iii) each element of remuneration; (iv) why the company chooses to pay each element; (v) how the company determines the amount for each element of remuneration; (vi) how each element of remuneration and the company's decisions regarding that element fit into the company's overall remuneration objectives and affect decisions regarding other elements of remuneration; and (vii) whether and, if so, how the company has considered the results of the most recent shareholder advisory vote on executive remuneration.[112]

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[107] 17 C.F.R. 229.402(c),(d),(f),(g),(h),(i),(j) and (t).

[108] 17 C.F.R. 229.402(k).

[109] 17 C.F.R. 229.402(e).

[110] 17 C.F.R. 229.402(s).

[111] Securities and Exchange Commission, "Staff observations in the review of executive compensation disclosure, Division of Corporate Finance, U.S." (10 September 2007) Available at: <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm> accessed 2 November 2012.

[112] 17 C.F.R. 229.402(b).

Section 953 of the Dodd-Frank Act requires firms to describe remuneration policies and to provide information on the relationship between executive remuneration and the financial performance of the company, including TSR.[113] This relationship between remuneration and financial performance can be presented in a graph. However, there is no precise definition of financial performance and the Act simply refers to TSR. The SEC will need to determine its meaning for this purpose (i.e., whether financial performance should be based on stock price, the company's earnings, return on equity or other measures).[114] It also requires the SEC to write rules to implement a requirement that public companies disclose the ratio between the total remuneration of a company CEO and the median remuneration of all other employees, which is known as the "pay ratio provision".[115] It is believed that the "pay ratio provision" will put pressure on corporate boards to be more restrained in pay packages to CEOs and will help to inform investor decision making to demonstrate the reasonableness of the CEO's remuneration compared to the firm's overall worker remuneration picture.[116]

However, the "pay ratio provision" has also been debated and is believed to be complicated. Casey and Leu maintain that this requirement is going to be burdensome:

> *[T]his [requirement] means that for every employee, the company would have to calculate his or her salary, bonus, stock awards, option awards, nonequity incentive plan compensation, change in pension value and nonqualified deferred compensation earnings, and all other compensation (for example, perquisites). This information would undoubtedly be extremely time-consuming to collect and analyse, making it virtually impossible for a company with thousands of employees to comply with this section of the Act.*[117]

Moreover, Lowell, who wrote in 2012 that the SEC, in spite of the two years since the passage of the Act, was unable to promulgate rules on the issue, insisted that there are many

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[113] Securities Exchange Act 1934, section 14(i).

[114] WJ Casey and R Leu, "United States: new executive compensation disclosure under Dodd-Frank Act" (Mondaq, 3 August 2010) <http://www.mondaq.com/article.asp?articleid=106962&signup=true&newsub=1> accessed 3 November 2012.

[115] Dodd-Frank Act 2010, section 953(b).

[116] G Shorter, "The 'pay ratio provision' in the Dodd-Frank Act: legislation to repeal it in the 113th Congress" (28 October 2013) Congressional Research Service: Report for Congress.

[117] Casey, (n 114).

technical issues which make it difficult for companies to comply with this section.[118] However, on 18 September 2013, the SEC released proposals to implement the pay ratio provision by adopting the new Item 402(u) of Regulation S-K.[119] The SEC has attempted to soften the impact of the requirement of pay ratio disclosure by primarily introducing broad flexible methods for companies to calculate the median annual remuneration of employees other than the CEO, which will reduce the comparability of a company's pay ratio information with that of other companies using different calculation methods.[120] However, at the time of writing (November 2014), the SEC had still not finalised the rules but expected to do so soon and was asking companies to disclose their pay ratio information with effect from 2016.[121]

The US disclosure rules form part of one of the most comprehensive disclosure systems in the world and have served as a model for other countries in developing their own disclosure rules. However, a notable exception in disclosure requirement is allowing companies to conceal specific quantitative or qualitative performance-related factors considered by the remuneration committee or the board of directors involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm to the company.[122] However, nearly 50 per cent of the big 100 companies exceeded the requirements in 2007 and provided this information about performance targets (for example, increasing revenue by 10 per cent or recording earnings of $2 a share for executive bonuses or equity grants).[123] This was also criticized as companies are still able to

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[118] JH Lowell, "Dodd-Frank Section 953(b): Why it is a legislated disaster" (*Bloomber BNA*, 23 May 2012) <http://www.bna.com/dodd-frank-section//> accessed 11 January 2013.

[119] H Lovells and others, "SEC issues proposal to implement Dodd-Frank CEO pay ratio disclosure requirement" (Lexology, 1 October 2013) <http://www.lexology.com/library/detail.aspx?g=d875deb4-d484-42dd-9e0f-dd166f966f24> accessed 15 December 2013.

[120] ibid.

[121] S Klinger, "Here's the first company to ever disclose CEO-to-worker pay ratio while citing the Dodd-Frank Act" (*Center for Effective* Governmant, 17 Novermber 2014) <http://www.foreffectivegov.org/blog/here%E2%80%99s-first-company-ever-disclose-ceo-worker-pay-ratio-while-citing-dodd-frank-provision> accessed 1 December 2014.

[122] 71 Fed. Reg. 53166.

[123] JS Lublin, "Does it pay to tell investors extra compensation details?" (*Wall Street Journal*, 2 April 2007) <http://www.wsj.com/articles/SB117546507649356158> accessed 3 November 2012.

obscure useful information by using complex sentences and confusing mass data and methods of calculation, even for the "summary compensation table".[124]

Another important element is the fact that disclosure is restricted to the top five executives, including the CEO and CFO. Despite the fact that those five can give shareholders a flavour of how they are remunerated, it does not give the full picture of the remuneration practices, as there might be 20 or even more whose remuneration is in the range of the top five. However, in my opinion a possible solution would be to require companies to file the names of the executives whose total remuneration is equal to or more than a certain percentage of the lowest executive of the top five (for example 75 per cent or 85 per cent) or whose remuneration is in a certain range, showing this in a separate table. This would give shareholders more precise information regarding remuneration practices.

6.3.2 Establishing a compensation committee

6.3.2.1 The composition of the committee

It is generally accepted as good corporate governance practice that the remuneration committee should be established and composed of two or more non-executive directors, preferably independent directors. The reason for the focus on their independence is to ensure that the executive directors do not influence their decisions regarding the remuneration level and structure. However, their independence can be compromised by financial consideration, as well as social and psychological factors.

Financial considerations arise when there are two executives from two different companies serving on each other's company's board as non-executives and sitting on the remuneration committee. In this case, there will be mutual unspoken understanding: "if you raise my remuneration, I will raise yours". Moreover, even allowing an executive of a company to serve on the remuneration committee will result in raising the level of remuneration, as the median will keep increasing and result in a general rise in the remuneration level among all companies, as they refer to the median when they decide remuneration.

The other factors are social and psychological. Here, as Bebchuk and Fried explain, even a director who is not influenced by the financial factor can be influenced by and go along with

[124] Effros, (n 101) 485.

the remuneration arrangements and favour the company's executives.[125] These other factors include friendship, collegiality, and loyalty, especially when they are invited by the CEO or the CEO does not mind them serving on the board.[126]

In the case of the US-listed companies, a member of the remuneration committee must be a member of the board of directors of the company and also independent.[127] There are four different rules which affect how a member of a remuneration committee can be considered independent. These are state law, the Internal Revenue Code, the listing rules, and the SEC rule.

Under state law,[128] a transaction between a company and its directors is subject to intense judicial review because of the inherent conflict of interests. In order for a company to avoid close scrutiny of remuneration contracts, remuneration arrangements should be negotiated and approved by directors who are disinterested in regard to the remuneration decision.[129]

The Internal Revenue Code[130] allows avoidance of the $1 million limit on the deductibility of executive remuneration with some conditions. The most important of these under this subsection is for the performance goals to be determined by two or more outside directors to qualify for the exemption.[131] The section defines an "outside director" as someone who is:

> *Not a current employee of the Company; is not a former employee who receives compensation for prior services (other than under a qualified retirement plan); has not been an officer of the Company; and does not receive, directly or indirectly (including amounts paid to an entity that employs the director or in which the director has at least a five per cent ownership interest), remuneration from the Company in any capacity other than as a director.*[132]

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[125] Bebchuk, *Pay without Performance* (n 41) 31.

[126] ibid.

[127] Securities Exchange Act 1934, section 10C(a)(2).

[128] For more discussion see section 6.2.

[129] MJ Segal and others, *Compensation Committee Guide*, Available at: <http://www.wlrk.com/webdocs/wlrknew/wlrkmemos/wlrk/wlrk.18330.11.pdf> accessed 16 November 2012.

[130] For more information see section 6.1.

[131] Internal Revenue Code, Section 162(m)(4)(c).

[132] Effros, (n 101) 425.

Section 16(b) of the Securities Exchange Act 1934, which concerns insider trading, allows companies to recover any profit made by directors or executives from any purchase and sale of any equity security of the company within a six-month period if the profit is made by reason of his or her relationship to the issuer. Rule 16b-3 creates an exception to section 16(b) if the equity issued to the insiders is part of equity remuneration plans approved by the board of directors of the issuer, the shareholder, or a committee of the board of directors that is composed solely of two or more non-employee directors.[133] A non-employee director is defined as someone who is not currently employed by the company or by a parent or subsidiary, is not receiving annual remuneration from the company or a parent or subsidiary (other than being a director) greater than $120,000, and does not have direct or indirect interest in the transaction in the amount of $120,000 or more.[134]

The listing rules of the NYSE and NASDAQ[135] require listed companies to establish a remuneration committee[136] consisting only of independent members.[137] Section 952 of the Dodd-Frank Act 2010 added section 10C to the Securities Exchange Act 1934, which requires the SEC to direct that the exchanges adopt listing standards that include certain enhanced independence requirements for members of issuers' remuneration committees. The section also requires the SEC to direct the exchanges to prohibit the listing of any company issuing equity securities, subject to limited exceptions, unless there exist specific conditions with regard to the authority or the remuneration committee, the independence of the members of the committee, and the consideration by the remuneration committee of specific factors relating to the independence of the remuneration advisers.[138]

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[133] 17 C.F.R. 240. 16b-3- Transaction between an issuer and its officers or directors.

[134] ibid.

[135] Unlike NASDAQ, which requires the remuneration committee to consist of two independent directors, the NYSE does not state a minimum number of required members.

[136] This requirement is subject to the exceptions stated in section 10C of the Securities Exchange Act 1934.

[137] NASDAQ has allowed the board of directors of a company which has at least three independent members on the committee to have one non-independent member who is not an executive officer or employee or a family member of an executive officer if it is in the best interests of the company and the nature of the relationship and the reason for appointment must be publicly disclosed.

[138] DM Lynn, LR Bard and DR Kahan, "SEC approves new compensation committee and adviser independence listing standards" (*Mondaq*, 29 January 2013) <http://www.mondaq.com/unitedstates/x/218038/Dodd-Frank%20Wall%20Street%20Reform%20Consumer%20Protection%20Act/SEC%20Approves%20New%20Compensation%20Committee%20and%20Adviser%20Independence%20Listing%20Standards> accessed 20 March 2013.

On 20 June 2012, the SEC adopted Rule 10C-1,[139] which is related to the independence of the members of a remuneration committee. However, neither the Dodd-Frank Act nor Rule 10C-1 defines independence. The Dodd-Frank Act obliges the SEC to direct the exchanges to consider: (a) the source of remuneration of a member of the remuneration committee of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to the director; and (b) whether a member of the remuneration committee of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. The SEC did not add any additional factors (other than to extend the rules to members of the board who oversee executive remuneration on behalf of the board in the absence of a formal committee)[140] to be considered by the exchanges in establishing their listing standards beyond what was required by the Dodd-Frank Act, which allows the exchanges to consider additional factors in determining the independence of a member of a remuneration committee. Therefore, the exchanges are provided with more discretion in setting the definition of independence compared to those independence criteria required for audit committee members.[141]

On 11 January 2013, the SEC approved amendments to the listing standards of both the NYSE and NASDAQ regarding the independence of the remuneration committee and its selection of advisors which were originally proposed in September 2012.[142] As with the SEC, the exchanges did not include any additional factors to be considered when the board assesses the independence of the members of the remuneration committee, other than those mentioned in the Dodd-Frank Act. NYSE rules set forth a three-part test to determine director independence for serving on a remuneration committee.

Firstly, the board needs to decide if a director violates one of the five listed "bright line" tests which are as follows:

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[139] ibid.

[140] Clifford Chance, "SEC finalizes requiring listing standards for compensation committees and compensation advisers" (June 2012) Available at: <http://www.cliffordchance.com/publicationviews/publications/2012/06/sec_finalizes_rulesrequiringlistingstandard.html> accessed 10 March 2013.

[141] Lynn (n 138).

[142] D Lilienfeld, and others, "The NYSE and NASDAQ issue proposed rules to implement the SEC compensation committee independence and advisor rules" (2013) 14(2) *Journal of Investment Compliance* 42.

a. If the director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company;

b. If the director has received, or has an immediate family member who has received, during any 12-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service;

c. If

A. the director is a current partner or employee of a firm that is the listed company's internal or external auditor;

B. the director has an immediate family member who is a current partner of such a firm;

C. the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or

D. the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time;

d. If the director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serve or served on that company's remuneration committee; and

e. If the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or two per cent of such other company's consolidated gross revenues.[143]

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[143] NYSE Listing Company Manual 303A.02(b).

Secondly, the directors will not qualify as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company.[144] These two tests are used to determine the independence of directors in general.

Thirdly, for directors serving on a remuneration committee the board of directors must consider all factors specifically related to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a remuneration committee member, including, but not limited to, the two factors in the Dodd-Frank Act.[145] However, in determining the independence of directors serving on the remuneration committee from the management, the NYSE gives the board broad discretion as it believes that it is difficult to provide a list of all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company.

NASDAQ, which has significantly enhanced its listing rules, has adopted a similar approach. Like NYSE, it has a three-part test to determine director independence for serving on a remuneration committee.

First, certain categories of directors may not be considered independent. These include:

a. an executive officer of the company,

b. a director who is or was in the last three years employed by the company,

c. a director who accepted or had a family member who accepted remuneration from the company exceeding $120,000 during any period of 12 consecutive months within the three years preceding the independence determination,

d. a director who is a family member of an individual who is or was in the last three years an executive director of the company,

e. a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the last three fiscal years that exceed five per cent of

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[144] NYSE Listing Company Manual 303A.02(a).

[145] NYSE Listing Company Manual 303A.02(a)(ii).

the recipient's consolidated gross revenues for that year, or $200,000, whichever is more,

f. a director of the company who is, or has a family member who is, an executive officer of another entity where at any time during the past three years any of the executive officers of the company served on the compensation committee of such other entity, and

g. a director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.[146]

Second, the board must ensure and form an opinion that the independent director relationship with the company would not interfere with the exercise of independent judgement in carrying out the responsibilities of a director.[147] Again, as with the NYSE, these two parts of the test are used to determine the independence of directors in general.

Third, for directors serving on a remuneration committee, NASDAQ has taken a different approach to implementing the two factors in the Dodd-Frank Act and the SEC requirements. It has tried to harmonize its independence standards for the remuneration committee member to be identical to those for audit committee members. NASDAQ, in implementing the first factor, has given a situation where a director is not independent and hence is not suitable to serve on the remuneration committee, a director who receives directly or indirectly any consulting, advisory or other compensatory fee from the company or any subsidiary other than fees for serving as a board member or fixed amounts of remuneration under a retirement plan. In addition, NASDAQ, as with the NYSE, has given the board of directors' wide discretion to consider whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company to determine whether such affiliation would impair the director's judgement as a member of the compensation committee.[148]

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[146] NASDAQ Listing Rules, 5605(a)(2).

[147] NASDAQ Listing Rules, 5605(a)(2).

[148] NASDAQ Listing Rules, 5605(d)(2)(A).

Therefore, the requirements of the Dodd-Frank Act have been passed onto the board of directors[149] to consider such factors and use its discretion.

6.3.2.2 The role and responsibilities of the committee

Both of the above listing requirements oblige listed companies to have a formal written charter which explains the role and responsibilities of the committee.[150] Generally, the role of the committee is to decide on the remuneration of executives and solve the conflict of interests inherent when the board deals with the issue directly. However, under Delaware corporate law, the board is still responsible even if it establishes a remuneration committee unless the certification of incorporation or bye-laws specifies otherwise.[151] So, the committee can be a decision maker or simply make recommendations to the board.

The NASDAQ listing rules are consistent with this as the remuneration committee can make decisions or recommendations to the board. However, the listing rules have been cautious when the board takes the decision for the CEO's remuneration by providing that the CEO "may not be present during voting or deliberations on his or her compensation".[152] The NYSE has a similar provision. However, the NYSE Listed Company Manual states that, with regard to non-CEO executive officer remuneration and incentive-remuneration and equity-based plans, the remuneration committee's role is to make recommendations to the board, as these are subject to board approval.[153] However, a commentary to this section clarifies that nothing in the section "is intended to preclude the board from delegating its authority over such matters to the compensation committee".[154]

The committee's role is also to review, monitor and amend the corporation's general philosophy of remuneration (or recommend amendments to the board).[155] The committee should review and discuss the CD&A report with the management.[156] The committee can also

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[149] There is one exception under the NASDAQ Listing Rules as discussed in this section.

[150] NASDAQ Listing Rules, 5605(d)(1); the NYSE Listing Company Manual 303A.05(b).

[151] Delaware General Corporation Law (n 33) section 141(a)&(h).

[152] NASDAQ Listing Rules, 5605(d)(1)(C).

[153] NYSE Listing Company Manual 303A.05(b)(i)(B).

[154] NYSE Listing Company Manual 303A.05.

[155] Effros, (n 101) 425.

