Executive Remuneration and Its Regulation

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Submitted in accordance with the requirements for the degree of Doctor of Philosophy

The University of Leeds Law School

October 2016

Acknowledgement

First, I want to send my thanks and best wishes to my supervisor, Professor Andrew Keay. Thank you so much for being supportive and considerate all the time. It has been four years' fantastic memory doing research under your professional supervision. I cannot finish this thesis without your help and comments.

I want to send thanks to my second supervisor, Dr. Jingchen Zhao. Thank you very much for your advice, help, patience and support.

I want to send all my love to my parents, Yanru Li and Qingyi Li. Thank you for supporting and trusting me from I was born. You are still the most important people in my life.

To my husband, Edward Yihuai Wang, I have known you for 16 years. I feel really grateful that my lifetime companion is you.

To my first son, Albert Weili Wang, life is so amazing. It has never been so adorable in my life to do anything as finishing this thesis with you under my belly.

Abstract

Executive remuneration is about how to pay executive directors for their work. The definition of executive remuneration is from the agency cost developed from agency theory, proposing that shareholders shall pay directors for managing the company since the separation of ownership and management of firms.

This thesis proposes that, three levels of elements are needed to understand executive remuneration: 1. The level and structure of executive pay; 2. The intrinsic factors that will influence the level and structure of executive remuneration: capital market, labour market, product market and corporate governance; 3. The regulation provided by government to interfere with executive remuneration issues. It will also be proposed that, there is no objective standard of justifying what is a good executive remuneration design. Pay for performance is currently the most proper principle and goal for remuneration design.

There are two research questions to be answered by this thesis, first is should executive remuneration be regulated and, second is what regulation should be made under current situation of executive remuneration.

After discussions around the problems of executive remuneration without regulation, the first research question will be answered by suggesting that executive remuneration problems cannot be solved without regulation. This thesis will then focus on the regulations that provided to solve executive remuneration problems. Various regulations from several countries from the company law and corporate governance perspective and their effects in adjusting the level and structure of executive remuneration will be analysed. The UK's 2013 reform which provides shareholder with a binding vote on executive remuneration will be emphasised to investigate the merits and faults that regulations can bring to executive remuneration.

Several suggestions towards remuneration regulation will be made in this thesis from the aspects of shareholder empowerment, board accountability and the design of executive remuneration. Targeted with the concerns left by the UK remuneration reform and other countries, these regulatory suggestions are designed from a normative perspective. They will answer the second research question by proposing that if regulations are designed in a proper way, certain problems of executive remuneration can be solved.

Chapter One

Introduction

Background

The board of directors leads and controls a company. According to the UK Corporate Governance Code 2016, an effective board is “collectively responsible for the long-term success of the company”.[1] The board links managers and investors, and is essential to good corporate governance and investor relations.[2] Mallin suggests that the board is responsible for determining the company’s aims and strategies, developing plans and policies to achieve the aims, monitoring progress in the achievement of those aims, and appointing a chief executive officer (CEO) with high leadership qualities.[3] Most commonly there are two types of board structure: the unitary board, which is one single board comprising executive and non-executive directors, and the dual board consisting of a supervisory board and an executive board of management. Unlike many other European countries that use dual boards, the UK employs unitary boards. Not only the CEO but also all the executive directors are responsible for the running of the company’s business, along with managers who are not board members. On the other hand, the non-executive directors have responsibility for monitoring the executives’ behaviour and contributing to board decisions. The board should always pursue a balance between executive and non-executive directors to avoid either group becoming too powerful.

With public companies, which is where one sees the most use of non-executive directors, under most circumstances the non-executive directors are paid an agreed set amount, which includes no share options and has no relevance to their performance on the board. In contrast, the executive directors generally receive

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[1] Financial Reporting Council (FRC), The UK Corporate Governance Code, April 2016, Section A, Leadership, available at https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx, last accessed, 12 July 2016

[2] C. A. Mallin, *Corporate Governance,* 4th edition (Oxford, Oxford University Press, 2013), p. 164.

[3] *Ibid*

not only basic salaries and annual bonuses, but also stock options and restricted share plans. It is obvious that the executive directors' payment is more complicated, as the UK Corporate Governance Code requires: "a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance".[4] In practice, the required link is not easily established, and executive remuneration remains a debatable issue.

The economist Roger Bootle once argued that "the level of executive pay is a total and complete scandal. There is a real crisis of capitalism about all this. Where people are paying themselves tens of millions of pounds, it adds up to a form of expropriation".[5] It was emphasised by the High Pay Commission in the UK that excessively high pay is "a symptom of a wider market failure based on a misunderstanding of how markets work at their best."[6] According to the Commission's investigation, in 2011, even though economic growth was still slow, executive remuneration in FTSE 100 companies[7]had risen by 49% on average, compared with a 2.7% average increase in employees' payments.[8] It was suggested that the growing income gap between top executives and average employees may pose a threat to companies' long-term interests.[9] What has driven executive remuneration to this level?

To understand the executive compensation problem, it is essential to have a general idea of the rationale for the awarding of compensation. In the UK, the Corporate Governance Code defines the board's role as "to provide

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4 *Supra*, n.1, FRC, Corporate Governance Code 2016, Section D, Remuneration, main principle.

5 The Guardian, J. Finch, J. Treanor & R. Wachman, "Critics unite over executive pay to force the 'aliens' of business down to earth", 31 March 2010, available at http://www.guardian.co.uk/business/2010/mar/31/myners-urges-fsa-to-investigate-shareholders-role, last accessed, 12 July 2016

6 The High Pay Commission, "Cheques with balance: why tackling high pay is in the national interest" (2012), available at: http://highpaycentre.org last accessed 12 July 2016

7 London Stock Exchange (LSE), "The FTSE UK Index Series is designed to represent the performance of UK companies, providing investors with a comprehensive and complementary set of indices that measure the performance of all capital and industry segments of the UK equity market" available at: http://www.londonstockexchange.com/statistics/ftse/ftse.htm last accessed 12 July 2016. FTSE 100 is the first 100 public companies listed in the LSE, FTSE 250 is the companies listed from the 101st to 250th in the LSE.

8 *Ibid.*

9 M. Jensen & K. Murphy, "Performance Pay and Top-Management Incentives" (1990) 98 *Journal of Political Economy* 225, p.261

entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed".[10] In many jurisdictions directors owe personal fiduciary duties to their companies, as well as a duty of care. One of the fiduciary duties is the duty to avoid conflicts, and this in particular requires a personal obligation to practice good conscience and loyalty to the company. Because a "deficient" remuneration structure can encourage risk-taking and thereby cause damage to the company,[11] directors cannot decide on the amount of their own remuneration. Neither can they permit someone who is dependent on the directors to decide on their remuneration, and nor may they receive an "excessive and unreasonable" amount of money.[12] Furthermore, it is often suggested that the shareholders, as the "owners" of the company, must be given the power to protect their interests, and they should have a right to express their views on the directors' remuneration or on the risks imposed by the company's remuneration practices.[13] From a contract perspective, when directors are employed by the company they are bound by the company's articles of association. Problems may then appear if the company seeks to amend the terms of a director's remuneration without complying with the articles.[14] According to the Code, this situation can be resolved by the introduction of a claw-back provision to prevent rewards for failure.[15]

Many scholars explain executive remuneration problems though "principal-agent" theory. As Conyon and Mallin[16] have suggested, shareholders are viewed as the "principal" while managers are seen as their "agents". The economic literature demonstrates that the compensation earned by senior management should be

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[10] *Supra*, n. 1, FRC, Corporate Governance Code 2016

[11] J. Miller, R. Wilseman & L. Gormez-Mejia, "The Fit between CEO Compensation Design and Firm Risk" (2002) 45 *Academy of Management Journal* 745, p.754

[12] J. Lee, "Regulatory regimes and norms for directors' remuneration: EU, UK and Belgian law compared" (2012) 13 *European Business Organization Law review* 599, p.603

[13] *Ibid.*, p.609.

[14] *Ibid.*, p.612.

[15] *Supra*, n.1, FRC, Corporate Governance 2016, Schedule A, "Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct." About Claw-back, "A claw-back is required when managers take a contractual share of early investment gains that are subsequently reduced by losses." D. L. Scott, *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investors,* 3rd Edition (Boston, New York, Houghton Mifflin Company, 2003) p.63

[16] M. J. Conyon & C. A. Mallin, "Directors' share options, performance criteria and disclosure: Compliance with the Greenbury Report" (1997), *ICAEW Research Monograph*, London, p.16

related to company performance for incentive reasons. In this context, a well-designed compensation policy will help to ensure that the objectives of directors and shareholders are aligned, using share options and other long-term incentives as a key mechanism. However, others, such as Bebchuk and Fried,[17] think that there are obvious flaws in companies' pay arrangements, which can hurt shareholders both by increasing pay levels and, even more importantly, by leading to practices that dilute and distort managers' incentives. The global financial crisis helped to highlight the inequities existing between executive directors' considerable remuneration and the underperformance of the companies in which they acted as agents. In this situation shareholders can lose vast sums of money, even their life savings, and employees may find themselves on shorter working weeks, lower incomes, or being made redundant.[18]

In Anglo-American systems, statutory provisions are designed to regulate executive remuneration by imposing reporting duties on directors and auditors. In order to improve corporate governance for the benefit of both shareholders and stakeholders, the statutory trend is to increase the disclosure of executive remuneration and empower shareholders' by granting them a "say on pay". In the UK the issue of executive remuneration has caused significant concern, ever since the 1980s. With the privatisation of many entities, the pay level of the executive directors in many companies increased dramatically without any evidence that their performance improved to reflect the increase in their pay.[19] In 1995 the Greenbury Committee was established as an industry-sponsored study group to address the remuneration problem. In the same year the Committee published the Greenbury Report, recommending that a code should be produced to force boards to give more detailed and audited remuneration disclosures, alongside the introduction of an independent remuneration committee that was to be a sub-committee of the board.[20] These suggestions were first included in the Listing Rules of the London Stock Exchange, and were then inserted into the

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[17] L. Bebchuk and J. Fried, "Pay without performance: The unfulfilled promise of executive compensation" (2004) *Harvard University Press*, Boston, MA., p.80
[18] *Supra*, n.2, Mallin, p.190.
[19] J. N. Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in" (2009) 46 *Harvard Journal on Legislation* 323, p.341.
[20] Greenbury Committee Report on Directors' Remuneration (1995) available at: http://www.ecgi.org/codes/documents/greenbury.pdf pp.26-34, last accessed 12 July 2016

Combined Code of Corporate Governance formulated in 1998 after the work of the Hampel Committee.[21] They were implemented on a "comply or explain" basis.[22] One important provision of the Code was the requirement that the remuneration packages of executives should be approved by the shareholders, especially when they are controversial or when they have changed significantly.[23]

The British Government intervened in 1999, publishing a consultation paper about the introduction of regulations that would empower shareholders of quoted companies to vote on executive compensation.[24] In 2001 a Green Paper was published by the Department for Trade and Industry concerning the issue of rewards for failure in cases of directors leaving the company, while also suggesting that shareholders should be given the power to change the culture in which directors exit the company after perceived failure, but nevertheless enriched by the amount of exit pay that is received.[25] These consultation papers led to the introduction of the Directors' Report Regulations, which commenced operation in 2002.[26] The Regulations mean that quoted companies were required to publish an annual directors' compensation report with details of remuneration packages, the company's future remuneration policy, and how the remuneration committee works in the boardroom.[27] According to the new provision in section 241A of the Companies Act 1985, which was introduced, shareholder democracy would be improved by authorising a mandatory but non-binding vote for the shareholders on deciding the annual remuneration report at the general meeting.[28] This report aimed to achieve three principles concerning directors'

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[21] UK Corporate Governance Code, available at: http://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/uk-corporate-governance-code, last accessed 12 July 2016

[22] *Supra*, n.1, FRC,

[23] Charlotte Villiers, "Controlling Executive Pay: Institutional Investors or Distributive Justice" (2010) 10 *Journal of Corporate Law Studies* 309, p.317.

[24] B. Main, "Directors' Remuneration and the DTI Review of Company Law" (2001) 53 *Economic Affairs* 48, p.54

[25] Department for Trade and Industry (DTI), Green Paper, "'Rewards for Failure' Directors' Remuneration – Contracts, Performance and Severance", June 2003, para 20

[26] Directors' Remuneration Report Regulations 2002, SI 2002/1986,

27 Companies Act 1985, s. 243B, referred by L. Roach, "The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration" (2004) 25 *The Company Lawyer* 141, p.145

[28] *Ibid.*

remuneration: accountability, transparency, and linkage between pay and performance.[29]

Critical shareholders of large public companies are often institutional investors such as pension funds, banks and insurance companies. To ensure the correct alignment between the interests of executives and shareholders, and in order to provide the best return to shareholders, the representatives of institutional shareholders also issued their own guidelines indicating their expectations of the compensation policy. For example, the Hermes Equity Ownership Service, the National Association of Pension Funds (NAPF, the now PLSA, Pensions and Lifetime Savings Association) and other institutional investors published their guidelines for their investees' remuneration practice.[30] Early in 2009, the NAPF Guidelines required that for the formulation and implementation of compensation policy, they "expect companies to give a transparent, succinct and easily understood statement of the objectives of their remuneration policies".[31]

The effects of regulations have been examined by various studies. According to the 2004 Deloitte survey of institutional investors, 70% of the respondents thought that shareholder votes have a very significant influence on companies' remuneration policies.[32] These regulations led to increased and richer dialogue between shareholders and companies, with shareholders getting more transparent information to consider and shareholder democracy was improved by being able to take a view on remuneration.[33] Ferri and Maber also found that there was an increase in penalties for poor performance, and controversial CEOs would be more easily removed because of shareholders' increased voting

[29] *Ibid.*
[30] Hermes EOS, NAPF et al, "Remuneration Principles for Building and Reinforcing Long-Term Business Success", November 2013, available at: http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0351_remuneration_principles_for_building_and_reinforcing%20_longterm_business_success_nov2013.aspx last accessed, 12 July 2016
[31] NAPF, Corporate Governance Policy and Voting Guidelines, February 2009, available at: http://www.plsa.co.uk/PolicyandResearch.aspx p.7, last accessed,12 July 2016
[32] Deloitte, Report on the Impact of the Directors' Remuneration Report Regulations: A Report for the Department for Trade and Industry (2004), available at http://uk.practicallaw.com/6-200-2235?q=&qp=&qo=&qe= p.13, last accessed, 12 July 2016
[33] D. Gilsham, "Say on Pay Six Years On: Lessons from the UK Experience", 2010, Railpen Investments and PIRC Limited, available at: http://www.corpgov.net/2010/07/say-on-pay-six-years-on-lessons-from-the-uk-experience/ p.16, last check on July 12th, 2016

powers.[34] This finding suggests that those regulations did contribute to reducing the rewards for failure. Additionally, early studies in 2009, carried out during the global financial crisis, showed a "significant upsurge in opposition to remuneration reports in general".[35]

However, there was a huge amount of evidence showing that the shareholders who rejected remuneration proposals did not always defeat proposed remuneration policies. By August 2009 there were only eight rejections among thousands of votes over the six years since the advisory vote had been introduced by the Companies Act.[36] Gilsham concluded that "given the low level of votes against remuneration reports prior to the current spike in opposition, we would query whether shareholders in UK companies have used the rights granted to them effectively".[37] Meanwhile, the executives' pay levels had not stopped increasing. More transparent compensation reporting actually had the effect of raising the pay level.[38] More intense monitoring leads to increased risk for managers, and as a consequence managers will require higher payment for the increased risk that they are subjected to. In turn, complaints from shareholders and employees about the excessive executive pay levels will then cause stricter monitoring, leading to a negative cycle.[39] Gordon thinks that the NAPF guidelines have also had a huge negative impact: they invite a tendency to "follow the guidelines, stay in the middle of the pack, and avoid change from a prior year, when the firm received a favourable vote".[40] Gordon suggests that "the system as a whole seems to tilt toward stasis rather than innovation in compensation practices".[41]

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[34] F. Ferri & D. Maber, "Say on Pay Votes and CEO Compensation: Evidence from the UK", (2013) 17 *Review of Finance* 527, p.551
[35] *Supra*, n.33, Gilsham, p.16.
[36] *Supra,* n.19, Gordon, p.341.
[37] *Supra,* n.33, Gilsham, p.16
[38] *Supra,* n.23, Villiers, p.317
[39] R.E. Hoskisson, M.W. Castelton & M.C. Withers, "Complementarity in Monitoring and Bonding: More Intense Monitoring Leads to Higher Executive Compensation" (2009) 23 *Academy of Management Perspectives* 57, p.63.
[40] *Supra*, n.19, Gordon, p.341
[41] *Ibid.*

On 27 June 2012 the British Government announced the draft of new regulations determining what companies must disclose in their pay reports.[42] New clauses made changes to Part 10 (section 226) and Part 15 (sections of 421, 422 and 439) of the Companies Act 2006, and the implementation of these clauses were supposed to commence by October 1st, 2013.[43] These provisions were designed to create a robust framework within which directors' pay is set, agreed and implemented, [44] while ensuring that shareholder engagement with the remuneration policy is sustained over the long term.

The UK 2013 remuneration reform specified that the directors' remuneration report should contain two distinct parts:[45]

> "1. A policy report setting out all elements of a company's remuneration policy and key factors that were taken into account in setting the policy. This part of the report will only be required when there is a shareholder vote on the policy.
> 2. A report on how the policy was implemented in the past financial year, setting out actual payments to directors and details on the link between company performance and pay."

To increase the confidence of investors, the UK reform upgraded shareholders' power of say on pay. The UK shareholders are able to use their binding say on pay to vote on the remuneration policy, which is regulated to be voted on a three year basis.[46] On the remuneration implementation report, shareholders have an

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[42] The BIS, "Government strengthens reporting framework for directors' pay", June 2012, available at https://www.gov.uk/government/news/government-strengthens-reporting-framework-for-directors-pay--2 last accessed, 12 July 2016

[43] UK Government Legislation, Enterprise and Regulatory Reform Act of 2013, Chapter 24, Payments to director of quoted companies, chapters 79-82, available at: http://www.legislation.gov.uk/ukpga/2013/24/part/6/crossheading/payments-to-directors-of-quoted-companies/enacted last accessed, 12 July 2016

[44] *Supra,* n.42*,* BIS, p.12

[45] The BIS, "Directors' Pay: Consultation on revised remuneration reporting regulations", June 2012, p.4, available at http://www.bis.gov.uk last accessed, 12 July 2016

[46] *Supra,* n.43, UK Government Legislation, Enterprise and Regulatory Reform Act of 2013, Chapter 79

advisory vote and listed companies shall provide their reports for resolution annually.[47]

This thesis seeks to make an original contribution to knowledge by investigating the effect of this new binding say on pay approach, suggesting that under current circumstances empowering shareholders to solve managers' remuneration problems does have some merit, with the rate of compensation increases slowing down and the board putting other concerns above the voice of their investors. However, this thesis also argues that the effect of the binding vote on remuneration policy is not enough to stop firms paying for executives' underperformance and to promote the structure of remuneration during pay setting, since the government's aim in publishing this regulation was to reduce the outrage felt in relation to excessive pay from the public and investors – acting rather like a camouflage, increasing shareholders' power but not focusing on reducing the level of remuneration and improving pay structures.

On the basis of accepting that shareholder intervention is still the right direction to take in regulating executive remuneration practice, it will also be recommended that to increase shareholders' engagement in board decisions and the board's accountability towards shareholders on remuneration issues, several other methods can be introduced into company law and the corporate governance code.

Research Questions

As mentioned above, how the commercial world should deal with executive remuneration has been a problem for many years, and it continues to be so. For instance, there has been a debate as to whether executive remuneration should be a matter left to the remuneration committee or the shareholders, or whether it should be the subject of regulation. The whole issue of executive remuneration warrants further examination. There are essentially two questions which this thesis seeks to answer.

[47] *Ibid.*

1. Is it necessary to regulate executive remuneration?

Joseph Lee claims that among all corporate governance issues, the problem of executive remuneration has proven itself to be “the most challenging area” for regulation.[48] According to Lee, regulating directors’ compensation means direct intervention from the government over market prices, which will raise questions concerning legitimacy in a liberal society, and efficiency in a market economy in which individual rights and freedom of contract are crucial constitutional conditions.[49] However, public outrage has reached a high point because of the gaps between the perceived excessive compensation received by executives and the low, stagnant wages of ordinary employees, together with concern that excessive executive compensation poses a risk to social and financial stability.

