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PART I

Chapter 1

Aligning Executive Interests with the Long-term Interest of the Company

The ability to effectively oversee executive remuneration is a central element of the current corporate governance debate. In responding to this and other corporate governance challenges, the OECD's Corporate Governance Committee launched a peer review process designed to facilitate the effective implementation of the OECD Principles of Corporate Governance and to assist market participants and policy makers to respond to emerging corporate governance risks. The process builds on Principle V.A.4. of the OECD Principles. This principle recommends that the board should fulfill certain key functions including "aligning key executive and board remuneration with the longer term interests of the company and its shareholders". This chapter discusses the market environment, the legal and regulatory frameworks and responses to remuneration and board practices, in particular, the use of remuneration consultants and board members' responsibility for shareholder engagement.

In its paper, *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles* (OECD, 2010), (hereinafter, the "*Conclusions*") the Corporate Governance Committee noted that the ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice and remains one of the central elements of the corporate governance debate in a number of jurisdictions. The nature of that challenge goes beyond looking merely at the quantum of executive and director remuneration (which is often the focus of the public and political debate), and instead more toward how remuneration and incentive arrangements are aligned with the longer term interests of the company.

The *OECD Principles* (OECD, 2004) state that responsibility for aligning executive interests with the company lies with the board. The core principle in this area is Principle VI.D.4 which recommends that the board should fulfil certain key functions including "aligning key executive and board remuneration with the longer term interests of the company and its shareholders". There are many facets to the Board's role and their relationship with other organs and stakeholders of the Company, and clearly the appropriate role for the board in the governance of remuneration will depend largely on the institutional and regulatory arrangements that exist in any given jurisdiction.

For instance, in companies with dispersed share ownership, the Board will have a more active and dominant role in negotiating remuneration arrangements, than in companies with a dominant (family) shareholder, where there is likely to be a greater level of connection between owners and managers. Similarly, some countries (such as Sweden) invest the General Meeting with very strong powers to set remuneration policy and the role of the Board is necessarily subscribed. Whereas in other jurisdictions such as the United States, the Board still retains significant autonomy about whether and how to align remuneration and incentives with longer term company performance.

Nonetheless, the *Conclusions* found a number of core areas where practices could be improved and that were consistent with the core framework of the Principles. The challenge for boards is to understand how risk flows through the structure of remuneration, and as importantly the remuneration metrics. This is not an easy process, since both the choice of remuneration components and the performance hurdles that attach will not have purely linear relationships to either risk or company performance.[1] This is exacerbated by the fact that there will be a certain degree of information asymmetry between the Board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics (with a consequent likelihood of gaming). Taken together, this underlines the importance of boards to treat remuneration and risk alignment as an iterative process.

Active shareholder engagement can aid the process, and the *Conclusions* noted the importance for Boards to disclose (in a remuneration report) the specific mechanisms that link compensation to the longer run interests of the company. This builds on the general Principle V.A.4 that "disclosure should include, but not be limited to, material information

on … remuneration policy for members of the board and key executives". Policy makers in several jurisdictions are responding to this challenge, (for instance, **Brazil**, **Japan** and **Portugal** amongst the reviewed countries) by recently introducing enhanced disclosure requirements related to director/executive remuneration in listed companies, focussed on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes (for example, key performance indicators such as relative share price) and their relationship to firm performance. In other jurisdictions, Code-makers have introduced amendments designed to encourage more description of how incentive arrangements align manager/director interests with those of the company and shareholders.

As a general rule, legislators and regulators capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the ***level*** of executive remuneration. Firm specific factors tend to mitigate against caps or salary controls, and this is more so, the more international or competitive is the market for executive talent. To the extent that skills are transferable across sectors, industry specific caps or controls will create distortions in the market, as will national controls. Regulatory arbitrage may also limit the effectiveness of any caps or controls, with firms and executives having significant incentive to adopt innovative remuneration arrangements to circumvent any hard constraints.[2]

Not surprisingly, then, policy makers have instead focused more on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised in terms of internal firm governance (and, in particular, fostering arms-length negotiation through mandating certain levels of independence), and providing a mechanism to allow shareholders to have a means of expressing their views on director and executive remuneration.

With respect to the former, the *Conclusions* noted the importance for companies to take steps to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved are clearly defined and separated, and with remuneration outcomes decided through a transparent and robust process. In terms of implementation, the key Principles relate to the twin general duties of directors to act in good faith and loyalty toward the company (Principle VI.A), and to exercise independent judgement (Principle VI.E), including giving consideration to assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks, such as the remuneration setting process, where there is a potential for conflict of interest. In those countries where there are dominant or controlling shareholders, the requirement of directors to treat all shareholders fairly (Principle VI.B) is also highly relevant, particularly in cases where the dominant shareholder exercises significant influence over the remuneration setting process. Finally, perhaps reflecting wider societal concerns about executive remuneration, there has been a tendency for policy makers and practitioners to also look at the impact of remuneration outcomes on other stakeholders (consistent with the recommendation of Principle VI.C), including firm level employees. (As an example of change in this area, while not specifically related to remuneration, the UK's new statutory statement of directors' duties places explicit emphasis on directors taking into account the interests of stakeholders.)

In terms of shareholder engagement, there has been an increased focus on introducing binding or non-binding votes ("say on pay") provisions. The *Conclusions* noted that, in order to increase awareness and attention, it was good practice for remuneration policies and implementation measures to be submitted to the annual meeting and that there be mechanisms to enable shareholders to express their opinions (consistent with the recommendation of Principle II.C.3). The experiences of the reviewed countries suggest that the effectiveness of "say on pay" provisions is fundamentally linked to the quality and timeliness of disclosure around incentive and remuneration arrangements. So where countries such as **Brazil, Japan** and **Portugal** have had shareholder voting, the effectiveness of those votes (and, consequently, the extent of shareholder engagement) has been compromised by the lack of data available to understand the links between pay, performance and risk. As such, the key policy focus in these jurisdictions has been to bolster the disclosure requirements to support pre-existing "say on pay" arrangements. Jurisdictions have also sought to identify novel mechanisms for encouraging better shareholder engagement. In the **United Kingdom**, the Financial Reporting Council has recently released a Stewardship Code that seeks to encourage more active institutional investors. In **Brazil**, amendments to the proxy solicitation rules are designed to facilitate more active engagement by shareholders, by reducing costs and facilitating disclosure. In **Portugal**, the securities regulator, CMVM, has issued a set of recommendations that seek to promote active and transparent engagement by domestic institutional investors in the exercise of their shareholder rights.

1.1. Market environment and norms

Underlying the public and political debate on director and executive remuneration are concerns that both the quantum of remuneration has grown disproportionately to labour rates in the wider market, and that there is a disconnect between pay and performance (or more, specifically, that below par performance is not negatively rewarded). To the extent that such trends are observed, a principle explanation advanced is that imperfections in corporate governance allow successful rent-seeking by managers to occur.[3] Such a view was one of the Key Findings in relation to the financial crisis: "The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length. Managers and others have had too much influence over the level and conditions for performance based remuneration with boards unable or incapable of exercising objective, independent judgement".