[156] NYSE Listing Company Manual 303A.05(b)(i)(C).

be responsible for setting the level and structure of remuneration along with the goals and objectives of the plans or recommend these to the board. The committee should also monitor the terms and performance of the company's retirement plans and plans related to the Employee Retirement Income Security Act.[157]

As a result of the Dodd-Frank Act, the remuneration committee may retain or obtain the advice of a remuneration consultant, independent legal counsel and other advisers with the responsibilities of the committee for the appointment, remuneration and oversight of the work of such consultants and advisers who work with the remuneration committee.[158] However, the company will be responsible for providing appropriate funding as determined by the remuneration committee for the payment of reasonable compensation for the consultants and advisers.[159] However, selecting a remuneration advisor must be done by considering the independence criteria that the Act states.

6.3.2.3 The remuneration consultant

The remuneration consultant can be a useful tool to assist the remuneration committee in establishing a remuneration policy that rewards performance and ensures that executive performance does not unfairly benefit or suffer from economy- or industry-wide trends. Thus, the consultant will help the committee to compare the firm's metrics with those of peer companies over the time period in question.[160]

The role of the remuneration consultant has received increasing attention in the academic literature.[161] According to Bender, the remuneration consultant's roles and services can be classified into three main groups.[162] Firstly, the consultant acts as an expert, providing data against which companies can benchmark pay, and giving advice regarding the possibilities for plan design and implementation. In this role, consultants have a direct and immediate influence on executive pay. That is, by influencing the choice of comparators, consultants

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[157] Effros, (n 101) 425.

[158] Securities Exchange Act 1934, section 10C(c)&10C(d).

[159] Securities Exchange Act 1934, section 10C(e).

[160] Effros, (n 101) 434.

[161] CA Mallin, *Corporate Governance* (4th edn, OUP, Oxford 2013) 206.

[162] R Bender, "Paying for advice: the role of the remuneration consultant in UK listed companies" (2011) 64(2) *Vanderbilt Law Review* 361.

both identify and drive the market for executive pay. They also bring their knowledge of pay plans and their views on what is currently acceptable to the market, thus spreading current practice more widely and institutionalizing it as best practice. Secondly, the consultant acts as liaison and serves an important role in the communication with certain institutional investors. The consultants can argue the case more effectively than company representatives on their own. Thirdly and probably most importantly, a significant aspect of the consultant's work is to legitimize the decisions of the remuneration committee by providing an element of perceived independence.[163]

Therefore, the consultant's independence is the issue which is most frequently discussed in the literature, as the conflict of interests that a remuneration consultant faces, especially when the consultant is providing other services to the firm, can lead to a higher level of executive pay. Several studies have found that executive remuneration is generally higher in companies that are the clients of remuneration consulting firms.[164]

Graef Crystal, who was the remuneration consultant for several major companies including Disney and dealt with the remuneration contract for Ovitz, provided in his 1991 book a statement that clarified the conflict of interests that faces remuneration consultants. He states:

> *I acted in the full realization that if I didn't please a client, I wouldn't have that client for long. I was, after all, hired by the CEO, and not by the board of directors. Therein lay the problem. If the CEO wanted more money, and I didn't want to recommend to the board that he should get more money, well, there was always a rival compensation consultant who could be hired.*[165]

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[163] ibid 395.

[164] See: C Armstrong, C Ittner and D Larcker, "Economic characteristics, corporate governance, and the influence of compensation consultants on executive pay levels" (2012) 17(2) *Review of Accounting Studies* 322; B Cadman, M Carter and S Hillegeist, "The incentives of compensation consultants and CEO pay" (2010) 49 *Journal of Accounting and Economics* 263; M Conyon and G Sadler, "Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK" (2010) 18(4) *Corporate Governance: An International Review* 296; L Goh and A Gupta, "Executive compensation, compensation consultants, and shopping for opinion: evidence from the UK" (2010) 25 *Journal of Accounting, Auditing and Finance* 607; R Kabir and M Minhat, "Multiple compensation consultants and CEO pay" SSRN Working Paper No. 1646326, Available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1646926> accessed 15 May 2014; K Murphy and T Sandino, "Executive pay and 'independent' compensation consultants" (2010) 49 *Journal of Accounting and Economics* 247; G Voulgaris, K Stathopoulos and M Walker, "Compensation consultants and CEO pay: UK evidence" (2010) 18 *Corporate Governance: An International Review* 511.

[165] GS Crystal, *In search of excess: the overcompensation of American Executives* (W.W. Norton & Company, New York 1991) 12.

In August 2006, the SEC issued new rules[166] requiring publicly traded companies to disclose the identity of their remuneration consultants and describe the nature of the consultants' assignments. However, companies were not required to disclose whether the consultant had other business relationships with the company.[167] Despite the rules, the House Committee on Oversight and Government Reform found that "in 2006, almost 100 Fortune 250 companies used executive compensation consultants that they did not disclose".[168]

In December 2007, the House Committee on Oversight and Government Reform published a report on the conflict of interests faced by remuneration consultants. The committee found that such conflicts of interest are widespread, especially when the consultant is providing both executive compensation advice and other services to the same company.[169]

In 2009, the SEC modified its disclosure rules to require companies to provide further enhanced disclosure when a remuneration consultant who is retained by the remuneration committee or any other person in the company has provided additional services in excess of $120,000 to the company or its affiliates in the last completed fiscal year.[170] However, this rule did not go as far as restricting the appointment of a remuneration consultant to the remuneration committee and prohibiting any consultant who was appointed by the management from providing remuneration consultancy-related services.

Another development was brought about by the Dodd-Frank Act. The Act gives the remuneration committee the authority to retain or obtain the advice of a remuneration consultant (without being required to follow the advice or recommendation) with responsibilities for the appointment, remuneration and oversight of the work of the consultant and responsibilities for the company to provide appropriate funding to the committee for the payment of reasonable compensation to the consultant. The Act also only asks the committee to consider five factors of independence that the Act states and allows the SEC to establish extra factors that are "competitively neutral among categories of consultants, legal counsel, or

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[166] Regulation S-K, section 407(e)(3)(iii).

[167] House of Representatives, Committee on Oversight and Government Reform, *Executive Pay: Conflicts of interest among executive compensation consultant*, (December 2007).

[168] ibid.

[169] ibid.

[170] Regulation S-K, section 407(e)(3)(iii).

other advisers and preserve the ability of compensation committees to retain the services of members of any such category".[171] These five factors are: (i) the other services to the company by the person who employs the adviser; (ii) the amount of fees received from the company by the adviser as a percentage of the total revenue of the adviser; (iii) the policies of the adviser that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the adviser with a member of the remuneration committee; and (v) any stock of the company owned by the adviser.

In addition to these five factors, the final rule of the SEC added a sixth factor: (vi) any business or personal relationship of the adviser or the person employing the adviser with an executive officer of the company. The requirement did not impose on the remuneration committee an obligation only to appoint an independent adviser as the committee can select or receive advice from any consultant that it chooses to consult after taking the six factors into account. Therefore, the positive effects of the Act in practice can be minimal. However, the SEC has used its traditional tool of disclosure and amended the disclosure requirements to oblige companies to identify any conflict of interests that is raised by the work of the remuneration consultant and disclose the nature of the conflict and how the conflict is being addressed.[172] Even the effect of disclosure and the readiness of companies to disclose any conflict of interests are doubtful, as was seen in the House Committee report in 2007.

When the exchanges amended their listing rules in 2013, they adopted only these six factors, in spite of the invitation by the SEC to the exchanges to add to the list.[173] However, the exchanges have a different approach to implementing the rules of the independence of the advisers. While NASDAQ has required its listed companies to stick with these six factors, the NYSE has asked its listed companies to consider all factors relevant to the independence of an adviser, including the six factors, in evaluating the independence of advisers.[174]

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[171] Securities Exchange Act 1934, section 10C(b)(2).

[172] Regulation S-K, section 407(e)(3)(iv).

[173] Lilienfeld (n 142) 44.

[174] NYSE Listing Company Manual 303A.05(c)(iv); NASDAQ Listing Rules, 5605(d)(3)(D).

6.3.3 Shareholder involvement and the newly adopted "advisory vote"

6.3.3.1 Shareholder proposals concerning remuneration issues

Shareholder resolutions are widespread in the USA, with 800-900 every year.[175] In the early 1990s, the SEC expanded the definition of allowable topics for shareholder proposals to include issues related to executive remuneration, as companies were relying on Rule 14a-8(i)(8), which constitutes a ground for companies to exclude proposals dealing with any matter relating to the company's ordinary business operations. However, the SEC has clarified that proposals directed at the remuneration of executives and directors are likely to pass the exclusion of the Rule,[176] not those proposals directed at the company's general remuneration policy. Therefore, it is likely that in the future more proposals will be directed towards executive remuneration and will receive strong support from institutional shareholders who are being criticized for not taking enough action to limit executive remuneration.[177] The reason is that it is relatively easy in the USA for shareholders to submit their proposals into the company's proxy statements to be voted on by shareholders.[178] In order for a shareholder to submit a proposal, s/he must be a beneficial owner of at least one per cent or $2,000 in the market value of shares that have voting power, must have owned those shares for at least one year, and must continue to hold those shares through the date of the meeting.[179] If the shareholder meets this requirement, s/he can submit only one proposal per year with no more than 500 words for the proposal and supporting statements.[180]

However, a company may exclude some proposals on the grounds of the situation in Rule 14A-8(i). Therefore, the management opposes such proposals on the grounds that the board of directors is charged by corporate law and stock exchange rules with the setting of

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[175] Mallin (n 161) 123.

[176] SEC No-Action Letter re: Bell Atlantic Corporation (1992) cited in: Effros, (n 101) 495.

[177] B Tricker and CA Mallin, "Institutional investors and corporate governance Reform" (4 December 2009) Available at: <http://corporategovernanceoup.wordpress.com/category/shareholder-proposals/> accessed 29 October 2012.

[178] Rule 14a-7 allows shareholders to obtain from the company a list of other shareholders to contact them directly or the company can ask from the shareholders the cost of printing and mailing the communication to other shareholders.

[179] 17 C.F.R. 240.14a-8(b).

[180] 17 C.F.R. 240.14a-8(c)&(d).

remuneration for the company's top executives and such proposals would diminish the effectiveness of the board's role.[181]

The Dodd-Frank Act made it clear that the introduction of the advisory vote on remuneration policies should not restrict or limit the ability of shareholders to make proposals related to executive remuneration.[182] The SEC in Rule 14A-8(i)(10) allows companies to exclude shareholder proposals related to executive remuneration and the frequency of the vote. However, companies must have the approval of a majority of votes cast on the matter and the adopted policy on the frequency of say-on-pay votes must also have been approved by the majority of shareholder votes cast in the most recent vote.

6.3.3.2 Say on pay

"Say on pay" is relatively new in the USA compared to the UK. The first proposals by shareholders seeking the implementation of a "say on pay" policy in the USA were made in 2006 and were submitted according to Rule 14a-8.[183] However, as a response to the financial crisis, Congress mandated that all firms receiving the Troubled Asset Relief Programme (TARP)[184] funds conduct say on pay beginning in 2009.[185] The Dodd-Frank Act extended the mandate to all US public companies.[186] The requirement of a general say on pay under section 951 of the Dodd-Frank Act is twofold. The first is that public companies must give their shareholders an advisory vote to approve or disapprove the executive remuneration at least once every three years, as disclosed under Item 402. The second is that public companies are required, at least once every six years, to give their shareholders an advisory vote on how frequently the say-on-pay vote is to occur.[187]

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[181] RS Thomas, AR Palmiter and JF Cotter, "Dodd-Frank's say on pay: will it lead to a greater role for shareholders in corporate governance?" (2012) 97(5) *Cornell Law Review* 1213, 1220.

[182] Securities Exchange Act 1934, section 14A(c)(4).

[183] Thomas, "Dodd-Frank's say on pay" (n 181) 1217&1218.

[184] TARP was established by 12 US Code 5212 after the authorization of section 101 of the Emergency Economic Stabilization Act of 2008.

[185] 17 C.F.R. 240.14a.20.

[186] Thomas, "Dodd-Frank's say on pay" (n 181) 1218.

[187] Securities Exchange Act 1934, section 14A(a).

Such an advisory vote is not going to oblige companies to respond to a negative vote, and this is what the Dodd-Frank Act asserts.[188] The SEC in its implementation of section 951 of the Dodd-Frank Act asked companies to start from the first meeting on 21 January 2011, unless the company is smaller, reporting $75 million or less in a public equity float; then it was required to start from 21 January 2013.[189] The SEC clarifies that the CEO, CFO and the three other executives should be named in the company's proxy remuneration tables, CD&A, and narrative discussion.[190] However, the SEC has excluded the directors' remuneration table as required by Item 402(k) and the narrative disclosure of the company's remuneration policies and practices as they relate to risk management and risk-taking incentives, which is required by Item 402(s), from the requirement of an advisory vote.[191]

However, the vote is only on the overall remuneration package and not a specific element of pay.[192] Companies are required to disclose the result of the vote on Form 8-K within four business days after the shareholder meeting and in the next year's CD&A, they must disclose whether and how the board considered the results of the shareholders say-on-pay vote in making any decisions.[193] To improve the effectiveness of the say on pay and provide guidance to other shareholders, institutional investors are required to report at least annually on any shareholder vote regarding the remuneration of executives.[194]

Despite the academic debate on the effectiveness of say on pay,[195] which has been discussed in Chapter Three, and the empirical evidence on the issue being inconclusive, some companies in the USA have responded to a negative vote either by changing the company's remuneration practices or offering additional disclosure to explain why the remuneration is structured in this manner.[196] I believe that there is a need for the classification of shareholders beyond that expressed in most of the literature, which divides shareholders into blockholders

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[188] Securities Exchange Act 1934, section 14A(c).

[189] 17 C.F.R. 240.14a.21(a).

[190] 17 C.F.R. 240.14a-21.

[191] 17 C.F.R. 240.14a-21.

[192] Thomas, "Dodd-Frank's say on pay" (n 181) 1225.

[193] ibid 1226.

[194] Securities Exchange Act 1934, section 14A(d).

[195] Thomas, "Dodd-Frank's say on pay" (n 181) 1228.

[196] ibid 1217.

and diversified shareholders.[197] The reason for this would be to give interested long-term shareholders a binding vote and short-term prospective shareholders an advisory one.

6.4 Federal laws and rules affecting remuneration directly

6.4.1 Employment contracts

In the USA there is no limit on the length of executive contracts. This has led some companies to offer a long contract and, as a consequence, pay huge termination remuneration for leaving executives. This led the California Public Employees' Retirement System (CalPERS) to recommend that executive employment contracts should include a specified termination date of no more than three years, as well as recommending that rolling contracts should not be on an open-ended basis. For severance payment, the recommendation from CalPERS states that executives should not be entitled to severance payment in the event of termination for poor performance, resignation under pressure, or failure to renew an employment contract.[198] However, all of these are recommendations from the institutional investors and are not binding upon the board of directors.

6.4.2 Capping remuneration

Capping was a result of the populist outrage directed against financial institutions which received TARP funds but paid their executives huge bonuses. President Obama stated that if TARP recipients could afford massive bonuses, they should also be able to pay back every penny to taxpayers.[199] Thus, the TARP regime contained a number of executive remuneration restrictions, the most notable of which limited tax deduction to $500,000 (for remuneration paid to the five named executives in Item 402 only), including all forms of remuneration when the company's aggregate distressed assets acquired by the programme exceed $300 million. TARP recipients were also banned from paying retention bonuses or incentive remuneration to affected employees, depending on the amount of TARP funds the firms

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[197] See: R Ridyard, "Toward a bank shareholder-orientated model: using double liability to mitigate excessive risk-taking" (2013)2(1) *UCL Journal of Law and Jurisprudence* 141, 153; J Gordon, "Executive compensation and corporate governance in financial firms: the case for convertible equity-based pay" (2010) *Columbia Law School and European Corporate Governance Institute*, Working Paper No. 373.

[198] CalPERS, Global principles of accountable corporate governance (February 2010) principle 5.12.

[199] Bainbridge, (n 71) 123.

received.[200] However, despite the fact that such restrictions put pressure on the firms to repay the fund quickly, this capping was criticized, as the problem with remuneration in the crisis arose from the structure rather than the level. It was also criticized as it focused on the very highest-paid executives, excluding traders and other junior risk takers who were incentivized to take excessive risks for short-term gain, thus creating the crisis.[201]

6.4.3 Ban on loans

Section 402 of the Sarbanes-Oxley Act prohibits a company from making, directly or indirectly, "personal loans" to its insiders and directors and also from arranging an "extension of credit".[202] However, this prohibition excludes some types of loans, such as company credit cards, borrowing by employees against a 401(k) plan,[203] margin loans by a brokerage house to its employees, and loans by financial institutions to their employees. Since the Act did not define the two key terms - "personal loans" and "extensions of credit" - it was claimed that advancement of legal expenses to officers and directors, which is authorized by state law, has been prohibited by section 402 of Sarbanes-Oxley. This conclusion was reached as a result of the lack of clarity of the phrase "extension of credit", as Delaware law treats the advancement of expenses as "a decision to advance credit".[204] However, the court refused this argument on the grounds it was "unpersuasive", believing that Congress had intended this to apply to large loans.[205]

Bainbridge[206] criticized the prohibition, arguing instead for enhanced disclosure, especially since loans made to insiders are treated as interested party transactions under state law. He also argued that federal intervention can be considered when state law fails to deal with the issue, and when the federal law can offer clear improvements, conditions which were lost in

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[200] ibid.

[201] ibid 124.

[202] Securities Exchange Act 1934, section 13(k).

[203] 26 US Code, section 401(k).

[204] *Advanced Min. Systems, Inc. v. Fricke* 623 A.2d 82 (Del. Ch. 1992).

[205] *Envirokare Tech, Inc. v. Pappas* 420 F.Supp.2d 291 (S.D.N.Y. 2006).