A second question that follows on from this is:

2. If regulation is appropriate, what form should it take?

It is a general international view that excessive executive remuneration is due to a lack of alignment between the interests of the board and shareholders, and the UK has not been the only nation using the shareholder advisory vote to solve the executive remuneration problem. In 2011, the Securities and Exchange Commission (SEC) of the United States (US) government introduced section 951 of the Wall Street Reform and Consumer Protection Act (commonly referred to as “Dodd-Frank”) to empower their public companies’ shareholders, giving them a non-binding advisory vote to approve or disapprove the remuneration of the five highest paid executive directors, at least once every three years.[50] This was known as “say on pay”. Evidence from the first two years has shown that the shareholders’ say on pay did help to link executive compensation with firm

[48] *Supra*, n.12, J. Lee, p.603
[49] *Ibid.*
[50] US Securities and Exchange Commission, “Testimony on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. SEC”, available at http://www.sec.gov/news/testimony/2011/ts021711mls.htm last accessed. 12 July 2016

performance and shareholder returns.[51] However, whether the shareholder advisory vote is the most efficient mechanism to curb excessive executive remuneration still remains to be seen.

In March 2013 Switzerland (the country which has the second highest median executive compensation in the period since 1997 (the US has the highest) passed a new law giving a binding say on pay to shareholders.[52] This was the strictest regulation in Europe to date regarding executive remuneration problem. In spite of its intention to keep an investor-friendly environment, the Swiss government was determined to stop remuneration of executive managers from growing excessively.[53] Is this binding vote the most suitable way to control excessive compensation? Will empowering shareholders in terms of payment policy be the right action to solve the remuneration problem? This thesis will endeavour to provide analysis of these questions.

Also, this thesis proposes that there are three levels in understanding the subject of executive remuneration: 1) the level and the structure of executive pay, which form the objective and also the obvious content of the pay design and report; 2) market factors that may influence objective issues: corporate governance, the labour market, the capital market, and the product market; and 3) regulations from various governments intended to solve executive compensation problems by adjusting those markets, most of which act by improving corporate governance, including increasing shareholder monitoring and board independence.

The correlation between these three levels is the key to solving and mitigating executive remuneration problems. If regulation (the third level) provides efficient methods for corporate governance (the second level), then the level and structure of executive pay (the first level) will remain reasonable and fair.

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[51] M. B. Kimbro & D. Xu, "Should Shareholders Have a Say on Executive Compensation? Evidence from Say-on-Pay in the United States", (2016) 35 *Journal of Accounting and Public Policy* 19, p.37

[52] The Economists, Berlin, "Fixing the fat cats", 9 March 2013, Business.

[53] Wall Street Journal, A. Peaple, "Swiss Shareholders Get More Say on Pay", 4 March 2013, available at http://www.wsj.com/articles/SB10001424127887324539404578340052679731408 last accessed, 12 July 2016

Aims

In particular, the thesis endeavours to address the following aims. First, it will discuss and analyse the theories that underpin the concept of remuneration. Second, it will examine the various components that can constitute an executive's remuneration package. Third, it will identify and examine the way that remuneration has become an issue over the years. Fourth, it will ascertain what obstacles have existed in the past, and some that still do exist, in determining the remuneration of executives. Fifth, the study endeavours to consider how various jurisdictions have addressed the issue of executive compensation, including examination of the regulations that have been enacted in some nations. Sixth, the thesis analyses whether regulation is the best way of dealing with the remuneration issue. The thesis argues that regulation is by far the best way, and it aims to assess the kind of regulation which is the most appropriate.

Methodology

In order to achieve the aims a mixture of research methods will be applied, which will be classified as doctrinal or theoretical. This will involve some consideration of existing empirical studies.

First, the doctrinal research will involve an in-depth study of relevant literature regarding executive remuneration issues in the UK. This research will then focus on reform in the UK, investigating how regulation will control excessive remuneration and improve the economy, as has been mentioned by the British Government. The review will consider academic papers, books, case law, news articles and company reports systemically. In addition, there will be some comparison of how other countries, like the US, Germany, Australia and Switzerland, regulate executive compensation, discovering what can be learned and borrowed from their legislative experience.

Second, the theoretical method will be used to examine relevant underpinning theories in relation to executive remuneration. Starting with agency theory, which explains why it is hard to achieve an alignment of interests between shareholders and directors, the thesis will proceed by investigating other theories, such as optional contract theory and managerial power theory, that derive from agency theory. These theories will contribute to understanding what causes the executive remuneration problem, and what is the rationale underlying it. After the theoretical research, the thesis will have arrived at a clear view of the remuneration problem and some indications as to how to address it.

Outline

After this chapter, Chapter 2 will examine the variety of theories that have been devised in relation to executive remuneration. To solve the problems around executive pay, it will be essential to understand this area and various factors relating to it. The study will start by distinguishing the role of the directors by analysing basic corporate governance theories. Agency problems, agency theory and optimal contracting theory from which manager's pay was developed will be analysed first. The managerial power approach, which has become the second popular theory in explaining executive remuneration will be discussed next. Its initiators, Bebchuk and Fried, have suggested that "any discussion of executive compensation must proceed against the background of the fundamental agency problem afflicting management decision-making".[54] There will be a discussion of the pros and cons of theories analysing how executive remuneration and the agency problem are linked. The optimal contract view emphasises that executives, who are always risk averse, will not automatically seek to maximise shareholders' benefits. Therefore, providing directors with adequate incentives in their remuneration is very important in solving agency problems. On the other side of the debate, the managerial power approach argues that executive remuneration should not only be viewed as a potential instrument for addressing the agency problem, but also as part of the problem in itself.

Chapter 2 will prove that, for all that scholars and theories have attempted to explain executive compensation, only one relationship can be certain, and its

[54] L. A. Bebchuk & J. M. Fried, "Executive Compensation as an Agency Problem" (2003) 17 *Journal of Economic Perspectives* 71, at p.72.

invariability will be applied to develop all of arguments in this thesis. This is the idea that executive pay must be aligned to performance. Also, Chapter 2 will offer a brief introduction of the key elements of remuneration packages, including base salary, bonuses, stock options and other option plans.

After Chapter 2 has discussed the relationships around executive compensation and suggested that it should be designed according to performance, Chapter 3 will explain how to align pay to performance and why this relationship has been disrupted, leading to excessive levels of pay and also their irrational structure. It will be shown that excessive remuneration problems and their clear unfairness cannot be solved by market forces (including the capital and product markets) and corporate control (such as independent boardroom and incentive compensation) alone. The necessity of regulating for remuneration will be discussed. A balance will be sought between government intervention and the freedom of the market.

Chapter 4 will provide a detailed history of executive remuneration in the US while analysing the influence of various factors. It examines the various approaches that have been taken to deal with executive remuneration, and it explores evidence collected from papers and reports on the current situation that exists as far as executive remuneration is concerned. Evidence from the US is examined because this jurisdiction has experienced an entire process, from executive remuneration acting as a solution to the agency problem to this solution becoming a problem in itself. Furthermore, large amounts of research that have been produced have been based on this country's experience. Chapter 4 also provides a comparison study on how executive remunerations are regulated under different legal systems and how these regulations work in particular circumstances. This will involve an examination of Anglo-American systems as well as systems from the European continent.

Chapter 5 will focus on the shareholders' binding vote that is used to regulate executive remuneration in the UK and Switzerland. After analysing how the previous advisory vote by shareholders worked as a mechanism (especially in the UK and the US), the pros and cons of the advisory vote will be summarised. Then this chapter will consider a variety of evidence that is able to analyse how the new reforms in the UK and Switzerland have solved executive remuneration problems. Evaluation will be carried out by investigating firms' performance and shareholders' paybacks compared to the previous few years, and by studying any changes in the level and the structure of executive remuneration. Moreover, a debate on whether the regulation will empower shareholders to control executive remuneration will be presented, since shareholders still suffer from an information asymmetry problem and there are other ways in which remuneration could be regulated, such as providing the say-on-pay power to the representatives of a company's employees. After that, a general idea of how the reform has changed UK companies will be provided, and the most appropriate regulation for the current economy will be examined.

Chapters 6 will then present a summary of problems in the corporate governance area, which still remain after the market adjustments and government regulations related to executive remuneration. This is followed by the provision of suggestions to address the problems.

After analysing the new regulations for executive remuneration in the UK and Switzerland, there will be some lessons to learn for some countries operating within the same legal systems. The rationale for choosing shareholder primacy in pay decisions will be emphasised, demonstrating that it is not only because of their efficiency and convenience that various regulations will empower shareholders and give them a say on pay; also, giving shareholders the right to intervene in pay policy within a reasonable scope will help to keep executive pay under control, and thus will promote the long-term success of the company. Moreover, how to allow shareholders to engage with remuneration decisions to have a better influence on pay will be discussed, and the range of shareholders' power over pay will be analysed. For example, governments in the US and Germany are also thinking of changing their regulations, especially whether or not to import shareholders' binding say on pay.[55] Whether the UK's binding vote is

[55] R. S. Thomas & C. Van der Elst, "Say on Pay Around the World", (2015) 92 *Washington University Law Review* 653, p.728.

useful to empower shareholders and reduce pay levels will be analysed. Suggestions towards how to use shareholder say on pay to influence remuneration more efficiently will be provided.

There are also problems related to the board and the remuneration committee designing pay policies with high levels of transparency and dealing with managerial influence while having actual remuneration paid to executive directors. Chapter 6 will make several suggestions for improving director accountability to shareholders and how to guarantee, on a normative level, the independence and competence of the remuneration committee and remuneration consultants. Additionally, for executive remuneration, the devil is in the detail; in the third section of Chapter 6 there will be a proposal for how to design some controversial elements of remuneration packages to ensure that pay is always be aligned with performance.

Chapter 7 will provide the conclusion to this research.

Chapter Two

The Foundation of Executive Remuneration

Introduction

This chapter will introduce the concept of executive remuneration in public companies, and discuss several theories dealing with the issue on how we should understand and explain executive remuneration. It will contribute to answering the first research question of why we need to regulate remuneration issues by building up a fundamental understanding of executive pay and its intrinsic problems caused by the creation of executive pay from a theoretical perspective.

Companies hire and pay executive directors to increase shareholders' interest. Companies are run by professional managers (some of whom will be executive directors and members of the board of directors) and, they are often said to be, owned by shareholders, due to dispersed ownership and the separation of ownership and management in the Anglo-American corporate system.[1] It is the managers' fiduciary duty to align their interests with the firm's, to improve company's performance and preserve it from takeover. However, most managers tend to protect themselves from failure and from incurring a bad reputation, rather than putting themselves in prudential positions by making decisions that may increase shareholders' benefits. To increase the executives' incentives to improve their companies' success and decrease their risk aversion, modern corporate governance has created and provided several ways to align the interests of executives and firms. One of the most efficient ways is executive remuneration.

There are many theories trying to explain the executive remuneration issues and to provide solutions towards how to solve problems that remuneration has caused.

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[1] From cases such as: ***Salomon v. A. Salomon & Co. Ltd*** [1897] AC 22 and ***Santa Clara County v. Southern Pacific R. Co.*** 118 US 394 (1886)

The agency theory proposed by Jensen and Meckling[2], the tournament theory by Lazear and Rosen[3], the human capital theory by Combs and Skills[4], the managerial power approach by Bebchuk and Fried, the institutional theory by Balkin[5], the political theory by Ungson and Steers[6], and the fairness theory by Wade.[7] This chapter will only select several of them which are important to understand the current system of executive remuneration.

In this chapter, for ease of exposition, different elements of executive remuneration will be analysed first. That is, we will consider the different incentives of remuneration that currently being used by companies to pay their executives directors.

Starting with the agency problem and the principal-agency theory, the second section of this chapter will explain the creation of executive remuneration and why we need to address remuneration as an important issue in modern corporate governance.

The third part of this chapter will give a general view of optimal contracting theory, addressing the issues on how we moderate conflicts of interest between managers and shareholders and how the managers' remuneration should be designed to align these interests.

In the fourth part, another popular but contestable theory, the managerial power approach, will be discussed. Since none of these theories can explain executive

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[2] M. Jensen & W. Meckling, "Theory of the Firm: Managerial behaviour, agency costs and ownership structure" (1976) 3 *Journal of Financial Economics* 305; also M. Jensen & K. Murphy, "Performance Pay and Top-Management Incentives", (1990) 98 *Journal of Political Economy* 225

[3] E. P. Lazear & S. Rosen, "Rank-Order Tournaments as Optimum Labour Contracts", (1981) 89 *Journal of Political Economy* 841

[4] J. Combs & M. Skills, "Managerialist and Human Capital Explanations for Key Executive Pay Premiums", (2003) 46 *Academy of Management Journal* 63

[5] D. Balkin, "Explaining High US CEO Pay in a Global Compensation: An institutional approach", (2008) *Global Compensation: Foundations and Perspectives*, edited by Gomez-Mejia & Werner, London Routledge

[6] G. Ungson & R. Steers, "Motivation and Politics in Executive Compensation," (1984) 9 *Academy of Management Review* 313

[7] J. Wade, C. O'Relly & T. Pollock, "Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation", (2006) 17 *Organizational Science* 527

remuneration and predict it in a satisfactory way, the fifth section will provide some detailed suggestions to improve these explanations and have a general understanding of executive remuneration set for this thesis.

I. Executive Remuneration

Generally, a public company has at least two kinds of directors, namely executive directors and non-executive directors. Executive directors are responsible for the running of the company's business, while non-executives are expected to monitor the executives' management behaviour as well as contribute to strategic decision-making. The following discussion will be focused on executive directors.

When directors are employed to be the managers of the company, they will sign a service contract under which they are responsible to exercise certain functions and be responsible, effectively, for the company's success. The contract also gives them the right to be paid. Directors owe their fiduciary duties to the company in the UK[8] and other common law jurisdictions. In this regard directors are regulated so as to ensure that they do not act in conflict with the interests of the company unless there are approved exceptions.[9] The UK's Companies Act 2006 gives an explanation of how the no-conflict rule should be applied.[10] The main point is that a director must avoid a situation where he has, or he may have, a direct or indirect interest that conflicts or may conflict with the interests of the company.[11] However, pursuing a penalty after the directors have broken their duties is often too late to get an appropriate remedy, sometimes even resulting in no remedy at all. On the other hand, case law shows that directors acting in good faith may be treated unfairly in a conflict situation.[12] In cases such as *Regal (Hastings) Ltd. v Gulliver*,[13] it might be said that the courts have applied the non-conflict rule too "inflexibly", so that directors acting in good faith in conflict

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[8] Sections 170-177 of the UK Companies Act 2006.
[9] A. Keay, "The Authorising of Directors' Conflicts of Interest: Getting a balance?" (2012) 12 *Journal of Corporate Law Studies* 129, p.136
[10] Section 175 of the UK Companies Act 2006
[11] *Ibid*
[12] *Supra*, n.9, Keay, p.136
[13] ***Regal (Hastings) Ltd V. Gullier*** [1967] 2 A.C.134; [1942] 1 ALL E.R. 378

situations are penalised.[14] To make sure that such conflicts of interest are avoided and to ensure that directors are responsible for the firm, it was thought that providing proper compensation was a good solution.[15] This suggestion was emphasised by Jensen and Murphy in 1990,[16] who argued that the problem of conflicts between executives and the firm will not be solved by only enforcing directors' duties or raising executive pay, but also by introducing compensation that could bring an alignment of interests. This alignment of interests may be achieved by offering fair incentives in relation to the directors' pay policy. Moreover, giving incentives in remuneration packages to encourage directors to improve the firm's performance has become a controversial issue, concerning whether executive pay can be designed according to their performance.

A. The elements of executive remuneration

The structure and level of remuneration are important methods to incentivise executive directors to align their interests with those of the firm. Normally the components of executive remuneration would include: a basic salary, bonuses, stocks and stock options, insurance, pensions, and other severance payments. According to the timing of the realisation of cash flow, these components can be classified as follows:

A.1. Short-term remuneration

The short-term remuneration includes basic salary and any bonus plans based on ex post performance. Separately speaking, the basic salary is based on the tasks and challenges that executives will face, their seniority and experience, and also the salaries earned by their peers in other firms in the same industry.[17] With the popularity of stock option plans since the 1990s, the basic salary has

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[14] *Ibid*.
[15] *Supra,* n.2, M. Jensen and W. Meckling, p.312
[16] M. Jensen & K. Murphy, "CEO Incentives-It's Not How Much You Pay, but How" (1990) 68 *Harvard Business Review* 138, p.150
[17] M. Goergen & L. Renneboog, "Managerial Compensation" (2011) 17 *Journal of Corporate Finance* 1068, p.1069.

accounted for a steadily declining percentage of an executive's pay.[18] However, in Murphy's analysis, basic salaries still draw substantial attention from outside because they can often be significantly high when compared with those of other employees.[19] Also, the executives are concerned about their basic salaries, which is a key component of their employment contract that guarantees a minimum increase in pay for the subsequent five years.[20] Because basic salaries constitute fixed amounts of cash compared to the other compensation components aligning pay to performance, executives who worry about poor performance leading to less pay will prefer to have a remuneration contract with a bigger fraction formed by the basic salary.[21] Moreover, the compensation committee will generally decide other elements of pay contracts, such as stock options and bonuses.[22]

The annual bonus is also determined by the remuneration committee, and is categorized in terms of the following components: performance measures, performance standards, and the sensitivity of pay and performance. These components can be explained as follows. Based on performance measures, the final bonus can be calculated either by aggregating the outcomes or measuring for other subcategories.[23] In a typical performance standard plan, no bonus should be paid unless a threshold performance has been achieved, and if only the threshold performance is attained then the executive will be paid a minimum bonus. Also, a target bonus is paid for achieving a performance standard, and normally there is a cap on this bonus. The range between the threshold and the cap is called the "incentive zone", implicating the "range of performance realisation where incremental improvement in performance corresponds to incremental improvement in bonuses".[24] The details of these three components will be discussed in the following chapters.

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[18] M. Conyon & K. Murphy, "The prince and the pauper? CEO pay in the United States and United Kingdom" (2000) 110 *Economic Journal* 640, pp.647-8
[19] K. Murphy, "Executive Compensation", (1999) Ashenfelter, Orley, Card & David (Eds.), *Handbook of Labor Economics. Elsevier*, North-Holland 2485, p.2494
[20] *Ibid*.
[21] *Ibid.*
[22] *Ibid.*
[23] P. Geiler & L. Renneboog, "Managerial Compensation: Agency solution or Problem?" (2011) 11 *Journal of Corporate Law Studies* 99, at p.108.
[24] *Supra*, n.19, Murphy, p.648

A.2. Long-term pay

A.2.1 Stock Options

Stock options were invented to give executives the right to buy shares of the firm's stock at a pre-specified price, which generally become exercisable over time.[25] For example, if executives are issued with shares by their firm, they may be only allowed to sell parts of these shares separately in the following five years. These executive-owned stocks should be rewarded with stock-price appreciation but not the total shareholder return that is usually available, because the latter includes dividends.[26] Additionally, these stock options are not allowed to be traded, and they will be forfeited if the executives leave the firm before their rights are exercised.[27]

Created in the 1950s, the method of using stock options to remedy the risk aversion of executive directors (risk aversion will be discussed later in this chapter) and to encourage them to make wise investments to enhance shareholders' wealth has been increasingly popular, and has been applied regularly since the 1990s.[28] As Geiler and Renneboog have summarised, under most circumstances, the options' exercise price is equal to the stock price on the date of the granting of the option.[29] Typically, the maturity of executive options will be after the elapse of ten-year service while they normally become vested after three years, meaning that executives can have access to the cash after three years.