This is clearly the case in some jurisdictions, and in some industries. For instance, amongst the reviewed countries almost all identified that remuneration and incentive arrangements were an issue in their banking and finance industry. However, while many of the questionnaire responses acknowledged the level of public disquiet over director/executive remuneration levels, very few actually identified it as a particularly pressing issue in their listed company sector. Where it was identified as an issue, often it related to social justice concerns and notions of relative pay. An overwhelming majority of respondents described their executive labour markets as largely internal to their country, and where they did so, director/executive remuneration was universally considered to be unproblematic. Given that there has been widespread policy and legislative responses, even in jurisdictions where remuneration is not considered problematic, suggests that the social concerns (and the pressure to be part of a global response to the issue) have acted as strong forces in driving governance policy.

Amongst the reviewed countries, a common perception was that pay outcomes in family controlled firms were more moderate than those with dispersed share ownership. In three of the reviewed countries (Brazil, Portugal and Sweden), family controlled firms are quite dominant amongst listed companies, and this is seen in those jurisdictions as a moderating influence on pay outcomes. Such an outcome would be consistent with a managerial power hypothesis, since in family controlled firms the owners have a vested interest in pay outcomes and a more equal bargaining position when compared with companies with dispersed ownership.

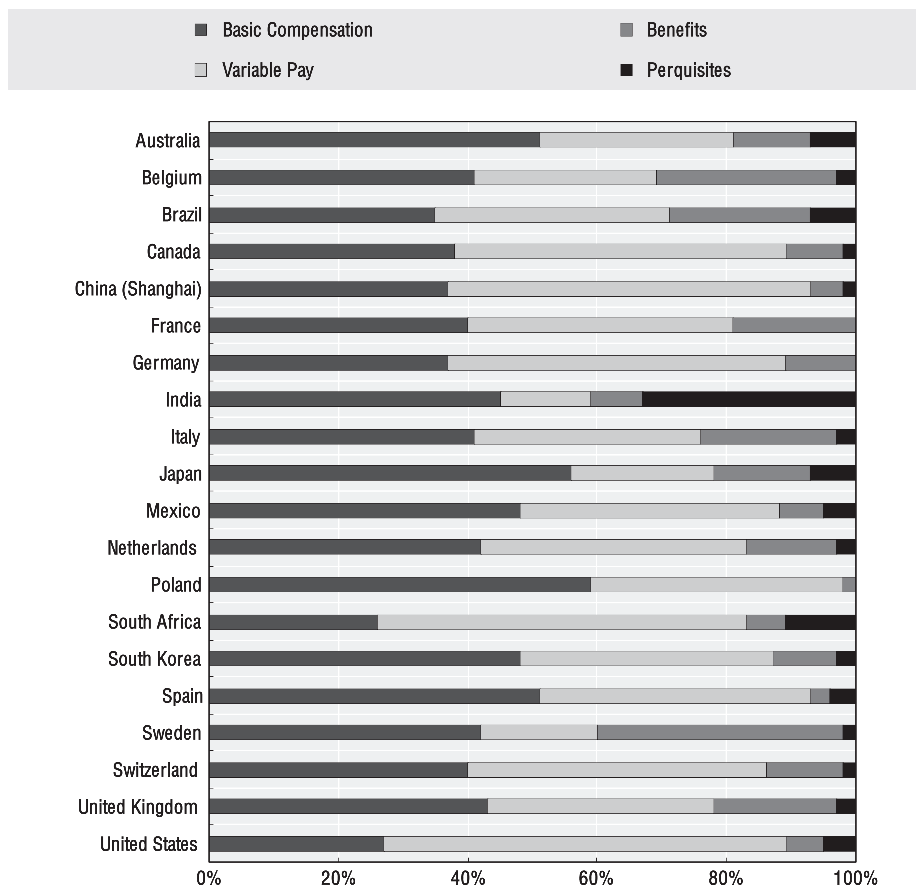
Anecdotally, market participants also felt that remuneration outcomes in companies with dominant shareholders were less complicated, and with a lesser weighting on long-term performance plans (with variable remuneration instead based more around bonus payments). This may reflect some of the inherent problems with performance based pay[4] as a driver of long-term alignment, and the capacity of dominant shareholders to use more efficient non-monetary rewards to tie executives and directors into the company's longer-term interests. This might be especially important in company groups. For instance, in **Portugal**, market participants suggested that management pay outcomes were sometimes lower in family controlled groups because of the implicit promise that there would be later opportunities within the group at later stages of an executive's career. It may also reflect unobservable remuneration being paid by other companies. For instance, in **Brazil**, the regulators noted that in foreign controlled companies sometimes longer term performance rewards for executives were provided by the international parent, and expressed in terms of the stock price of the parent.

In both cases, this raises the risk that managers' interests will be aligned with the interests of dominant shareholders, instead of all shareholders, although these risks can be substantially moderated if the capacity for abusive related party transactions can be avoided (as is the intention with Portugal's company groups law[5]). As a starting point, it is important for minority shareholders that any arrangements with related companies or groups are clearly disclosed, and it is worth noting that in the case of both Brazil and Portugal extensive disclosure regulations have been introduced in 2010 that would require comprehensive disclosure of payments by related parties.

Despite the perceptions that remuneration structure is an issue for a limited number of countries, amongst large capitalisation companies around the world (which, on average, are more likely to have dispersed ownership) the split between variable and fixed remuneration shows significant disparity across countries, although significant amounts of variable pay are a common feature across most jurisdictions (Figure 1.1). A notable outlier is the **United States**, where remuneration at risk is substantially in excess of fixed pay. However, there is no clear split between countries which have dispersed ownership structures and those more likely to have concentrated ownership. For instance, in **Germany** the study identified a higher level of variable remuneration than in the **United Kingdom**.

The use of equity incentives is almost universally an integral part of remuneration design. A 2008 Towers Perrin study highlighted that, amongst major companies around the world, stock options remain the most popular type of long-term incentive in most countries, although use has declined in the Netherlands, Spain, Switzerland, the U.K. and the U.S. At the same time, there has also been a significant expansion in the use of restricted stock and performance shares. Restricted stock has gained ground in Canada,

Figure 1.1. **Pay components 2005 - Chief Executive Officer (as percentage of total remuneration)**



Source: Towers Watson (2006), "Managing Global Pay and Benefits", *Worldwide Total Remuneration Report 2005-2006*, www.towersperrin.com.

France, Mexico, Singapore and the U.S., although its use is a majority practice only at companies in the U.S. Performance shares have become more widespread in Canada, France, Mexico, the Netherlands, Switzerland, the U.K. and the U.S.

One observation that can be made based on the review is that performance pay needs to be put in the context of the wider cultural attributes and the company culture. It is clear that in **Japan**, the concept of life time employment, and affiliation to the company, is still a strong influence on executives with a resulting impact on the structure and quantum of remuneration. The use of bonuses is widespread to incentivise employees to short term performance, but longer term incentives are relatively less common, with executives personal interests strongly aligned to the company via cultural factors. The historically high proportion of salary taken in the form of retirement benefits reinforces the longer term horizons of directors and executives but may also make them risk-averse. In **Sweden**, similarly, cultural factors also play some part in dictating structures. Executives and directors are particularly attuned to income differentials with CEO salaries often measured in terms of a multiple of "industrial worker salaries".