[206] Bainbridge, (n 71) 126.

prohibiting loans to insiders. Moreover, it is argued that executive loans can be a useful tool for aligning executive and shareholder interests.[207]

6.4.4 Clawback

Executives receive their variable remuneration based on financial and non-financial performance targets. For example, financial measures and targets can be accounting-based (for example, earning per share) or market-based (market share price) or both (for example, total shareholder return). Executives sometimes take advantage of the accrual accounting standards to manipulate their revenue figure by recognizing revenue early that should not have been recognized, which will have an impact on profit. Negligence in keeping the books can also present problems.[208] Such misstatement of earnings will result in the company restating its financial figures. For example, a report in the USA has shown that 6.8 per cent of listed companies had to restate earnings for the period July 2002 to September 2005.[209]

Section 304 of the Sarbanes-Oxley Act introduced clawbacks. This clawback operates when a company has restated its financial statement due to misconduct, and the CEO and CFO must return to the company any bonus, incentive remuneration and equity-based remuneration they received during the 12 months following the original issuance of the restated accounts and any profits realized from the sale of the stocks during that period. However, the section does not define "misconduct", creating ambiguity about whether the CEO and the CFO have to be guilty of "misconduct" to be liable.[210] The federal district court accepted the SEC's argument that "the misconduct of corporate officers, agents or employees acting within the scope of their agency or employment is sufficient misconduct to meet this element of the statute".[211]

In one case, a massive fraud was committed by CSK Auto Corporation senior executives, in which the company was required to restate its financial statements. Even though the CEO was not charged with misconduct, he was required in accordance with section 304 to return

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[207] R Romano, "The Sarbanes-Oxley Act and the making of quack corporate governance" (2005) 114 *Yale Law Journal* 1521.

[208] Effros, (n 101) 474.

[209] United State Government Accountability Office, "Financial restatement: update of public company trends, market impacts, and regulatory enforcement activities" (5 March 2007).

[210] Effros, (n 101) 475.

[211] *SEC v. Jenkins* 718 F.Supp.2d 1070 (D. Ariz. 2010).

the remuneration he had received. The court maintained that the wording and construction of section 304 "require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO".[212]

The Dodd-Frank Act extended this requirement with section 954, which requires the SEC to direct the exchanges to prohibit the listing of the securities of issuers that have not developed and implemented remuneration clawback policies.[213] The remuneration clawback policy must provide for clawing back any "excess"[214] remuneration to any current or former executives received during the three-year period prior to the date on which the company was obliged to issue the restatement. Many shortcomings have been identified. The section appears not to allow companies to recover remuneration unless a restatement is required.[215] It was acknowledged by the Senate committee that the policy only applies to a very limited number of employees.[216] The problem with such limitation is that "decisions of individuals such as proprietary traders, who may well not be among [the executives of the company] can adversely affect, indeed implode, a firm".[217]

The section in Dodd-Frank appears not to require the recovering of excess pay arising from executive sale of company stock at prices inflated by errors in earnings or other metrics, even when there is no evidence of misconduct by any specific individual.[218] Attention should be paid to other issues which lack clarity under section 954. For example, it is unclear what kind of misstatement of financial performance should trigger clawback provision and whether this is intended to cover misconduct, negligence, and/or unwitting mistakes. It is also unclear whether clawback should be applied to everyone who received remuneration, or only those who were at fault, or those at fault and their supervisors.[219]

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[212] ibid.

[213] Securities Exchange Act 1934, section 10D.

[214] The section defined "excess" remuneration as the difference between what the executive was paid and what the executive would have received if the financial statement had been correct.

[215] J Fried and N Shilon, "Excess-pay clawbacks" (2011) 36 *Journal of Corporation Law* 722, 724.

[216] Cited in: Bainbridge, (n 71) 132.

[217] R Romano and S Bhagat, "Reforming executive compensation: focusing and committing to the long-term" (2009) 26 *Yale Journal on Regulation* 359, 366.

[218] Fried (n 215) 724.

[219] Effros, (n 101) 475.

6.4.5 Golden parachutes

Executives leaving a firm may be contractually eligible to receive a special form of remuneration which, in theory, makes them less likely to oppose an acquisition or takeover that could cost them their job but would benefit shareholders.[220] Regulating this type of remuneration was introduced and requires disclosure of a golden parachute and an advisory shareholder vote. Item 402(t) of Regulation S-K requires tabular and narrative disclosure regarding golden parachute arrangements for each named executive officer of both the acquiring company and the company being targetted. The disclosure covers any written or unwritten agreement or understanding concerning all types of remuneration agreed between such named executives and the acquiring company or the target company that is based on or otherwise relates to the merger or similar transaction. Such disclosure must be tabular, present the individual elements of merger-related remuneration, and include a narrative disclosure describing any material factors necessary to an understanding of conditions or obligations regarding the payment.[221] The other tool that is used to control this kind of remuneration is the advisory vote by shareholders.

6.5 Incentive-based remuneration for financial institutions

6.5.1 Background

Following the financial crisis of 2007-09, the spotlight was turned on the incentives created by the structure of remuneration and its effects on risk-taking. A realization of the need to regulate such incentives was agreed. Relevant regulations have been introduced on many levels - international, European and national - and the situation in the USA is no exception.

Section 39(c) of the Federal Deposit Insurance Act (FDIA) was enacted in 1995. This allows the Federal Reserve, the Office of the Controller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) (hereafter, the four agencies) to prescribe rules or guidelines for all insured depository institutions[222] that prohibit unsafe and unsound practices likely to provide any executive officer, employee,

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[220] ibid 479.

[221] 17 C.F.R. 229.402(t).

[222] Federal Deposit Insurance Act 1995, section 39(c).

director, or principal shareholder of an institution with excessive remuneration. This also includes rules or guidelines that prohibit unsafe and unsound practices which could lead to material financial loss to such institutions.

However, it appears that the focus of the section was on the level rather than the structure of remuneration, as it gives information and instructions intended to help control excessive remuneration but provides no details for controlling remuneration practices that could lead to material loss.[223] After the financial crisis and the adoption of the P&S, the four agencies issued the "Guidance on Sound Incentive Compensation Policies" (the Guidance). The Guidance was initially proposed in October 2009 and adopted in June 2010.[224]

The four agencies received many comments regarding the Guidance including one which questioned whether the agencies had the authority to introduce the Guidance. In response, the agencies maintained that they have power under several sections. For example, section eight of the FDIA issues orders to any institutions that have "engaged or participated in any unsafe or unsound practice in connection with any insured depository institution or business institution".[225] Section 956 of the Dodd-Frank Act gives clear authority to seven agencies to prescribe regulations or guidelines regarding incentive-based remuneration. These regulations or guidelines require disclosure of the nature of incentive-based remuneration to allow agencies to determine whether the remuneration structure is excessive or could lead to material loss. They must also prohibit incentive-based remuneration that encourages inappropriate risk-taking.[226] The agencies proposed rules (the Rule) in April 2011 in which they asserted that this Rule was intended to supplement the existing Guidance, but at the time of writing the final Rule had not been adopted.[227] Therefore this section will discuss only the Guidance; the Rule is based largely on the Guidance and section 39(c) of the FDIA.[228]

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[223] Federal Deposit Insurance Act 1995, section 39(c)(2).

[224] 74 Fed. Reg. 55227.

[225] Federal Deposit Insurance Act 1995, section 8(e)(1)(ii), 12 US Code, 1818 (b) and for savings associations 12 C.F.R 563.39.

[226] Dodd-Frank Act, section 956.

[227] 76 Fed. Reg. 21170.

[228] K Lin and N Jordan, "Federal agencies propose interagency rule on incentive-based compensation for financial institutions" (*DavisPolk*, 4 March 2011) Available at: <http://blogs.law.harvard.edu/corpgov/2011/03/22/federal-agencies-propose-interagency-rule-on-financial-institution-compensation/> accessed 4 November 2013.

6.5.2 The scope

6.5.2.1 Banking organizations covered by the Guidance

The Guidance is intended to cover all banking organizations operating in the USA which are supervised by one of the four agencies and focuses on incentive-based remuneration. The objective is to assist banking organizations in designing and implementing incentive remuneration policies that effectively consider potential risks and risk outcomes.[229] Thus, incentive-based remuneration must be aligned with the safety and soundness of the organization, even when such alignment "go[es] beyond those needed to align shareholder and employee interests".[230] The four agencies maintained that one key objective is to encourage banks to incorporate the risks related to incentive remuneration into their risk management framework.[231]

Such scope has raised concerns regarding smaller banks, whose incentive remuneration practices are not problematic from a safety and soundness aspect and should, therefore, be exempt from the Guidance. The agencies clarified that the application of the Guidance will be on a principles-based approach and the application will also vary depending on the size, nature, and complexity of the organization and its level of using incentive remuneration, and, therefore will have less impact on smaller banks.[232] The agencies will differentiate between smaller banking organizations and large banking organizations (LBOs). LBOs are defined depending on the guidelines of the relevant agencies of what is considered large, whereas "smaller" covers any organization not defined as not being an LBO.[233]

LBOs are expected to adhere to systematic and formalized policies, procedures, and processes, whereas the policies and procedures of smaller banking organizations that use incentive remuneration are expected to be less extensive, formalized, and detailed.[234] All the relevant bank organizations need to ensure the incorporation of the three principles into their

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[229] 75 Fed. Reg. 36405.

[230] 75 Fed. Reg. 36405.

[231] 75 Fed. Reg. 36405 and 36407.

[232] 75 Fed. Reg. 36399 and 36400.

[233] 75 Fed. Reg. 36400.

[234] 75 Fed. Reg. 36406.

incentive remuneration practices and to regularly review their incentive remuneration for employees covered by the Guidance to correct identified deficiencies.[235] However, banking organizations that do not use incentive remuneration remain outside the scope of the Guidance which does not prescribe any rule to limit the level or prohibit certain forms of remuneration.

Another comment suggested that the agencies should work with other domestic and foreign authorities to promote a level playing field in this area. The agencies acknowledged the importance of national and international coordination to foster sound remuneration practices and maintained that the Guidance is consistent with the P&S, promising to review and update the Guidance to incorporate best practices that emerge.[236]

6.5.2.2 Employees covered by the Guidance

In terms of personnel, the Guidance applies to senior executives and other employees who individually or as a group have the ability to expose the banking organization to material risk.[237] According to the Guidance, these employees are: (i) senior executives and others responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executives, whose activities may expose the organization to material amounts of risk (for example, traders with large position limits relative to the organization's overall risk tolerance); and (iii) groups of employees subject to the same or similar incentive compensation arrangements and who, in aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (for example, loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).[238] Basically, the Guidance applies to personnel who supervise material business lines and/or material risk takers either as individuals or as a group.

The first issue needing clarification is the exact meaning of "material risk". The Guidance does not give enough assistance in determining what constitutes material risk, placing the

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[235] 75 Fed. Reg. 36405 and 36406.

[236] 75 Fed. Reg. 36403.

[237] 75 Fed. Reg. 36399.

[238] 75 Fed. Reg. 36407.

onus on the relevant organizations to consider the full range of inherent risks arising from their activities, as well as the time horizon over which those risks may be realized regardless of any risk-management process or control that used to limit the exposure of the risks. The Guidance does explain that risks are material when they are material to the organization, or to a business line or operating unit which is itself material to the organization, even if they are not large enough to threaten the solvency of the organization.[239]

This explanation is undoubtedly provided to avoid a "one size fits all" approach and to take account of the different circumstances that firms may face, but provides limited advice to organizations covered by the Guidance meaning that what is considered material can be measured differently, not only from firm to firm, but also from person to person in the same firm. However, the four agencies opted to not take a formalistic approach to this issue and more research and investigation are needed in deciding what material risks are. The second progress report of the FSB also emphasizes the significantly different approaches taken by member states in identifying "material risk takers" due to: (i) differences in national regulations and supervisory guidance, and (ii) differences in the size, nature or complexity of institutions, and acknowledges the need to promote good practices among member states, at the same time recognizing the need for proportionality between firms.[240]

Some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety and soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

6.5.3 The three principles

6.5.3.1 Balanced risk-taking incentives

The first principle of the Guidance focuses on ensuring that the incentive provided to employees through remuneration creates an appropriate balance between risks and rewards

[239] 75 Fed. Reg. 36407.

[240] Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Second Progress Report* (26 August 2013) 2 (FSB, 2013 *Progress Report*).

and does not encourage imprudent risk-taking. This requirement is achieved when the amount paid to an employee appropriately takes into account the full range of risks as well as the financial benefits, the employee's activities and the impact of those activities on the organization's safety and soundness.[241] This balance should also be in both the design and the implementation of the remuneration plan. For example, when two employees generate the same amount of short-term revenue or profit for an organization, they should not receive the same amount of incentive if the risks taken by the employees in generating that revenue differ materially, as the employee whose activities create materially larger risks for the organization should receive less than the other employee, as well as the actual payments varying based on risks or risk outcomes.[242]

Balancing remuneration with risk by adjusting pay commensurate with the level of risk taken is not only a challenging task facing companies and their remuneration committees, but may also diminish business opportunities, innovation, and growth initiatives, since if risk aversion is the primary focus in designing pay packages, in practice this will penalize employees who are involved in functions that inherently bear greater risk.[243]

When remuneration arrangements are unbalanced, features must be added or modified to bring them into balance and make them sensitive to risk. Four methods are often used for this purpose. These are as follows:[244]

a. **Risk adjustment of award:** The amount of an incentive remuneration award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. The measures may be quantitative (where available) or may rely on informed judgement supported by available information and subject to appropriate oversight, such as for "bad-tail risks".[245]

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[241] 75 Fed. Reg. 36407.

[242] 75 Fed. Reg. 36407 and 36408.

[243] Buck Research, "Final guidance on sound incentive compensation policies applicable to banking organizations" (2 July 2010) 33(41) <http://www.buckconsultants.com/portals/0/PUBLICATIONS/FYI/2010/FYI-07-02-10-Final-Guidance-on-Sound-Incentive-Compensation-Policies-Applicable-to-Banking-Organizations.pdf> accessed 6 November 2013.

[244] 75 Fed. Reg. 36408 and 36409.

[245] Bad tail risks were defined by the Guidance as the risks which may have low probability of being realized but would have highly adverse effects on the organization if they were.

b. **Deferral of payment:** The actual payment of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted and altered (either formulaically or judgementally subject to appropriate oversight) according to risk outcomes and actual losses or other aspects of performance that are realized or become better known only during the deferral period. A further requirement for senior executives of LBOs involves a substantial portion of their executive incentive remuneration being deferred over a multi-year period to allow reduction of the deferred amount in the event of poor performance, substantial use of multi-year performance periods, or both. Moreover, payment of a significant portion of incentive remuneration to the senior executives of LBOs is to be in the form of equity-based instruments which vest over several years and the ultimate number of instruments received by those senior executives should depend on the performance of the organization over the deferral period.[246]

Such provisions, which allow organizations to reduce deferred payment according to risk outcomes which are based on judgement rather than formulaic and quantitative measures, may expose organizations to the legal risk of litigation by employees who are not happy with the way that judgement by the organization has reduced the payment they were expecting. Even though the Guidance has urged banking organizations to describe how judgement is expected to be exercised to achieve balance and to communicate to employees the ways in which incentive remuneration awards and payments will be reduced as risks increase, this does not solve the problem created when an employee expecting a certain amount of money after a year or so is then told that the payment has been reduced or fortified based on a judgement that s/he does not agree with, and consequently disputes. It is unclear whether the decision of an independent remuneration committee would be considered final or whether the court would not accept such a reduction and award the employee the full amount, especially given these grey areas.

It can be argued that golden handshakes can weaken the effect of deferral if senior executives are going to receive such payments similar to, if not exceeding, the forfeit-

[246] 75 Fed. Reg. 36410.

deferred remuneration. However, allowing departed executives to receive the adjusted deferred amount will reduce the ability of banks to retain qualified and talented executives and increase the incentive for such executives to leave the firm. Vesting a deferred amount or guaranteed payment upon departure and giving a golden parachute without regard to performance may give executives incentives to expose the bank to undue risk.[247] However, the Guidance does not specify any rules in this regard, simply asking banks to consider carefully their potential effects on the risk-taking behaviour of employees.

c. **Use of longer performance periods:** The time period covered by the performance measures used in determining an employee's award can be extended (i.e., from one year to two or more years).

d. **Reduction of sensitivity to short-term performance:** The rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s) can be lowered to reduce the magnitude of such incentives.

The Guidance clarifies that banking organizations can use additional methods. It also emphasizes that on the one hand the risk adjustment (*ex-ante*) method is much better when reliable risk measures exist, as this can take account of the full range and time horizon of risks, compared to deferral, which simply catches those risk outcomes that occur or become more evident during the deferral period. It also points out, on the other hand, that deferral of payment (*ex-post*) method may be more effective than risk adjustment in mitigating the incentive to take risks that are hard to measure. However, in some cases two or more methods may be needed in combination to balance risk and reward in an incentive remuneration arrangement.[248]

6.5.3.2 Compatibility with effective controls and risk management

To minimize negative effects that may arise when an employee tries to evade the process established by a bank to achieve balanced remuneration arrangements, risk management and internal control should reinforce and support the development and maintenance of balanced

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[247] 75 Fed. Reg. 36410.

[248] 75 Fed. Reg. 36409.

remuneration arrangements.[249] This requires the integration of incentive remuneration into the risk-management and internal-control frameworks and having appropriate control and risk-management personnel to participate in the design and assessment of incentive remuneration arrangements. Such controls should be sufficiently documented to permit auditing for the effectiveness of their processes for establishing, modifying, and monitoring to achieve balanced remuneration arrangements and ensure that awards and payments are reduced to reflect risk outcomes or high levels of risk taken.[250] However, to preserve the independence of those personnel and avoid the conflict of interests that may arise from their remuneration, payment should be sufficient to attract and retain qualified personnel, primarily based on the achievement of the objectives of their function and not substantially based on financial performance.