In the UK, performance-vested stocks are forfeited unless a performance threshold is achieved. When purchasing stock options, executive managers pay

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[25] C. Frydman & D. Jenter, "CEO Compensation", (2010) 2 *Annual Review of Financial Economics* 75, p.80
[26] Investopedia, Ben MacClure, "A Guide to CEO Compensation", February 2007, available at http://www.investopedia.com/articles/stocks/04/111704.asp last accessed, 12 July 2016
[27] *Ibid.*
[28] C. Frydman & R. Saks, "Executive Compensation: A new view from a long-term perspective" (2010) 23 *Journal of Financial Study* 2099, pp.2107-8
[29] *Supra,* n.22, P. Geiler & L. Renneboog, p.108

a fraction of the strike price[30] when options are granted and the remaining part will be due at the exercise of options.[31] If executives fail to realize their options, for example if they have not achieved certain performance requirements, they will lose their prepaid price. Meanwhile, executives can still hold reload options.[32] The reload options are the rights to buy the remaining shares which have not been paid for by executives according to the firm's stock options plans. If executives exercise these options before their maturity, they will have to pay the exercising price with shares, rather than with cash, and then receive additional reload options for the same number of shares and maturity as for the exercised options.[33] That is to say, if executive directors have foreseen that they cannot achieve their target performance before their options are exercisable and they do not want to lose the money they have already paid to buy the shares, they can trade the shares they own to buy new options and extend the maturity. The exercising price of the new reload options is equal to the share price at the time the options are exercised. Thus, executives can lock in all future price appreciations through their options.[34] As a result, the value of the executive stock option is less than that of the equivalent stock-exchange traded option. However, in practice, executives who are risk-averse may still prefer their bonus in cash rather than options, while demanding a premium salary for taking more of these risky options.[35]

A.2.2 Restricted stocks

Restricted stocks are shares whose ownership is transferred to the executives after certain conditions are met. For example, these shares will not be granted if the executives leave the firm, for when an executive leaves any right to them is

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[30] "A Strike Price is the fixed price at which an option contract can be exercised. In the trade market, strike price is important to the option buyer because it determines the price at which they can buy or sell in the future, or if they choose not to exercise, how much profit/loss will occur in the trade." Dough, Strike Price Definition, available at: https://www.dough.com/blog/strike-price-options last accessed, 12 July 2016

[31] M. Georgan & L. Renneboog, "Managerial Compensation" (2011) 17 *Journal of Corporate Finance* 1068, at p 1077

[32] *Ibid.*

[33] *Ibid.*

[34] *Supra*, n.23, P. Geiler & L. Renneboog, p.109

[35] *Supra,* n.31, M. Georgan & L. Renneboog, p.1078

forfeited. This possibility allows for several benefits, such as executives avoiding taxation on the shares until restrictions lapse, or costs from the shares which can be amortised in their vesting period and recorded as the grant-date stock price.[36] The first condition of restricted stock is normally the vesting period, which is usually three to five years. In the UK there are additional conditions; for example, options can only be vested when specific performance targets have been achieved.

A.2.3 Long-term incentive plans

Long-term incentive plans are issued based on cumulative executive performance, usually vested over three to five years in the US. After the publication of the Greenbury Report on Directors' Remuneration in the UK in 1995, the popularity of long-term incentive plans increased rapidly. With the advent of the UK Corporate Governance Code which encourages companies to apply incentive plans in executive pay,[37] long-term incentive plans have replaced stock options in accounting for the biggest fraction of long-term pay in executive remuneration packages.

A.3. Retirement plans and others

Top executives will often join supplemental executive retirement plans (SERPs) over and above the existing company-wide retirement programmes. SERPs benefits are based on firm performance or the tenure of the executives. Besides this, executives may receive substantial remuneration from additional programmes or components, such as cash recruitment incentives, known as "golden hellos", or pay for relocation consumption.

Additional compensation may include severance pay and golden parachutes. A golden parachute or golden goodbye is a type of substantial benefit given to an

[36] *Ibid.*
[37] FRC, the UK Corporate Governance Code 2016, Schedule A, available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx, last accessed, 12 July 2016

executive director in the event that companies are taken over by another firm with directors' employment being terminated as a result. This benefit will take the form of share options, cash bonuses or combinations of these benefits.[38] The purpose of these types of pay is to encourage executives to work hard for the shareholders while minimising their concern that they will lose their jobs. Severance pay and golden parachutes do not create any incentives, and setting them creates a big problem for remuneration committees.

B. Who decides on the level and structure of executive pay?

The UK and US remuneration routes are mostly the same. In the UK, the Corporate Governance Code 2016 provides that a remuneration committee, which contains at least two (for smaller public companies) or three independent non-executive directors, should be established by the board of a public company.[39] The independent directors are typically defined as directors who are neither current nor past employees, and who have no direct business tie with the firm.[40] However, the recommendations for executive remuneration are seldom made by the remuneration committee alone, but by remuneration consultants, since the directors of the remuneration committee rarely examine market studies of competitive pay levels or propose new incentive plans. These remuneration consultants are expected to be experts who know about executives' basic salaries and bonuses in the same industry and know how to design and evaluate option plans for executives. After recommendations for executive pay, including pension rights and any compensation payments, have been discussed and passed by the remuneration committee, these recommendations will be presented for the

[38] L. Bebchuk & J. Fried, "Executive Compensation as An Agency Problem"(2003) 17 *Journal of Economic Perspectives* 71, p.88

[39] *Supra.,* n.37, FRC, Corporate Governance Code 2016, Section D, D.2.1.

[40] Summarised by K. Murphy, *Supra* n.19; in Mallin's *Corporate Governance*, (Oxford, Oxford University Press, 2010)
. "Directors' independence can be examined as follows: whether the director was a former employee of the company or group within the last five years; whether additional remuneration (apart from the director's fee) is received from the company; whether the director has close family ties with the company's other directors and advisors; whether he or she has served on the board for more than ten years; whether he or she represents a significant shareholder."

approval of the full board of directors, and then presented to the shareholders. The remuneration committee should also have a formal and transparent procedure for setting the levels of executive pay. In the US, public companies have a compensation committee in which there are two to three “outside” directors, i.e. independent directors as they are referred to in the UK. The compensation committee is designed to prevent executives from setting their own compensation levels. Nonetheless, in the US the recommendations from compensation consultants will always be delivered to the executives for revision or approval before they are sent to the compensation committee.[41]

The boards in UK and US companies, like those in several Member States of the European Union, are unitary boards. In the unitary board system, both the executive and the non-executive directors work in one single board, which is responsible for all the activities of the firm. In comparison, dual boards, consisting of a supervisory board and an executive board, are predominant in companies in Germany, Austria, the Netherlands and Denmark. The supervisory board monitors the executives and the direction of the business, while the executive board works on the management of the business. Generally, supervisory board members should not hold any position on the executive board, nor should they have any advisory role in relation to the boards of the firm’s competitors. In the dual board system, the remuneration committee consists of the whole of the supervisory board. According to the Cromme Code in Germany, which is a typical dual board nation, members of the remuneration committee decide on the executive compensation based on suggestions from the compensation consultants, while the supervisory board members’ compensation, which is also performance-related, is set during the general meeting or regulated in the articles of association.[42]

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[41] *Supra*, n.19, K. Murphy,
[42] Germany Corporate Governance Code, (the Cromme Code), available at: http://www.ecgi.org/codes/code.php?code_id=44 last accessed, 12 July 12 2016

C. The problems that excessive executive remuneration can cause

Generally, there are two main methods used by remuneration committees and pay consultants to set pay, which are according to stock performance and according to peer group comparison. It has been a general view that aligning the interests of executive managers and investors should be achieved by regulating pay through the company's equity share return; if the executive pay level outpaces the increasing stock price, then executives may be over-compensated.[43] The other method is according to pay information from the same industry and similar sized companies, although executives of the leading firms within an industry may be paid higher than their peers. However, the majority of managers should be paid at about the same level.[44]

Several concerns stem from the pay policies mentioned above, for instance the problem that relying on the remuneration committee and compensation consultants to set executives' pay may lead to unreasonable levels of pay, since problems like insider-dealing between independent directors and executives and shirking behaviour among non-executive directors are common in big firms. Issues like this will be discussed from a theoretical aspect in the following sections of this chapter, but the main point here is the importance of paying attention to executive remuneration problems and the necessity of reducing excessive levels of executive pay. Excessive executive compensation does not only jeopardise notions of fairness and social cohesion, it also imperils economic growth. The reasons for this are explained as follows.

C.1. Inequality

[43] Investopedia, J. Kuepper, "Evaluating Executive Compensation", Feb 2007, available at: http://www.investopedia.com/articles/stocks/07/executive_compensation.asp last accessed, 12 July 2016

[44] M. Conyon, S. Peck & G. Sadler, "Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom" (2009) 23 *Academy of Management* 45, p.53.

Thomas Piketty suggests that excessive pay for top managers is a "key driver" in the increasing income inequality in the EU nations and North America.[45] This inequality will also harm political stability. According to research by the High Pay Centre, the growing pay gap does not help social cohesion aspects of government policy making.[46] Public consent will be hard to obtain under a system which is mostly run by the well-paid elite and is perceived as beneficial to them; any regulation from such a government will not be appealing to the general public.[47] The President of the Institute of International Finance has emphasised that failures to decrease the income gap will risk "brewing more populist pressure on governments".[48]

C.2. Economic Case

Raghuram Rajan suggests that the reason why low- and middle-income households' debts are increasing is because of rising inequality and their willingness (or difficulty) in keeping pace with the standard of living enjoyed by the rich.[49] On the other hand, Lansley proposes that the economy will be forced to slow its pace of recovery because so much wealth is concentrated in the hands of such a small number of people.[50] Moreover, the economist Andrew Smithers suggests that the UK cannot recover sustainably from the 2008–2009 financial crisis unless the government provides regulation of the incentives that are provided for in executive pay packages.[51]

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[45] Y. Allaire & M. E. Firsirotu, "Inequality and Executive Compensation: Why Thomas Piketty Is Wrong?" (2014) *Institute for Governance of Private and Public organizations,* p.3

[46] High Pay Centre, "Reform Agenda: How to make top pay fairer" (2014), available at: http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer pp. 9-10, accessed, 12 July 2016

[47] *Ibid*.

[48] Bloomingberg, "Davos Finds Inequality Its Business as Backlash Seen" 23 January 2014, available at: http://www.bloomberg.com/news/2014-01-23/davos-makes-inequality-its-business-as-political-backlash-seen.html last accessed 12 July 2016

[49] R. Rajan, "How Inequality Fuelled the Crisis" July 2013, available at: http://www.project-syndicate.org/commentary/how-inequality-fueled-the-crisis last accessed, 12 July 2016

[50] S. Lansley, *The Cost of Inequality: Why Economic Equality is Essential for Recovery* (London, Gibson Square Books Ltd, 2011) p.37

[51] A. Smithers, *The Road to Recovery: How and why economic policy must change* (New Jersey, John Wiley & Sons, 2013) p.104

However, compared to the effects that a large pay gap may cause in society, uncontrolled pay levels will cause more serious economic problems, since compensating managers highly regardless of low shareholder return will certainly influence the confidence of investors and the productivity of a nation. As will be discussed in future chapters, managers in listed companies tend to focus on their short-term profits rather than the long-term productivity of their firms. Take the UK as an example: from 1990 to 2015, with the investment of gross domestic product ("GDP") in the UK declining from 26% to 17%, economists propose that it is the remuneration to blame for this decline, as the country was paying excessively to directors for a short-term success. [52] Investors worried about the threat constituted by executive remuneration incentives designed for short-term profits and the jeopardising of firms' long-term success, their confidence towards investing in this country has made the investment situation even worse. [53] However, investment is needed to increase productivity. Thus, excessive incentives in executive pay lead to low investment, while low investment may cause low productivity and slow the recovery of the economy. This is the rationale of governments emphasising long-term productivity of public firms and their countries when they provide regulations towards executive remuneration, which will be mentioned in the following chapters.

Also, from the business perspective, excessive pay will not only affect firms by giving them bad reputations, but also in terms of staff turnover, absenteeism and complaints from the public. [54] Additionally, studies show that companies with more equal levels of pay amongst their employees have performed better, and their employees are more loyal because they are less resentful of executive directors and the implementation of distributive justice makes them feel more attached to their firms. [55]

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[52] Financial Times, A. Smithers, "Executive Pay Holds the Key to the Productivity Puzzle", 28 May 2015.
[53] *Ibid.*
[54] High Pay Centre, "The High Cost of High Pay: An analysis of pay inequality within firms" January 2014, available at: http://highpaycentre.org/pubs/the-high-cost-of-high-pay-unequal-workplaces-suffer-more-strikes-and-higher last accessed, 12 July 2016
[55] D. Cowherd, "Product Quality and Pay Equity Between Lower-level Employees and Top Management: An investigation of distributive justice theory" (1992), 37 *Administrative Science Quarterly* 302, p. 316; see also, P. Martins, "Dispersion in Wage Premiums and Firm Performance" (2008) 101 *Economic Letters* 63, at pp. 64-5.

C.3. Further concerns

A high level of executive compensation will provide standards for people from various positions, which may increase the pay gap between the well-paid elite and others. Studies carried out by Professor Wilks suggest that executive remuneration has set a "benchmark" for other leading professions, such as financial services, corporate law firms and accountants.[56]

Inequality in one generation may not only influence people's life from a horizontal perspective, but also in a vertical way – that is to say, there may also be an effect on the next generation. Evidence has shown that household income differences can have huge effects on children's education outcomes.[57] Research from the Education Institution in London has indicated that income gaps influence generations differently according to the size of the gaps.[58] They proposed that the differences in adulthood between children who grew up in the 1970s and 1980s, during which time the pay gap was wider than in the period after World War II, were more obvious than among those who grew up in the 1950s and 1960s.[59]

From the above, we can conclude that executive remuneration was invented to decrease the interest conflict between shareholders and managers, but the problems developing from it can be serious indeed. The definition of executive pay and why its incentives should be designed to reward executive performance will now be analysed.

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[56] S. Wilks, *The Political Power of the Business Corporation* (2013), Cheltenham, Edward Elgar Publishing Ltd., p.82.

[57] Joseph Rowntree Foundation, "Does Money Affect children's outcomes?" (2013), available at: http://www.jrf.org.uk/publications/does-money-affect-childrens-outcomes last check on July 12th, 2016

[58] J. Blanden & L. Macmillan, "Education and Intergenerational Mobility: Help or Hindrance?" (2014), *CASE – Social Policy in a Cold Climate Working Paper 08*, Centre for Analysis of Social Exclusion, LSE, p.21

[59] *Ibid*.

II. Agency Problem and Agency Theory

A. The Agency Problem

Many suggest that a company is owned by its shareholders and managed by its directors. In the eighteenth century Adam Smith predicted a number of potential problems stemming from the separation of ownership and management: "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance (as if it were their own)."[60]

In 1932 Berle and Means published *The Modern Corporation and Private Property*, describing their proposal for the separation of corporate ownership and management control. This gave rise to a huge literature elaborating, refuting and testing their theory. Berle and Means developed theoretical categories of control types, which are divided into "owner-control" and "management-control".[61] Ownership-management structural change leads to problems connected with the delegation of control to agents. Under agency theory, agents are viewed as having a tendency to use their positions to satisfy themselves, rather than making more profits for the principal. During the 1960s and 1970s the risk-sharing literature described how risk-sharing can arise as a problem when cooperating parties hold different attitudes towards risk.[62] Agency theory then broadened this examination to explain the agency problem, which occurs when there are parties with different goals and where there is division of labour.[63]

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[60] G. Kennedy, "On Smith's Approach to Corporate Governance", October 2009, available at: http://adamsmithslostlegacy.blogspot.co.uk/2009/10/on-smiths-approach-to-corporate.html last accessed, 12 July 2016

[61] J. Cubbin & D. Leech, "The Effect of Shareholding Dispersion on The Degree of Control in British Companies: Theory and measurement" (1983) 93 *The Economic Journal* 351, p.352.

[62] K. Arrow, *Essays in the theory of risk bearing* (Chicago, Markham, 1971) p.79; R. Wilson, "On the theory of syndicates", (1968) 36 *Econometrica* 119, p.127.

[63] *Supra*, n.2, M. Jensen & W. Meckling, p.311; S. Ross, "The Economic Theory of Agency: The principal's problem" (1973) 63 *American Economic Association* 134, p.136

From the company law perspective, the agents are directors and the principals are shareholders, and agency problems can be caused by opportunism or self-interest among directors. Though enacted in different jurisdictions, in general every company law will set a non-conflict rule[64] to specify that directors must avoid conflicts with their company's interests, to prevent directors from using their management power to further their own interests. Once again taking the UK as an example, case law uses this rule, now found in s.175 of the Companies Act 2006 to make sure that directors, who owe fiduciary duties to firms and shareholders, will not be tempted to foster their own interests to the detriment of the company.[65] There are also provisions in the UK Company Act (such as sections 171-177) regulating the duties of directors to ensure that they act in the best interests of the company.

B. Agency Theory

In corporate governance, the agency theory is directed at the agency relationship in which the principals, i.e. the shareholders, delegate work to the agents, the managers, who perform that work and have control of the company's affairs. The managers are those directors who are executives employed by the company, as well as senior non-director managers who have critical roles to play in the company's management. Agency theory attempts to describe this relationship using the "metaphor" of a contract.[66] Narrowly speaking, agency theory was expected to resolve two problems that can occur in such a contract. The first is the agency problem that arises when: (1) the desires or goals of the principal and the agent are in conflict; and (2) it is difficult or expensive for the principal to verify what the agent is doing.[67] The issue here is that the principal cannot verify that the agent has behaved appropriately. The second problem is the risk sharing that

[64] B Hannigan, *Company Law* (Oxford, Oxford University Press, 2nd edn, 2009), p. 246.
[65] ***Wilkinson v West Coast Capital*** [2005] EWHC 3009 (Ch), [2005] BCC 717, [251]. See, A. Keay, "The Authorising of Directors Conflicts of Interests" (2012) 12 *Journal of Corporate Law Studies* 129, p.150
[66] K. M. Eisenhardt, "Agency Theory: An assessment and Review" (1989) 14 *The Academy of Management Review* 57, pp.59-60
[67] *Ibid*.

arises when the principal and agent have different attitudes towards risk. Here, the principal and the agent may prefer different actions because they possess different risk preferences.[68] The agent in the company context is assumed to be risk-averse while the principal is risk-neutral, because the potential firm income has different effects on their relationship with the company – the agent's security and profits are inextricably tied to the single firm, while the principal can diversify investments in multiple companies.[69] Moreover, executive managers' utilities are positively related to financial incentives provided by the firm in terms of pay, and negatively related to effort.[70] This is why executive compensation was created, in order to align interests between these two parties, with financial incentives designed in the form of specific executive pay packages.

Agency theory emphasises the importance of incentives in manager's remuneration and self-interest in their organisational thinking and suggests that these issues can be dealt with in several ways.[71]As Jensen, a leading writer on agency theory, has suggested,[72] there are four factors that can mitigate the agency problems between executive directors and shareholders in publically traded companies. These factors include: (a) corporate internal control, namely a firm's board of directors; (b) capital markets, which affect efficient cash flow and equity transactions; (c) legal systems; and (d) the product market.[73] Jensen proposes that the latter two factors can ameliorate agency problems and excess capacity when the former two factors have failed to do so.[74] The factors identified by Jensen will now be examined.

B.1. Boards of directors

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[68] *Ibid*.

[69] R. Wsieman & L. Gomez-Mejia, "A Behavioral Agency Model of Managerial Risk Taking" (1998) 23 *Academy of Management Review* 133, p.135; also O. E. Williamson, "Managerial Discretion and Business Behavior" (1963) 53 *American Economic Review* 1047, p.1041.

[70] G. Donaldson, *Managing corporate wealth: The operation of a comprehensive financial goals systems* (New York: Praeger,1984) p.110

[71] C. Perrow, *Complex Organisations* (New York: Random House, 1986) p.90

[72] M. Jensen, "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems" (1993) 48 Journal of Finance 831, p.850.

[73] *Ibid*.

[74] *Ibid*.

As mentioned above, a fraction of directors on the board's remuneration and nomination committees are independent, in that they are hired from outside the firm. Conceptually, having independent directors on these committees can help to reduce the agency problem by threatening errant executives with termination and by enforcing highly incentivised contracts which tie pay to performance.[75] The contracts drawn up by such committees are supposed to tie executives' pay to the value that they create, through stock options, restricted stock and other forms of pay-for-performance measures. Under optimal contracting theory, these contracts contribute to the maximisation of shareholder value because they provide executives with enough compensation to make them eager to work, and make sure they will take future responsibilities seriously since the incentives provided by the contract align the company's performance to their compensation.[76]

Many scholars have expressed surprise at the low levels of performance-based executive compensation that have been approved by shareholders and boards.[77] From an agency theory perspective, however, they should not be so surprised, since excessive compensation may be produced under an incomplete information system. This is the problem of information asymmetry, one of the main forms of which is characterised by incomplete contracts (another form is the cognitive limitations of contracting parties).[78] From the economic perspective, it is impossible for contracting parties to make complete provisions for every eventuality in a contract because of the limitations of the human mind.[79] Agency theory reminds us of the importance of information, which should be treated as a commodity among and inside organisations. Agent opportunism can be controlled if the information system in a company can be well investigated. Specifically, the

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[75] Summerised by K. Murphy, "Executive Compensation: Where we are, and how we got there" (2012) *Handbook of the Economics of Finance*, edited by G. Constantinides, M. Harris & R. Stulz, North Holland: Elsevier Science, p.132

[76] *Ibid*.