1.2. Legal and regulatory frameworks

Legal and regulatory responses to director remuneration have tended to cover three broad areas: *i)* provisions relating to the structure and quantum of remuneration; *ii)* requirements relating to the governance of the remuneration process; and *iii)* disclosure requirements on both the constituents of remuneration and the policies that underlie remuneration outcomes.

Box 1.1. **Director versus Executive Remuneration**

In general, much of the regulation of remuneration is related to members of the Board of Directors in companies with single tier boards and to either or both the Supervisory Board and Management Board in dual tier companies. For simplicity, references in the paper to directors' remuneration refer to members of the Board of Directors/Supervisory Board and to Members of the Management Board. References to executive remuneration refers to the remuneration of senior employees whether inside or outside of these company organs.

In relation to normative requirements on structuring remuneration, as noted above, policy makers have been quite restrained, reflecting the difficulty of providing frameworks that can be applicable across a broad range of companies. Where legislation does contain provisions on the quantum and structure of remuneration, it tends to be in the form of guidance on the factors that companies should take into consideration. For instance:

- in **Estonia**, the law provides that total payments made to the management and supervisory Boards must be in reasonable proportion to their duties and economic situation; **Austria** has a similar requirement although it applies to the Supervisory Board only;
- similarly, in **Denmark,** remuneration should not exceed an amount which is considered normal given the nature of the duties, scope of work and company financial position;
- **Greece** has similar provisions, although limited to the remuneration of non-executive board members, with the requirement that they be proportional to the time they devote to their responsibilities;
- in **Brazil**, the legislation provides that board proposals for remuneration should consider the responsibilities of the officer, their dedication, competence, professional reputation and market value of their services.

Amongst OECD countries, **Germany** appears to have gone further than most in this area. In 2009, it passed a Law on the Appropriateness of Directors' Pay (refer Box 1.1) which contains a number provisions on how pay can be structured and the processes by which it is approved. In terms of structure, the German Stock Corporate Act now provides that, in the case of listed companies, the pay structure must be based on the sustainable development of the company (meaning the long-term positive trend and growth of the company). Furthermore, variable pay components, in particular bonuses, must be based on a multi-annual basis of assessment in the case of listed companies. It is important to stress that the German approach is still principles-based; there is no statutory upper limit on remuneration, and the relative proportion of fixed and variable remuneration is also not specified.

In the very rare cases where jurisdictions have imposed specific caps, this has generally related to situations where Government is involved as a shareholder, on either a temporary or permanent basis. As an example**, Slovenia**, has introduced laws to cap fixed executive remuneration in companies with state ownership to relatively low multiple of average worker salaries, with the ratio proportionate to company size (being three, four or five times average salary). Variable component of remuneration are also then capped at a maximum amount of 30% of the basic executive annual salary.

Some jurisdictions have made moves to introduce "clawback" arrangements that allow for the repayment or *ex-post* readjustment of variable remuneration, generally where the payment was based on false information. In the **Netherlands**, the government has decided to introduce a clawback regulation, whereby the level of variable remuneration can be adjusted (by the company organ that fixes the remuneration) if payment would be unreasonable: a clawback provision applies if bonuses have been paid on the basis of false information regarding the bonus criteria. In the **United States**, under new SEC rules to be issued as a requirement of the Dodd-Frank Act, listed companies' policies on variable remuneration will be required to include mandatory recovery of that compensation following a restatement due to material non-compliance with financial reporting requirements. In **Denmark**, the revised Danish Corporate Governance Code recommends that in exceptional cases, companies should be able to reclaim in full or in part variable components of remuneration that were paid on the basis of data, which proved to be manifestly misstated.

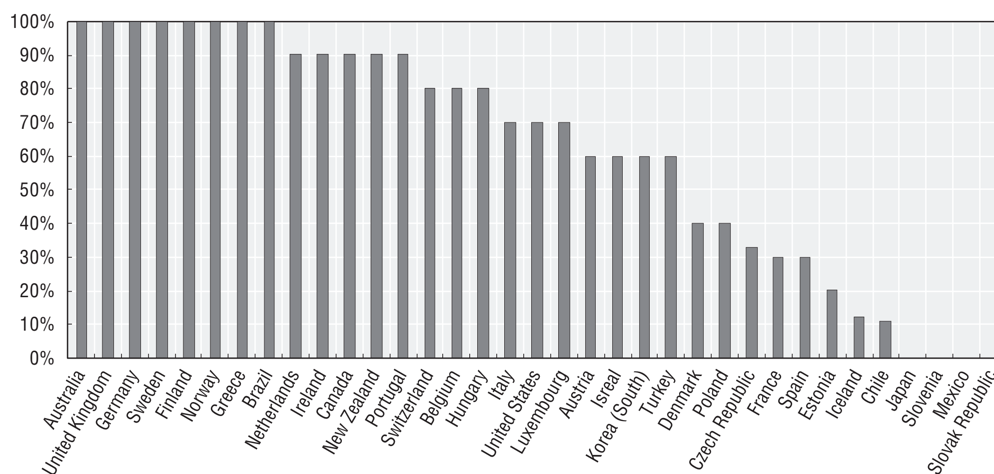
The most common approach among **OECD** countries is for the legislation to provide some degree of prescription as to how the process of remuneration setting is governed, normally in terms of assigning responsibilities amongst company organs and, less frequently, by mandating certain criteria for independence. In relation to the former, Principle II.C.3 recommends that "shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval". Thus, the principle has two separate components: *i)* some form of shareholder engagement on remuneration policy for both boards and executives and *ii)* explicit approval of any share based schemes.

For the first of these, the basic approaches that jurisdictions have taken are to mandate either a binding or non-binding vote on board remuneration and/or remuneration policy. To be entirely consistent with the principle, this vote should encompass the remuneration policy (not necessarily levels) and should cover both directors and executives.

The OECD commissioned Manifest Information Services to conduct a top-level survey of incentives and risk management at listed companies across OECD countries and Brazil. The research focussed on the top ten listed companies in each jurisdiction by market capitalisation.[6] To the extent that larger capitalised companies are more likely to be at the front end of corporate governance reform, the survey is more likely to highlight the trends in individual country practices, rather than current practice. With respect to "say on pay" provisions, Figure 1.2 provides a description of the number of survey respondents that had a remuneration related resolution as part of their most recent annual meeting. The data shows that there are still a sizeable number of jurisdictions where remuneration related voting is not common and where it would be difficult to conclude that practice is

consistent with the recommendations of Principle II.C.3. However, some caution should be exercised with this data since in some jurisdictions (notably Japan) shareholder voting is compulsory but is only required when there is a change in the total level of remuneration allowed. Voting often occurs less than annually, with approval sought for a total envelope greater than actual payments. It is also worth noting that there have been recent reforms in many jurisdictions regarding "say on pay" (for instance, the 2009 European Commission Recommendations – refer below) that would not be reflected in the survey data. When those reforms are implemented, it would seem reasonable to suggest that the level of adherence to the principle, while not universal, will be substantial.