Such requirements were criticized as imposing an undue burden on smaller banking organizations. The agencies maintained that monitoring methods and processes used by banks should correspond to the size and complexity of the bank and the level of using incentive remuneration. For example, a small and non-complex bank that uses incentive remuneration to a limited extent may find that it can appropriately monitor its arrangement through normal management processes.[251]

6.5.3.3 Strong corporate governance

The third principle emphasizes the need for good corporate governance practices that support the achievement of the main objective of the Guidance. It states that the board should have the ultimate responsibility for ensuring that sound remuneration practices that comply with the Guidance are in place. However, this requirement is not intended to marginalize the role of the remuneration committee, as the Guidance urges LBOs and other organizations that use incentive remuneration to a significant extent to consider the establishment of a remuneration committee with primary responsibility for overseeing the organization's incentive

[249] 75 Fed. Reg. 36411.

[250] 75 Fed. Reg. 36411&36412.

[251] 75 Fed. Reg. 36412.

remuneration systems. The committee should be composed solely or predominantly of non-executive directors[252] unless a higher standard is required by other authorities.

The Guidance further states that the board has several duties. These are: (i) ensuring that the bank's incentive remuneration for all covered employees is appropriately balanced and does not jeopardize the safety and soundness of the bank; (ii) directly approving remuneration arrangements for senior executives; (iii) approving and documenting material exceptions or adjustments to the incentive remuneration of the senior executives considering and monitoring the effects of such exceptions or adjustments; (iv) monitoring the performance and regularly reviewing the design and function of incentive remuneration; and (v) closely monitoring incentive remuneration payments and the sensitivity of the payments to risk outcomes.

To assist the board in fulfilling its duties, the Guidance urges the importance of the structure, composition, and resources of the board in being constructed to permit effective oversight of incentive remuneration. However, such a vague principle is of no help, as the Guidance does not clarify its expectation of how such a structure, composition, and resources should be achieved. The Guidance also strongly recommends that the board's members have relevant expertise and experience in risk-management and remuneration practices in financial services or that they have access to this.

This has raised concerns that all banks are required to have members with expertise in remuneration and risk management. Moreover, the standard required of the board is not clear and phrases such as "closely monitor" and "actively oversee" raise concerns that a high standard is being imposed on the board with regard to the oversight of incentive remuneration. The agencies have clarified that risk-management and remuneration expertise and experience at board level may be present collectively among the members of the board, and may come from formal training or from experience in addressing risk-management and remuneration issues, including receiving advice from outside consultants or other experts in incentive remuneration and risk management. Furthermore, the agencies recognize that smaller organizations with less complex and extensive incentive remuneration arrangements may find it unnecessary either to require board expertise or to retain and use outside experts

[252] 75 Fed. Reg. 36413.

in this area.[253] Finally, management is required to provide the board with sufficient data and analysis to allow the board to assess the overall design and performance of the bank's incentive remuneration plan and its consistency with the bank's safety and soundness; a greater depth of detail and quantity of data will need to be presented to the board of an LBO or other organizations that use incentive remuneration to a significant level.

The other tool of corporate governance on which the Guidance focuses is disclosure. The Guidance requires banks to provide an appropriate amount of information concerning their incentive remuneration and its relation to risk management, control and governance to shareholders. This disclosure should go beyond senior executives, with the scope and level of the information disclosed tailored to the nature and complexity of the bank and its incentive remuneration.

This disclosure requirement raised the issue of the need to protect the privacy of employees, which will in turn affect the ability of the organization to attract and retain talent as well as not creating extra burden for listed banks which are already required to provide extensive information regarding their remuneration practices to the markets.[254] However, such a vague requirement does help banks to implement this effectively. Moreover, the Guidance was partly issued in the realization that the interests of shareholders and employees may not be sufficient to protect the safety and soundness of a banking organization, as shareholders in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness.[255] Thus, encouraging shareholders to be involved might contradict the philosophy underpinning the Guidance, even if the objective is to urge shareholders to monitor any risk taken beyond their tolerance level of risk,[256] as this will raise other issues such as the free rider problem and the ability of shareholders to conduct effective checks.

Generally, the Guidance principles are too broad, vague and of little practical help regarding their effective implementation, relying on banks to ensure that their incentive remuneration

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[253] 75 Fed. Reg. 36402.

[254] 75 Fed. Reg. 36402.

[255] 75 Fed. Reg. 36396; L Bebchuk and H Sparmann, "Regulating bankers' pay" (2010) 98 *The Georgetown Law Journal* 247.

[256] 75 Fed. Reg. 36413.

does not encourage excessive risk-taking and is consistent with safety and soundness. Interestingly, the P&S, which are adopted on an international level, have more detail and are more prescriptive than the US Guidance. This can probably be explained by the refusal of the US Federal Reserve to implement the P&S, despite the fact that President Obama himself has agreed to do this. The US Federal Reserve is opposed to the P&S on the grounds that a single formula-based approach could exacerbate excessive risk-taking.[257]

6.5.4 Supervisory initiatives

Turning to the role of the agencies in supervising and monitoring implementation of the three principles by banking organizations, the agencies expect banks to evaluate their incentive remuneration to ensure that it does not encourage imprudent risk behaviour and is consistent with the safety and soundness of the bank. The agencies will: (i) promote further advances in designing and implementing balanced incentive remuneration plans; (ii) regularly review the incentive remuneration and related risk-management, control, and corporate governance practices of LBOs and work to incorporate oversight of incentive remuneration arrangements into the regular examination process for smaller firms; (iii) take enforcement action to ensure material deficiencies which threaten the safety and soundness of a bank are promptly addressed; and (iv) update the Guidance to incorporate best practices as they develop over time.

The agencies failed to provide sufficient detail in the Guidance regarding how this review and supervision should take place and how regularly. There is not enough information on what is meant by "material deficiencies" and how the agencies will deal with allegations made by banks that they have a contractual relationship with employees that must be met to avoid breach of contract. Moreover the agencies did not specify how such a review is going to be conducted by them, whether each agency will do this for the institutions it covers, or whether there is going to be a collective approach via a special committee of representatives from the four agencies to secure unified application and eliminate divergence. This raises the issue of what happens in the case of a difference of opinion on an issue related to incentive remuneration, and whether the view of the bank or the agencies would prevail. If a bank

[257] T Braithwaite, K Guha and G Farrell, "Fed rejects one-size pay rules" *Financial Times* (London, 23 October 2009); Murphy, "Regulating Banking Union" (n 698).

maintains that its remuneration policy conforms to the principles outlined in the Guidance and the agencies do not agree, it will be difficult to resolve such a problem in the light of such broad and vague principles.

6.6 Conclusion

In the overview of the US context, it was noted that regulation has been influential in shaping remuneration practices. Calls from academics and shareholder activists in the 1980s, as well as a wave of takeovers, encouraged the use of equity-based remuneration and generous golden parachute agreements. The Deficit Reduction Act 1984 was introduced to curb over generous agreements, by imposing a special tax on payments exceeding three times the executive's average recent remuneration, but it was argued that this had a negative effect, encouraging companies to introduce changes in control agreements and use the "three times" amount as standard. Equity-based remuneration and other incentive agreements were also encouraged by tax and accounting incentives. Any non-performance related remuneration in excess of $1 million was described as unreasonable and not deductible as an ordinary business expense. Accounting treatment for stock options encouraged their use, as companies were not required to expense them.

A series of accounting scandals at the start of new millennium revealed that executives had been incentivized to focus on short-term market movement to be awarded their options, meaning they adopted very risky strategies and manipulated their published accounts. Expensing options were dropped from the proposal for the Sarbanes-Oxley Act 2002 and was later introduced by the FASB in December 2004 as a result of increasing shareholder calls for the expensing of options.

Like previous reports by the FSB, Turner and de Larosière, US officials concluded that remuneration played a role in encouraging short-term gain without proper consideration of the long-term consequences.

This was followed by an examination of US court judgements on derivative cases regarding remuneration practices. As in the UK system, US courts will not pronounce on what constitutes a reasonable remuneration level or structure, focusing instead on ensuring that senior directors have operated an honest and fair procedure that recognizes the formal requirements of the law and that, ultimately, the company has made a proper business

judgement. Therefore, the US courts will respect a decision made by shareholders or disinterested directors upon disclosure of all material facts unless shareholders can prove that the disinterested directors breached their duty of loyalty or care, or that the remuneration plan amounts to corporate waste.

The general approach to regulating remuneration practices in the US was also discussed, with disclosure and independent remuneration committees emerging as the most important tools available until the Dodd-Frank Act 2010 introduced shareholder advisory votes.

With regard to the independence of the board, the US practice is to recommend that the majority of the board members are non-executive directors, whereas in the UK a balance of executive and non-executive is preferred together with the separation of the roles of CEO and chairperson as limiting guaranteed tenure.

Independent remuneration committees with a specified level of responsibility are also an important tool in solving the conflict of interests that arises when deciding executive remuneration if they are used to make objective decisions on what constitutes a fair and competitive remuneration policy. The operation of the committee benefits from discussion with executive directors and recommendations from independent remuneration consultants. However, it was noted that various financial, social and psychological factors can affect the independence of a committee. The various forms of qualitative and quantitative disclosure were explained.

Shareholder voting and involvement was also identified as a potentially useful tool although this cannot legally change company policy. The chapter analysed important aspects of remuneration contracts and how the law and regulation have dealt with these.

Incentive-based remuneration was also discussed in relation to section 39(c) of the FDIA. This was introduced in 1995, allowing the Federal Reserve, the OCC, the OTS, and the FDIC to prescribe rules or guidelines for all insured depository institutions that would prohibit unsafe or unsound practices that would provide any executive officer, employee, director, or principal shareholder of the institution with excessive remuneration or could lead to it suffering material financial loss. Following the financial crisis of 2007 and the P&S all four agencies issued the Guidance based on the three principles but less detailed than the P&S. In addition, section 956 of the Dodd-Frank Act also prescribes regulations or guidelines which require disclosure of the nature of incentive-based remuneration to allow agencies to

determine whether the remuneration structure is excessive or could lead to material loss. They are also required to prohibit incentive-based remuneration that encourages inappropriate risk taking. The agencies proposed the Rule in April 2011 to supplement the existing Guidance, but these have yet to be adopted.

Chapter 7 The regulation of remuneration practices in Saudi Arabia[1]

7.1 Introduction

The regulatory framework for corporate remuneration practices in Saudi Arabia has two core aspects: the first is related to the members of the board (executive and non-executive) whilst the second involves executive remuneration. With regard to the former, the law has decided on the highest level of remuneration that can be paid to an executive or non-executive director, for serving on the board. However, it remains silent on the issue of executive remuneration.

The Corporate Governance Regulations (CGRs) issued by the CMA as well as the Principles of Corporate Governance (PCG) and Rules on Compensation Practices (RCP) issued by the SAMA, contain instructions for listed companies, Saudi banks and other banks operating in Saudi Arabia with regard to the issue of establishing and fixing executive remuneration. However, this chapter will argue that the area of regulating executive remuneration in Saudi Arabia is not only inadequate, falling short of the best practice standards,[2] but also fails to empower shareholders and grant them the minimum level of protection from excessive levels of remuneration. Adequate disclosure requirements do not exist and since there is no requirement for executive remuneration to feature as an agenda item at the AGM, the possibility of debate on this topic is effectively eliminated. Moreover, in the case of SAMA regulation, it seems to lack the power to pass rules on remuneration and corporate governance

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[1] As discussed in section 1.4, to help overcome the obstacle of the lack of academic literature on the topic of remuneration regulation in Saudi Arabia, the discussion in this chapter has benefited from informal discussions with senior officers of the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA), both of which play a crucial role in the policy formulation process. At SAMA, I interviewed a senior advisor to the Deputy Governor, Mr. Jameel Ahmad and at CMA, I interviewed the Head of the Corporate Governance Department, Mr. Alwaleed Alsenani, one of his senior advisors, Mr. Ghassan Kashmeeri, and a legal advisor Mr. Majed Albuti.

[2] For example, the existing CGRs are insufficient to solve the conflict of interest inherent in the decision-making process of remuneration, as they allow executives to sit on the remuneration committee and the standard of disclosure requirements are minimal and inconsistent.

principles. In addition, international agreements must be ratified by Royal Decree[3] and not by the authorities with responsibility for supervising banks. Neither the Banking Control Law (BCL) nor SAMA's Charter grant SAMA the power to issue such regulations. However, this legal issue can be overcome by granting SAMA the necessary powers. This chapter will also argue that the scope of implementation by SAMA of its Rules on Compensation Practices may give rise to regulatory arbitrage. SAMA's failure to clearly specify the personnel to whom the rules on the structure of remuneration apply, has led to the blanket application of the rules.

The chapter is divided into four sections. Following the introduction, the second section examines the current law and regulators of the financial industry in Saudi Arabia. The third section moves on to investigate how remuneration practices are regulated. Finally, a conclusion will be drawn in the light of the discussion.

7.2 Laws and regulation of the financial industry in Saudi Arabia

7.2.1 Laws governing public companies and financial institutions

Before moving on to examine the role of regulators, this section presents an overview of the most important laws affecting Saudi financial markets and institutions. The Insurance Law which lies outside the scope of this thesis has been excluded.

7.2.1.1 Companies Law 1965

Business organizations operating in Saudi Arabia can take one of three forms: sole trader, partnership or incorporation. Partnerships can be established without going through the Register of Companies and can take the form of one of the well-known types of association outlined in Islamic *Fiqh*.[4] Incorporation is governed by the Companies Law (CL) 1965, the

[3] Basic Law of Government, Article 70. The official English translation was used for all the Saudi legislation cited in this thesis with the exception of the Companies Law which is my own translation.

[4] Section Two of the Commercial Court Law 1931 briefly mentions these partnerships. However, there was clearly a need to develop a comprehensive company law illustrating the provisions for corporations' establishment, conduct of their business activities and liquidation, as well as specifying the authority of the Ministry of Trade to monitor and supervise companies for the purposes of public interest. This led to the issuance of the Companies Law 1965. See: MH Aljaber, *Saudi Commercial Law* (4th edn, Riyadh 1996) 156.

overall structure of which is derived originally from French law via Egyptian law.[5] The CL covers many issues related to incorporation or establishment, governance, liquidation, merger, and dissolution of the eight different forms of corporation. Chapter Five of the CL is devoted to joint-stock companies as 101 of the 234 articles of the Law (some 43 per cent of the Law) are concerned with this type of corporation and every aspect of their business is very heavily regulated in comparison with the other forms of corporation. Joint-stock companies have the option to go public and have their shares listed on the stock market. Establishing a joint-stock company entails obtaining a Resolution from the Minister of Commerce and Industry after fulfilling all the requirements of the CL while listing requires conforming to the Listing Rules (LR) issued by the CMA. Some kinds of joint-stock companies require a Royal Decree.[6]

Since joint-stock companies are limited liability companies, their accounts must be externally audited[7] and external auditors must be changed at least every five years.[8] Such companies must have a board of directors consisting of no fewer than three members[9] and no more than eleven if they are listed.[10] When company losses equal or exceed 75 per cent of its capital, the board of directors has to call an Extraordinary General Assembly (EGA) for a meeting to consider the continuation of the company or its dissolution, and in all cases the Resolution must be published in the official State newspaper.[11]

However, there is a new proposal to enact a new Companies Law, which at the time of writing had not been fully publicly disclosed. After being approved by a Resolution of the *Shura* Council, this proposal has now been referred to the Council of Ministers. The Law will be made up of 12 chapters containing a total of 226 Articles in comparison to the current Law's 15 chapters and 234 articles. Some aspects of the *Shura* Council discussion have been

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[5] HA Ghazzawi, "Islamic Law" (*Saudi Legal, Saudi Arabian Law Overview*) <http://www.saudilegal.com/saudilaw/01_law.html> accessed 15 July 2013.

[6] Companies Law 1965, Article 52.

[7] Companies Law 1965, Article 130.

[8] The Minster of Commerce and Industry, Ministerial Decision No. 266 on 9 August 2008.

[9] Companies Law 1965, Article 66.

[10] Capital Market Authority, *Corporate Governance Regulations in the Kingdom of Saudi Arabia*, Article 12(a).(CGRs)

[11] Companies Law 1965, Article 148.

reported in Press, the most debated issue being Article 76 (replacing Article 74 of the current Law) which concerns the remuneration of the board of directors. [12]

7.2.1.2 The Charter of SAMA 1957

This Law created the Central Bank of Saudi Arabia, which is known as the Saudi Arabian Monetary Agency (SAMA). As a central bank, SAMA is charged with: (1) the issuance and strengthening of the Saudi currency and stabilizing its internal and external value; (2) dealing with the banking affairs of the government; and (3) supervising commercial banks and exchange dealers.[13] The Charter sets out the duties and responsibilities of SAMA and presents its governance structure. Banks operating in Saudi Arabia must provide a monthly statement of their financial position in accordance with the specimen forms prepared by SAMA and maintain minimum deposits with SAMA, the levels of which are adjusted from time to time to suit the prevailing circumstances in accordance with a decision passed by the Minister of Finance upon the suggestion of the Agency. SAMA's role in supervising and regulating banks will be discussed further in the following subsection.

7.2.1.3 Banking Control Law 1966

According to the Law, the carrying out of banking activities must be licensed, and banks are required to take the form of a joint-stock company and apply for a license to SAMA. After receiving approval from the Council of Ministers, licensing is granted by the Minister of Finance.[14] The Law also charges SAMA with the responsibility of supervising banks after incorporation and requires banks to have a statutory deposit with SAMA of a sum equal to 10-17.5 per cent of their deposit liabilities, decided at SAMA's discretion. However, SAMA can lower or exceed these limits under the Law with the approval of the Minister of Finance.[15] Banks are also required to have liquidity[16] equal to 15 per cent of their deposit liabilities; SAMA has the right to increase this to 20 per cent. When a bank's liability deposit

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[12] A Alshehri, "Article 76 and the corridors of the *Majlis Al-Shura*," *Aleqtisadiah* (Riyadh, 6 April 2011) Available at: <http://www.aleqt.com/2011/04/06/article_523466.html> accessed 12 July 2013.

[13] Charter of SAMA 1957, Articles 1 and 3.

[14] Banking Control Law 1966, Article 3.

[15] Banking Control Law 1966, Article 7.