[77] J. Pearce, W. Stevenson & J. Perry, "Managerial Compensation Based on Organisation Performance: A time series analysis of the effects of merit pay" (1985) 28 *Academy of Managerial Journal* 261, p.265; G. Ungson& R. Steers, "Motivation and Politics in Executive Compensation" (1984) 9 *Academy of Managerial Review* 313, p.318.

[78] A. Keay & H. Zhang, "Incomplete Contracts, Contingent Fiduciaries and A Director's Duty to Creditors" (2008) 32 *Melbourne University Law Review* 141, p.154

[79] *Ibid*.

more information that principals have, the more they can contribute to decreasing managerial opportunism and increasing performance-contingent pay.[80] One relevant information system for monitoring the executives is the board of directors. Optimal contracting theory holds that if the board of directors provides richer information for the shareholders about what the executives are doing and how the committee is planning to pay the executives, the executives are more likely to engage in behaviours that are consistent with the shareholders' interests.[81] Elisenhardt also provides several practical ways to improve the board's monitoring function with richer information, such as increasing the frequency of board meetings, hiring more members with managerial and industry experience, and increasing members' tenure on the board.[82] Therefore, if the transparency of information provided to shareholders can be improved and the remuneration committee plans a remuneration policy with a broader disclosure of the firm's equity income and peer compensation, the pay for performance sensitivity in the executive pay contract can be increased. These situations will be discussed in detail later.

There are also problems around boards which are dominated by independent directors. These directors have little material interest in the firm, and they do not necessarily make decisions and engage in a process of bargaining leading to contracts with executives for the benefit of shareholders who select them. Even worse, independent directors may be influenced by executives to over-pay the latter, since they are in need of social networks and this action might enhance such networks. The non-executives are in effect paying the executives with the shareholders' money (rather than their own). This situation will be mentioned again in a later section on managerial power theory.

B.2. Capital markets

[80] K. M. Elisenhardt, "Agency theory, An assessment and review" (1989) 14 *The Academy of Management Review* 57, p.63.
[81] *Ibid*.
[82] *Ibid*.

The second factor referred to by Jensen in mitigating agency problems is capital markets. Capital markets are financial markets where individuals and institutions can sell and buy debt or equities, which, according to Jensen's research, developed on a worldwide level with capacity expanding quickly in the nineteenth century.[83]

There are three main effects that capital markets can have on executive directors.[84] The first is that capital markets, shareholder activists and large-block institutional shareholders can mitigate agency problems by pressing firms to strengthen links between executives' income and the firm's share price performance. Second, capital markets contribute to resolving agency problems by incentivising executives to make every effort to achieve or even exceed analyst and market earnings expectations for their companies. Thirdly, pressures from capital markets will encourage executives to focus on the "expectation market", in which investors gamble on expectations of future performance, rather than the "real market", in which goods and services are produced and sold and value is created or destroyed.

In particular, economists have also investigated how executive pay, if it contains stock incentives, is influenced by a firm's share price and the condition of capital markets. Calcagno and Heider found that without other distracting factors, like the existence of executives' self-serving deals, a more informative stock price and a more liquid capital market can lead to executive pay that is market-based to a greater degree.[85] Other scholars have also established the relevance of the extent of stock incentive executive pay and market trading conditions,[86] which will be discussed and analysed further in later chapters.

B.3. The legal system

[83] *Supra*, n.72, Jensen, p.850
[84] *Supra*, n.75, Murphy, p.133
[85] R. Calcagno & F. Heider, "Market Based Compensation, Price Informative and Short-term Trading" (2007) *European Central Bank, Working Paper Series*, No. 735, p.17
[86] Q. Kang & Q. Liu, "Stock Market Information Production and CEO Incentives" (2005) *University of Hong Kong Working Paper* p.11; B. Holmsrom & J. Tirole, "Market Liquidity and Performance Monitoring" (1993) 101 *Journal of Political Economy* 678, p.688.

Agency problems, especially executive remuneration, have been recognised as an international issue, which cannot be simply solved by the economy and markets, a matter that will be developed further in Chapter 3. Therefore, governments have started to create their own laws, securities rules, regulations and listing requirements aimed at preventing embezzlement, corporate theft and fraudulent conveyances.[87] Interference from government includes tax policies, accounting rules, disclosure requirements and direct legislation empowering shareholders and giving them a greater say on pay.

There are three main consequences arising from these legislative innovations: increasing shareholder intervention; making the pay policy more transparent; and giving the board total independence. However, as suggested by Murphy, the independence requirements which were expected to reduce excessive executive pay levels have been disappointing in their effects. Evidence shows that both the level of pay and the implementation of equity-based compensation increase with the proportion of independent directors on the board.[88] Murphy proposes that this phenomenon may be consistent with independent directors not fully understanding the opportunity cost of equity-based compensation.[89]

On the other hand, Murphy also thinks that it is not wise to relate board independence to the setting of appropriate executive pay.[90] Many shareholder activists argue against the idea that the CEO can be a member of her/his own remuneration committee, since there would be managerial influence on the board to overpay the CEO, and ultimately this harms the interests of the shareholders. However, according to Bizjak and Anderson's research, CEOs who sit on their own remuneration committees turn out to be paid less than CEOs who do not, although they have relatively more shares and are usually the firm's founder or the founders' family members.[91] Under Murphy's analysis, CEOs sitting on their own remuneration committees in the above situation would not influence the

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87 *Supra*, n.75, Murphy, p.54
88 *Ibid*.
89 *Ibid*.
90 *Supra,* n. 75, Murphy, p.132
91 R. C. Anderson & J. M. Bizjak , "Corporate Governance and Firm Diversification" (August 23, 1998), available at http://ssrn.com/abstract=121013, last accessed on July 26th 2016, pp.19-20

board to increase their own compensation, but rather would use their power to adjust the level and structure of compensation for subordinates – for example, by decreasing other executives' stock options or bonuses in the interests of shareholders.[92] Therefore, prohibiting such CEOs from joining in their own remuneration discussions may harm shareholders, illustrating a potential cost of the "one-size-fits-all" nature of corporate governance regulation in this regard.[93]

All of these attempts to regulate executive compensation, in Murphy's view, have failed to remedy the problem. He maintains that even well intentioned regulation inherently focuses on relatively narrow aspects of compensation, leaving other areas open to expensive mistreatment, while he also suggests that "the only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly".[94] This conclusion will be discussed towards the end of this chapter.

B.4. Product markets

Product market is economically a marketplace where final goods or service is bought and sold. Competition in product markets can have the effect of either reducing or increasing the agency problem,[95] and companies that have no power to compete in their product market cannot survive. Therefore, product markets will contribute to disciplining executive behaviour when they have failed to create value for firms and markets. Further, product markets do not only help to force executives to save their jobs, they also encourage them to increase value for their firms.[96]

Thus, product markets provide one important mechanism to force executives to improve firm performance in case they are replaced – i.e., to avoid takeovers. Takeover has been identified as playing two roles in markets. The first is to

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92 *Supra*, n. 75, Murphy, pp.39-40
93 *Ibid*.
94 *Ibid*.
95 O. Hart, "The Market Mechanism as an Incentive Scheme" (1983) 14 *Bell Journal of Economics* 366, at p 370; D. Scharfstein, "Product Market Competition and Managerial Slack" (1988) 19 *Rand Journal of Economics* 147, at p 149
96 *Supra*, n.75, Murphy, at p 137

achieve synergies between the bidder and the target company, while the second is to replace incompetent managers in the target company.[97] The latter function, known as a discipline takeover, has two main functions in disciplining the executives.[98] The first is that the takeover can play an important role in driving senior executives to align their interests with the firm's, since the possibility of being taken over serves as a threat that may reduce their non-value-maximising behaviour.[99] Second, the bidders who have observed executives' poor performance may cause these executives to lose their positions if the takeover is successful.

As mentioned above, all the mechanisms for improving executive performance that are discussed by agency theory, such as having an executive remuneration committee on the board, the capital market, regulation from government and the threat of takeovers, are sometimes seen as weak because they are all external. When these mechanisms become weak, companies tend to use monetary incentives in their pay policies to encourage executives to align their interests with those of the firm,[100] as predicted by optimal contracting theory.

III. Optimal Contracting Theory

Various financial economists have noted that optimal contracting theory emphasises contracts between agent and principal, which should be designed to attract talented agents and incentivise them to exert effort to maximise the principal's interest while minimising the cost of doing so.[101]

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[97] K. J. Martin & J.J. McConnell, "Corporate Performance, Corporate Takeovers and Management Turnover" (June 1991) 46 *The Journal Finance* 671, at p 680.
[98] *Ibid*.
[99] At this point directors have an obligation to take into account the interests of creditors. See, D. Milman, *The Governance of Distressed Firms* (Cheltenham, Edward Elgar, 2013) p.117; A Keay, "Directors' Duties and Creditors' Interests" (2014) 130 *Law Quarterly Review* 443, p.450
[100] M. Bertrand & S. Mullainathan, "Executive Compensation and Incentives: The impact of takeover legislation" (December 1998), *National Bureau of Economic Research Working Paper*, No. 638, available at: http://www.nber.org/papers/w6830 p 22, last check on July 12th, 2016
[101] A. Edmans & X. Gabaix, "Is CEO Pay Really Inefficient? A survey of new optimal contracting theories" (2009) 5 *European Financial Management* 486, p.490

A. The main idea of optimal contracting theory

Optimal contracts are concerned with one specific concept, namely agency cost. Because of the separation of ownership and management, agents need to be paid and monitored in managing business for the principals, which is the source of agency cost. According to the solutions provided by agency theory, as discussed above, there are two main ways to solve agency problems, which are shareholder monitoring[102] and pressure from capital markets and government intervention (generally the government intervenes by strengthening shareholder monitoring). However, the agency cost from shareholder monitoring can be significant, and it will only generate a sufficient payoff when the monitoring shareholder owns a large proportion of shares.[103] Therefore, optimal contracting theory was proposed to design agency costs optimally by encouraging the agents to work for the principals, who are shareholders in the company, and ensuring returns for them while minimising the cost of doing so.

According to Jensen and Meckling, there are three elements that make up agency costs: incentive and monitoring expenditures by the principal, bonding expenditures by the agent, and the residual cost.[104] The residual cost includes payouts when agents expand the business for principals, an issue which will not be discussed in this thesis. The agent's bonding expenditure is used to ensure that there will be some penalty for the agent if the agent takes actions to harm the principal. The incentive and monitoring expenditures from the principal come from shareholders, establishing appropriate incentives for the agent and incurring

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[102] Shareholders' indirect monitoring takes place through the remuneration committee, while direct monitoring can be though proxy proposals (P. Cziraki, L. Renneboog & P. Szilagyi, "Shareholder Activism Through Proposals: The European perspective" (2010) 16 *European Finance Management* 738, p.760; L. Renneboog & P. Szilagyi, "Corporate Restructuring and Bondholder Wealth" (2008) 14 *European Finance Management* 792, p.801), shareholders coalitions (M. Becht, J. Franks, M. Julian & S. Rossi, "Returns to Shareholder Activism: Evidence from a clinical study of the Hermes UK Focus Fund" (2009) 23 *Review of Finance Study* 3093, p.3102), and the threat of discipline takeovers (J. Franks, C. Mayer & L. Renneboog, "Who Disciplines Management in Poorly Performing Companies?" (2001) 10 *Journal of Financial Intermediation* 209, p.230).

[103] *Supra,* n.17, M. Goergen & L. Renneboog, p.1073

[104] *Supra,* n.2, M. Jensen & W. Meckling, p.350

monitoring costs designed to limit harmful activities; these are compensation for managers and the cost of hiring a board in a firm.

Specifically in terms of executive remuneration, optimal contracting theory suggests that boards of directors will seek to align the interests of executive directors with those of shareholders by tying a much larger portion of the executives' pay to the increase of the shareholders' wealth. Shareholders' wealth will generally increase in line with the firm's share prices. Therefore, one of the ways to align those interests is by issuing stock options to executives. According to Jensen and Murphy, variable alignment mechanisms can be categorised as: (a) compensation, including the executives' annual salaries, bonuses, new equity and other gifts; (b) changes in the value of executives' ownership of stock and options; and (c) the possibility that the market's assessment of the executives' human capital may decrease after termination because of their poor performance. For executives below the level of the CEO, the chance of promotion may also be an incentive.[105]

B. Discussion around optimal contracting theory

There was a good deal of discussion in the 1970s and 1980s around whether we should use compensation as a way to motivate directors. Criticisms of introducing pay-for-performance plans came primarily from psychologists and behaviourists, who claimed that monetary rewards were counterproductive.[106] Slater once argued that "getting people to chase money … produces nothing but people chasing money. Using money as a motivator leads to a progressive degradation in the quality of everything produced."[107] In addition, Kohn thought that monetary rewards encourage people to focus narrowly on a task, only doing that task as quickly as possible while taking few risks.[108] What is worse, financial incentive

[105] M. Jensen & K. Murphy, "Performance Pay and Top-Management Incentives" (1990) 98 *Journal of Political Economy* 225, p.252, summarised by J. Core, W. Guay & D. Larcker in their paper, "Executive Equity Compensation and Incentives: A Survey", (2003) *Economic Policy Review* 27, p.38.

[106] G. P. Baker, M. Jensen & K. Murphy, "Compensation and Incentives: Practice vs. Theory" (1988) 43 *The Journal of Finance* 593, p.610

[107] P. Slater, *Wealth Addiction* (New York: Dutton, 1980), p.130.

[108] INC, A. Khon, "Incentive Can Be Bad for Business", January 1988, pp. 93–94.

measures were thought to induce significant adverse side effects on employee morale and productivity. In the behavioural literature, since a horizontal equity pay system, which ensures that employees at the same level in an organisation receive the same pay, has long been accepted as fair and equitable, an aggressive pay-for-performance system will ultimately jeopardise employee morale by treating them differently from each other.[109] Hammer suggested that in a context of imperfect performance measurements, financial incentives would decrease the motivation of employees because some executive directors mismanage the pay-for-performance system.[110] Holmstrom's "informativeness principle"[111] proposes that stock-based measures should be used to decide on executive compensation, not because it is the shareholders' desire to have higher share prices, but because the share price can be useful for the shareholders' understanding of information provided about what the executives have done. He also suggests that if non-stock-based measures can be "sufficiently statistical" in describing the executives' actions, stock-based information will not necessarily be required.[112]

However, Baker, Jensen and Murphy believed that these criticisms of pay-for-performance systems do not indicate that these incentives are counterproductive, but rather that they are too effective. They hold that a strong pay-for-performance system may motivate employees to do exactly what they should do. Financial incentives generate unintended and possibly counterproductive results because they are lacking in practical and precise measurements. Baker et al. suggested in the 1980s that it is how to develop the pay-for-performance system that really matters, rather than discussing whether it should exist, because in the 1990s stock options had replaced base salary as the biggest single component of executive remuneration in the US.[113] Additionally, empirical evidence that will be

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[109] *Supra,* n.106, G. P. Baker, M. Jensen & K. Murphy, p.611
[110] W. C. Hammer, "How to Ruin Motivation with Pay" (1975) 7 *Compensation Review* 17, p.24.
[111] B. Holmstrom, "Moral Hazard and Observability" (1979) 10 *The Bell Journal of Economics* 74, pp. 82-3.
[112] *Ibid*.
[113] M. Useem, "The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Function of the Corporate Board" (2011) *Sage Handbook on Corporate Governance*, edited by Thomas Clarke & Douglas Branson p.233; H. Wells, "U.S. Executive Compensation in Historical Perspective" (2011) *Research Handbook on Executive Compensation*, edited by Hill *et al*, p.100

discussed below will also show that there are no grounds to argue over whether a pay for performance system should exist or not; rather, the important question is how to develop it to improve the design of executive remuneration.

Jensen and Murphy think that actual executive remuneration contracts, in which financial incentives play an important role, cannot be predicted by economic theory in several circumstances.[114] Economic theory predicts that executive pay should not be based on factors beyond the control of the executives,[115] and therefore executive compensation should be based on performance measured relative to the performance of all firms or at least firms in the same industry, not only on measures relating to their own firm's performance. Jensen and Murphy suggest that absolute firm-value changes should be the predictor of basic salary and bonuses, rather than value changes measured by the industry and the market. They also suggest that the pay-performance relation is independent of stock ownership. Moreover, Holstrom and Milgrom[116] proposed their "multiple" optimal contracting model, with conditions where executives owning stock options will be successful: (a) the executives are not too risk-averse; (b) the variance of stock options is low; and (c) the variance of measurement in other aspects of the executives' performance is low. However, though it was reasonable for Jensen and Murphy to suggest that basic salary and bonuses should be emphasised in executive pay and that economic theory contains some errors in explaining in an increase in financial incentivising pay because of the efforts of other peers within the same industry, long-term incentive equity and other share options are still the most important part in promoting pay for performance. In the decades since Holstrom and Milgrom proposed their idea, it is not the variance of financial incentives that remuneration committees should concern themselves with, but rather the setting of them to improve the firm's long-term success, with executives taking a proper level of risk to allow them to run the company.

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[114] M. Jensen & K. Murphy, "Are Executive Compensation Contracts Structured Properly?" (1988) 87 *Harvard Business School and University of Rochester Working Paper* February, p.40

[115] *Supra,* n.111, G. Holmstrom,

[116] B. Holmstrom & P. Milgrom, "Multitask Principal-Agent Analyses: Incentive contracts, asset ownership, and job design" (1991) 7 *Journal of Law, Economics, and Organization* 24, p.34.

There are also several problems within optimal contracting theory in terms of explaining what executive remuneration is and how it may be developed. According to Kevin Murphy's research, there are three factors in optimal contracting theory that need to be corrected in explaining the growth of stock options in executive pay packages.[117] First, optimal contracting theory suggests that the sky-high incentives among executives in the 1990s were because the executives became less risk and effort-averse, while shareholder returns increased over this period.[118] However, Murphy has simply objected to these explanations using economic theory,[119] claiming that these explanations lack support from empirical evidence.[120] There will be further discussion of the high executive remuneration incentives in the 1990s in later chapters. Second, Murphy was not satisfied with the fact that optimal contracting theory mentioned the increase in equity-based remuneration, but did not explain why this increase came entirely in the form of stock options.[121] As mentioned above there are several equity incentives, such as restricted stock options and long-term incentive plans. Third, in Murphy's view the biggest mistake made by optimal contracting theory lies in assuming that the increase of equity-based compensation in the 1990s was because pay contracts were suboptimal before the 1990s.[122] There may be other explanations for the state of affairs, in terms of other aspects of remuneration, such as social relationships inside the boardroom and influence from executives in designing their own pay policy.

Thus, optimal contracting theory developed from agency theory while focusing on executive remuneration, and it has explained why the pay for performance relation exists from an optimal economic perspective, and why using financial incentives may align interests between managers and shareholders. However, this theory alone cannot fully explain why regular incentive pay plans have led to high levels of executive compensation since the 1990s, which did not match the

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117 *Supra,* n.75, K. Murphy, p.142
118 *Ibid*.
119 Theories provided by C. Prendergast, "The Tenuous Trade-off between Risk and Incentives" (2002) 110 *Journal of Political Economy* 1071, p.1101; J. Zabojnik, "Pay-performance Sensitivity and Production Uncertainty" (1996) 53 Economic Letters 291, p.293.
120 *Supra*, n.75, Murphy, p.133.
121 *Ibid*.
122 *Ibid*.

payback for companies. Theories emphasising other remuneration relationships will be introduced in the following discussion.

IV. Managerial Power Theory

Managerial power theory, which sums up nearly every perspective on the disadvantages of current executive remuneration arrangements from the management point of view, has led to a remarkable and highly controversial debate within academia. The theory has been promoted by law academics, Lucian Bebchuk and Jesse Fried, who started by disproving optimal contracting theory and describing it as an “arm’s-length bargaining approach”.[123] The central view of managerial power theory is that in practice it is the executive directors who decide on how much they are paid, and therefore the presumption of optimal contacting theory will not stand, and optimal contracting theory cannot explain or solve executive compensation issues.