Figure 1.2. **Companies with a remuneration related resolution**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

In the **UK** and **Australia**, a non-binding vote on remuneration has been in place since 2002 and 2003 respectively. The introduction of non-binding votes in both Australia and the UK were contentious reforms. In both countries, (and in other countries, such as the **United States**, **Canada** and **New Zealand**) there is a comparatively higher degree of autonomy afforded to the Board, and the case against voting on remuneration rests largely on the proposition that it would diminish the authority of the Board to exercise its responsibilities. This has led to a high degree of resistance to the introduction of shareholder voting in these jurisdictions. Underlying this resistance in countries other than the United States is the view that if shareholders are unhappy with the board, then they have the capacity to remove them. In practice, in neither the UK or Australia have there been widespread cases of shareholder revolt, although the few high profile cases do seem to have had the effect of making Boards more responsive to the concerns of shareholders, and more pro-active in engaging with them on remuneration issues.

In continental European countries with two tier boards, there has historically been a clear delineation between the role of the shareholders meeting and the supervisory and management boards. For example in both **Poland** and **Germany**, as a general principle, the management board is in charge of setting the remuneration of employees, the supervisory board negotiates the remuneration of the members of the management board and the remuneration of the supervisory board is determined by the shareholders meeting. Under such a structure, in many continental countries there is a high level of adherence to

Principle II.C.3 with respect to Supervisory Board members, but relatively less with respect to executives. A shareholder vote on management remuneration does not easily fit within this hierarchical structure, which may explain the relatively low adoption of shareholder votes for executives in some European jurisdictions.

This situation is quickly changing, however, in part driven by the European Commission's 2004 recommendation[7] on director remuneration, which proposed that member states should adopt either a binding or non-binding vote on remuneration policy, as an explicit item on the agenda of the annual general meeting (**Germany**, for instance has recently adopted a non-binding vote on remuneration as part of its Law on the Appropriateness of Directors' Pay). Similarly, **Portugal** vests power for setting remuneration policy in the hands of the general meeting (although, in practice, this is often delegated to a committee established by the general meeting). The **Netherlands** also has a mandatory binding vote on the management remuneration policy and, in principle, the shareholders meeting has the responsibility to fix directors' remuneration in accordance with the policy (although in practice, this is commonly delegated to a remuneration committee composed of members of the Supervisory Board).

The Commission's 2004 recommendation also proposed that share based payments should be subject to explicit approval, consistent with the position in the Principles. **Sweden** has gone furthest in this area, with the shareholders having a General meeting having a broad mandate to decide remuneration of each individual director; all share- and share-price-related incentive schemes for the executive management, (in most cases with a quorum requirement of 90% of the votes cast); and a binding vote on the annual guidelines for the remuneration of the executive management as proposed by the board.

Among other OECD, and Enhanced Engagement countries, it seems relatively common for shareholders to have a binding vote on director remuneration.

- In **Norway**, the remuneration of board members is decided by the general meeting, and is required to prepare remuneration guidelines for executive personnel to be disclosed to the general meeting. Where these include share based payments, they also must be approved by the general meeting.
- In **Israel**, director remuneration must be approved by the audit committee, the board of directors and the general meeting (with supermajority provisions where there are controlling shareholders).
- In **Korea**, the shareholders' meeting sets the total remuneration for the Board, with individual remuneration of directors set within that global limit.
- Similarly in **Indonesia**, board remuneration is set by the general meeting (although setting of management board remuneration can be delegated to the supervisory board).
- In **Mexico**, the annual Shareholders' Meeting determines the salaries of managers and board members, when they have not been established in the by-laws of the company.
- In **Brazil**, the law requires shareholder approval of at least the global amount of director remuneration, based on a recommendation of the board of directors, and subject to specific criteria.

1.2.1. Recent reforms or proposals on the structuring and/or approval of remuneration

On 30 April 2009, the European Commission released a recommendation regarding the remuneration of directors of listed companies[8] that sought to complement earlier

regulations in 2004 and 2005[9]. The recommendation advocates that the structure of directors' remuneration should promote the longer term sustainability of the company and ensure that remuneration is based on performance. Variable components of remuneration should therefore be linked to predetermined and measurable performance criteria, including criteria of a non-financial nature, and limits should be set on the variable components of remuneration.

The recommendations from the Commission have elicited various responses from member states. In **Finland**, the Corporate Governance Code (which is binding on listed companies) has been updated to explicitly provide for shareholder approval of both remuneration levels and the basis of remuneration. In **Belgium** detailed legislation has been passed that requires that one quarter of any variable remuneration will have to be based on criteria with a duration of a minimum two years; another quarter will need to be based on criteria over a minimum of three years. This means that only half of the variable remuneration can be linked to performance criteria of the concerned year. These provisions do not have to be taken into account if the variable remuneration forms less than one quarter of the total remuneration or if approved explicitly by the general assembly of shareholders. In **Germany,** the existing provisions of the Joint Stock Corporation Act, which covers both supervisory board and management board members, were amended by the Law on the Appropriateness of Directors' Pay (Vorstandsvergütungsangemessenheitsgesetz). The law provides that director remuneration must be appropriate and that variable pay components must be based on a multi-annual basis of assessment in the case of listed companies (refer Box 1.2).

In July 2010, the **United States** passed the Dodd-Frank Wall Street Reform and Consumer Protection Act that amends U.S. requirements relating to executive compensation practices in a number of respects. First, the SEC is obliged to promulgate rules by mid-2011 that will require members of the compensation committee for listed companies to be independent directors (with independence to be defined according to a number of factors, including the source of compensation and lack of affiliation with an issuer). Under new "say on pay" provisions, the act requires at least once every three years, a shareholder advisory vote to approve the company's executive compensation as disclosed pursuant to SEC rules. The "say on frequency" provision requires companies to put to a shareholder advisory vote every six years, whether the "say on pay" resolution should occur every one, two or three years. In addition, in any proxy statement asking shareholders to approve an acquisition, merger, consolidation or proposed sale of all or substantially all of a company's assets, the Dodd-Frank Act generally requires disclosure about, and a shareholder advisory vote to approve certain agreements or understandings with the company's named executive officers concerning compensation that is based on or otherwise relates to the extraordinary transaction, unless the arrangements were already subject to the periodic say-on-pay vote.