[16] Liquidity refers to cash, gold or assets, which can be converted into cash within a period not exceeding 30 days (Banking Control Law 1966, Article 7).

exceeds fifteen times its reserve and capital, the bank is required to either increase its capital or reserve to the prescribed limit or deposit 50 per cent of the excess with SAMA.[17] Large exposure is limited to 25 per cent of the equity with SAMA having the right to increase this to 50 per cent.[18]

The Law prohibits banks from engaging in certain activities entirely while other activities require the permission of SAMA.[19] Under the provisions of the Law SAMA has the right to issue rules regarding limiting loans, prohibiting certain kinds of loans, laying down specific terms and conditions with regard to particular transactions between a bank and a customer, collateral, and the assets to be maintained by every bank in Saudi Arabia.[20] However, in doing so, SAMA must have the approval of the Minister of Finance.[21] The Law also grants SAMA the right to inspect the books and accounts of any bank following the approval of the Minister of Finance.[22] Article 23 gives SAMA the right to penalize specified actions.

The Law has been criticised as being inadequate for the purposes of modern finance law for many reasons. Most importantly, SAMA needs an enabling law, similar to the Capital Market Law, that gives it formal independence and authority in exercising its duties, as it currently has to obtain the approval of the Minister of Finance and the Council of Ministers on various issues. The Law fails to specify clear objectives for SAMA. With regard to prudential regulation and supervision, SAMA has made substantial efforts to introduce Basel II-III and is applying a risk-based approach to supervising banks without clear mandate in the Law.[23] Finally, the scope of SAMA's accountability is not clearly defined in the Act, although the articles giving the Minister of Finance power over certain aspects of the work of SAMA are to certain extent relevant in this respect. In addition, the Board of Grievances has the power

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[17] Banking Control Law 1966, Article 6.

[18] Banking Control Law 1966, Article 8.

[19] Banking Control Law 1966, Articles 9, 10 and 11.

[20] Banking Control Law 1966, Article 16.

[21] Banking Control Law 1966, Article 16.

[22] Banking Control Law 1966, Article 18.

[23] International Monetary Fund, *Saudi Arabia: Financial Sector Assessment Program Update—Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision* (July 2013) Available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr13213.pdf> accessed 12 November 2013.

to review any final administrative decision by all authorities including SAMA and reverse this in the following instances:

> *When the decision was challenged based on the lack of jurisdiction, a defect in process, a defect in the cause, violation of Laws and Regulations, error in application or interpretation, abuse of power [...]However, the refusal of the administrative body or its refraining from making a decision that should have been taken in accordance with the Laws and Regulations is considered to give cause for a challenge.*[24]

In 1986 SAMA issued a set of Rules for enforcing provision of the BCL through a Ministerial decision in accordance with Article 26 of the Law.

7.2.1.4 Capital Market Law 2003[25]

This Law announced the creation of new bodies tasked with regulating and supervising the securities markets and investment firms. The CMA has oversight of these bodies, and was created to replace the Ministerial Committee comprising the Ministries of Finance and of Commerce and Industry together with SAMA in regulating and supervising the stock market[26] (which was the only financial market for securities at that time).

The Capital Market Law (CML) defines the objectives, duties and powers of the CMA, the Saudi stock exchange *(Tadawul*), the Securities Depository Centre, the Committee for the Settlement of Securities Disputes and the Appeal Panel. The Committee for the Settlement of Securities Disputes is a special body with jurisdiction over all claims and matters falling under the CML and its implementation and regulation together with regulations, rules and instructions of the CMA.

7.2.2 Financial industry regulators and instruments affecting remuneration practices

The financial system in Saudi Arabia has evolved from having SAMA as the sole regulator of the system to the establishment of the CMA as the body with specific responsible for

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[24] Law of the Board of Grievances 2007, Article 13(b).

[25] For extensive review and analysis of the law see: JW Beach, "The Saudi Arabian Capital Market Law: A Practical Study of the Creation of the Law in Developing Markets" (2005) 41 *Stanford Journal of International Law* 307.

[26] ibid 311.

regulating and supervising the securities sector. Therefore, SAMA is responsible for supervising banking, and for regulating and supervising the insurance sector whilst the CMA is charged with regulating and supervising the securities sector. Saudi Arabia is applying institutional regulation, where each regulator is charged with a certain sector, rather than functional regulation, where each regulator deals with non-sectoral functions irrespective of the type of business activity.[27] The next two subsections are devoted to exploring the power and duties of the two regulators along with their statutory instruments which affect remuneration practices.

7.2.2.1 SAMA

7.2.2.1.1 Overview

There are 23 licensed banks in Saudi Arabia, but only 20 are "active". Of these, 12 are Saudi incorporated banks.[28] As previously mentioned,[29] the Charter of SAMA and the BCL are currently inadequate and a new law needs to be introduced. No objectives have been set for SAMA to pursue in fulfilling its duties with regard to supervising and regulating banks and, as a result, SAMA has always been accused of protecting banks and not taking adequate care of the interests of customers and investors. Slow progress has started to be made in this area following the recent establishment of the Consumer Protection Department[30] although this is also without a clear mandate in the Law.

It seems that SAMA has far exceeded its power in introducing some aspects of regulation, taking advantage of the fact that Saudi banks are "obedient", according to SAMA officials. The fact that the current legislation has insufficient provisions does not give SAMA the right to issue rules and instructions in the form of circulars, which are usually not publically available, beyond its mandate. For example, in my opinion, introducing Basel rules without going through the process of a Royal Decree or at least a Ministerial decision in accordance

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[27] KK Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (World Bank: Washington, DC, 2006) 10.

[28] International Monetary Fund, "Saudi Arabia: Financial Sector Assessment Program Update—Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision" (n 23).

[29] See sections 7.2.1.2 and 7.2.1.3.

[30] Speech by Mr Fahad Almubarak, Governor of the Saudi Arabian Monetary Agency, on the occasion of the issuance of the 49th Annual Report, Riyadh, 17 March 2014 Available at: <http://www.bis.org/review/r140411c.htm> accessed 25 May 2014.

with Article 16 of the BCL constitutes a breach of SAMA's duties and it is acting beyond its power. In addition, Article 12 of the BCL introduces basic aspects of the fit and proper test, but this does not give SAMA the right to issue corporate governance principles to banks and rules on compensation practices.

As explained above,[31] SAMA does not have the independent authority to act alone in most cases, even those related to licensing and regulation, which make up most of its duties in the Law. When issuing the BCL and the Charter of SAMA, the Regulatory Authority used an Arabic word which means "supervising".[32] The same word is used in the title of the BCL which, strictly speaking, should be translated as the Banking Supervision Law. Article 1(c) of the Charter of SAMA[33] also uses the same Arabic word with the meaning of "supervise", which was subsequently changed to "regulate" when it was translated into English.

Although SAMA might not see a difference between supervising and regulating, or perhaps reasons that supervising requires regulation, the Regulatory Authority seems to see a difference since, as discussed above,[34] Article 16 of the BCL does not give SAMA the sole right to introduce regulation on many issues without obtaining the approval of the Minister of Finance. It could be argued that Article 3(d) of the Charter of SAMA[35] gives this body the right to regulate since it concerns the functions or duties of SAMA in relation to fulfilling its roles as stated in Article 1 of its Charter.[36] Again it is argued here that the English translation is not accurate as the word "regulate" is used instead of the more accurate "instruct". Thus Article 3(d)[37] which states one of SAMA's functions should be translated as "supervising commercial banks and exchange dealers and issuing instructions whenever SAMA deems this necessary". These instructions must not exceed the powers legally given to SAMA for the purpose of fulfilling its supervisory role. Therefore, SAMA does not appear to have the legal right to introduce the Rules on Compensation Practices or the Corporate Governance

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[31] See sections 7.2.1.2 and 7.2.1.3.

[32] The word which means "supervision is used in the title of the Banking Control Law 1966, and Article 1(c), Charter of SAMA 1957.

[33] Charter of SAMA 1957, Article 1(c).

[34] See section 7.2.1.3.

[35] Charter of SAMA 1957, Article 3(d).

[36] Charter of SAMA 1957.

[37] Charter of SAMA 1957.

Principles. However, since the two regulatory instruments exist and they can easily be legitimised by introducing a new law that grants SAMA the power to regulate, these will now be discussed.

7.2.2.1.2 Rules on Compensation Practices

Rules on Compensation Practices were enclosed in a letter issued to all banks from the Governor of SAMA on 3 May 2010, which stated that they were to come into immediate effect.[38] Banks were given until 31 December 2010 to bring their employment contracts into conformity with the Rules or alternatively to approach SAMA by 30 June 2010 with their reasons for not being able to do so.[39] The reason for this reduced timescale was that SAMA had already asked banks to take into account the guidance provided in the P&S when establishing their compensation policies and practices.[40]

The Rules on Compensation consist of seven sections. Prior to their introduction , SAMA had conducted a survey of banks' practices,[41] and was not convinced by the suitability of the P&S for Saudi banks due to the intrusive and conservative model of supervising and regulating these institutions.[42] In addition, the remuneration practices in the banking sector showed a tendency to use fixed pay as a major part of the payment with bonuses representing only a "fraction" of the total payment (accordgin to a SAMA official). However, SAMA introduced the Rules to fulfil Saudi Arabia's obligations as a member of the G20. SAMA unilaterally introduced the Rules even though it does not have the power to do so, as international treaties and agreements must be ratified by the process of a Royal Decree after the issue has been studied by the *Shura* Council and the Council of Ministers.[43] However, it could be argued that

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[38] SAMA, *Rules on Compensation Practices* 1.4.

[39] I was told in the interview with Mr Jameel Ahmad, advisor to the Deputy Governor for Technical Affairs at the Saudi Arabian Monetary Agency, that none of the banks approached SAMA in relation to this matter.

[40] SAMA, Circular No. BCS 842 dated 26 August 2009; SAMA, Circular No. BCS/ 1984 dated 9 January 2010 to the banks

[41] I was told in the interview with Mr Jameel Ahmad, advisor to the Deputy Governor for Technical Affairs at the Saudi Arabian Monetary Agency, that only one bank had used shares as part of its remuneration of top executives before the Rules were introduced but after their introduction, many banks adopted this practice.

[42] For example, any derivative trading must be reported to SAMA, even if it is on behalf of a customer and any loans to non-resident entities or persons must be reported to SAMA.

[43] *Shura* Council Law, Articles 17 and 18; Law of the Council of Ministers, Article 20.

since King Abdullah agreed to the P&S in the G20 summits, this serves to ratify their introduction but SAMA has not been explicitly charged with implementing them.

The Rules apply to commercial banks on a consolidated basis. Thus, the majority-owned financial subsidiary of a commercial bank, be it an insurance company or investment firm, lies within the scope of the Rules.[44] Those insurance companies and investment firms which do not form part of a commercial bank are excluded. SAMA officials reported that the reason for this is that local commercial banks and their subsidiaries (insurance companies and investment firms which have been ring-fenced since 2004) dominate the Saudi financial system with a 95 per cent market share whilst the remainder is divided amongst the rest of the financial institutions in the market. The P&S are applied to significant financial institutions only, meaning there is no need to extend the Rules beyond commercial banks. There is also no danger of talented employees leaving the banks, as the salaries in these banks are far more lucrative than those on offer in the other financial institutions due to their size. It could be argued that there is a danger of talented employees leaving Saudi banks to go to other banks in the region which do not apply the P&S. However, this danger is lessened by the fact that some countries in the region, especially some of the largest GCC [Gulf Cooperation Council] countries have introduced similar regulations.[45]

Foreign subsidiaries of a locally incorporated bank must apply the Rules if the local banks have majority ownership and oversee branches of local banks unless the Rules are inconsistent with the regulatory requirements of the host country. All foreign banks licensed and operating in Saudi Arabia must apply the Rules.

The Rules do not clarify to which personnel they apply but in the Implementation Framework, SAMA has clarified that Standard six of the FSB Implementation Standards only affects key executives whose appointment is subject to no objection by SAMA, and those employees whose actions have a material impact on the risk profile of the bank. However, Material Risk Takers have not been defined, either in the SAMA Rules or in the P&S, which

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[44] SAMA, *Rules on Compensation Practices*, 1.3.

[45] Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Progress Report* (13 June 2012) (FSB, 2012 *Progress Report*).

means this issue is left up to the banks to decide. At the time of writing, the FSB was in the process of identifying good practice in this area.[46]

7.2.2.1.3 Principles of Corporate Governance

In July 2012, SAMA also issued the Principles of Corporate Governance for Banks Operating in Saudi Arabia. These cover issues related to the board of directors, shareholder rights, and disclosure and are intended to complement the regulations, rules and circulars issued by SAMA and the CMA.[47] However, banks must put the Principles of Corporate Governance at the head of Corporate Governance Regulations, as SAMA is the primary regulatory body for banks. These principles are more detailed than the Corporate Governance Regulations and specifically tailored to banks. There will be more discussion of these two instruments later when discussing their effects on remuneration practices.

7.2.2.2 CMA

7.2.2.2.1 Overview

The CMA was established in July 2004 and is governed by a Board which comprises five Commissioners who are appointed by Royal Order, including the Chairperson, who is also the CEO, and the Vice Chairperson.[48] The CMA was given the rule-making authority and enforcement powers necessary to fulfil its objectives, namely the protection of investors, ensuring orderly and equitable dealings in the securities business by regulating and monitoring the issuance of securities and the activities of entities, and the fairness, efficiency, and transparency of the capital market.[49] The Law mentions three types of legislation that the CMA can issue: regulations, rules and instructions. However, the CMA has not clarified the difference between these three, nor does it use them as distinct from each other. It possesses both civil and criminal authority and may seek civil sanctions, ranging from warnings to monetary penalties, property seizure, and licence suspension or revocation. Its regulatory responsibilities are broad and include the issuance of securities, listing, trading and settlement

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[46] Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Second Progress Report* (26 August 2013) (FSB, 2013 *Progress Report*).

[47] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia*, Principle 74.

[48] Capital Market Law, Article 7.

[49] Capital Market Law, Article 5.

on *Tadawul*, credit rating agencies, investment funds, disclosure by issuers and governance, licensing, and the supervision and enforcement of its regulations.[50]

The CMA's remit includes all offers of securities in Saudi Arabia, whether public offers or private placements; the establishment, offering and management of funds, and the regulation of participants in the capital market, including any over-the-counter (OTC) activity. The regulation of banks and insurers is the responsibility of SAMA, except to the extent that they have obligations as listed companies, in respect of which they fall within the jurisdiction of the CMA.[51] Unlike SAMA, the CMA is clearly accountable to the President of the Council of Ministers and concerned parties have a clear procedure for raising matters against the CMA with the Committee for the Settlement of Securities Disputes. However, there is a danger in that this body is appointed by the CMA Board. However, this is somewhat mitigated by the establishment of the Appeal Panel, which was formed by a resolution of the Council of Ministers.[52] In addition, all of these fears will be minimised when the Board of Grievances takes over all of its new responsibilities for reviewing the decision of all tribunals as part of the new judicial reform.

7.2.2.2.2 Corporate Governance Regulations

An awareness of the importance of good corporate governance began to emerge in the Kingdom of Saudi Arabia in the wake of the market collapse of 2006.[53] The CMA enacted the CGRs in 2006 for all listed companies on a "comply or explain"[54] basis. However, due to the low level of awareness of the importance of corporate governance and compliance, the CMA established the Corporate Governance Department,[55] as well as obliging listed companies to comply with some Articles of the CGRs which are seen as important to secure minimum good practice. The CGRs represent the minimum standards that listed companies have to comply with and the CMA, as represented in its Corporate Governance Department,

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[50] Capital Market Law.

[51] International Monetary Fund, Saudi Arabia: *Financial Sector Assessment Program Update—Detailed Assessment of Observance of the IOSCO Objectives and Principles of Securities Regulation* (July 2013) Available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr13212.pdf> accessed 12 November 2013.

[52] Capital Market Law, Article 25.

[53] Capital Market Authority, *Annual Report: First Report* 2006.

[54] CGRs, Article 1(c).

[55] Capital Market Authority, *Annual Report 2008*.

encourages companies to go beyond the minimum requirements. The CGRs cover issues related to shareholder rights, board of directors and disclosure. The CGRs are the first to regulate executive remuneration.

7.3 Regulation of remuneration practices in public companies and banks in Saudi Arabia

This section will investigate the regulation of remuneration, examining the CL 1965, the CGRs issued by CMA, and the RCP and PCG issued by SAMA. There are two sets of laws and regulations: one applies to all board members and their service on the board, and the other, to executive directors. Therefore, this section will discuss both these issues.

7.3.1 The remuneration of board members

The CL 1965 provided that the company's Constitution shall explain the way in which the members of the board are remunerated and this can take the form of salary, allowances for attendance, benefits in kind, and a certain percentage of the profits.[56] Companies can use one or more of these methods of remuneration or use other methods of rewarding board members. However, Article 74 itself does not mention any limit or maximum level of remuneration for board members unless these individuals are remunerated through the profit rate. In this case, there are two conditions: (1) the maximum percentage that can be granted to the members of the board must not exceed 10 per cent of the net profit after deduction of expenses, depreciation and reserves established by the General Assembly; and (2) a distribution of dividends to shareholders must not be less than five per cent of their paid capital.[57]

Article 74 addresses the method of rewarding members of the board of directors in their capacity as members of the board attending meetings and performing the required roles of the board. The board of directors has two main categories of director: executives and non-executives. Executive directors are responsible for managing the day-to-day business, whereas the key role of non-executive directors is to monitor the performance of the management, challenge ideas they put forwards and help develop proposals regarding

[56] Companies Law 1965, Article 74.