A. Denial of previous theories

Bebchuk and Fried assume that executive directors naturally tend to be self-interested,[124] so that permitting them to set their own pay would certainly generate significant agency costs. Therefore, it is the board’s job to work out the remuneration policy. Arm’s-length bargaining, which they view as an official theory of explaining executives’ pay, assumes the board is negotiating pay with executives at arm’s length, solely based on the interest of shareholders, but according to Bebchuk and Fried that does not happen.[125]

The managerial power approach denies the board’s function in restraining the executive directors’ power and protecting the rights of shareholders, with Bebchuk and Fried suggesting that arm’s-length bargaining does not even exist in the

[123] L. Bebchuk & J. Fried, “Pay Without Performance: The Unfufilled Promise of Executive Compensation” (Cambridge, Massachusetts, Harvard University Press, 2004) p.21
[124] *Ibid*., p. 62.
[125] *Ibid*.

process of executive compensation design between the board and the managers, for the following reasons.

First, from the social and psychological points of view, non-executive directors tend to satisfy the executives. Non-executive directors always want to hold positions on the board so as to be provided with financial and non-financial benefits, such as the prestige of using the company's assets and valuable business and social connections. According to Bebchuk and Fried, since it is the executives who have considerable and often decisive influence over the non-executives' nomination process, the non-executives will want to benefit the executives in order to be reelected to the board.[126] Apart from the nomination process, a situation may occur where one company's executives may be another company's non-executives, which will bring interlocking benefits for each other.[127] There are also several objective factors, such as the fact that independent non-executives are not supplied with sufficient information by the company's human resources department or with advice from compensation consultants, along with an under-developed pay-setting process, which will lead to unrealistic and excessive executive compensation.[128]

Second, they argue that shareholders have limited ways to constrain unreasonably high executive remuneration.[129] Shareholders are given rights to challenge the board's decisions on executive pay packages in courts by pursuing breaches of directors' fiduciary duties. However, in practice, due to procedural restrictions and the courts' delay in reviewing the substantive merits of board decisions, the courts have failed to impose any meaningful constraints on executive pay.[130] The case of Disney, *Brehm v. Einser* in 1997 proved this argument.[131] In January 1997 a derivative suit was brought by Disney shareholders challenging the compensation of Michael Ovitz on the grounds of a

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[126] *Ibid*.
[127] *Ibid*, pp.27–31.
[128] *Ibid*.
[129] *Ibid*.
[130] *Ibid*., pp.46–47.
[131] ***Brehm v. Eisne*r,** 746 A.2d 244 (Delaware, 2000).

breach of fiduciary duty.[132] Michael Ovitz, who was recruited to be the president of the board, was terminated after only a year in the job, and had received up to 140 million dollars in termination benefits, which was higher than the payment for his full five-year term of employment.[133] The shareholders, William Brehm and others, sued the company and the board for making and approving this payment decision.[134] The court decided to proceed only because there was egregious carelessness during the compensation decision-making process, which lasted for only an hour, not because of certain flaws and perverse incentives in Ovitz's pay package.[135] In the final analysis, the court upheld the board's decision while ignoring the substantive merits of Ovitz's compensation arrangement.[136] Even though Disney's board "fell significantly short of the best practices of ideal corporate governance", their decision was perceived by the court to have been made in good faith.[137] However, should there be any consequence for the board after deciding in favour of such unreasonable compensation under the influence of their CEO? Since the recent improvements in corporate governance regulation in the US, through Dodd-Frank, shareholders have been given the power to have a say on executive pay and remove the members of remuneration committees, or even the CEO, if they are not satisfied with the results of the final pay policy. These modernising rules will be discussed further in Chapter 4.

Bebchuk and Fried also mention that even though shareholders have the power to vote on the executives' stock option plan in the remuneration package, shareholders cannot decide whether the option incentive plan is excessive because they do not have detailed information about it.[138] Evidence from the Disney Company case again supports this argument. Michael Eisner, the CEO and Chairman of Disney until 2005, who was a good friend of Ovitz's and acted

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[132] C. Y. Yablon, "Bonus Questions-Executive Compensation In the Era of Pay For Performance" (1999–2000) 75 *Notre Dame Law Review* 271, p.298.
[133] *Supra*, n.131, Brehm v. Eisner,
[134] *Ibid*.
[135] *Supra*, n.123, Bebchuk & Fried, at 79
[136] The New York Times, L. M. Holson, "Ruling Upholds Disney's Payment in Firing of Ovitz" August 2005, Business, available at: http://www.nytimes.com/2005/08/10/business/media/10ovitz.html?_r=0 , last accessed, 12 July 12 2016
[137] *Ibid*.
[138] *Supra*, n.123, Bebchuk & Fried, p.90

in good faith when promoting Ovitz to the position of president, received a substantial amount of criticism from the shareholders about his compensation as well as Ovitz's termination.[139] However, Eisner still had his sky-high compensation plan approved after a four-hour meeting with shareholders, since the majority of shareholders were persuaded that 98% of his remuneration was performance-based.[140] Therefore, Bebchuk and Fried conclude from this that shareholders do not have enough knowledge to help the board to make arm's-length arrangements.[141]

Third, Bebchuk and Fried do not agree with the "Chicago School" view, which understands the market as an important factor in regulating executive pay. Bebchuk and Fried think that because dismissals of executive directors are rare and takeovers are usually well defended by the board, executives will not fear pressures from the labour market and the market of corporate control.[142] Additionally, since selling additional shares to the public and the executives' diversion of company profits may not always affect the cost and quality of the firm's products, a market for additional capital and the product market will not prevent executives from chasing higher payoffs.[143] Again, market forces are "unlikely" to impose tight constraints on executive remuneration.

Thus, Jensen's factors that might act within agency theory to promote an optimal remuneration contract have all been rejected by Bebchuk and Fried from a management perspective. These authors' ideas about compensation and financial incentives will be introduced next.

B. The main idea

After analysing and rejecting the classic arm's-length bargaining approach, Bebchuk and Fried propose their own view of executive remuneration. Since it

[139] *Supra*, n.132, Yablon, p.300
[140] *Ibid*.
[141] *Supra*, n.122, Bebchuk & Fried, p.37
[142] *Ibid*, pp. 28-9
[143] *Ibid*, p.70

has been proved that the influence of boards, shareholders and market forces have all failed to stop executive directors from increasing their own payments, the more powerful the executives are on the board, the more they will be paid and the less sensitive their payments are to their performance. Nonetheless, there is still one important restraining factor, which Bebchuk and Fried refer to as the "outrage cost".[144]

If a board approves a pay policy favourable to the executives, the extent of the economic and social cost which the board and its executives will bear will depend on how this policy is perceived by the parties whose views matter to the board and the executives. When the policy is perceived as outrageous or unreasonable, shareholders will tend to veto it or even vote against the retention of executives. This outrage cost can lead to another problem, known as "camouflage".[145] In order to minimise outrage cost, the designers of excessive remuneration packages will seek to obscure and legitimate both the level and the performance-insensitivity of the remuneration.[146] This pay arrangement can be hidden within numerous remuneration policy practices, such as "postretirement perks and consulting arrangements, deferred compensation, pension plans, and executive loans".[147] Overall, these camouflage methods end up by allowing executives to reap benefits at the expense of shareholders.

Bebchuk and Fried then give a detailed analysis of elements of pay, explaining how executive directors are paid excessively without corresponding positive performance. They propose that, although they are ignored by many financial economists, cash compensation strategies such as bonuses, favourable loans, pensions and deferred compensation have been shown to be weakly correlated with firm performance, but are generously awarded. In terms of the equity option, Bebchuk and Fried's analysis indicates that because executives are powerful enough to obtain this option that favours themselves, it will enable them to reap substantial rewards even when their performance is mediocre or even poor.[148]

[144] *Ibid*, p.97
[145] *Ibid*, p.103
[146] *Ibid*, p.105
[147] *Ibid*.
[148] *Ibid*, p.114

It can be concluded from Bebchuk and Fried's research that there is no efficient way to stop executives from benefitting themselves. Executives' managerial influence on their own pay will dilute their incentives to improve performance and will decrease shareholder value, which is Bebchuk's greatest concern. Unrestrained executive remuneration has already imposed significant losses on shareholders, according to data from the US during the years from 1998 to 2002.[149] Furthermore, prevailing executive compensation arrangements will provide weaker incentives to reduce managerial slack and increase shareholder value than would be the case under arm's-length bargaining. Current remuneration practices can lead to perverse incentives for executives, who will use their influence to obtain options and shares while misreporting results, suppressing bad news and choosing projects and strategies that are less transparent to the market.[150]

Bebchuk and Fried's ideal situation with regard to executive remuneration would be to cut it down to a reasonable level without weakening managerial incentives. However, according to the previous analysis in which managerial influence has no real restraints, this situation needs practical schemes to be implemented. They suggest: first, since outrage cost can serve as a check on managerial rent extraction, executive compensation arrangements should be regulated so that they are highly transparent; second, since we cannot rely on arm's-length contracting between executives and the firm to arrive at a proper executive compensation, directors on boards should be insulated not only from the executives but also from shareholders so as to allow them to agree neutral pay policies.[151]

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[149] *Ibid*, p.129
[150] *Ibid*.
[151] *Ibid*.

C. Criticism of managerial power theory

This managerial power theory explains specifically how boards are manipulated by greedy executive directors in order to secure overpayments. However, the theory's criticism of optimal contracting theory and the implication that boards should be made more independent are compelling, although controversial. According to Rakesh Khurrana, the growth in executive compensation over the past decade has occurred because of greater shareholder involvement and director independence.[152] Kevin Murphy criticises the Bebchuk view as both "problematic" as a theoretical matter, and too "simplistic" in explaining executive remuneration arrangements.[153] Franklin Snyder recognises that this theory only provides a partial picture of the executive remuneration puzzle, and at worst it may be entirely misguided.[154]

C.1. Not conflicting with optimal contracting theory

Core, Guay and Thomas point out that optimal contracting theory, which Bebchuk and Fried referred to as arm's-length bargaining, and the managerial power approach are not competing.[155] On the contrary, these commentators argue that these two theories are complementary in explaining executive remuneration.

First, they propose that even though Bebchuk and Fried view optimal contracting as synonymous with arm's-length bargaining, meaning negotiation between executive directors who are trying to argue for high compensation and the board who are seeking to set up this compensation in the best interests of shareholders, these two definitions are not the same.[156] An optimal contract is not necessarily achieved on the basis that there is an independent board, sometimes allowing

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152 R. Khurana, *Searching for A Corporate Savior: The irrational quest for charismatic CEOs*, (New Jersey, University of Princeton Press, 2002) p.47

153 K. Murphy, "Explaining Executive Compensation: Managerial power versus the perceived cost of stock options" (2002) 69 *The University of Chicago Law Review* 847, p.850.

154 F. Snyder, "More Pieces of The CEO Compensation Puzzle" (2003) 28 *Delaware Journal of Corporate Law* 132, p.136.

155 E. Core, W. Guay and Randall S. Thomas, "Is U.S. CEO Compensation Inefficient Pay without Performance?" (2005), available at: http://ssrn.com/abstract=648648, last accessed, 25 July 2016
p.6

156 *Ibid*, pp.30-31

some influence from executives with the aim of maximising net shareholder value, given the fact the board also has other duties to implement.[157] Therefore, managerial power does not automatically change the pay policy into a suboptimal contract. Second, they disagree with Bebchuk and Fried on the standards for deciding whether a compensation contract is optimal. They note that it is important to distinguish “contracts that are optimal in the presence of contracting costs” from “suboptimal contracts”.[158] The former are contracts that are made under a rational process by the remuneration committee, which may be influenced by executive directors but will not set pay policies that are bad for its shareholders’ interests. The latter contracts are set under perverse incentives, which are not related to shareholders’ benefits and are sometimes only beneficial to executives. Core, Guay and Thomas provide empirical evidence comparing the efficiency of US executive remuneration with that in European countries, and show that the US remuneration environment has not made shareholders as dissatisfied as in other countries.[159] Therefore, they conclude that it is dangerous to judge an executive remuneration policy to be suboptimal or inefficient simply because it is not determined from an arm’s-length bargaining position.[160] On the other hand, Core, Guay and Thomas accept that executive directors do influence the board.[161] They conclude that these two theories should complement each other in explaining executive remuneration, and they are not contradictory.

C.2. Exaggerating the influence of executives

Franklin Snyder actually doubts the nature of executives’ influence on the determination of remuneration packages.[162] He asserts that Bebchuk and Fried failed to distinguish between executives’ improper dominance over the compensation negotiating process and executives’ bargaining power. He suggests that a situation in which executives have more bargaining power than the board does not necessarily compromise the firm’s financial decisions, and

[157] *Ibid*, p.32
[158] *Ibid*.
[159] *Ibid,* p.33
[160] *Ibid*, pp.34-35
[161] *Ibid*, p.37
[162] *Supra,* n.154, F. G. Snyder, p.141

neither does it mean that executives dominate in deciding on the determination of their payment at board level.[163] There is a significant degree of expense associated with hiring or replacing executives, and therefore the board tends to make concessions on remuneration policies for the new or incumbent executives, even when the executives have not become dominant over the board.[164] Also, Snyder employs Bebchuk and Fried's analysis of how executives use their power to extract rents during takeovers to prove that there is a huge difference between: (a) executives who can still persuade the board to offer high levels of pay; and (b) executives using their bargaining power to delay or prevent desirable acquisitions.[165] He proposes that the former situation requires executive domination, while the latter needs the executive managers' bargaining power.[166] Therefore, he concludes that since Bebchuk and Fried misunderstand these executive-enriching situations in takeovers, it is worth considering whether they have described managerial power over the board too seriously.[167]

C.3 Can the managerial power approach fully explain executive remuneration?

To examine the managerial hypothesis, Murphy assumes that incumbent executives use their power and influence over boards in order to extract rents through their own compensation arrangements.[168] The following situations should have been predicted if managerial power explains executive compensation:

(1) Executive compensation will decline because of public outrage.[169] Murphy makes a strong case that public outrage was usually high in the early 1990s and remained this way through the following decade, while executive remuneration remained sky-high during the same period.[170]

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163 *Ibid*., pp.164–165.
164 *Ibid*.
165 *Ibid*.
166 *Ibid*., p.167.
167 *Ibid*.
168 *Supra*, n.153, K. Murphy, p.854
169 *Supra*, n.154, F. G. Snyder, p.148
170 *Ibid*.

(2) Executive compensation will decline as boards become more independent.[171] As described above, if executives' domination of their own payment process is the main reason for excessive compensation, then a more independent board should provide an important solution.[172] However, boards became increasingly independent during the 1990s, which was a period when executive remuneration soared to an unachievable/unacceptable level.[173]

(3) Increased transparency will lead to lower remuneration.[174] According to managerial power theory, if camouflage from the board is the main way to disguise high executive payments, greater transparency in pay policies should result in lower compensation.[175] However, after the US's new SEC disclosure regulation was published in 1992, requiring more transparent remuneration policies, executive remuneration actually rose to even higher levels.[176]

(4) Executive directors promoted from lower positions in firms are compensated at a higher level than ones hired from outside.[177] Again, if executive domination is the key to higher compensation, incumbents from within the firm should be in a prime position to earn higher remuneration.[178] But according to Murphy's research, data shows that executives hired from outside earn substantially more than the ones promoted from inside.[179]

(5) Executives are seldom terminated from their jobs, and if they are they will not earn higher pay.[180] Under Bebchuk and Fried's logic, the "entrenched" executives who always earn more than market returns through dominating their board will rarely leave the firm voluntarily because then they will not be able to influence their compensation and benefit from market returns.[181] Additionally, they also

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171 *Ibid*
172 *Ibid*.
173 *Supra*, n.153, K. Murphy, p.852
174 *Supra*, n.154, F. Snyder, p.149
175 *Ibid*.
176 *Supra*, n.153, K. Murphy, pp.856-7
177 *Ibid*, p.854
178 *Ibid*.
179 *Ibid*. p.855
180 *Supra*, n.154, F. Snyder, p.150
181 *Ibid*.

suggest that if executives are gaining above-market remuneration because of their domination, the level of this remuneration will not be the same if they are moving to a new board where they do not have the same managerial influence.[182] Again, however, Murphy's data shows that total compensation is rather higher for executives hired from outside than for executives from within, which is not consistent with Bebchuk and Fried's hypothesis.[183] Also, according to research by Fee and Hadlock, executives who leave their old firms to go to a new one will always receive a pay increase.[184]

Generally, Murphy thinks that Bebchuk and Fried's hypothesis is not consistent with the most important developments in executive remuneration arrangements, and their prescription to focus on rent extraction in examining "the regulation and practice of corporate governance" is potentially misguided and diverts attention from more important issues.[185]

C.4. Can managerial power explain the growth in the use of stock options?

The majority of options would be issued to executives.[186]

If, as Bebchuk and Fried have suggested, option plans are made to satisfy the greed of executives, then there should be a majority of options issued to executives.[187] Conversely, however, Murphy finds that nearly 80% of options were granted to managers and employees whose positions in the firm were below the top five executives in the company in terms of pay, and since 1992 options granted to individuals below the top five have been generally increasing.[188]

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182 *Ibid*.
183 *Supra*, n.153, K. Murphy, p.855
184 C. E. Fee & C. J. Hadlock, "Raids, Rewards and Reputation in the Market for Managerial Talent", (2003) 16 *The Review of Financial Studies* 1315, p.1334.
185 *Supra,* n.153, K. Murphy, p.850.
186 *Supra*, n.154, Snyder, p.151
187 *Ibid*.
188 *Supra*, n.153, K. Murphy, p.856

The level of executive remuneration will decline as the executive's tenure decreases.[189]

Under managerial power theory, while executives serve on boards they tend to appoint their "cronies" to the board as well.[190] With the tenure of executives decreasing, it may be inferred that this cronyism will decrease, and so will the influence executives have on the board.[191] Therefore, executives will earn less remuneration. However, evidence shows the opposite; during the 1990s there was a dramatic decline in executive tenure, but nevertheless their compensation rose sharply.[192]

Interestingly, Bebchuk and Fried responded to some of these critiques in their book published in 2004. Their main responses were around the increasing level of executive compensation during the 1990s with more independent boardrooms and more transparent pay reports, while according to their predictions, the pay should have decreased.[193] They claim that a change in the compensation environment will not necessarily lead to a decline of managerial influence on boards.[194] They briefly explain that with shareholders' growing interest in linking executives' performance with pay through option plans, and in the context of the broader stock market boom in the 1990s, it was the directors on the boards who implemented the executives' willingness to add more equity-based compensation into their pay packages, causing executive compensation to increase sharply.[195] Furthermore, they add that while the bullish capital market meant that shareholders' outrage about executive pay declined since the 2000s, the outrage towards excessive remuneration has recently been re-ignited,[196] and this was even before the financial crisis.

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189 *Supra*, n.154, Snyder, p.151
190 *Supra,* n.123, Bebchuk & Fried, p.175
191 *Ibid*.
192 *Supra*, n.153, K. Murphy, p.857
193 *Supra*, n.123, Bebchuk & Fried, p.72.
194 *Ibid*.
195 *Ibid*, p.73
196 *Ibid*, p.74

However, as Kevin Murphy has suggested, explaining the executive compensation issue merely by comparing the optimal contracting and managerial power hypotheses is not "productive" enough.[197] He suggests that the hypotheses are not mutually exclusive; indeed, the same institutions that have evolved to mitigate conflicts of interest between managers and shareholders (i.e. optimal contracting) have simultaneously allowed executives to extract rents (i.e. exercise of managerial power).[198] For example, the first "line of defense" against agency problems is the outside members of the board of directors, elected by shareholders and responsible for monitoring, hiring, firing and setting top executive compensation.[199] However, these outside board members, who pay executives with shareholders' money and not their own, are not perfect agents for the shareholders who elected them. Instead of viewing optimal contracting and managerial power as competing hypotheses, it is more productive to acknowledge that outside dominated boards mitigate agency problems between managers and shareholders but create agency problems between shareholders and non-executives.[200] Rigidly adopting either extreme hypothesis that director incentives are fully aligned with shareholder preference or with those of incumbent CEOs will inevitably result in less interesting and less realistic conclusions.[201]

Although there have been many debates triggered by the managerial power approach, one important contribution should not be ignored: the level of executive remuneration comes from the faulty setting of compensation structures, which is caused partly by social relationships and the managers' influence over the board, and partly because of markets and legislation which are supposed to function well under agency theory. Developed from agency theory, optimal contracting theory has focused mostly on an ideal macroeconomic view of remuneration and less on the social networks inside the board, presuming that appointing non-executives will naturally promote independence, and thus the managerial approach can provide additional information from this perspective. However, the levels of

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197 *Supra*, n.75, K. Murphy, p.142
198 *Ibid*, p.143
199 *Ibid*, p.144
200 *Ibid*.
201 *Ibid*, p.147

independence and accountability of the remuneration committee and the board that Bebchuk requires in managerial power theory is too perfect, and therefore it is reasonable for Murphy to suggest that the rigidity in the theory's framework will lead to limited conclusions and neglect possible improvements in pay if efforts are made by these two parties.