In **Australia**, in March 2009, Government asked the Productivity Commission (PC) to conduct a broad ranging inquiry into the regulation of executive remuneration, including current disclosure requirements and the roles of shareholders and institutional investors. The report was publicly released on 4 January 2010, and recommended increased independence in the remuneration setting process; better disclosure through simplified remuneration statements; and recommendations to improve shareholder engagement. In April 2010, the Australian Government released its response to the PC inquiry, supporting

Box 1.2. **German Laws on Director Remuneration**

- In the case of listed companies the pay structure must be based on the sustainable development of the company. This means a long-term positive trend and growth of the company.
- Variable pay components, in particular bonuses, must be based on a multi-annual basis of assessment in the case of listed companies (§ 87 paragraph 1 German Stock Corporation Act). Multi-annual means at least three years. In this way, the directors are equally affected by any subsequent deterioration in a company's situation. Short-term incentives are therefore no longer possible.
- The supervisory board should agree on a way of limiting bonuses should there be extraordinary developments. "Extraordinary" means extremely high share increases, offers of a takeover, etc. All parts of the remuneration – fixed or variable – shall be in itself and together appropriate and shall not encourage over excessive risk taking (no. 4.2.3 paragraph 2 German Corporate Governance Code).
- Share options should be taken at the earliest four years after the options have been granted. Share options for the Supervisory Board are not allowed to avoid conflicts of interest.
- A supervisory board has to reduce directors' pay at a later date if a company's situation deteriorates. Such deterioration can be said to have occurred, for example, if the company has to dismiss staff and no longer pays out dividends. Pensions can also be reduced; see § 87 paragraph 2 German Stock Corporation Act.
- Contrary to the situation in Germany before the Law on the Appropriateness of Directors' Pay, decisions about directors' pay may no longer be delegated to a small group within the supervisory board but must be approved by the full board, which includes employee representatives.

nearly all of the PC's recommendations. Implementing the recommendations will involve changes to the Act, the ASX Listing Rules and the ASX Corporate Governance Principles.

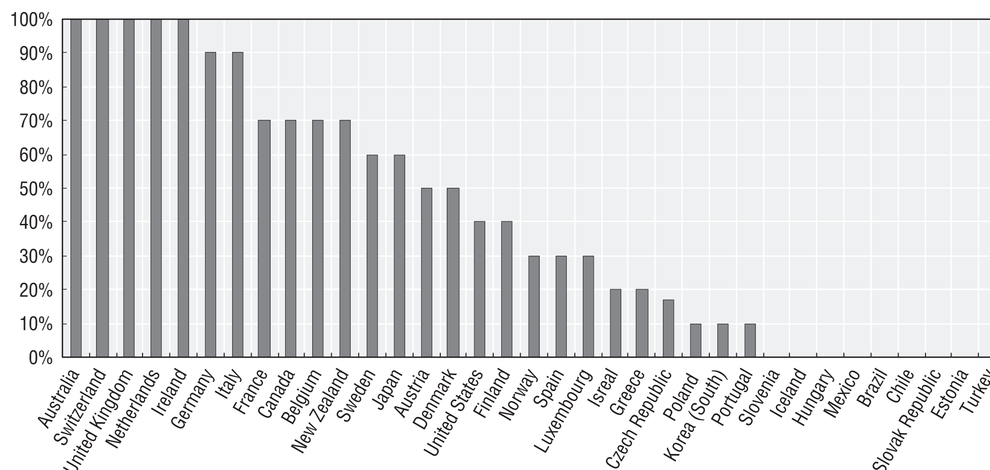
1.2.2. Requirements related to disclosure and transparency

A recognition of the need for effective disclosure of remuneration and incentive arrangements for directors and executives was a key outcome of the Committee's work on corporate governance and the financial crisis. While Principle V.A.4 provides that "disclosure should include material information on remuneration policy for members of the board and key executives" one of the Key Findings was that "transparency needs to be improved beyond disclosure. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and; how the remuneration is adjusted for related risks". The annotations to the principles also make clear that of particular interest is the link between remuneration and company performance. Companies should be expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance.

A key element of this disclosure relates to share-based remuneration. Using the Manifest survey data commissioned by the OECD, it is clear that such disclosure is by no

means widespread. Where disclosure is low, this will in part be a reflection of the fact that, in these jurisdictions, share-based remuneration is itself not widespread. Nevertheless, the data (Figure 1.3) would seem to imply that current disclosure in some jurisdictions is not strong in explaining the components of remuneration or a commentary on the relationship to risk, as suggested by the Key Findings.

Figure 1.3. **Companies disclosing share-based remuneration**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

There is a clear trend toward countries introducing stricter disclosure requirements relating to director and executive remuneration. Among the reviewed countries, **Japan**, **Portugal** and **Brazil** have recently introduced new, more comprehensive disclosure standards.

In Europe, the Commission's 2004 recommendation proposed that listed companies should disclose a remuneration policy statement on an annual basis that included information on, inter alia, the relative importance of variable and non-variable components of director remuneration; information on performance criteria; and information on the link between pay and performance. The Commission's 2009 recommendation takes this further, emphasising the need for the remuneration statement to be clear and easily understandable (consistent with the *Conclusions*), and providing greater detail on how disclosure of performance related pay should be implemented. This includes, for instance, recommendations that remuneration statement should include an explanation how the choice of performance criteria contributes to the longer term interests of the company, and an explanation of the methods, applied in order to determine whether performance criteria have been fulfilled.

European jurisdictions are responding to the Commission's recommendations by either amending legislative/regulatory requirements on disclosure and/or making amendments to their Codes. In **Belgium**, the recent legislation noted above requires a remuneration report containing a description of the remuneration policy, including the procedure used to determine remuneration; the principles of the remuneration; the relative importance of each component; the criteria for the evaluation of the performance regarding the objectives, the periodicity of the evaluation and the description of the

method used to check if the performance criteria are fulfilled. In **Spain**, for instance, a draft Bill on Sustainable Economy (Anteproyecto de Ley de Economia Sostenible) will upgrade the transparency requirements on director remuneration consistent with the Commission recommendations and **Portugal** has already issued new regulations applying to the listed sector. **Slovakia** has addressed the 2004 recommendation via its code, and anticipates that this will be also updated to reflect the 2009 recommendation. While not a member of the EU, **Turkey** plans to implement amendments to the Capital Market Board's Corporate Governance Principles to be consistent with the Commission recommendations. In **Finland**, the Securities Market Association (which issues the Code) will issue an updated Guideline on Remuneration Statements in autumn 2010 with the emphasis on implementing the Commission's 2009 disclosure recommendations.

The use of remuneration statements is also common outside of the European Union. In **Australia,** the Corporations Act mandates a high level of disclosure to be contained in the remuneration report of the Annual Directors' statement. This includes a full description of the policy on remuneration, the link between the policy and performance, the performance conditions and the mix of fixed and variable remuneration. In **Norway,** the law requires that the board of directors establish guidelines on the remuneration of executive personnel, with these to be communicated to the annual general meeting.

In the **United States**, (prior to the amendments noted above) executive and director compensation was already one of the disclosure areas mandated by SEC rules. SEC registrants must disclose detailed information about all plan and non-plan compensation awarded to its named executive officers and directors on an individual basis. A reporting company must also provide a Compensation Discussion and Analysis (CD&A) that explains all material elements of its executive compensation programme; the objectives of the programme; what the program is designed to reward; each element of compensation; why the registrant chooses to pay each element; how the registrant determines the amount to pay for each element; and how each element fits into the overall compensation program. The SEC rules also require a registrant to disclose whether it has a compensation committee, provide disclosure regarding the committee's charter, and describe the registrant's processes for determining executive and director compensation. In addition, the Dodd-Frank Act requires the SEC to amend its executive compensation disclosure requirements to require a company to disclose in its annual meeting proxy materials the relationship between executive compensation actually paid and the company's financial performance. It is likely that the SEC's rules will require disclosure in a number of filings of the CEO's annual total compensation, the median annual total compensation of all other employees, and the ratio between these two amounts.