[57] ibid.

strategy by attending board meetings and the meetings of the committees to which they are appointed as members. Therefore, a board member may be solely a member of the board of directors or, in addition to the membership of the board, s/he may be an executive director or a finance officer of the company or otherwise. Thus it seems that Article 74 deals with the subject of the remuneration of the members of the board. This is also clear as the disclosure requirement stated in the Article necessitates the separation of what has been paid to the board members in this capacity, using the four methods and what has been paid to them in other capacities, such as managing directors and/or the Chairperson according to Article 79.[58]

A decision dated 5 May 1992, issued by His Excellency the Minister of Trade as No. 1071 on the basis of item 12 of the Council of Ministers' Resolution No. 202 (15 May 1984), put an upper limit on the remuneration of the board. This upper limit concerned two of the methods mentioned in Article 74 of the CL. The first regards allowances which must be set at a maximum of 3,000 Saudi riyals for each meeting of the board of directors attended by a director. The second is related to the profit rate. A decision by the Minister added a third condition for the use of the profit rate as a reward method to a member of the board of directors, in that 10 per cent was not to be more than 200,000 Saudi riyals on an annual basis for each member. It is noted that this decision did not set an upper limit for the methods of remunerating the board members as salaries and benefits in kind remain without limitation. The decision also did not take into account whether a company was successful or not and how much work was involved, as big companies need more effort and time, and also did not take into account the effort made by the member or expected from the member of the board when determining the remuneration.[59]

In addition, the decision by the minister asserted the requirement of disclosure in Article four and added to it the requirement to present this disclosure to the General Assembly at the AGM, during which it has become a norm or common practice for Saudi-listed companies to table a resolution for the shareholder vote on the remuneration of the board of directors.

A new proposal for the CL is being discussed and is currently on its way to being passed and receiving a Royal Decree as a replacement of the 1965 CL. According to the newspaper

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[58] Article 79 was modified by Royal Decree M/29 on 15 January 1998.

[59] A Almhmoud, "The Remuneration of the members of the board of directors in Saudi Companies" (2013) 79 *ALTHAQAFIYA* 40.

Aleqtisadiah, the draft of the new CL approved by the *Majlis Al-Shura* will reword Article 74 again to stress the need for the company's constitution to show the way in which a company remunerates its directors. The remuneration can be paid in the form of salary, attendance allowance for meetings, benefits in kind, and a certain percentage of the profits, and may combine two or more of these. However, if the reward is based on or uses a certain percentage of company profits, the company is not permitted to increase this percentage to more than 10 per cent of the net profit after distribution of dividends to shareholders, and not less than five per cent of the company's capital paid by shareholders.

The proposed Article stresses proportionality between the paid remuneration and the number of meetings attended by the member, and every estimate otherwise is void. The Article also emphasises that – in all cases – the total remuneration received by any member of the board must not exceed 500,000 Saudi riyals per annum. The annual report of the board of directors to the AGM must include a comprehensive statement of everything that each member of the board receives in his or her capacity as a member of the board during the financial year in terms of salary, net profits, attendance fees, expenses and other benefits, and should also include another statement of what has been paid to each member in any other capacity, such as being an executive, a member of staff, administrator or adviser. The annual report should also include a statement of the number of meetings of the board and the number of meetings attended by each member since the date of the last meeting of the General Assembly. The proposed Article also permits the AGM to terminate the membership of an absent member for failing to attend three consecutive meetings of the board without a legitimate excuse. This termination resolution must be submitted through a recommendation of the board.[60]

The new proposed rewording of the Article relating to the remuneration of the board of directors caused a great deal of discussion and argument in the *Majlis Al-Shura*.[61] One of the most contested issues was the 10 per cent limit on rewards based on net profit, as it had been

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[60] M Alsalamah, "The end of the debate on the remuneration of members of corporate boards: a maximum of 500 thousand riyals", *Aleqtisadiah* (Riyadh, 15 March 2011) Available at: <http://www.aleqt.com/2011/03/15/article_514917.html> accessed 16 September 2013.

[61] M Alsalamah, "'Shura' moves to adjust the boards' remuneration of joint stock companies", *Aleqtisadiah* (Riyadh, 6 February 2011) Available at: <http://www.aleqt.com/2011/02/06/article_500721.html> accessed 18 September 2013; Alshehri (n 1010); T Alsuhail, "Remuneration and benefits of board members in Saudi companies raised controversy in the Shura", *Alsharq Alawsat* (London, 14 February 2011) Available at: <http://aawsat.com/details.asp?section=6&article=608205&issueno=11766#.Uiqubsamiz4> accessed 20 September 2013.

voted on to drop it from the Article; this was a sensible proposal, even though it was not successful in securing enough votes, as there is no need for the 10 per cent with the new cap unless the two are used together so directors' remuneration must not exceed 10 per cent of net profit in total with no more than 500,000 for each member.[62] Alsaramy was surprised that the current system allowed for seven people to get 10 per cent of the profits at the expense of the rest of the shareholders, and demanded the existence of a mechanism for calculating the dues of members of boards of directors to ensure justice for everyone.[63]

It is noted that this Article is very similar to the present one, but has been developed to solve a number of issues. The most important difference was imposing a complete cap on the maximum rewards obtained by members so that these do not exceed a total of 500,000 Saudi riyals in the fiscal year. Another factor is to ensure symmetry between the reward and the sessions attended by a member of the board of directors. However, the Article does not differentiate between the size of the company and the expected effort needed, and hence proposes a requirement that companies must explain and disclose why they reward their board members such remuneration and for which aspects of work individually undertaken during the financial year. A third reason for issuing the Article is to resolve the problem of multiple absences from meetings of the board. In addition to the requirement for a balance between reward and the number of meetings attended by members, in order to put pressure on the members of the board not to miss meetings, the Article gives the right to the AGM to terminate the membership of a member who has been absent for three consecutive meetings without a valid excuse. The proposed Article does not require the board of directors to include this on the agenda, but makes it optional if the board wants to recommend this to the AGM, and this may weaken the impact of this Article in practice.

It is clear that the law in Saudi Arabia is trying to impose limits on the remuneration of the board of directors but is leaving companies to decide for themselves how to set these limits without any additional guidance or requirements, other than the fact that the new proposal

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[62] A Albaloy, "*Shura'* vote to drop the 10% bonus for members of corporate boards", *Al Riyadh* (Riyadh, 26 January 2011) Available at: <http://www.alriyadh.com/2011/01/26/article598363.html> accessed 30 August 2013.

[63] S Alarfaj, "Economists demand the setting of remuneration of the members of the boards of companies according to their efforts", *Al Riyadh* (Riyadh, 15 February 2011) Available at: <http://www.alriyadh.com/2011/02/15/article604937.html> accessed 27 August 2013.

requires a symmetry between the reward and the sessions attended by the members of the board of directors.

The law is right to impose a limit on the maximum level of remuneration in order to protect the interests of minority shareholders as in many cases the majority shareholders are the company directors. The new proposed maximum level is very high compared with the amount of work that is done in the board room as well as compared to the average level of wages and salaries in Saudi Arabia.[64] The law has not imposed any requirements concerning how the remuneration of the board members is set around the maximum level and what justifies it being at a certain level. Some listed companies state in their Constitution the amount of remuneration that board members and the Chairperson deserve for their services regardless of their efforts. This has led to the reward mechanism being seen as more like an acquired right or an annual custom.[65]

According to Adal Alsaramy, the lucrative remuneration earned by members of corporate boards has contributed to membership turning into an activity that is highly sought after by everyone, regardless of their eligibility and competence.[66] However, it is also argued that imposing an upper level will restrict companies wishing to attract talent to the boards of joint-stock companies. The second argument is probably true if the amount of remuneration of executive directors is included in the limit.[67]

The law has stopped short of restricting the rules to non-executive directors and excludes executive directors, as their total remuneration as executives should include and cover their service on the board if they are appointed to it. Such a law has probably contributed to and led to some companies establishing a unitary non-executive and independent board of directors to hide the remuneration of executive directors and avoid the requirement to hold a

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[64] There is no requirement for a general minimum wage; however, the government imposed minimum wages in some sectors and a proposal was reported on 5/June/2013 in *Al Riyadh* which suggests a minimum wage of 75,881 Saudi riyals. Available at: <http://www.alriyadh.com/2013/06/05/article841054.html> accessed 26 August 2013.

[65] MF Alomran, "Senior executives remuneration again!!" *Aleqtisadiah* (Riyadh, 15 March 2011) Available at: <http://www.aleqt.com/2011/03/15/article_514917.html> accessed 2 September 2013.

[66] Alarfaj (n 63).

[67] A Alnafa, "Shura Council places a higher ceiling on directors' remuneration", *Al Riyadh* (Riyadh, 1 April 2011) Available at: <http://www.alriyadh.com/2011/04/01/article619269.html> accessed 2 September 2013.

shareholder vote on executive remuneration which tends to be very high and can cause shareholder outrage. Alomran acknowledges that:

> *A large number of companies disclose in detail the amount of remuneration paid to the members of the boards of directors, but the disclosing of the remuneration granted to senior executives finds them using the method of generalization rather than detail; it became apparent with some companies that they manipulated the list of senior executives by hiding the real names of senior executives and showing the names of the least important executives to avoid revealing the huge value of the remuneration paid to the true senior executives!*[68]

Such boards, in my view, do not comply with the best practice of corporate governance and also violate the obligatory or mandatory paragraph (C) of article 12, which states that "The majority of the members of the Board of Directors shall be non-executive members".[69]

In addition, such a board of non-executive directors, if established in a one-tier board system,[70] would lack effectiveness and proper communication with the company's management. The reason is that for non-executive directors to be effective, they need the information that executives have about the company and its affairs to enable them in effective participation and monitoring. Without the presence of executives as members of the board and the absence of any requirement that obliges them to attend board meetings and provide the necessary information to the non-executive board members,[71] the board is ineffective. Therefore, it can be said that the law has left the remuneration of executives unregulated other than in relation to the disclosure and voting on the remuneration of executives who are members of the board. This has led the CMA as the security regulator to introduce some regulation to its CGRs, which will be discussed in the next section.

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[68] MF Alomran, "Misconception of remuneration!" *Aleqtisadiah* (Riyadh, 28 December 2011) Available at: <http://www.aleqt.com/2011/12/28/article_611116.html> accessed 10 July 2013.

[69] CGRs, Article 12(c).

[70] All Saudi listed companies have one board and Article 66 of the Companies Law asserts the need for the establishment of a board of directors for public companies.

[71] The Corporate Governance Regulations article 11(g) requires on the basis of comply or explain that the board of directors ensures that sufficient information about the company is available to all members of the board of directors generally, and, in particular, to the non-executive members, to enable them to discharge their duties and responsibilities in an effective manner. However, this requirement does not apply to executive directors unless they are a member of the board.

Before moving on to this discussion, it is worth noting that on 3 May 2010 SAMA issued a circular to all banks operating in Saudi Arabia to remind them that they had to:

> *fix the remuneration and attendance fee of their Board members in an Article and disclose all the amounts paid to them during a financial year in their Annual Report. Furthermore, the remuneration of Audit Committee members as determined by the Board of Directors should compare reasonably with the remuneration paid to other Board members. The remuneration of the chairmen and members of the Board of Directors of banks has also been fixed at a minimum of SR 240,000 and a maximum of SR 360,000 per person per annum plus SR 3,000 for attending each meeting, which is subject to proper disclosure and provided that the total remuneration so paid shall not exceed five per cent of the net profit. Banks should ensure compliance of these instructions and, if required, amend their Bye-laws/Articles to make them consistent therewith.*[72]

Despite the fact that this circular represents an intervention in the banks' internal matters, in which SAMA has no power to intervene, and since the banks must be in the form of a joint-stock company[73] governed by the rules of CL, SAMA's power and mandate do not give it the right to amend a Law issued by a Royal Decree.[74] Thus, this circular represents an overreach of SAMA's powers and the banks are not obliged to obey.

7.3.2 The remuneration of executive directors

A decision-making body responsible for deciding the level and structure of remuneration, disclosure requirements, shareholder power and other rules or guidelines assisting the decision-making body are the tools best suited for controlling remuneration practices, as this subsection will now discuss in detail.

7.3.2.1 The decision-making body

Article 15 of the CGRs obliges listed companies to set up a committee named the "Nomination and Remuneration Committee". This should be mainly composed of or have a

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[72] Letter From SAMA to All Banks (3/May/2010) Available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/Rules/Documents/Compensation%20Practices/SAMA%20Circular%20on%20Compensation%20Practices.pdf> accessed 7 September 2013.

[73] Banking Control Law 1966, Article 3.

[74] Basic Law of Government, Article 70.

sufficient number of the non-executive members of the board of directors,[75] the reason being that the CGRs see the issue of deciding remuneration as a source of conflicts of interest.[76] However, the CGRs have stopped companies being obliged to have a fully non-executive remuneration committee with some independent directors¸ which has resulted in the involvement of executive directors in remuneration committee membership. The Corporate Governance Principles issued by SAMA are more precise on the issue of the composition of the remuneration committee, specifying that the board appoint a minimum of three members to sit on the committee, two of whom must be independent members. The Rules on Compensation issued by SAMA clearly request banks to set up a remuneration committee of non-executive members and preferably independent members,[77] adding that this committee should work closely with the bank's risk management committee.[78] Moreover, the members of the remuneration committee should have the knowledge, skills and expertise necessary to take independent and impartial decisions on compensation policies and practices, and the incentives created for managing risk, capital and liquidity.[79] However, all of these instruments have stopped short of requiring the setting up of solely a remuneration committee, as practices and regulation aspects have combined the work of the remuneration and nomination committees, which results in a weakly designed remuneration policy which does not reward performance but instead sets a high fixed payment.

Article 15 of the CGRs has elaborated the role of the committee with regard to nominating people to the board. However, the role of the committee with regard to setting the level and structure of remuneration is simply to "[d]raw clear policies regarding the indemnities and remunerations of the Board members and top executives; in laying down such policies, the standards related to performance shall be followed".[80] This issue has been left to the boards of the companies, who must explain the duties, the duration and the powers or mandate of each committee, and the manner in which the board is to monitor its activities.[81] According to

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[75] CGRs, Article 13(c).

[76] ibid Article 13(c).

[77] SAMA, *Rules on Compensation Practices*, 2.3(i).

[78] SAMA, *Rules on Compensation Practices*, 2.3(v).

[79] SAMA, *Rules on Compensation Practices*, 2.3(iv).

[80] CGRs, Article 15(c/6).

[81] ibid Article 13(b).

Article 13(b), "the board shall approve the bye-laws of all committees of the Board, including, *inter alia*, the Audit Committee, Nomination and Remuneration Committee". Therefore, it can be argued that the CGRs have effectively recommended[82] the restriction of the role of the remuneration committee to that of an advisory body to the board rather than a decision-making body that is able to solve the conflict of interests, given that the board takes decisions with regard to the remuneration of executive directors in spite of the fact that the CL allows the board to delegate certain responsibility to some of its members or to appropriate others.[83] The reason why the board is composed of a majority of non-executive directors and, therefore, the issue of a conflict of interests probably ceases to be a significant concern if the board takes the lead regarding decisions in this context.

This issue is similar in the case of banks, since SAMA has the ultimate responsibility of supervising and regulating their activities. SAMA's Rules on Compensation have clearly stated that "[d]espite the establishment of a Board Compensation Committee, the Board shall be ultimately responsible for promoting effective governance and sound compensation practices".[84] The Principles of Corporate Governance for Banks Operating in Saudi Arabia issued by SAMA state that "[t]he use of committees of the Board aims to enhance independent opinion on issues where there is potential conflict of interests, and assist in providing advice in various areas".[85] The reason for this is that boards in the banking sector are composed of a majority of non-executive directors and, in some cases, a wholly non-executive board and, therefore, the issue of a conflict of interests does not arise when the board takes the lead on decisions in this regard.

The Rules on Compensation issued by SAMA clearly define minimum requirements for the board in relation to remuneration. These are as follows: the overall design and oversight of the compensation system; reviewing and approving the remuneration policy and any revision or update to it on the recommendation of the Compensation Committee; reviewing and approving the recommendations of the Compensation Committee regarding the level and

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[82] The term "recommended" is used here is that Article 13 of the CGRs is applied on a "comply or explain basis" in accordance with Articles 1(b) and (c).

[83] Companies Law 1965, Article 73.

[84] SAMA, *Rules on Compensation Practices*, 2.1(i) and (ii).

[85] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia*, Principle 58.

composition of the remuneration of the key executives; and ensuring that the management has put in place elaborate systems and procedures and an effective oversight mechanism to ensure compliance with these Rules and the P&S.[86]

The Rules on Compensation issued by SAMA also clearly define minimum requirements for the remuneration committee in relation to remuneration, which are as follows: overseeing the design and operation of the remuneration system on behalf of the board of directors; preparing the remuneration policy and placing it before the board for approval; periodically reviewing the remuneration policy either on its own decision or when advised by the board, and making recommendations to the board regarding amendments to or updating of the policy; periodically evaluating the adequacy and effectiveness of the remuneration policy to ensure that its stated objectives are achieved; evaluating practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain; making recommendations to the board on the level and composition of the remuneration of key executives of the bank; determining the bonus pool based on the risk-adjusted profit of the bank for payment of performance bonuses; reviewing compliance of the remuneration policy with the Rules of SAMA and the P&S; and reviewing the implementation of the policy on at least a half-yearly basis to ensure achievement of its stated objectives and performing any other related tasks to comply with the regulatory requirements.[87]

In addition to these, the Principles of Corporate Governance for Banks Operating in Saudi Arabia add that the remuneration committee should ensure that the amount of remuneration is consistent with the prevailing national practices and supervisory regulations, and that it is aligned to the interests of depositors, shareholders and the bank's long-term strategic objectives. The committee shall ensure that the incentive system is periodically reviewed and does not induce participation in high-risk transactions to achieve short-term profits and that it complies with the bank's risk policy as approved by the board.[88]

The establishment of the remuneration committee is to enable the board to perform its duties in an effective manner and obtain opinions and advice from specialists in these committees

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[86] SAMA, *Rules on Compensation Practices*, 2.1.

[87] SAMA, *Rules on Compensation Practices*, 2.3(ii) and (vi).