It can be concluded here that both optimal contracting theory and the managerial power approach are derived from agency theory, accepting the pay for performance rationale and suggesting that monitoring and regulating power by shareholders, the markets and legislation should be emphasised in pay, though the two approaches have different views of the influence of executive directors' and the effects of stock options on pay for performance. However, what if there are other views besides agency theory that can explain the relationships around executive remuneration?

V. Other Theories and Recommendations

A. Other theories

A.1. Bainbridge's Director Primacy Model

As well as the arguments suggesting that Bebchuk's managerial power theory cannot satisfactorily explain the problems of executive remuneration mentioned above, Bainbridge proposes that pay problems cannot be solved only by emphasising the interests of a constituency.[202] He suggests that shareholder wealth maximisation should be "a proper decision-making norm" in corporate governance rules, but setting shareholder interests as the single "normative end of corporate governance" is not wise.[203]

[202] S. Bainbridge, "Executive Compensation: Who Decides?" (2005) 83 *Texas Law Review* 1615, p.1644
[203] *Ibid*

Bainbridge's ideas about managers' compensation are developed from stewardship theory, which, along with agency theory, is among the four general theories in the corporate governance area.[204] While agency theory regards the company as a nexus of contracts between shareholders and directors who, if they are not monitored, will maximise their own interests at the expense of the former, it holds that there should be certain financial incentives in directors' pay in order to motivate them to perform in favour of the shareholders and prevent them from engaging in shirking type behaviour.[205] However, building on proposals from organisational psychology and sociology, suggesting that managers may tend to contribute to the firm to exercise responsibility and authority and gain recognition from peers and bosses, rather than only for monetary rewards,[206] the stewardship theory suggests that there are also non-financial motivations underlying managers' efforts to run companies, and agency theory's assumption that there is a natural conflict of interest between principal and agent may be debatable in the corporate governance context.[207]

The effectiveness of executive performance is not mostly governed by their financial incentives, but is also affected by the firm's organisational structure. A good structure will facilitate the executives to formulate and implement business plans for higher performance.[208] Moreover, it is proposed by the stewardship theory that CEOs should also hold the position of board chair, since compared to increasing the independence of the board, the CEO's duality of role will create

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[204] According to C. A. Mallin, *Corporate Governance,* 4th (Oxford, Oxford University Press, 2013) there are four main theories within the Corporate Governance area: Agency Theory, Stewardship Theory, Stakeholder Theory and Transaction Cost Economics Theory, at p. 265

[205] Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Market, Relational Contracting* (New York, Free Press, 1985) p.148

[206] David C. McClelland, "The Achieving Society" (1961) *University of Illinois at Urbana-Champaign's Academy for Entrepreneurial Leadership Historical Research Reference in Entrepreneurship*, p.15; and also F. Herzberg, B. Mausner & B. Snyderman, *The Motivation to Work* (New York, John Wiley and Sons, Inc., 1959.) p.31

[207] D. Silverman, *The Theory of Organisations* (London, Heinemann, 1970) p.210; also, J. B. Barney, "The Debate Between Traditional Management Theory and Organizational Economics: Substantive differences or intergroup conflicts" (1990) 15 *Academy of Management Review* 382, p.385.

[208] Lex Donaldson, *In Defence of Organisation Theory: A Reply to the Crisis* (Cambridge, Cambridge Press, 1985) p.115

financial incentives for the managers to work more efficiently in motivating them to work hard in favour of shareholder returns.[209]

Bainbridge explains executive compensation with his own model, which he calls director primacy. Starting with a denial of the possibility of reuniting ownership and management, first, Bainbridge states that though there are several problems which agency theory cannot solve, and shareholders must not expand their control to all the business decisions in the firm.[210] However, while admitting that institutional investors are intervening more in the running of companies compared with previous decades, Bainbridge nevertheless argues that situations where a majority of shares are held by one institution are rather rare thus the influence from institutional shareholders will be less than expected.[211] Nonetheless, the level of executive remuneration has increased dramatically with more shareholder intervention.

Secondly, Bainbridge proposes that the dispersion of ownership and control is crucial in corporate functioning. To explain his idea, Bainbridge borrows a mechanism from Kenneth Arrow, dividing the decision-making processes into two types: “consensus” and “authority”.[212] Corporations tend to use the consensus decision-making process when the stakeholders with power to vote have access rights to the firm’s information and can claim certain interests from the firm.[213] Small companies often use the consensus mode because the agency cost of information collecting is rather low in firms with a small group of people and a closer relationship between ownership and control. Yet with public companies, where there will be greater information asymmetry and more conflict of interests among stakeholders, most public companies will prefer the authority-based process to settle their decisions, since doing so costs less for the firm.[214]

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209 L. Donaldson & James H. Davis, “Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns” (1991) 16 *Australian Journal of Management* 49, p.56

210 *Supra*, n. 202, Bainbridge, p.35

211 *Ibid*.

212 M. P. Dooley, “Two Models of Corporate Governance” (1992) 47 *Business Law* 461, at p. 511, originally mentioned in K. J. Arrow, *The Limits of Organization* (New York, W. W. Norton & Company, 1974) p.134

213 *Supra*, n.202, Bainbridge, p. 36

214 *Ibid*, p.37

According to this agency cost analysis, corporate governance in public firms needs to adjust the balance between executive directors' discretion and the requirement to ensure this discretion is used accountably.[215] Thus, Bainbridge's theory asks the same question as agency theory: what should companies do to address this balance problem?

Bainbridge suggests that directors certainly cannot be held accountable without the firm undermining their discretionary authority. He then suggests that monitoring work, termed "authoritative control", can be undertaken by the board, and it is the duty of corporate law to vest this ultimate control in the board rather than the executives. On the other hand, compared to the shareholders who will be hampered by the length and complexity of corporate disclosure documents, this monitoring authority is better vested in the board, which costs much less in terms of making informed decisions. On the issue of managerial influence on the board, Bainbridge holds that as more independent directors are appointed to the board, who have relatively small "investments" in the firm's social network, it becomes less likely that they will risk their positions to benefit the executive directors. Additionally, he indicates that in practice boards rarely make decisions about executives without considering alternative options and the shareholders' reactions. Even if the board's decisions are proved wrong, shareholders still have the ex post right to remove the directors involved. However, due to information asymmetry which can make it difficult for investors to distinguish between competent and negligent management, it is not necessary to empower shareholders with a specific ex ante vote on the board's decisions.

It is Bainbridge's central proposition that after ensuring the virtues of executive directors' discretion, shareholders should not interfere with the board's and the executives' decision-making authority in the name of accountability. Giving shareholders the power to review and monitor the firm's activities will be sufficient.

[215] *Ibid*, p.38

Although the stewardship theory and the director primacy theory hold different views from agency theory on the relationship between the firm and its managers, on executive directors' power restraint and on the board's absolute insulation in making decisions about executive remuneration, those two theories both admit the effects of financial incentives in executive pay in terms of motivating better performance (although they also suggest that other non-financial incentives work as well). Still, their suggestions only contradict agency theory in one of the factors that Jensen proposed, namely the board's utility (as mentioned above, the other factors are capital markets, product markets and legislation), while providing another way of thinking about pay-for-performance systems. The accountability of boards will be discussed further in Chapter 6.

A.2. Lynn Stout's Unselfish Pro-social Behaviour

The trend for arguments stating that the executives and the board may be trustworthy regarding the issue of executive compensation leads to many other constructive ideas, one of which is particularly interesting as it re-defines the incentives which should be used in a pay for performance system. Lynn Stout proposes a model of unselfish pro-social behaviour, emphasising that optimal contracting theory is too enthusiastic in believing that tying executives' pay to their performance will improve the firm's performance, while using monetary income as an incentive for executive contribution to the firm is dangerous since it may tempt senior managers even deeper into the selfishness abyss.[216]

Before introducing the unselfish pro-social behaviour model, Stout suggests that optimal contracting theory draws a conclusion like this because it rests its assumptions on another theory – "the Homo Economicus theory", which presumes that employers and employees will follow whatever course of action maximises their interests.[217] Therefore, under this rationale, the incentives for executives to engage in better performance ought to be monetary. Thus, optimal contracting theory indicates that only by relying on a selfish monetary pay contract

[216] L. A. Stout, "Killing Conscience: The unintended behavioral consequences of 'Pay for Performance'", (2014) 39 *Journal of Corporation Law* 525, p.539
[217] *Ibid*.

can an employer trust the employee to make his best effort for the firm. However, this “reliable” incentive mechanism may lead to opportunistic, unethical and even illegal management behaviour, such as accounting fraud and excessive risk-taking.[218]

Stout suggests that the reason why we rarely believe that conscience is a common behavioural phenomenon is because it has been seldom realised, but according to scientific research, conscience exists.[219] Through important social cues, such as instructions from authority, decreasing in-group bias and beliefs about other people’s behaviour, we can trigger conscience in society.[220] More importantly, based on conscience studies from the behavioural sciences, unselfish pro-social behavioural theory may be used to explore an alternative way to encourage executives instead of offering financial incentives. Stout proposes that under the pay-for-performance system, the design of executives’ agency contracts with financial incentives remains a problem that can never be solved because of contractual uncertainty, complexity and un-observability in nature. Therefore, maybe the opposite approach, which provides executives with modest and nonmonetary incentives according to the manager’s ex post behaviour, might help to stimulate the conscience and thus improve executive performance.[221]

This perspective finds its own support in relation to the issue of executive remuneration. Tyler Cowen mentions that ego, reputation and social effort norms motivate executives in their work, not financial incentives.[222] Bold as the suggestions from this theory may seem, the notion that defining incentives from a pro-social perspective and reconsidering the pay-for-performance system’s

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[218] D. B. Thompson, “The Next Stage of Health Care Reform: Controlling Costs by Paying Health Plans Based on Health Outcomes” (2011) 44 *AKRON Law Review* 727, p.740; also M.B. Rosenthal, R. Frank, Z. Li & A. Epstein, “Early Experience with Pay-for-Performance: From Concept to Practice” (2005) 14 *The Journal of the American Medical Association* 29, p.33; M.B. Rosenthal & R. G. Frank, “What is the Empirical Basis for Paying for Quality in Health Care?” (2006) 63 *Medical Care Research and Reviews* 135, p.141

[219] *Supra*, n.216, L. Stout, p.540

[220] *Ibid*, p.541

[221] *Ibid*.

[222] Wall Street Journal, T. Cowen, “Nice Work if You Can Get It” December 2004, available at: http://online.wsj.com/articles/SB110375547970307651 last accessed, 12 July 2016

assumptions are worthy of attention. There are certain confusions in implementing this perspective on remuneration design: should remuneration committees reward executives with cash or in other monetary ways for being responsible to investors and other stakeholders in the company's pay policy? Or should other plans for encouraging ethical actions be designed and factored into pay policies for future rewards?

In fact, of course, no matter how effectively these unselfish behaviours might be encouraged in future pay plans or rewarded in pay reports, currently pay for performance is still the usual strategy, measured by the financial income of firms, and equity options are still the main method used to motivate managers. This thesis will focus mainly on the financial factors and financial measurements of executive remuneration.

B. Murphy's opinions

Bebchuk and Fried are lawyers, and they prefer to study executive remuneration through the procedure of a firm's pay policy making and the social network surrounding it. As an economist, however, Kevin Murphy tends to investigate executive pay structure and its economic costs.

After summarising the failures of Managerial Power Approach and Optimal Contracting Theory to explain and predict executive remuneration, Murphy suggests that we should consider another way to explain the options granted to executives in the 1990s, in order to find a way to develop a healthy executive pay situation. [223] He emphasises that when stock options (including other stock-related arrangements such as restricted stock options and long-term incentive plans) are granted, both the board and the remuneration committee always value the options only according to the number of options that will be issued to executive directors, while neglecting the options' economic costs. Under Murphy's logic, in practice, when a company grants an option to an executive it bears an economic cost equal to the amount that an outside investor would pay for the option.[224]

[223] *Supra,* n.153, K. Murphy, p.857.
[224] *Supra,* n.75, K. Murphy, at p.150.

However, the company bears no outlay of cash or suffers any accounting charge. Usually, when the option is exercised the company issues a new one to the executive, while receiving both the exercise price and a tax deduction for the difference between the stock price and the exercise price. Therefore, the aforementioned factors make the board's perceived cost of an option appear to be much lower than the economic cost.[225] So, what are the actual economic costs of issuing options to executives?

The economic cost of an incentive option is measured by the amount that an outside investor would pay for this option.[226] That is to say, the economic cost is the risk that a company takes by issuing the options to the executives, rather than selling them to an outside investor. Generally, the investor has the right to trade or sell the option, and to take actions to hedge the risk of holding the option. Therefore, it can be inferred that the firm risks a potential loss if the value of the options granted to the executive is higher than the value of his contribution to the firm's performance. Also, there is a potential concern that if executives re-price the options to a higher level before they are exercised, there will be more damage to the firm and potentially also to the capital market. Therefore, although it may seem to be providing for incentive, even carefully structured executive compensation can still lead to poor performance or damage if the actual economic cost has been ignored.

According to this analysis, Murphy indicates that both firm and public (including governments and investors) perceive these options to be nearly costless, which could explain why large quantities of options started to be granted to executives during the 1980s and executive remuneration rose sky-high in the 1990s.[227] The history of international executive remuneration development will be discussed and analysed in detail in the following chapters.

One direct solution to the perceived cost of executive pay, as suggested by Murphy, could be to impose an accounting charge to be paid by executives for

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[225] *Ibid*.
[226] *Supra*, n.153, Murphy, p.859
[227] *Supra*, n.75, Murphy, p.150

the stock options. The importance of accounting consideration in preventing the re-pricing of stock options before they are exercised has been shown in practice.[228] Take US regulation as an example; before Statement 128 of the Financial Accounting Standards[229] came into force in 1998, requiring that companies that are re-pricing options must use "variable accounting" to realise accounting charges annually based on stock price, companies were able to grant new or re-priced options with an exercise price equal to the grant-date market price.[230] Therefore, regulation of accounting charges can help to remind companies of how much executives have earned and if they are worth their income.

Murphy also suggests that government intervention in executive compensation, which has been largely ignored by researchers, may be a useful trend to follow in endeavouring to solve executive pay issues.[231] "The reason political influence on CEO pay adds an important new dimension to the agency problem is because the interests of the government differ significantly from those of shareholders, directors, and executives."[232] The pay-for-performance system is still workable to solve remuneration problems, but the crucial part is how to design and regulate the alignment of the competing sets of interests.

Conclusion

Executive remuneration, a mechanism by which agency theory seeks to solve the agency problem, has become a problem itself. Before investigating how to solve the executive remuneration problem, it is important to understand the existing explanations of this issue. Optimal contracting theory and the managerial power approach are currently the most popular explanations. However, these two theories cannot explain, predict and solve executive remuneration problems

[228] M. Carter & L. Lynch, "An Examination of Executive Stock Option Repricing" (2001) 61 *Journal of Financial Economics* 207, p.217
[229] FAS, Index of Documents, available at: http://www.xavierpaper.com/documents/usgaap, last accessed, 12 July 2016
[230] *Supra*, n.75, Murphy, p.151
[231] *Ibid*.
[232] *Ibid*.

perfectly. Invented by financial economists, optimal contracting theory relies too much on designing the structure of remuneration in order to provide enough incentives for executives to improve the firm’s performance, while ignoring the social networks inside firms and other non-executives’ intentions. Proposed by corporate lawyers, the managerial approach puts too much focus on the social networks between executives and the board; undue influence from the executives has become an overarching focus, neglecting the empirical research reflecting that executive behaviour can be constrained and proper influence from executives is tolerated.

However, neither of these two theories, both developed from agency theory, has denied that the pay-for-performance method may still be able to solve the remuneration problem, even though there have been many failures in restraining the levels of pay and mistakes in setting pay structures ever since the 1990s. Moreover, other theories explaining executive compensation have come from different backgrounds, such as the director primacy approach proposed by Bainbridge and the unselfish pro-social behavioural approach developed by Stout, taking into account different motivations and intentions of executive managers’ performance. However, these approaches still rely on the pay-for-performance system to improve remuneration, with financial factors emphasised as the most workable incentives.

From this chapter, it can be concluded that not only the markets and non-executive directors have an influence on executive remuneration; regulations and government policies should also contribute to improving remuneration design. Complicated as the executive remuneration problem is, it is important to understand the current situation and how it has arisen. The next chapter will investigate how the pay-for-performance system has failed to adjust remuneration from various points of view, and why regulation is needed.

Chapter Three

Market Failure in Fixing the Problems of Executive Remuneration

Introduction

After having a discussion about several theories that explain executive remuneration and the problems it has brought in Chapter 2, it can be understood that problems of executive remuneration are caused by various factors: intrinsic causes such as elements of remuneration structure and extrinsic causes such as undue influence from executive directors over the board. Those factors have led the level of executive remuneration to an excessive level since the 1990s.

This chapter provides a deep analysis of the levels and structure of executive remuneration, to explain why levels may be excessive and why structures can be destructive in facilitating company performance, while aiming to argue that the problems of executive remuneration cannot be solved simply by market forces and internal control by companies. This chapter will answer the first research question by proposing that regulation is needed in solving the problems of executive remuneration because of the failures of markets.

First, several basic factors will be introduced and analysed to provide a general understanding of executive remuneration. The public is always concerned about excessive levels of executive remuneration, however, the real concern is that the structure of it involves greater potential for managers to manipulate their own pay. The structure of remuneration will be emphasised in this chapter, financial incentives in pay will be investigated, and the measures used to set incentives will be introduced.

Second, the chapter will examine how pay design and the current remuneration situation can be evaluated, scrutinising the sensitivity between executives' pay and performance. According to agency theory, executive remuneration is created to align the interests of shareholders and managers so as to ensure that managers perform well and loyally; sensitivity between performance and pay is a legitimate and proper way by which to evaluate executive remuneration. However, sensitivity is a norm that is hard to understand and explain. This thesis will provide an analysis of this norm from the point of view of three relationships: influences from the board, executive share ownership, and the investors. These relationships will be drawn from empirical studies undertaken by financial scholars to provide scope for the interaction between corporate performance and executive income.

Since this thesis focuses on the question of why should executive remuneration be regulated and how this should be done, it is necessary to investigate how the remuneration of directors has developed without regulation. In section III there is an examination of how market forces and corporate control have failed to control executive remuneration. There will entail a detailed explanation of how the four types of markets affect corporate governance, and also how they influence executive directors and their payment. These markets, though theoretically able to monitor executives' and firms' behaviour, cannot stop fraud, especially in terms of stock price manipulation for various purposes and arguably cannot prevent collapses. Therefore, control from the corporate system should provide methods to offset the shortcomings of market control. Unfortunately, empirical evidence has shown that the current corporate governance framework cannot solve these problems. After recognising that the current design of executive remuneration has failed to achieve pay for performance and the level of remuneration cannot be controlled efficiently by market forces and corporate internal control (such as remuneration committees), it will be argued that problems of executive remuneration cannot be overcome sufficiently without other adjustments.

This thesis proposes that there are three levels at which we can understand executive remuneration: first, the problems of executive remuneration, which can be observed from pay levels and the structure of arrangements; second, the factors that can influence pay levels and the structure of executive pay, which are the capital market, the product market, the labour market and corporate governance. Third, the legislation provided from various perspectives to regulate remuneration. Among all these factors, it is pay for performance that provides a standard to justify whether arrangements are effective or not. In this chapter, we will investigate how the former two factors, the design of remuneration system and the various markets, have failed to promote pay for performance.