In December 2009, the SEC adopted amendments to its proxy statement disclosure rules to enhance the disclosure requirements concerning company compensation and other corporate governance matters. One of the amendments will require a company to discuss its compensation policies and practices as they relate to risk management for all employees, and not just for executive officers, if those policies and practices are reasonably likely to have a material adverse effect on the company. The SEC adopted this amendment based on its belief that disclosure of a company's compensation policies and practices in certain circumstances can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk taking by its employees.

Individual disclosure

Disclosure of remuneration outcomes is often a contentious issue for regulation, and in many cases this is fundamentally related to whether disclosure should be mandated on an individual basis. While the Principles note that individual disclosure is increasingly regarded as good practice, the Methodology makes clear that this is not essential for the Principle to be fully implemented, and jurisdictions have taken varied approaches to the issue. Many countries (for instance, **Denmark**[10] and **Korea**) rely on aggregate disclosure; others, such as **New Zealand**, use a system of remuneration bands, with directors aggregated among the different levels. In **Australia** and **Israel**, the remuneration paid to the five highest executives (regardless of whether they are directors), must be individually disclosed.

In both **Japan** and **Brazil**, when revising their disclosure requirements in 2010 the authorities considered whether individual disclosure was desirable, with both seeking to balance the greater transparency of individual disclosure with the perceived risks of such an approach. In **Japan**, the recently released FSA regulations seek a balanced approach by requiring individual disclosure of directors'[11] remuneration, but limiting it to directors whose remuneration is greater than JPY 100 million on a consolidated basis for the financial year. The disclosure must include the total amount of remuneration, the director's name, and a breakdown by the type of payments. For those directors earning less than JPY 100 million, disclosure is aggregated by the different type of office-holders. In **Brazil**, regulators opted for aggregate disclosure, but with separate identification of the amounts paid to the highest and lowest paid directors. **Belgium** has also recently introduced legislation that requires company remuneration statements to provide comprehensive disclosure on an individual basis.

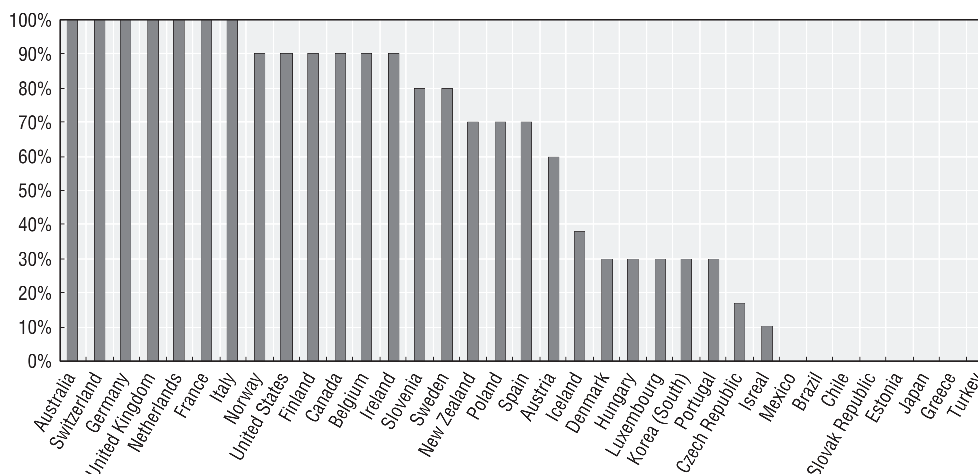
The divergence of approaches is reflected in the survey data collected by Manifest Information Services (refer Figure 1.4). Across all companies in the survey, only just over half (54%) disclosed individual remuneration. Many of those where individualised disclosure is most likely are in developed markets where, in many cases, regulatory regimes require it, such as Australia, the UK, the US and many Western European countries.

The perceived risks of increased disclosure

The arguments against greater disclosure of director and executive pay (and particularly, at the individual level) have, in OECD countries, revolved around a concern that it can lead to an upward pay spiral. This could occur, for instance, where the remuneration setters (*e.g.* Boards or Remuneration committees) routinely seek position their executives' pay outcomes in a preferred band (such as upper third quartile) with the collective outcome that director and executive pay continually ratchets up. **Sweden**, for instance, considered adopting individual disclosure, but ultimately decided against it because of such a risk. While this may be a genuine concern in some jurisdictions, the recent study by the Productivity Commission in **Australia**, found no evidence of an upward pay spiral there, where individual disclosure has been mandated since 1998.

A completely unrelated argument in some jurisdictions (for instance, **Mexico**) has been a concern that individual disclosure may create security concerns for the executives. This issue was also raised in **Brazil** during public consultation on a proposal for individual

Figure 1.4. **Individual disclosure of remuneration**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

disclosure. In the end, Brazil did not mandate individual disclosure, although for reasons not necessarily related to director security.

Given the sensitivity of the issue in many jurisdictions, the use of soft law may be a way to adequately address this issue and in this regard, the approach of **Brazil** is instructive. After the high level of opposition to individual disclosure, the new disclosure regulations introduced in 2010 did not mandate individual disclosure. At the same time, the Corporate Governance Code now provides that best practice in this area is for individual disclosure, and some companies have started to adopt this approach. Over time, it is hoped that concerns (particularly related to security) may be alleviated leading to wider adoption of more detailed disclosure.

Market trading

Even though it is not explicitly stated, the intent of the Principles (for example VI.D.6) clearly envisages the need for disclosure of market trading in the company's shares and securities by board members and key executives, including their close family members and associates. This is particularly important in allowing the Board and shareholders to assess whether share based remuneration is serving its purpose in aligning director remuneration with the companies longer term interest. An emerging issue that has arisen in some jurisdictions is the use of personal hedging to alter the risk profile of share based remuneration. In **Portugal**, in response to specific cases, the new regulations now require any personal hedging to be disclosed. Similarly, in the **United States**, under the new laws, the SEC also is required to issue rules requiring companies to disclose in their annual meeting proxy statements whether directors or employees are permitted to purchase financial instruments designed to hedge any decrease in market value of equity securities granted as part of their compensation. In **Australia**, the Productivity Commission report goes further and recommends that the Corporations Act 2001 should prohibit company executives from hedging unvested equity remuneration or vested equity subject to holding locks.

1.2.3. Soft law requirements

Code makers have necessarily had a higher degree of flexibility in their approach to remuneration, having the advantages of being more flexible to changing market circumstances and, in most cases, their non-binding nature. Because of this, in many jurisdictions Codes tend to go further in providing guidance on the structure of remuneration systems and the alignment of corporate and director/executive interests. For instance:

- In **France**, the Corporate Governance Code of Listed Corporations[12] provides detailed criteria for determining the fixed, variable and share based components of remuneration. For instance, the variable component must be understandable by shareholders; for a fixed period; must be a maximum percentage of the fixed, with the relationship between the two clear; and must be subject to pre-determined, specific quantitative and qualitative criteria.
- In the **Netherlands**, the Code provides that the variable components should be linked to predetermined, assessable and influenceable targets. The structure should be simple and transparent and promote the medium and longer term interests of the company.[13]
- In **Brazil,** the code stresses the importance of a balanced compensation policy combining short and longer term incentives, linked to performance. It also stresses using remuneration to align the interests of executives with those of the company.
- In **Switzerland**, 2007 amendments to the Code of Best Practice provide that the compensation system should reward conduct aimed at medium- and long-term corporate success with compensation elements available at a later date and should be structured in such a way as to avoid false incentives.