[88] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia*, Principle 74.

and not to take decisions on behalf of the board, as there is no conflict of interests when the board takes the lead in deciding on the issue as most boards' members are non-executives and the regulation does not prevent management from sitting on the remuneration committee.

7.3.2.2 Disclosure requirement

The disclosure requirement is explained in the CL, CGRs, Corporate Governance Principles and the Compensation Rules. CGRs require disclosure for all board members (executive and non-executive) and should include the mandate of the remuneration committee, the name of the members of the committee,[89] and the amount of the remuneration paid. However, there is no requirement to disclose the remuneration policy itself.[90]

The disclosure should take the form of what has been paid for board service and what has been paid for other services as an executive.[91] The CGRs have asserted this requirement by asking for disclosure of the Chairperson and members of the board of directors and added to it by requiring disclosure for the five executives who have received the highest compensation and remuneration from the company. The CEO and the CFO must be added to the list if they are not among the top five.[92] The wording of paragraph (e) is not consistent with the requirement of the CL, as it does not ask companies to divide the remuneration of the members of the board between remuneration for board services and remuneration for being an executive, especially when one or more of the board executives is not among the top five.

The practice of disclosure has not been consistent which led the CMA to recommend that companies use a three-column schedule: the first covering non-executive directors, the second, executive directors for board service, and the third, the top five to seven executive directors. However, despite this recommendation, companies can divide their disclosure into two columns covering the requirements of two subparagraphs of Article 9(e), as was the case

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[89] Article 9 (d) stipulates that disclosure in the board of directors' report shall include "A brief description of the jurisdictions and duties of the Board's main committees such as the Audit Committee, the Nomination and Remuneration Committee; indicating their names, names of their chairmen, names of their members, and the aggregate of their respective meetings".

[90] CGRs, Article 15(c)(6).

[91] Companies Law 1965, Article 74.

[92] CGRs, Article 9(e).

for some board of directors' reports in 2013.[93] Other companies did not use the schedule at all and disclosed the information required by stating the numbers only.[94] Some companies did not specify the number of executives to whom the remuneration for the top executives has been paid,[95] as this number can range from five to seven.[96] Moreover, some companies report and disclose in detail providing names whereas others disclose the total amount of money paid without identifying individuals. The schedule design also varies: some companies use the Article nine definition of remuneration meaning salaries, allowances, profits and any of the following: annual and periodic bonuses related to performance; long- or short-term incentive schemes; and any other rights; others do not.[97]

Moving to the requirement of disclosure in the banking sector, SAMA requires banks to provide further disclosure through its Rules on Compensation. This disclosure should be in the form of aggregate quantitative information on remuneration paid to various categories of employees and their number, with a breakdown of fixed and variable components stating the forms of payment. SAMA wants banks to categorize employees into five groups, including key executives whose appointment is subject to no objection by SAMA, risk takers, employees engaged in control functions, outsourced, and other employees. All listed banks have followed this criterion despite the fact that they could reduce the groups in accordance with the Rules on Compensation, which states that "[t]he categorization of employees will include key executives whose appointment is subject to no objection by SAMA, employees engaged in control functions, outsourced, etc".[98] However, officials described Saudi banks as being "obedient and not making a lot of trouble to the regulators".

SAMA's rules also require some qualitative disclosure. This relates to:

> *The salient features of its Compensation Policy and its implications for the bank's risk profile as well as the composition and the mandate of the*

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[93] For example: SABB, *Directors' Report 2013*.

[94] For example: SAMBA, *Directors' Report 2013* & Arab National, *Directors' Report 2013*.

[95] For example: CHEMANOL, *Directors' Report 2013* and SABIC, *Directors' Report 2013.*

[96] This range relates to the wording of the article which obliges companies to disclose the remuneration of the five executives with the highest remuneration, adding the CEO and CFO if they are not among these, which has led to different practices among companies.

[97] CGRs, Article 9(e).

[98] SAMA, *Rules on Compensation Practices*, 6(i).

> *Compensation Committee. Such disclosure should also provide information on the overall design of the compensation system and the manner of its implementation, description of the manner of risk adjustment, linkage of compensation with actual performance, deferral policy and vesting criteria, parameters for allocating cash versus other forms of compensation, and achievement of the stated policy objectives.*[99]

In this context, the practice of the listed banks is diverse and when searching the 2012 Annual Reports no information was found regarding the description of the manner of risk adjustment, linkage of compensation with actual performance, deferral policy and vesting criteria, parameters for allocating cash versus other forms of compensation, or achievement of the stated policy objectives, with most of them using a brief general statement to provide their qualitative information. In my opinion, the reason for this is that variable remuneration is a small part of the total remuneration of banks' employees and hence it does not induce excessive risk-taking. An official also explained that the reason for applying the international P&S is to fulfil Saudi Arabia's obligations as a member of the G20 and not because the regulator is convinced that such rules are needed since Saudi banks did not have a culture of excessive bonuses.[100] However, some banks have provided a brief description of how their financial and non-financial objectives are used to calculate variable remuneration without providing more detail on exactly what these objectives are and how variable pay is linked to the achievement of such objectives. In my opinion, SAMA needs to help banks to meet the regulatory requirements.

I believe there should be a regulatory instrument that organizes the way in which companies disclose their remuneration to guarantee consistency and eliminate divergence. In addition, the CMA should improve the schedule and incorporate this into the CGRs as a mandatory requirement for listed companies who need to disclose more qualitative data particularly those relating to their remuneration policy. SAMA should assist banks to disclose qualitative information about their remuneration policy since they provide generalizations which are unhelpful in assessing the degree of their compliance with the rules.

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[99] SAMA, *Rules on Compensation Practices*, 6(ii).

[100] There are 198 key executives in the 11 listed banks in 2012; their fixed pay was 294 million Saudi riyals and their variable pay was about 164 million Saudi riyals.

7.3.2.3 Shareholder involvement

Shareholder rights have been explained in the CL 1965 and are clarified in the CGRs when they attend the annual meeting of the General Assembly. There are three types of General Assembly, depending on the topics being discussed. The first, the Constituent Assembly, is required for the issuance of the Minister of Trade and Industry's decision to declare incorporation.[101] This assembly is responsible for the following: verification of the underwriting of all capital in accordance with the provisions of the Companies Law with minimal capital and the deserved amount of stock value; stating the final texts of the company's constitution (noting that this Assembly has no power to introduce substantial changes or modifications); appointing the members of the first board of directors for a period not exceeding five years and the first auditors if they have not been appointed in the company's articles of association and/or the company's Constitution; and deliberation of the founders' report of the expenses necessitated by the establishment of the company.

The second type of General Assembly is the Extraordinary General Assembly.[102] It has the power to approve a reduction of the company's capital, as well as amendments to the company's Constitution with the exception of the following matters: amendments that would deny the fundamental rights of the shareholder, which are derived from the CL and the company's articles of association and Constitution (the provisions of this Regulation or of the company for which the rights are enshrined in Articles 107 and 108); amendments that would increase the financial burden on shareholders; modifying the purpose of the company; transferring the headquarters of the company outside the Kingdom; and an amendment of the nationality of the company. In addition, this General Assembly has the right to pass resolutions on matters falling within the terms of reference of the AGM and with the same conditions and restrictions applied to such matters.

The third General Assembly is the Ordinary General Assembly or the AGM, which is responsible for all other matters relating to the company with the exception of the matters that would fall within the remit of the Extraordinary General Assembly. An AGM must be held at

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[101] Companies Law 1965, Articles 63 and 64.

[102] Companies Law 1965, Article 85.

least once a year, during the six months following the end of the financial year of the company.[103]

Shareholders who have the right to attend the meetings also have the right to discuss and raise relevant questions with board members and the external auditor related to the issues listed in the agenda and vote on them. To increase the accountability of the board, a ministerial decision in 1992 required companies to present the remuneration of the board of directors to the General Assembly at the AGM, and it became the norm or common practice for Saudi listed companies to table a resolution for a shareholder vote on the remuneration of the board of directors for their services to the board.

Despite the fact that listed companies must disclose information on the remuneration of their executive directors, there is no requirement for a shareholder vote, the reason being that remuneration practices do not represent a concern for the CMA which needs the involvement of shareholders. Voting on the share grant to directors and executives is not required unless this is included in the issue of a securities application for registration and admission to listing and is not already listed to employees through an employee share scheme.[104] However, when a share grant involves issuing new shares, the company must obtain the approval of an Extraordinary General Assembly as it involves an increase in the capital of the company. For a valid meeting of an Extraordinary General Assembly, the number of shareholders who attend must represent 50 per cent of the capital of the company unless the company's Constitution states a higher percentage. If the company fails to secure the required percentage of attendance, it can invite shareholders to a second meeting at which shareholder attendance must represent 25 per cent of the capital for it to be considered valid. The decision to raise or lower the capital of the company must secure a vote of 75 per cent of the shares represented at the meeting.[105] However, this voting requirement does not give shareholders a say on pay, but simply on a change to the capital structure by issuing new shares.

Although shareholders have the right to ask questions in the AGM regarding the items listed in the agenda,[106] executive remuneration does not feature amongst these issues, as by law

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[103] Companies Law 1965, Article 85.

[104] Capital Market Authority, *Listing Rules*, Article 27.

[105] Companies Law 1965, Article 92.

[106] Companies Law 1965, Article 94.

companies tend to list the remuneration of the board of directors and hold a shareholder vote on this. As Aljaber explained, it is possible that listing executive remuneration is not required because joint-stock corporations have not succeeded in transferring power to shareholders, since this became a means of concealing the control by business leaders in the absence of shareholders attending General Assemblies. Consequently, the board members have a monopoly of authority and have assumed control of the project.[107] It is true that there have not been any reports of listed companies having their directors' remuneration reports voted down.

In my opinion, voting on directors' remuneration reports should be abolished as such a vote can give a kind of legitimacy which can prevent later litigation. Instead, both the quantitative and qualitative information provided to shareholders via the reports on board member remuneration and on the most highly remunerated executives should be improved and they should be listed on the AGM agenda for discussion and questions without voting. This is similar to the Winter Report recommendation,[108] which stated that remuneration should only be debated in the AGM rather than being tabled for a vote. This opinion in the report was probably influenced by the different ownership structures in the European states (as it is more likely to have a nil or minimal effect on blockholding structure ownership).[109] With regard to the ownership structure of Saudi listed companies, about one third of the market's total capital is owned by the government (including the two government pension funds), and another third is tied up in strategic holdings (founding families). Most of the remaining shares (the required free float is set at 30 per cent) are in the hands of Saudi retail investors, who are responsible for 93 per cent of trading activities.[110]

7.3.2.4 The structure of remuneration: rules or guidelines concerning remuneration practices

Generally, listed companies do not need to follow special requirements when designing their remuneration policies. However, joint-stock companies are precluded from granting their

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[107] Aljaber (n 4) 286.

[108] This recommendation was discussed under sections 5.2.1 and 5.2.3.

[109] The High Level Group of Company Law Experts, *Report on a Modern Regulatory Framework for Company Law in Europe* (4 November 2002) 65 (Winter Report).

[110] World Bank, *Report on the Observance of Standards and Codes (ROSC): Corporate Governance Country Assessment: Kingdom of Saudi Arabia* (February 2009) Available at: <http://www.worldbank.org/ifa/rosc_cg_saudia_arabia.pdf> accessed 22 July 2013.

directors a cash loan of any kind or insuring any loan held by one of them with third parties.[111] The general requirement for all listed companies to design clear policies regarding the indemnities and remuneration of the board members and top executives takes into account the use of performance-related criteria.[112] However, the CMA has no clear method of assessing compliance with this obligatory requirement, especially when companies are not required to disclose such information or list it among the issues on the AGM agenda for discussion and/or voting.

However, this is not the case for banks, as the SAMA Rules and Corporate Governance Principles are more active and intrusive than the CMA CGRs. The Principles of Corporate Governance for Banks Operating in Saudi Arabia add that the remuneration committee should ensure that the amount of remuneration is consistent with the prevailing national practices and supervisory regulations, and is connected to achieving the interests of depositors, shareholders and the bank's long-term strategic objectives.[113] Complying with this requires banks to use a survey to establish the prevailing practices within the Saudi banking sector. However, it is unclear how banks will comply with the requirement to take into account the interests of both shareholders and depositors regarding remuneration practices, especially when they may have different interests. Shareholders want executives to take more risk at the expense of depositors in order to increase their profits. Depositors, who do not have any explicit form of guarantee for their deposits nor gain interest on their deposit[114] want their deposit to be secure and available upon request. In addition, directors are required to represent shareholders as a whole and work on behalf of their interests, not those of depositors, and would be liable if they fail in their duties.[115]

Due to the international P&S, the SAMA Rules on Compensation have been more active on the issue of structuring and measuring performance-based remuneration. With regard to the structure of remuneration, banks must first have a written remuneration policy approved by

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[111] Companies Law 1965, Article 71.

[112] CGRs, Article 15(c)(6).

[113] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia*, Principle 74.

[114] This is the case for most depositors if their accounts are held by an Islamic bank, due to the prohibition of interest in accordance with *Shari'a* rules.

[115] Companies Law 1965, Article 77; CGRs, Article 11(d).

their board of directors. The remuneration policy should cover all aspects of the remuneration, and in order to ensure that risks related to remuneration are being prudently managed, it should be designed to attract and retain quality staff with sufficient knowledge, skills and expertise to conduct the business of the bank effectively.[116] The Rules do not go far enough as to recommend that the remuneration policy should provide motivation to employees, not only in retaining and attracting them. Nonetheless, the remuneration policy should at least state the objectives of the remuneration, which should link pay to performance, taking account of all types of risks. It should cover all levels and categories of employees including board members and key executives; and detail the composition of the remuneration, which should include cash, equity and other non-cash benefits, major perquisites, etc.[117]

Given that SAMA also wants the remuneration structure to promote effective risk management and achieve its objectives, it also requires banks to have the remuneration of people who work in control functions, such as risk management, internal auditing, compliance, financial control and internal control, set by people who have no connection with the business areas monitored by them to ensure objectivity and independence.[118] However, SAMA has tried not to require a full separation of the remuneration of staff working in control functions from the business areas they oversee which need to be carefully monitored, since on the one hand if the remuneration of people working in control functions depends on the performance of the business areas they oversee, they might allow some kind of excessive risk-taking to inflate their own remuneration; on the other, if their remuneration is completely separate, they might hinder the profitability of the bank by being conservative.

SAMA has asked banks to use *ex-ante* and *ex-post* risk adjustment measures. As with the P&S, SAMA wants banks to take into account all types of risks when determining the remuneration of an employee. However, it did not fully implement the P&S *ex-post* measures as the Rules do not provide much information on malus, claw-back, deferral and payment by instrument. However, in this case, the P&S, especially Standard 6, can be relevant to all banks, as SAMA asks banks to apply this to senior executives and MRTs. However, such

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[116] SAMA, *Rules on Compensation Practices*, 2.2(ii) and (iii).

[117] SAMA, *Rules on Compensation Practices*, 2.2(iv).

[118] SAMA, *Rules on Compensation Practices*, 5(iv).

rules are intended to be restricted to employees who take excessive risk and have most or half of their remuneration in the form of variable pay; when they receive most of their remuneration as fixed pay they should be excluded from the application of the rules on the structure of remuneration.

SAMA has also agreed with the P&S on the issue of share grants as it requires banks to have separate dates for vesting which should be at least three years after the date they are granted and shares must also be subject to a share retention policy.[119] SAMA has asked banks to decrease variable remuneration when a bank experiences a negative financial performance as well as reducing the payout of previously earned and using clawback arrangements.[120] Such a vague and possibly illegal requirement[121] can put banks and employees under pressure. Banks might face litigation when claiming back variable remuneration without evidence that the employee received it by misstating or deceiving the bank. Employees may be put under pressure if the bank claims back a variable remuneration paid to them just because it has experienced a negative or subdued financial performance.

With regard to the performance measure, the Rules ask banks to have a Performance Measurement System to evaluate and measure the performance of employees.[122] However, as banks are not required to submit or disclose any information about the operation of such a system, it is difficult to obtain information about this area. In setting up such a system, those setting the Rules need to see a clear and documented process for performance that avoids undue influence and conflicts of interest, is transparent to the employees concerned, and the bank's overall performance.[123] However, this does not preclude discretion, as "managerial judgement" can be used to supplement the determination of the performance of individuals for their performance-based remuneration; in general the performance should be based on longer-term performance, not based solely on the current year's performance, especially for senior-level employees.[124] Financial and non-financial measures should be used, the latter

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[119] SAMA, *Rules on Compensation Practices*, 5(vi) and (vii).

[120] SAMA, *Rules on Compensation Practices*, Appendix (1).

[121] SAMA cannot ask banks to claim back remuneration already lawfully paid.

[122] SAMA, *Rules on Compensation Practices*, 3(i).

[123] SAMA, *Rules on Compensation Practices*, 3(ii) and (vi).

[124] SAMA, *Rules on Compensation Practices*, 2.3(vi) and (v).

giving due weight to adherence to a risk management framework, implementation of internal controls, and compliance with the regulatory requirements. The financial measures should not be based solely on the bank's gross revenue or profit earned as risks are associated with the underlying transactions; the quality of business transacted, customer satisfaction, risk-adjusted return on capital, etc. should be taken into account.[125]

7.3.2.5 Oversight of remuneration practices by the regulators

Neither regulator has stated that it has serious concerns regarding remuneration practices, which explains the reason for the loopholes in the regulation of remuneration practices including allowing executives to sit on the remuneration committee, and combining the work of the remuneration and nomination committees. However, as part of its implementation of the international P&S, SAMA requires banks to submit a compliance report twice a year to enable it to monitor the implementation of its Rules and the P&S other than those required in the annual report, along with the terms of reference of the remuneration committee, the remuneration policy and details of the remuneration practices and the remuneration of the top 12 highest-paid employees in the form of two schedules attached to the Rules in Appendices One and Two.[126] The compliance report should provide at least information on the following: the composition of the remuneration committee, including the names, qualifications and status of each member; confirmation to the effect that all employment contracts negotiated or renegotiated after issuance of the SAMA Rules are compliant with the Rules; confirmation to the effect that the bank has formulated a remuneration policy with the approval of its board of directors; details of the measures taken to ensure compliance with the SAMA Rules and the P&S by the bank; details of the measures taken to ensure compliance of the SAMA Rules and the P&S by the local and foreign subsidiaries and foreign branches of the bank; categories of employees and their numbers to which measures are taken to implement the SAMA Rules and the P&S; listing the material changes to date in the compensation practices of the bank/subsidiaries since implementation of the SAMA Rules and the P&S; a brief description of the disclosures made in the bank's annual report with regard to the risk management framework, internal controls and compensation policy and practices; confirmation to the

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[125] SAMA, *Rules on Compensation Practices*, 2.3(iii) and (v).