I. The Level and Structure of Executive Remuneration

As Harwell Wells's analysis has indicated, executive remuneration can also be related to "the evolution of the industrial system, corporate disclosure and privacy, the tax policy, the balance of power in the national political economy, international economic competitiveness, and a nation's basic intuitions of fairness and justice".[1] As mentioned in the previous chapter, influenced by various factors to do with the design of its procedure and policy setting, executive remuneration has many aspects. To understand these complicated relations, it will be useful to investigate pay from its most observable aspect.

For executive remuneration per se, two factors will be used to explain how it is formed currently; these are the level of remuneration and the structure of remuneration, both of which implicate the alignment between executives' performance and their payment. However, the incentivised structure of pay has also influenced the level of pay, which has resulted in pay failing to reflect managerial performance.

A. The level of executive remuneration

Generally, executive pay levels have increased steadily as firms have increased

[1] H. Wells, "U.S. Executive Compensation in Historical Perspective" (2011) *Research Handbook on Executive Compensation* p.1

in size over the past seven decades.[2] High levels of executive pay have been criticised for failing to reflect wider stakeholder interests, and particularly for failing to engage with the social justice implications of stratospheric pay awards.[3] From the UK perspective, the annual average pay of FTSE 100 executives rose from £100,000 in the early 1980s to over £1 million at the beginning of this century, and to £4.3 million by 2012.[4] Even after the introduction of new regulations in 2013 which empower shareholders with a binding say on pay, the average pay still stands at £4.5 million according to 67 FTSE company reports delivered after the introduction of the binding say on pay.[5] This annual payment, according to the High Pay Commission, is still growing.[6]

According to agency theory, the level of executive remuneration should be related to shareholder equity returns and the firm's performance. However, history has shown that this is only partly reflected in reality. Taking the US as an example, the S&P 500 experienced inflation-adjusted total annual returns averaging around 10% during the decades of the 1950s, 1960s, 1970s and 1980s.[7] In the 1990s, however, the average return rose to 14.7%. This increase was justified as a result of IRC section 162 (m), which helped to tie executive remuneration directly to share prices[8] (this regulation will be analysed later in Chapter 4). The 2000s are remembered by investors as the worst decade of equity return, showing an average negative 3.4% for inflation-adjusted annual returns, while executives still enjoyed their increasing levels of remuneration.[9]

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[2] C. Frydman & R. Saks, "Executive Compensation: A new view from a long0term perspective, 1936-2003," (2010) 23 *The Review of Financial Studies* 2099, pp.2117-8
[3] G. Ferrarini, N. Moloney & MC. Ungureanu, "Executive Remuneration in Crisis: A critical assessment of Reforms in Europe," (2010) 10 *Journal of Corporate Law Studies* 73, p.80
[4] High Pay Centre, "Reform Agenda Final Report" July 2014, available at: http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer, at p.4, last accessed 13 July 2016
[5] *Ibid*.
[6] *Ibid,* p.8
[7] L. A. Stout, "Killing Conscience: The unintended behavioral consequences of 'Pay For Performance'" (2014) 39 *Journal of Corporation Law* 525, p.532
[8] *Ibid*, p.533
[9] *Ibid*.

B. The structure of executive remuneration

As mentioned in Chapter 2, basic salary, annual bonuses, stock options and other incentive option plans make up executive remuneration packages. The use of options was negligible from 1970 to 1985, and did not increase rapidly until the late 1980s.[10] During that decade executives' flow compensation was still composed of cash salaries and bonuses, and only 30% of CEOs were granted stock options.[11] However, according to Core and Guay's research, by 1994 stock options had become a major component of executives' compensation, with 70% of CEOs receiving new option grants.[12] In the US the mean options granted to CEOs in 1994 amounted to $1.2 million, while their cash salaries were $1.3m.[13] During the decade after 1993, the fraction of stock options increased while the salary percentage decreased.[14]

The structure of executive remuneration has improved because companies learned to use stock options and other option plans as incentives to increase the sensitivity of executive pay to the wealth of the companies, and to encourage executive directors to increase efforts. Agency theory suggests that stock options will help to align interests between executives and shareholders, while having more stock options will produce more financial incentives. Compared to salary and bonuses, setting stock options as part of pay packages may improve the correlation between remuneration and the firm's share performance, although this also causes several problems in deconstructing pay for performance.

C. Incentive Structure of Executive Remuneration and Valuation

According to a summary provided by Jeffery Gordon, executive remuneration is designed to achieve four main goals which are not in stable relationship with one

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[10] *Supra,* n.2, C. Fryman & R. Saks, p.2116

[11] J. E. Core, W. Guay & D. F. Larcker, "Executive Equity Compensation and Incentives: A survey" (2003) 9 *Economic Policy Review* 27, p.29

[12] *Ibid*.

[13] *Ibid*.

[14] *Ibid*, p.30

another.[15] The first goal is to ensure a reward for executives' successful prior service; the second is to provide enough incentives for their future services; the third is to retain and attract managerial talent; and the final goal is to align the interest of managers and shareholders, which is the most important goal for current mandatory rules on executive remuneration.[16] Overall, we can conclude that executive remuneration should be designed to reflect managerial performance while providing fair incentives in pay to motivate and retain talented executive directors and ensure payback to shareholders. How to plan incentives in executive pay is a crucial issue. Normally, incentives are determined by two factors. The first is how performance is measured, and the second is how the remuneration is varied with the measured performance.

C.1. Annual Bonus

When a remuneration committee drafts an executive pay package, it is not only the base salaries which have already been written into the employment contracts that they should be concerned with. The key questions are how to set bonuses and how many stock options should be distributed as incentives. The criteria and measures that the remuneration experts and committee will use are as follows.

After the financial crisis in 2008, some scholars started realising that maybe it was not only the equity compensation that should receive attention; in addition, non-equity incentive pay, paid on the basis of past short-term profits, should also be considered by the regulators. Compared to the equity incentive strategy, the setting of non-equity incentive bonuses is determined by extra factors. Under a typical bonus plan, as described in the previous chapter, no bonus will be paid unless a threshold level of performance is achieved by the executive. Generally speaking, the annual bonus is linked to the firm's strategy and budgeting process.[17]

[15] J. Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Muddling Through," (2009) 46 *Harvard Journal on Legislation* 323, p.329
[16] *Ibid*.
[17] L. Liu & A. Stark, "Relative Performance Evaluation in Board Cash Compensation: UK Empirical Evidence" (2009) 41 *The British Accounting Review* 21, p.24.

C.1.1 Performance Measures

Bonus payments are determined by a matrix of performance measures. Performance measures can be divided into two categories: financial measures, and non-financial measures. Accounting measures, such as revenues, net income, operating profits and economic value added, constitute the majority of the financial measures. [18] Non-financial measures include performance relative to pre-established objectives, customer satisfaction, operational and strategic objectives which may involve increasing plant capacity, bringing new products on line in time, and environmental objectives.[19] As mentioned in Chapter 2, this thesis will not discuss about non-financial measures further.

C.1.2 Performance Criteria

There are also two types of criteria for determining an executive's bonus: objective criteria and subjective criteria.[20] It is worth separating the objective criteria from the subjective ones, since performance-based remuneration is entirely related to the objective criteria, and this portion of executive income can be tax deductible according to various government policies, such as the US Internal Revenue Code Section 162(m) which will be discussed further in Chapter 4.

The objective criteria are goals set for executives whose attainments can be readily observed. Those criteria include budget criteria based on performance and measured against the company's annual budget goals, such as budgeted-net-year growth or earnings objectives.[21] However, according to Bebchuk, attainment of this criterion will hardly indicate that the executive has increased shareholder value.[22] This is because after achieving the budget goals of the firm, executive

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[18] K. Murphy, "Executive Compensation" (1999) Ashenfelter, Orley, Card & David (Eds.), 3 *Handbook of Labor Economics. Elsevier*, North-Holland 2485, p. 2496
[19] *Ibid*, p.2497
[20] L. Bebchuk & J. Fried, *Pay Without Performance: The unfulfilled promise of executive compensation* (Cambridge, Massachusetts, Harvard University Press, 2004) pp.124–5.
[21] *Supra*, n. 18, K. Murphy, p.2497
[22] *Supra*, n. 20, Bebchuk & Fried, p.126

bonuses will take a big fraction of this income, leaving little for the shareholders.[23] Prior-year figures are the second objective criterion, including plans based on year-on-year growth or improvement such as increases in operating profits.[24] These criteria may have negative effects on shareholders' interests, since the use of past accounting results may enable executives to receive their bonuses even if they perform poorly, perhaps because the industry as a whole has improved over the prior year.[25] Other timeless objective criteria include plans measuring performance relative to a fixed standard; an example might be a 20% return on assets, where the 20% moves in a predetermined way independent of actual performance, or the cost of capital criterion, referring to performance based on the company's cost of capital.[26] However, these timeless criteria are not as important as the other criteria mentioned above.

On the other hand, subjective criteria are based on the judgments of the board or the remuneration committee. Discretionary criteria relate to pay plans where performance targets are set subjectively by the board of directors, following a review of the company's business plan, the previous year's performance, budgeted performance and a subjective evaluation of the difficulty of achieving the budgeted performance.[27] Peer group criteria include plans based on performance measured relative to other companies in the same industry or market, which is usually based on the same industry.[28] If there are subjective criteria set in the executive remuneration design, observers from the board, shareholders and creditors can reasonably disagree on whether those goals have been achieved, if they read the remuneration report carefully enough.

A bonus plan, as an important incentive method, can achieve its goal of aligning pay and performance by using both objective and subjective criteria. Normally, firms will use several of the objective criteria in setting the bonus plan, since they

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[23] *Ibid*.
[24] *Supra*, n. 21, K. Murphy, p.2497
[25] *Supra*, n. 20, Bebchuk & Fried, p.139
[26] *Supra*, n. 21, K. Murphy, p.2498
[27] *Supra*, n. 20, Bebchuk & Fried, p.126
[28] *Supra*, n. 21, K. Murphy, p.2498

are easier to use in observing improvements in executive performance.[29] However, there are problems with only applying objective criteria, since they may cause dissatisfaction and revolt among managers, and the single use of rigid rules may decrease their passion for the company.[30] The addition of subjective criteria can give the board a more complete and accurate picture of executive performance.[31]

C.1.3 Pay-Performance Structures

Payouts from bonus plans are determined in a variety of ways. The most common payout method is the "80/120" plan.[32] Under such a plan, no bonus is paid unless performance exceeds 80% of the performance standard, and bonuses are capped once performance exceeds 120% of the performance standard.

At year-end, the actual bonus pool is determined by modifying the target pool up or down depending on whether actual performance exceeds or falls short of the performance standard.[33] The pool is set to zero unless threshold performance is reached, and the pool is capped typically at some multiple of the sum of the target bonuses.

There are also other non-equity incentives in executive remuneration, such as acquisition bonuses, golden parachutes and golden goodbyes, and beneficial retirements. As these have less function in linking executive pay to performance, these incentives will be considered in later chapters.

On the other hand, equity incentives, which are the most important elements of executive remuneration according to section I, are worthy of more discussion as follows.

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29 *Ibid*.
30 Deloitte, "Executive Compensation: Plan, Perform and Pay, CFO Insights", available at: http://www2.deloitte.com/us/en/pages/financial-services/articles/executive-compensation-plan-perform-pay.html last accessed, 13 July 2016
31 *Supra*, n.20, Bebchuk and Fried, p.126
32 *Supra*, n.21, K. Murphy, "Executive Compensation", p.2499
33 *Ibid.*

C.2. Equity incentives

As mentioned in Chapter 2, stock options are contracts giving executives the right to buy a share of stock at a pre-specified price on a pre-specific term. Executive options are non-tradable for a period of time, and will typically be forfeited if the executives leave the firm before these options are exercisable. The equity incentives discussed in the following include stock options, restricted stock options, and long-term incentive plans.

C.2.1 Stock options

An executive stock option grants directors a right to buy shares at a specific price (usually called an exercise price or strike price) and trade them in the market during a certain period of time.[34]This right lasts until a particular date, which is usually called the expiration date or termination date.

For example, an executive may be granted 1,000 shares as his stock option, with a grant date price of £1 per share. This option setting allows the executive to buy 1,000 shares after three years (the vesting period) at a price of £1 per share, and sell these shares during the following ten years. If after the three-year vesting period (at the exercise point) the stock price is £51 per share, the executive can still buy the 1,000 shares at the price of £1 per share and sell them in cash for a profit of £50,000 per share. However, if the stock price is still at or below £1 at the exercise point, the executive cannot exercise the option for profit. Therefore, while potentially providing high profits, the stock option is also a risky proposition for directors.

There are three features that make stock options exceptional among the other incentives in executive pay package, and also among the other usual options. First, normal trading stock options give the owner the right to purchase existing shares of a firm, while executive stock options are new shares that the firm creates for the

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[34] *Supra*, n.18, K. Murphy, p.2501

executives when they can exercise their options.[35] The second feature is that executive stock options are not transferrable. This feature makes a difference in tying the executive's portfolio to the firm's profit.[36] Granting the options will still create cost and risk for the firm; if the firm chooses to shoulder this expense for its executives, it has to be certain of their commitment, and therefore the stock option cannot be transferrable.[37] Third, the executive stock option has a vesting period after which the executive will be allowed to buy and trade the options.[38] If executives leave the firm before the vesting period has elapsed, they will forfeit the options and receive nothing. This feature will reduce the stock option's value and attraction for executives, but variable as the stock market situation usually is, since executives can exercise their options immediately after the vesting time (which is usually shorter than the expiration time), this makes the stock option still a valuable and useful strategy.

In calculating the value of stock options, the definition of the intrinsic value of an option must be introduced. The intrinsic value of an option is the difference between the stock price and the exercise price at a particular moment, which equals the profit that executives can earn from exercising the options immediately after the vesting period.[39] Normally, if the firm is performing well the intrinsic value will be the excess of the firm's stock price over the exercise price of the options. If the stock price is at or below the exercise price, the intrinsic value of the option will be zero.

Thus, granting equity stock options can be a very powerful incentive for executives to create firm value, because if the price of the vesting stocks remains stagnant or falls the executives will have no income from these options, while if the executives'

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[35] R. W. Kolb, *Too Much Is Not Enough: Incentives is executive compensation* (Oxford, Oxford University Press, 2012) p.18.
[36] *Ibid*.
[37] *Ibid*, p.19
[38] *Ibid*.
[39] M. Conyon, "Executive Compensation and Incentives" (2006) 20 *Academy of Management Perspectives* 25, p.27

vesting shares increase there is still no ultimate cost to the firm.[40]

C.2.2 Restricted option

A restricted option is a commitment to grant shares depending on a certain condition being fulfilled. The condition can be the fulfillment of a vesting time, or an achievement in increasing the stock price. The executive will own full title to the options after a certain period of time, which is also called the vesting period, and if he or she leaves the firm before the shares are vested the options will be forfeited.

The usage of restricted options causes complications in valuing the options, if the granting condition is that the executive should stay in the firm for a certain period of time. If stock prices go down during the required period, there still will be some income for the executive while the firm faces a loss. This situation will be discussed in the next section.

C.2.3 Long-term incentive plans

Long-term incentives are similar in structure to stock options; the only difference is that they have a three- to ten-year period before they are granted, while some stock options take only three to five years.[41] The payoff of long-term plans may be in cash or stock grants. The restrictions of stock grants are almost the same as with restricted options.

D. Pay-performance sensitivities and problems

From the above, the alignment between executive pay and performance appears to be well developed. However, in practice, it is debatable whether these measurements and incentives work efficiently and encourage managers to perform well.

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40 *Ibid*.
41 *Supra*, n.35, Kolb, p.15.

D.1. Alignment between pay and performance

Three basic techniques developed from agency theory (particularly from Jensen's suggestions) to attempt to control and reduce the conflicts of interests between executives and the company.[42] The first of these is "self-constraint" through judicial enforcement, which is known as fiduciary duty, and the second is to eliminate conflicts by internal corporate control, including the use of independent directors on remuneration committees and the empowerment of shareholders on pay policies. The third one, which was built on the assumption that executive directors do have an influence on boards, is the most popular device, known as "pay for performance".[43] This suggests that executive pay should be aligned to the firm's interests by tying the wealth of the firm to their income; this technique relies mostly on the capital market and the product market to measure the firm's performance.

Calculating pay-performance sensitivities for options requires the exercise price and expiration-term information for each outstanding option grant.[44] Moreover, among the incentive factors in the pay package mentioned above, the restricted stock option and the executive stock option are the most likely to vary with the current year's stock market.[45] Evidence has also shown that the executive's incentives to do a good job and increase the firm's stock value are mainly related to equity incentives, rather than to the pay they receive in a particular year.[46] Therefore, any comprehensive design of a pay-for-performance system should include the remuneration awarded to the executive plus the revaluations of his stock and stock option holdings.[47] Also, empirical research undertaken by Habib and Ljungqvist has demonstrated that in the finance industry it is the companies

[42] J. Hill & C. M. Yablon, "Corporate Governance and Executive Remuneration: Rediscovering managerial positional conflict" (2010) 25 *University of New South Wales Law Journal* 294, p.307
[43] *Ibid*.
[44] M. A. Habib & A. P. Ljungqvist, "Firm Value and Managerial Incentives: A stochastic frontier approach" (2003) *NYU Working Paper*, No. 2451/26705, p.6
[45] *Supra*, n.35, Kolb, p.17
[46] *Ibid*.
[47] B. J. Hall & J. B. Liebman, "Are CEOs Really Paid Like Bureaucrats?" (1998) 113 *The Quarterly Journal of Economics*, MIT Press 653, p.667.

which provide the most generous financial incentives for managers that improve their executives' performance the most.[48]

From those economic assumptions, well-designed pay incentives can encourage managers to greater efforts and motivate them to stay longer in one firm to improve long-term productivity. However, problems arising from various factors, such as internal corporate management and accounting issues, can still have the ability to disrupt the relationship between pay and performance. From the previous section, it can be observed that executive bonuses are measured more by a firm's annual accounting performance, while equity incentives are aligned to stock market performance. However, sometimes the annual accounting results may be good even with poor stock performance, and return from long-term executive stock options may be high even with poor annual stock returns.[49] It is not enough to say that pay for performance means shareholders get richer so executives are richer too.

Moreover, for an individual executive manager, there are two important factors concerning pay for performance. First, sometimes executive directors have little or no control over the results that are supposedly being achieved in their pay policy; Second, these performance results are more often produced by a team of executives or even the whole organisation. Therefore, usually an individual manager's pay is linked to a group's performance.[50] This concern leads to one important motivational issue, namely risk.