1.3. Board practices

The need for boards to exercise objective, independent judgement in the remuneration setting process (Principle VI.E.1) is something that needs to be established in the broader context of establishing "an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated is something commonly addressed *via* soft-law approaches" (see *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*). How this is achieved in each individual country will depend on the role of the board *vis a vis* other company organs. Where greater responsibility is placed in the hands of the General Meeting this could be considered of lesser importance, although even in these cases the Board tends to have a role in both recommending policy and implementing the policy via the contractual arrangements, both of which benefit from an independent perspective.

Reflecting the different legal frameworks, countries have adopted varying approaches to board independence in remuneration setting. The European Commission recommendation of 2005 recommends that boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors should play an effective role in key areas where there is a potential for conflict of interest, and where the board plays a role in remuneration it should establish a remuneration committee (except in cases where the board is small, in which case the function can performed by the board as a whole). Such an approach is consistent with the observation in Principle VI.E.1 that it is considered good practice in an increasing number of countries that remuneration policy

and employment contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors.

In general, member countries of the EU have implemented this recommendation, usually as part of their soft-law framework. For instance, in **France**, the Code provides that the remuneration committee should not include any executive directors, and should have a majority of independent directors. The French Code also recommends that cross-membership of remuneration committees by executives of two companies, should be avoided. A 2009 RiskMetrics study on monitoring and enforcement practices in corporate governance in member states noted that in almost all jurisdictions, a majority of companies amongst their sample had established a remuneration committee. On average 62% of the members of the remuneration committees were deemed independent.

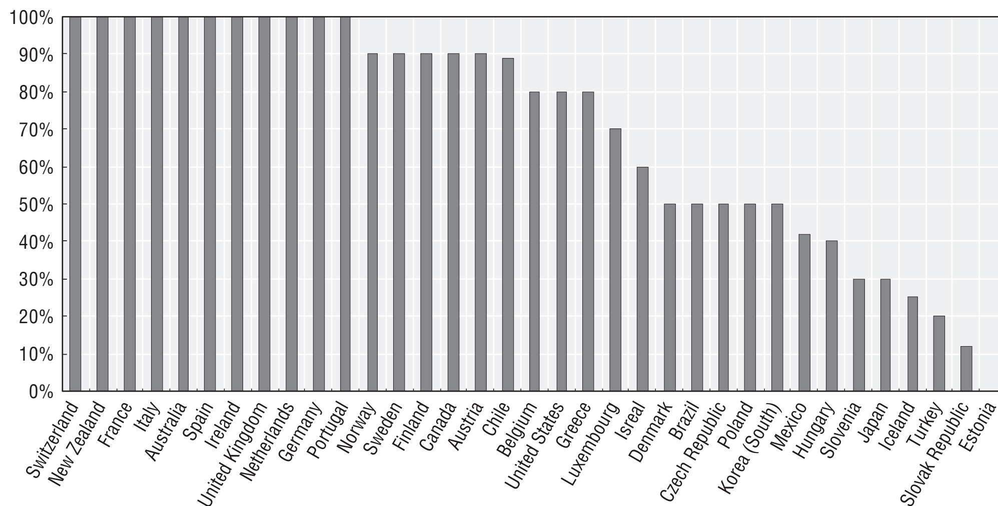
The listing requirements in the United States generally mandate independence in the remuneration setting process. The New York Stock Exchange requires listed companies to have a compensation committee composed entirely of independent directors. The Nasdaq requires that executive officer compensation must be determined, or recommended to the board for determination, by either a compensation committee (comprised solely of independent directors) or by the majority of the board's independent directors. The Wall Street Reform and Consumer Protection Act requires the SEC to adopt rules that direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer unless, to the extent the issuer has a compensation committee, each member of the issuer's compensation committee is a member of the board of directors and independent..

Amongst other OECD countries, the regulatory and code arrangements are generally supportive of remuneration committees with high levels of independence:

- in **Brazil**, **Norway** and **Switzerland**, the respective Codes recommend boards to consider appointing a remuneration committee, which should be comprised solely of independent members;
- in **Israel**, director remuneration is approved by the audit committee, which must comprise at least two independent directors;
- in **Korea**, the Commercial law provides that the board may establish a remuneration committee. Once it is established it is subject to specific requirements as to disclosure of its operations; and
- in **New Zealand**, the NZX Best Practice Code and Listing Rules encourage the establishment of a remuneration committee (which is widely followed);
- in **Mexico**, the Code of Corporate Best Practices (mandatory for listed companies) recommends that an intermediate body, such as an ad hoc committee, shall assist the Board of Directors in the establishment of the evaluation and compensation criteria, applicable to the CEO and senior officials of the company.

In practice, the Manifest survey supports the view that remuneration committees are relatively widespread (Figure 1.5). Fewer than a quarter of the countries in the survey displayed a minority of companies with a Remuneration Committee, with the majority of countries surveyed showing 80% or more of their companies having one. The most common reason for a lack of a specific Remuneration (sub-) Committee is that remuneration matters are decided by the board as a whole. It is therefore perhaps unsurprising that some of the countries characterised by smaller average board sizes, such

Figure 1.5. **Companies with a remuneration committee**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

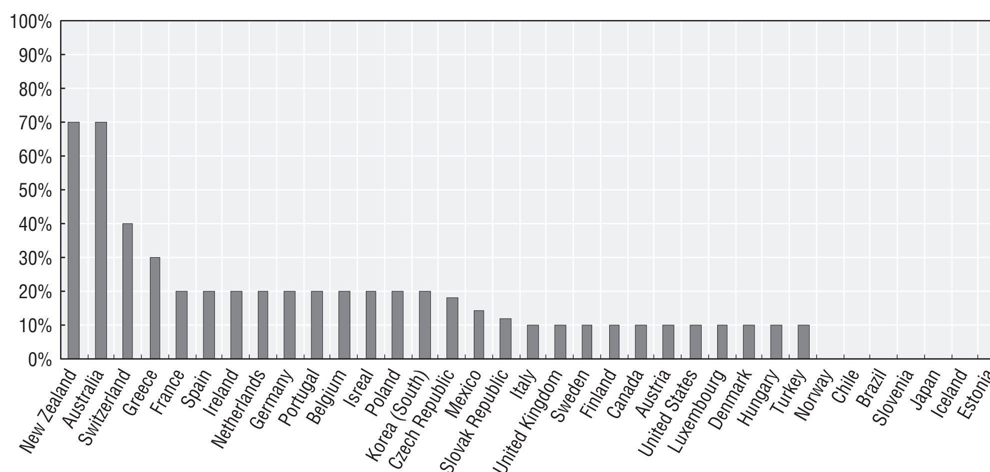
as Turkey, Estonia and Iceland also have a low proportion of companies with separate Remuneration Committees.