[126] SAMA, *Rules on Compensation Practices*, 2.3(iii), and Appendices (2) and (3).

effect that the bank has established appropriate compliance arrangements by seeking commitment from its employees not to use personal hedging strategies or other methods to undermine the risk alignment effects embedded in their compensation arrangements; an account of any unexpected issues that have been encountered to date in the implementation of the SAMA Rules and the P&S; and details of the steps planned for the next half-year for further refinement of compensation practices.[127]

Despite SAMA's view, it is clear that excessive risk-taking is not a problem in Saudi banks, and producing a six-monthly compliance report is a comprehensive and daunting undertaking. It is not obviously apparent to me why SAMA has asked for two reports a year but the official explanation is that it wanted to monitor the situation closely initially (the first report was expected to cover the period until 30 June 2010 and be submitted within two months). When SAMA is happy with compliance in the banking sector, this requirement can be scaled back to an annual report. It also asks banks to identify and assess risks arising from remuneration policies and practices as part of the bank's Internal Capital Adequacy Assessment Plan. SAMA will also review remuneration policies and practices during its on-site visits and Supervision Review Process in the bank.[128]

SAMA Rules state that "in the case of material deficiencies", SAMA can direct the bank to rectify these deficiencies and/or may increase the capital requirements of the bank and/or impose penalties in the case of serious violations.[129] SAMA does not explain the meaning of, or what constitute, "serious violations". According to a SAMA official when a bank experiences a loss and pays a huge bonus, this can trigger the flagging up of a serious violation. Thus, it looks as if SAMA has left it to the discretion of its supervisory team to put banks under pressure if they have a prohibited type of contractual agreement with certain employees. Contractual agreements should be on a fixed basis, as guaranteed bonuses are totally prohibited[130] and SAMA intends to apply the Rules under principle-based supervision to try to assist banks. In addition to this, SAMA is unlikely in the current circumstances to use an increase in capital requirements as a disciplinary measure because the average ratio of

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[127] SAMA, *Rules on Compensation Practices*, Appendix 3.

[128] SAMA, *Rules on Compensation Practices*, 7(ii).

[129] SAMA, *Rules on Compensation Practices*, 7(iii).

[130] SAMA, *Rules on Compensation Practices*, 5(v).

capital among banks is 17 per cent, which is well above the minimum requirements of the Basel Accord.

The Rules grant SAMA the right to intervene directly in the remuneration policy of a bank and limit variable remuneration as a percentage of the total net revenues when it is inconsistent with the maintenance of a sound capital base or with risk management practices.[131] In my opinion, even if this rule were taken directly from standard three of the FSB and is similar to what the EC has advocated in its CRD IV, the right that SAMA has granted for itself is illegal and represents an intervention in a business decision by an official authority. Nonetheless, SAMA can intervene if it injects cash into a bank (as a lender of last resort) and helps the institution to get through a very difficult situation. In such cases, SAMA can even ask the bank to stop paying bonuses and variable remuneration until its money can be returned.

7.4 Conclusion

The regulatory framework for corporate remuneration practices in Saudi Arabia has two core dimensions: the first relates to members of the board (executive and non-executive) and the second involves executive remuneration. With regard to board members, the law has set the highest level of remuneration that can be paid to executive or non-executive directors but it remains silent on the issue of executive remuneration. The CGRs issued by the CMA as well as the Principles of Corporate Governance (PCG) and the Rules on Compensation Practices issued by SAMA, contain instructions to listed companies, Saudi banks and other banks operating in Saudi Arabia with regard to the issue of establishing and deciding on executive remuneration. The tools used in these instruments are general, namely independence, disclosure, and shareholder vote.

The chapter has argued that the current system is inadequate in many aspects. The Law introduced an upper limit on the remuneration of the board of directors but this limit needs to be restricted to non-executives, as the package for executives should cover their services on the board. The current Law, combined with the ministerial decision on tabling the remuneration of the board of directors for shareholder votes, has contributed to the popularity

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[131] SAMA, *Rules on Compensation Practices*, 7(iv).

among listed companies of unitary non-executive boards to avoid subjecting executive remuneration to a vote. These have proved ineffective.

The CMA was the first to introduce regulation of executive remuneration through its CGRs which introduced the establishment of nomination and remuneration committees and of disclosure requirements with the aim of controlling remuneration practices among companies. However, the CGRs allow executives to sit on the committee of their own listed company, which effectively means they can influence committee decisions by setting high remuneration levels and easy objectives for the variable element of remuneration.

Listed companies and banks need help from regulators to introduce remuneration policies that will motivate and incentivize top executives by creating a separate remuneration committees to take advantage of specialist advice and establish general guidelines. Shares should be used as part of remuneration policy.

It was established that SAMA lacks the authority and power to introduce regulations regarding corporate governance and remuneration issues, illustrating the urgency of passing an enabling law to grant it such powers.

Chapter 8 Conclusion and Recommendations

8.1 Conclusion

This thesis has focused on problems relating to remuneration practices which were highlighted by the 2007 financial crisis. As this thesis has illustrated, the problems related to remuneration are considerable; the main purpose of this work, however, has been to analyse how different regulatory bodies in the chosen jurisdictions have dealt with the problems associated with these remuneration practices, with the aim of making recommendations which will contribute to the reforms in this area in Saudi Arabia. The problems which were identified can be summarised as follows:

a. Conflicts of interest in the remuneration setting process;

b. High levels of remuneration beyond what could be explained by economic or social determinants;

c. The disconnect between remuneration and performance; and

d. A flawed structure that encourages excessive risk taking.

This section will summarise the solutions adopted by each jurisdiction for the key problems identified, with some solutions being applicable to more than one problem.

8.1.1 Conflicts of interest in the remuneration setting process

Similarities were found between the jurisdictions in dealing with conflicts of interest in general, with independence being pursued as the primary tool, with some variations in how this is interpreted.[1] Thus, the UK has recommended a balance between executives and non-executives when structuring boards,[2] further enhancing board independence by encouraging the separation of the roles of CEO and chairperson,[3] and reducing the guaranteed tenure

[1] See sections 3.3.1, 5.2.3, 5.2.4, and 6.3.2.

[2] See section 3.3.1.1.

[3] See section 3.3.1.1.

periods of executives to reduce their influence on both the board and the company.[4] With regard to the US approach to independence, companies there have a majority of non-executive members on their board of directors but have eschewed separation and reducing the guaranteed tenure period.[5] Some institutional shareholders have started to push for reduced tenure but this is not legally binding as in the UK. The EU has refrained from interfering in the board structure as there are differences between member states. However, it emphasises the importance of electing sufficient numbers of independent non-executive directors or supervisory directors to ensure any conflicts of interest are dealt with effectively. Therefore, independence is sought via a remuneration committee in a one-tier board structure, and/or the supervisory board in a two-tier structure to take responsiblility for setting the remuneration for key executives to sovle the conflict of interests inherent in the process.[6] The Saudi approach to board structure is that the majority of the members of the board shall be non-executive directors. However, in practice many companies establish a unitary board of non-executive directors.[7] Such a board cannot be expected to be effective.[8]

The UK, the EU and the US also recommend the establishment of a remuneration committee with an identified minimum role.[9] However, the composition of this committee differs somewhat. While the UK and the US appreciate the importance of the committee being composed solely of independent directors,[10] the EU recommends instead that the committee should be comprised of non-executives with the majority being independent.[11] In Saudi Arabia, companies are encouraged to establish a committee, but the CGRs and company practice means that they tend to combine the work of the remuneration and nomination committees within one committee, which results in a poorly structured remuneration policy. The CGRs do not preclude executives from sitting on the committee of their own companies,

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[4] See section 3.3.1.2.

[5] See sections 3.1.1.1 and 6.4.1

[6] See sections 5.2.3 and 5.2.4.

[7] See section 7.3.1.

[8] See section 7.3.1.

[9] See sections 3.3.1.3.1, 5.2.4 and 6.3.2.2.

[10] See sections 3.3.1.3.2 and 6.3.2.1.

[11] See sections 5.2.3 and 5.2.4.

which can result in a conflict of interest when setting the remuneration policy.[12] The CGRs do not specify sufficient minimum requirements regarding the role of the committee.[13]

The operation of the committee should be supported by guidelines from the regulators and access to advice and information to enable it to reach an informed decision that serves shareholder interests. Moreover, when the services of a consultant are used by the committee, attention should be paid to the conflict of interest this may entail if he or she has any other relationship with the firm.[14]

8.1.2 High levels of remuneration

Solutions to this problem, which is viewed as a major issue, are similar to those pertaining to the disconnect between pay and performance.

Since US remuneration levels are much higher than those in the UK or elsewhere, tax was used to control levels of remuneration but this has not achieved the desired outcome, as companies use the regulatory minimum as a benchmark. Thus, while some have reduced their fixed pay, others have raised their remuneration levels to legal requirements and then added variable remuneration.[15] The Saudi approach to controlling levels of remuneration is different from that of the US. Since there is no income tax in Saudi Arabia, an upper limit or cap on the maximum level of the remuneration of board members is set by law and this only concerns board services. However, this upper limit has been heavily criticised.[16]

In the UK and EU, there are no specific measures to tackle the problem of high levels of remuneration; instead, extensive disclosure and shareholder vote has been viewed as a better alternative, with institutional shareholders and their representatives being relied upon to affect the changes that started to be introduced in 1995 with the Greenbury Report.[17]

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[12] See section 7.3.2.1.

[13] See section 7.3.2.1.

[14] See sections 3.3.1.3.3, 5.5.1.1 and 6.3.2.3.

[15] See section 6.1.

[16] See section 7.3.1.

[17] See sections 3.3.3.1, 5.2.3 and 5.2.4.

Disclosure has also been used in the USA, with voting being introduced in 2010 by the Dodd-Frank Act.[18]

8.1.3 The disconnect between remuneration and performance

As with the previous problem, shareholder vote and disclosure are seen as the main solutions for ensuring that remuneration committees structure remuneration policies in a way that rewards performance. The UK, the EU and the USA rely on institutional shareholders to make changes by getting involved in the remuneration process to ensure fairness and competitiveness for shareholders and executives.[19] Although the details regarding disclosure vary, the general aim in the UK, the EU and the USA is to provide sufficient quantitative and qualitative information to facilitate shareholder voting, and market and media coverage.[20]

In Saudi Arabia, company practices are inconsistent in presenting the quantitative disclosure for remuneration and the regulation does not forbid this, so a regulatory intervention is needed to solve the problem of ambiguity in disclosure practices. In addition, there is no requirement for companies to provide qualitative information concerning the relationship between the remuneration policy and company performance. So, shareholders do not know how the company arrived at granting the executives a particular amount of variable remuneration.[21]

The USA introduced an advisory vote on company remuneration policy in 2010,[22] whilst the UK changed from this system (introduced in 2002) to a compulsory vote on this policy and an advisory vote on the implementation of remuneration policy, both of which form part of the annual remuneration report.[23] In the EU, shareholder voice became an element in the reform of remuneration regulation following the 2004 recommendation although this was not supported by the Winter Report; it was left up to individual member states to decide whether to make this an advisory or mandatory vote. However, a new development at EU level will

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[18] See sections 6.3.1 and 6.3.3.

[19] See sections 3.3.3.2.2.1, 5.5.1.1 and 6.1.

[20] See sections 3.3.3.1 and 5.2.4.

[21] See section 7.3.2.2.

[22] See section 6.3.3.

[23] See section 3.3.3.2.

follow the UK approach in mandatory voting on the remuneration policy and an advisory vote on the implementation of the policy.[24]

In Saudi Arabia voting is restricted to the remuneration of board members.[25] There is no requirement to vote on top executives' remuneration, unless they are board members.[26] In my view this difference in treatment has led many companies to avoid appointing top executives to the board of directors in order to avoid the remuneration report being rejected. However, I do not support the extension of voting and believe that voting should be abolished, as a vote of this type can serve as a legitimizer for excessive payment, preventing subsequent litigation on the grounds that the payment was approved by shareholders. Instead, both the quantitative and qualitative information provided to shareholders via the reports on board member remuneration and on the most highly remunerated executives should be improved. Moreover, these should be listed on the AGM agenda for discussion and questions without voting, in line with the Winter Report recommendation.[27]

The practice of mandatory vote on giving share grant and share options to directors and executives was supported in the UK, the EU, and the US as it is related to the change in capital structure. In Saudi Arabia, there is no requirement for voting on either share grants or share options, unless the grant involved increases the capital of the company.[28]

8.1.4 A flawed structure that encourages excessive risk taking

Saudi Arabia, the UK, the EU and the USA have all implemented the P&S, but the EU and the UK were stricter in their implementation of these,[29] even before the introduction of the CRD IV, which is recognised as the most demanding remuneration practices regulation in the financial sector.[30] US regulation is less demanding than the P&S since it allows greater

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[24] See section 5.2.4.

[25] See section 7.3.1.

[26] See section 7.3.2.3.

[27] See section 7.3.2.3.

[28] See section 7.3.2.3.

[29] See sections 4.31 and 5.5.1.2.

[30] See section 5.5.2.

discretion to the firms affected and it does not specify a percentage for deferral payments.[31] However, in keeping with the P&S, the UK, the EU and the US want to see *ex-ante* and *ex-post* measures to ensure remuneration does not encourage excessive risk taking.[32] With the exception of the UK, the EU adopted the CRD IV which caps the maximum ratio between the fixed and variable payment, believing this to be the best way of reducing excessive risk taking.[33] Although it is opposed to this ratio, the UK has implemented it in accordance with its obligations as an EU member state.[34] At an international level the P&S introduced some of the best practice in the decision-making process for financial services remuneration by recommending independence in decision making either via remuneration committees for large institutions or independent board and disclosure for others.[35] In addition, national authorities are encouraged to be more intrusive in assessing remuneration practices and ensuring that they do not encourage excessive risk taking.[36]

8.2 Recommendations

The main objective of this thesis has been to study the laws and regulations related to remuneration practices in order to make recommendations which will help to inform the process of reform of this area in Saudi Arabia. It is therefore recommended that:

a. With regard to the remuneration of the members of the board and top executives:

- The upper limit for remuneration for board services is set at a very high level, making the appointment to the board highly attractive for influential people who might not have the required skills and experience to run the company.
- Companies should be required to explain to the shareholders how their remuneration has been set and what kind of performance measures they used and how these measures related to the payments made.

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[31] See sections 6.5.3 and 6.5.4.

[32] See sections 4.3.2.3.2.5, 5.5.2.4.3 and 6.5.3.1.

[33] See section 5.5.2.4.2.

[34] See section 4.4.2.

[35] See section 2.3.3.2.

[36] See section 2.3.3.5.

- The profit share method of distributing remuneration to the board members should be abolished since there is an upper limit on the maximum remuneration that can be paid to a board member.
- The upper limit on remuneration should be restricted to non-executive directors. Remuneration for executive directors should cover their services on the board, removing the need for separate remuneration.
- A review of the role of non-executive directors is needed to make it more effective, and I believe the UK's efforts are a good example in this respect.[37]

b. For the remuneration committee:

- The regulation should require companies to establish a separate specialised remuneration committee setting minimum requirements for the committee's responsibilities. The practice of combining the work of the remuneration and nomination committees in one committee results in a weak remuneration structure.
- The remuneration committee should consist only of non-executive and independent directors and there should be minimum requirements or standards in the mandate of the remuneration committee in relation to setting remuneration for top executives. The SAMA regulation is a good example in this respect.
- Remuneration committees should be given independence in some aspects, especially those related to designing the remuneration of top executives and setting challenging goals and objectives.

c. **Disclosure** should be improved in terms of the quantitative and qualitative information provided, using legislation to organize the way in which companies disclose their remuneration to guarantee consistency and eliminate divergence. In addition, the CMA should require listed companies to disclose more information on their remuneration policy as required by Article 15 of the CGRs, especially with regard to the link between remuneration and performance. Therefore, companies

[37] See sections 3.3.1.3.2.1 and 3.3.1.3.3.

should not be left to present disclosure information on the remuneration of the board of directors as they wish and there should be a regulation that organizes such disclosure to promote consistency and prevent camouflage and ambiguity practices. SAMA should assist banks in disclosing qualitative information about their remuneration policy, as banks currently provide generalizations which are unhelpful in assessing the degree of their compliance with the rules.

d. **Shareholder engagement** should focus on the discussion of the remuneration of directors at the AGM, by requiring this topic to be an agenda item rather than tabling it for vote in a climate in which boards are able to dominate and control the company by taking advantage of inactive shareholders failing to exercise their right to attend the AGM. In such circumstances, a vote can legitimize remuneration practices and prevent litigation.

e. The regulators should revise guidelines to help companies in designing their remuneration policies.

f. Clawback arrangements related to the variable remuneration should be considered to be a matter of law in instances of misstatement or misconduct. The US experience provides a good example in this respect, whilst bearing in mind the shortcomings that have been identified there. [38]

g. SAMA should be granted formal and independent powers to regulate and supervise banking under the supervision of the Saudi Minister of Finance.

h. The application of the P&S in Saudi Arabia, particulary those relating to the structure of remuneration, should be restricted to banks that use incentive remuneration heavily. Banks that do not use such incentives should be excluded from the rules, to avoid rigid application.

[38] See section 6.4.4.

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