The Key Findings report highlighted how in many cases boards had failed to adequately fulfil their duty of aligning key executive and board remuneration with the longer-term interests of the company and its shareholders (Principle VI.D.4), noting that in many cases it is striking how the link between performance and remuneration was very weak or difficult to establish. Some of the reasons cited in the report for this failing included a high degree of complexity; a lack of appropriate understanding of the linkages of remuneration policies to corporate risks; and an incomplete understanding by boards of the drivers of remuneration outcomes. In this context, a striking feature of the Manifest survey was the low incidence of specialised board committees to deal with risk (Figure 1.6). In contrast to Remuneration, the issue of Risk Management is currently much less commonly stipulated by company law or best practice code as needing or requiring a separate committee in order to address it. Consequently, few companies in the survey had a committee whose title included any reference to Risk Management. Typically, the risk management function within the board might most commonly be found within the Audit Committee, but the challenge with such arrangements is to have the committee focus on explicit separate management of corporate risks as opposed to financial control.

1.3.1. The use of compensation consultants

There has been some controversy over the use by boards of compensation consultants to assist in the remuneration setting process. On the one hand, their use is justified as providing the board with access to expertise on the structuring of appropriately incentivised remuneration arrangements. More negatively, there is the potential for their interests to be aligned with those of management (particularly if engaged on other tasks). The *Conclusions* document noted a number of good practices that would facilitate the independence of consultants: that they be engaged by the board with a key role for independent board members (e.g. the remuneration committee or equivalent); that their role, including other work for the company, should be disclosed in a remuneration report;

Figure 1.6. **Companies with a committee with explicit reference to risk**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

and by prohibiting or limiting the contemporaneous provision of other remuneration services and by requiring them to adhere to a code of conduct.

Amongst the reviewed countries, the use of consultants was particularly identified in the **United Kingdom** as being potentially problematic. The Walker Review (into corporate governance of banks) noted that remuneration consultants were quite widely seen as having been self-interestedly responsible for some part in the escalation in remuneration with an undue focus on median or inter-quartile ranges of external comparatives rather than broader focus on the spread of underlying data and the different characteristics of companies. In response, the leading remuneration consultants operating in the UK have established a Voluntary Code of Conduct to bolster their independence and professionalism.

Sweden has also made amendments to its Code of Corporate Governance in 2010, to provide that "If the remuneration committee or the board uses the services of an external consultant, it is to ensure that there is no conflict of interest regarding other assignments this consultant may have for the company or its executive management". This is broadly consistent with the European Commission recommendation of 2009 that proposes that "when using the services of a consultant with a view to obtaining information on market standards for remuneration systems, the remuneration committee should ensure that the consultant concerned does not at the same time advise the human resources department or executive or managing directors of the company concerned".

In the **United States**, amendments to SEC disclosure requirements in 2009 now require disclosure that will permit investors to assess whether consultants who provide executive or director compensation consulting services may be subject to potential conflicts of interest based on receipt of significant fees for providing other services to the company[14]. In addition, the Dodd-Frank Act requires the SEC to identify, by rule, factors that affect the independence of compensation consultants and other compensation committee advisers and authorizes a compensation committee to retain a compensation consultant only after taking into consideration the factors identified by the SEC.

1.3.2. Board members responsibility for shareholder engagement

Beyond the formal attributes of a say on pay regime, the underlying objective of such arrangements are to provide investors with a stronger voice; to encourage a better dialogue between companies (executives and boards) and investors, based on more transparent disclosure. In jurisdictions where "say on pay" proposals have been introduced there is some evidence that the proposals have led to a greater level of dialogue on compensation plans, both in the development phase and in the lead up to the voting process.

However, there are also criticisms of the effectiveness of "say on pay" as a means of improving the interaction between shareholders and boards. Gordon (2009) argues that, based on the U.K. experience, mandatory voting creates the risk that companies choose from a narrow menu of approaches to very firm specific problems of director compensation, often exacerbated by the use of compensation consultants. According to such an argument, a narrow range, close to a "one size fits all," is highly likely because the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs. Custom-tailored evaluation is costly; monitoring for adherence to "guidelines" or "best practices" is cheap.

In contrast, the experience across review countries was that there was a high investor demand for a greater voice in remuneration outcomes, which would not be readily apparent if remuneration structures were considered "boilerplate". However, to the extent this is a risk, it merely reinforces the importance of boards taking an active role in ensuring that remuneration and incentive structures are appropriately matched to the risk profile and operations of the firm.

Notes

1. For instance, options are relatively more aggressive in promoting "upside" incentives compared with shares, but are asymmetric in that they provide little downside risk. Once "under water", they provide little incentive which can then force the Board into renegotiation. Large equity holdings can promote alignment, but where there are long vesting periods (and/or they comprise a significant component of executives total wealth) may make executives risk averse.
2. This can have implications for the extent to which pay structures are optimally aligned to incentives, as well as the level of transparency of the arrangements including the resulting disclosure to shareholders. The cap on corporate tax deductions for cash salaries of USD 1 million in the US at the beginning of the 1990s, and the resulting preferential tax deductibility of stock options is widely credited with increasing the use of options in "performance" based pay.
3. Most notably, Bebchuk and Fried (2004), in the context of the US, have referred to this as managerial power theory. The theory proposes that executives obtain remuneration outcomes more favourable than those that would arise from "arm's length" bargaining processes, due to their influence over 'captive' company boards. Not only is there a principal–agent problem between company owners and managers, there is also an agency problem between shareholders and the boards they elect to represent them.
4. Namely, that risk averse managers will require over-compensation for performance based pay because they will discount the rewards, and the measurement difficulties (causing managers to focus on the measured aspects and to the extent that these differ from the long term interests of the company, then there will be a divergence from shareholder interests).
5. The law contains a system of protection for subsidiary companies, their outside shareholders and creditors, by imposing on the parent a duty of covering the annual losses of the subsidiary and a direct joint liability for the settlement of subsidiary debts.
6. In some cases. smaller companies were chosen by reasoning of better disclosure, either in terms of data or language. In some countries, it was not possible to obtain sufficient data for ten companies,

as follows: Chile (nine companies), Czech Republic (six companies); Iceland (eight companies); Mexico (seven companies); Slovak Republic (eight companies).

7. European Commission Recommendation of 14 December 2004 Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies (2004/913/EC).
8. Recommendation 2009/385/EC.
9. Recommendations 2004/913/EC and 2005/162/EC.
10. While this is the position under the Danish Financial Statements Act, it should be noted that the 2010 revised Danish Corporate Governance Code recommends individual disclosure.
11. Including statutory auditors.
12. Prepared jointly by the Association Française des Entreprises Privées (AFEP) and the Mouvement des Entreprises de France (MEDEF).
13. This wording is reflective of the wording of the European Commission's 2009 recommendation that "Award of variable components of remuneration should be subject to predetermined and measurable performance criteria. Performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long term value creation, such as compliance with applicable rules and procedures". Many European countries have utilised their Codes as a means of implementing the Commission's recommendation.
14. The Dodd-Frank Act requires the SEC to make rules that are similar to, though worded differently, to these current disclosure requirements relating to compensation consultants.

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