Generally, risk in pay appears most often in leveraged companies such as banks, hedge fund companies and other types of financial firms.[51] The relation between risk and pay is derived from agency theory assumptions about the different

[48] *Supra*, n.44, Habib & Ljungqvist, p.25
[49] *Supra*, n.35, Kolb, p.89.
[50] Jay Lorsch & Rakesh Khurana, "The Pay Problem: Time for a new paradigm for executive compensation" (2010) *Harvard Magazine*, May-June, available at: http://harvardmagazine.com/2010/05/the-pay-problem, last check on July 13th, 2016, pp.30-5,
[51] Brookings, "Regulating Systemically Important Financial institutions That Are Not Banks," May 2013, available at: http://www.brookings.edu/research/papers/2013/05/09-regulating-financial-institutions-elliott, last accessed,13 July 2016

attitudes of managers and shareholders towards risk. Executive directors are assumed to be risk averse and shareholders are risk neutral, as mentioned in Chapter 2. However, financial companies with purely monetary assets will focus more on financial trading, which will increase risk-taking for firms.[52]

The definition of risk-taking is complicated, however. In this thesis it means a potential loss, or even company insolvency, that may be incurred while executives are trying to improve the firm's share performance; this can influence both the firm's long-term productivity and the manager's share income.[53] Normally there are two elements in executive pay that involve risk: the first is equity options in executive compensation, and the second is other cash rewards if the firm remains solvent, such as defined benefit pensions and deferred compensation.[54] Executive managers may engage in risky investments such as sub-prime lending, over-expansion or other derivatives trading in the name of the company because they are compensated in a large fraction by the company's stocks and other share options.[55] Also, it is debatable whether risk-taking can be controlled by executive pay design; according to the academics who focus on shareholders, compensation and risk-taking are not related to governance variables but co-vary with ownership by institutional investors who tend to have short-term preference and the power to influence firm management policies.[56] However, opinions like this may exaggerate the shareholders' ability to affect the investments of the company and the pay contracts made with managers, ignoring the influence of incentive compensation on managers' risk-taking. Empirical research shows that there is a positive relationship between incentives and firm risk. In Prendergast's summary of studies on risk-taking, he found that a balance between incentives in pay and risk-taking

[52] R. Merton & A. Perold, "Theory of Risk Capital in Financial Firms," (1993) 6 *Journal of Applied Corporate Finance* 16, p.17
[53] Developed this definition from Webster Dictionary, available at: http://www.learnersdictionary.com/definition/risk–taking last accessed, 13 July 2016
[54] Y. Landskroner & A. Raviv, "The 2007-2009 Financial Crisis and Executive Compensation: An analysis and a proposal for a novel structure" (2009) *NYU Working Paper* No. FIN-09-003, pp.7-8
[55] A. Edmans, "Debt-Based Pay May Give Much-Needed Balance" (2010) issue No.7 *IESE insight* Fourth quarter 29, p.31
[56] I-H. Cheng, H. G. Hong, & J.A. Scheinkman, "Yesterday's Heroes: Compensation and Risk at Financial Firms" (2014), *ECGI – Finance Working Paper* No. 285, March 24, p.29

can seldom be observed:[57] when greater incentives are added to pay packages and executives expect higher compensation, the executives are induced to increase efforts and thus there will be higher levels of risk taking. This conclusion can be verified by the 2007–09 financial crisis, with incentives included into executive pay packages causing excessive risk-taking behaviour in the asset market, and the pay for performance system even under suspicion of reducing the effectiveness of incentivising sustainable growth.[58]

So do high financial incentives naturally improve company's performance? Contrary to the assumptions underlying setting financial incentives in executive directors' pay packages, such as using stock options to provide them with a large proportion of the shareholding, evidence has shown that there is nearly no correlation between managers' ownership of shares and the firm's performance. After an extensive investigation of corporate acquisition behaviour and particularly this relationship, Loderer and Martin found that there is no case to prove that the executives' stockholdings from financial incentives provided by the firm have affected the decisions that they have made. This suggests that higher stock ownership does not necessarily drive executives to pursue high share prices.[59] Loderer and Martin conclude from their research that there is little evidence to suggest that agency problems in large companies can be reduced through "arbitrarily" forcing executives to accept more stockholdings.[60] Core et al even point out that the ownership of executive shares has a negative correlation with compensation levels.[61] Loderer and Martin also propose that there may be other factors related to the product and corporate markets that force executive directors

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[57] C. Prendergast, "The Tenuous Trade-off Between Risk and Incentives" (2002) 110 *Journal of Political Economy* 1071, p.1097

[58] Columbia Business School, "Governance, Executive Compensation, and Excessive Risk in the Financial Industry" 27–28 March 2010, available at: http://www.fes-globalization.org/new_york/"governance-executive-compensation-and-excessive-risk-in-the-financial-services-industry"/ last accessed 13 July 2016

[59] C. Loderer & K. Martin, "Executive Stock Ownership and Performance Tracking Faint Traces" (1997) 45 *Journal of Financial Economics* 223, p.248.

[60] *Ibid*.

[61] J. E. Core, R. W. Holthausen & D. F. Larcker, "Corporate Governance, Chief Executive Officer Compensation and Firm Performance" (1999) 51 *Journal of Financial Economics* 371, p.406;

to improve their firms' performance, namely to avoid restructuring and takeovers.[62]

From the aforementioned studies, there may be some problems in practice that affect the pay for performance system in the design of incentives in executive remuneration policies.

D.2 Problems around Pay for Performance

First, a big problem with stock options and other incentives alike is not that they cannot provide enough incentives, but that they may lead to unexpected consequences.[63] Due to shareholders' information asymmetry, directors may engage in some behaviour that they are not paid to engage in. Kerr has suggested that one error worthy of notice is that under some circumstances, shareholders and the board may reward a director for A while hoping for B.[64] This situation may occur when directors are engaged in multiple tasks,[65] A is a lower level of accounting or equity performance of the firm, or a totally different performance outcome compared to B. However, when an executive director's performance is just A, and not good enough for B, his payback is still the same as B. The situation of paying for B while performance results in A can be corrected by a "relational contract", as proposed by Gibbons, which is a contract with terms setting out specified situations that both principal and agent can expect while signing it, which nonetheless is still adaptable to new information when it becomes available.[66]

In most practical remuneration policy, these relational contracts are made with some subjective criteria in the pay for performance considerations, such as discretionary criteria and peer group criteria from the above, which can still reward executives for result A within a flexible scope. This design of remuneration

[62] *Supra*, n. 59, Loderer & Martin, p.241
[63] *Supra*, n. 39, Conyon, p. 29
[64] S. Kerr, "The Folly of Rewarding A While Hoping for B" (1975) 18 *Academy Management Journal* 769, p.775
[65] B. Holmstrom & P. Milgorm, "Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design" (1992) 7 *Journal of Law, Economics and Organization* 24, p.25
[66] R. Gibbons, "Incentives Between Firms and Within" (2005) 51 *Management Science* 2, p.17.

contracts seems unreasonably generous, especially when result A is a lower level of performance outcome compared to B. These generous contracts may be settled to retain the talented on the board, although they can still lead to a great deal of agency cost, such as equity re-loading, which will be mentioned later in this chapter, and other cases of pay for underperformance in the following chapters.

Another concern around the use of stock options to provide incentives to perform is that they may encourage opportunistic behaviour among directors, such as the manipulation of performance measures and cheating in accounting reports.[67] CEOs with higher incentives can sometimes lead to greater earnings manipulations.[68] What is worse, there are studies showing that the possibility of a company becoming the target of fraud allegations is positively related to their use of financial incentives.[69] This problem is even more serious than the former contracting issue, and will be investigated later in this chapter.

There is a debate as to whether the pay for performance factor has been weakened or strengthened over time. As mentioned before, the empirical relationship between executive compensation and firm performance was proposed by influential research carried out by Jensen and Murphy in 1990.[70] According to the rules set by Jensen and Murphy, later studies undertaken by other scholars such as Conyon, Main and Ferrnandes show that pay-performance sensitivities were low from the mid-1990s to the 2000s.[71] In contrast, Hall and Liebman found that

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[67] *Supra*, n.39, Conyon, pp.33-4; also L. Gruber & M. Owings, "Physician Financial Incentives and Caesarian Section Delivery" (1996) 27 *Rand Journal of Economics* 99, p.110.

[68] E. Bartov & P. Mohhanram, "Private Information, Earnings Manipulations and Executive Stock Options Exercises" (2004) 79 *The Accounting Review* 889, pp.911–2.

[69] D. Denis, P. Hanouna & A. Sarin, "Is There A Dark Side to Incentive Compensation" (2006) 12 Journal of Corporate Finance 467, pp. 479-80

[70] M. C. Jensen & K. J. Murphy, "CEO Incentives: It is not how much you pay, but how" (1990) 68 *Harvard Business Review* 138, pp.138-153.

[71] M. Conyon, "Corporate Governance and Executive Compensation" (1997) 15 *International Journal of Industrial Organisation* 493, p.501; N. Feranades, M.A. Ferreira, P. Matos & K.J. Murphy, "The Pay Divide: Are U.S. Top Executive Paid More?" (2009) *ECGI Working Paper Series in Finance* No. 255, p.20; B. G. Main, M.A. Bruce & T. Buck, "Total Board Remuneration and Company Performance," (1996) 106 *Economic Journal* 1627, p.1633

this relation has stayed the same.[72] Jensen and Murphy found little evidence that performance relative to other firms in the same industry acted as a "yardstick" for managerial incentives.[73] On the other hand, Gibbons and Murphy found that performance relative to both industry and market played an important role in shaping executive remuneration.[74] They also established that market relative performance had a stronger effect than industry relative performance, with their research involving a large sample of 9,425 firm years over the period from 1974 to 1984.[75]

From the above, it can be concluded that it is the financial incentives in executive remuneration that have helped in aligning pay and performance, but these incentives have also led to serious problems that may destroy this link. Therefore, this chapter will go on to analyse why this situation has arisen, and examine the factors that have led to such problems. According to the remuneration regulated system that was defined at the beginning of this chapter, various reasons will be developed below from the dysfunctions of corporate governance rules, capital markets, labour markets and product markets in regulating executive remuneration.

II. How Pay for Performance Fails

Sykes suggests that the main causes of inappropriate remuneration practices are: the lack of independence on remuneration committees, incorrect choice of remuneration consultants, a mismatch between the period of remuneration incentives and the underlying shareholders, inappropriate earnings criteria, and the reinforcing nature of conflicts of interest.[76] These factors can be discussed in

[72] B. Hall, "What You Need to Know about Stock Options" (2000) *Harvard Business Review*, March–April, 121, p.124; B. Hall & J. Liebman, 'Are CEOs really paid like Bureaucrats?' (1998) 113 *The Quarterly Journal of Economics* 653, p.677.
[73] *Ibid*., B. Hall & J. Liebman
[74] R. Gibbons & K. J. Murphy, "Optimal Incentive Contracts in The Presence of Career Concerns: Theory and Evidence" (1990) 100 *Journal of Political Economy* 468, p.480
[75] *Ibid*, p.481
[76] A. Sykes, "Overcoming Poor Value Executive Remuneration: resolving the manifest conflicts of interest" (2002) 10 *Corporate Governance* 256, pp. 257-9.

the context of the underlying principle of this thesis; among them, remuneration committees and boards are ranked at the top.

A. The board and remuneration committee

The contract between firms and executive directors for their future payment is their pay policy, and at a company's annual general meeting a report on how the board has designed an executive pay policy and implemented executive pay policy will be presented to shareholders. The power of the remuneration committee in terms of how to design and implement the pay policy, as well as reporting to the annual general meeting, is authorised by the articles of association of the firm.

As mentioned in Chapter 2, the independence of the remuneration committee and the board is important to guarantee a healthy design in the company's remuneration policy. However, in practice, although there are regulations concerning outsider directors on the board in the government's corporate governance code,[77] there are still difficulties in establishing independence since companies are often reluctant to comply with these requirements:

> "independence is inherently virtually impossible to observe, and its surrogate definition is a rule-based list of conditions that cannot hold if a director is to be deemed independent. Consequently, firms may focus on satisfying the rules for independent directors rather than the broader concept of independence, similar to situations where people focus on rules to specify ethical behavior instead of evaluating whether particular behavior is ethical."[78]

Additionally, suppose that there are enough outside non-executive directors on the remuneration committee; it will still be hard to maintain independence, since

[77] For example, the UK Corporate Governance Code 2016 requires that there should be at least three independent non-executive directors on the remuneration committees of big listed firms, and the SEC Dodd-Frank Act 2010 requires that all members of the remuneration committee should be independent.
[78] E. M. Matsumura & J. Y. Shin, "Corporate Governance Reform and CEO Compensation: Intended and unintended consequences" (2005) 62 *Journal of Business Ethics* 101, pp.108-109.

commonly in the dialogue between the remuneration committee and individual executives, it is the executive director who takes the lead in negotiating pay. As one of the FTSE 100 remuneration committee chairs suggested:

> "I think it's up to the chief executive – I feel very strongly that it is management that should be recommending to the remuneration committee how they think and in particular how the chief executive thinks the company should best be run in terms of reward."[79]

Studies investigating the tendency towards an increasing use of the board in solving corporate governance issues have shown that prior to executive ownership of shares and the power of shareholders, the board had more influence on executive pay and performance.[80] Research done by Core et al has shown that the level of executive compensation will be lower if the percentage of inside directors on board is increasing.[81] But this level will be higher with a bigger board size, and an increase in the percentages of outside directors who are appointed by the CEO, those who are over the age of 69, or those who serve on more than three company boards.[82] Also, their results suggest that CEO remuneration will be lower if there is a non-CEO internal board member or an outside stockholder holding at least 5% of the firm's shares.[83] Another view also contributes to the idea that share ownership among board members and the separation of the roles of chair and CEO is positively correlated with better "contemporaneous" and future operating performance, since directors with proper stock ownership on the board will have an incentive to provide effective monitoring over important corporate decisions.[84]

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79 K. M. Sheehan, *The Regulation of Executive Compensation: Greed, accountability and say on pay* (Cheltenham, Edward Elgar Publishing Limited, 2012) p. 70

80 J. E. Core, R. W. Holthausen & D. F. Larcker, "Corporate Governance, Chief Executive Officer Compensation and Firm Performance" (1999) 51 *Journal of Financial Economics* 371, p.384; S. Bhagat & B. Bolton, "Corporate Governance and Firm Performance" (2008) 14 *Journal of Corporate Finance* 257, p.271.

81 *Ibid.,* J. E. Core, R. W. Holthausen & D. F. Larcker

82 *Ibid.*

83 *Ibid.*

84 *Supra*, n.80, Bhagat & Bolton, p.271

However, in contrast to policies that recommend putting more independent directors on boards, the study done by Core et al finds no evidence supporting the hypothesis that independent directors can create more effective boards than inside directors, and also no evidence that greater equity holdings among independent outside directors will contribute to better corporate performance.[85] Other suggestions such as board independence will definitely improve firm performance are probably misguided, and should only be used to discipline poor management if necessary, for investigation shows that board independence has a negative correlation with the firm's operating performance.[86]

Therefore, from the empirical evidence, there may be several concerns about the effectiveness of boards and remuneration committees in terms of remuneration and performance, and the most important is that a lack of independence will jeopardise pay for performance. To understand these issues, it is necessary to know how remuneration policies and reports are made. There is a certain procedure followed by remuneration committees before pay policies and reports are presented to shareholders in annual general meetings. From the committee's review of the existing pay strategy to the final decisions and implementations, there are various factors that are considered by the directors on the remuneration committee.

According to Kym Sheehan, the remuneration committee must engage in two kinds of process before arriving at the final pay policy, namely an annual review of remuneration and a major review of remuneration practice. During an annual review, the committee has to adhere to the following process:[87]

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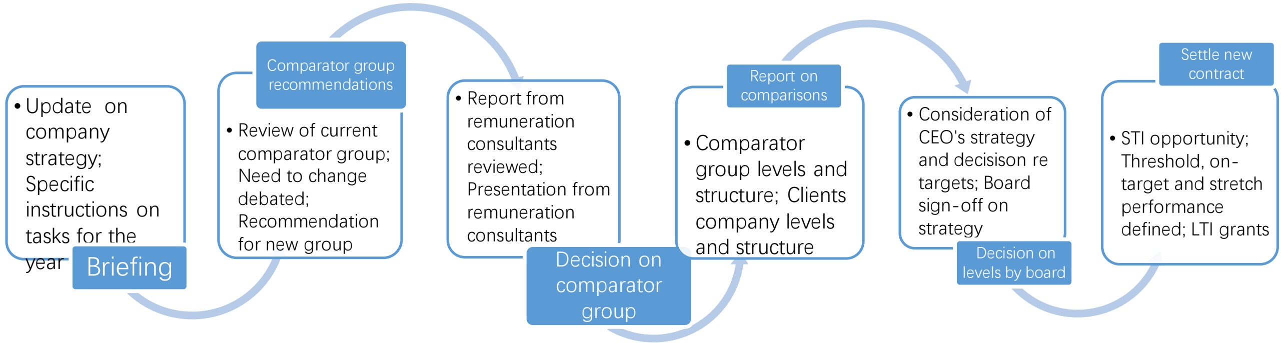
[85] *Supra*, n. 81, Core *et al*, p.385
[86] *Supra*, n. 80, Bhagat & Bolton, p.271
[87] *Supra,* n. 79, K. M. Sheehan, p.134



Source: K. M. Sheehan, *The Regulation of Executive Compensation: Greed, accountability and say on pay* p.134

Annual reviews of pay are more common than major reviews of pay, but the latter will be carried out in more extensive detail if a huge percentage of the shareholders vote against the last year's pay plan or report. For example, under the UK's say on pay rule, shareholders hold an advisory vote on the remuneration implementation report, and if a majority of the shareholders veto this report there will be a new pay policy next year under the committee's major review of pay strategy, but there will not be an ordinary annual review. Under the annual review every element of executive pay will be measured, such as individual executives' performance related to their bonuses, and how much they should get paid from the bonus sector this year.

The first section in the review will be an analysis of the firm's market performance and the former pay policy, concerning whether there is pay for good luck and pay rises that are not related to the firm's market performance. In practice these factor reviews will consider information from the company's comparators.[88] After former pay packages have been investigated there will be several dialogues with remuneration consultants, who will usually provide information about the market and the firm's peer group's executive pay. The role of the remuneration consultant is important in pay setting, not only because they have more information than a

[88] J. M. Bizjak, M. L. Lemmon & L. Naveen, "Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation" (2008) 90 *Journal of Financial Economics* 152, at p.154

single remuneration committee, but also because the committee members are not always experts with enough professional knowledge about financial incentives in pay. A detailed discussion of these consultants will be presented in Chapter 6. The remuneration strategy, or policy will not be necessarily renewed every year. UK listed firms are required to present a new pay policy every three years for consideration in the annual general meeting, along with an annual pay report with information about how the firm has implemented executive pay. Thus, in the annual review fixed factors such as basic salary and pensions will not be consulted on every single year, although bonus issues will be.[89] Moreover, as mentioned above, normally there will be dialogue between executives and the remuneration committee on how to design pay strategy, and the committee members often will not abide by the wishes of executive managers.

After a draft pay strategy that has been developed with the consultants has been presented to the board, the board chair will hold a meeting with other members in the company, such as the CEO and the CFO, in order to make revisions to the pay plan. These meetings will be rather subjective, considering the performance of individual executives and their efforts towards running the business. As will be discussed shortly, rent-seeking behaviour, option repricing and reloading manipulation will be taken into account during these meetings. However, for the board and its members, these decisions can be seen as strategies to retain key executives and promote future corporate success. After the chair's sign-off, the new pay strategy will be presented to the shareholders for adoption.

Since there may be unsuitable decisions made by the board and the remuneration committee during the executive pay setting process, is there any solution for monitoring this behaviour? Under most circumstances it will be the votes of shareholders that may function as a pre-warning and a potential correction of pay. The shareholders' voting power is granted by government regulations, which will be discussed in the next chapter. Although firms and scholars used to think that

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[89] *Supra*, n. 20, Bebchuk and Fried, p.29

providing financial incentives was an efficient way to encourage executives to protect and develop the business of their companies, the perverse effects of these incentives on companies and even the whole economy have shown that this assumption was wrong. What is more, during the past decade the development of executive remuneration has focused on tying executive pay more directly to the interests of shareholders, while relying on markets and inner corporate control to set proper pay policies. As described in the previous section, aligning these two interests can be achieved by providing more incentives in executives' pay. However, unfortunately there is little evidence to indicate that higher pay-performance sensitivities will lead to higher stock-price performance.

In terms of reasons why executive remuneration can be so excessive, lawyers tend to blame the failure of the market and government policies, while financial economists tend to lay the blame on the internal control of companies. Fryman and Saks concluded that using consistent methods to value pay is particularly important when considering stock options, which were measured differently in research conducted between the 1950s and the 1970s in comparison with the common practice of today.[90] After analysing stock option problems in the history of the US, the lessons learned from scandals since 2000 may be noted here.

Examples from Enron, RBS, Bear Sterns and Fannie Mae show how financial incentives induce executives and CEOs to play so-called "earning management games".[91] Executives play these games when they want to adjust the firm's earning reports to release news which will be beneficial to their financial income, and when they fabricate stock prices concerning the date on which their options were issued.

In the US Fannie Mae, as a representative of all firms involved in executive earning management, is famous for making "one of the largest (financial earning)

[90] *Supra*, n. 2, C. Fryman & R. E. Saks, pp.2106-7
[91] *Supra*, n. 35, Kolb, p.140.

restatement(s) in American corporate history."[92] Its CFO, Timothy Howard, and its CEO, Franklin Raines, were accused of misstating the firm's earnings from 1998 to 2004 by inflating them by more than $11 billion.[93] The purpose of doing so illustrates how financial incentives drive executives to chase benefits while ignoring the interest of the firm. Due to IRC section 162(m)'s tax deduction rule, more than 94% of Raines's pay package was performance-based.[94] Like the structure of executive remuneration discussed above, if the performance measure was not satisfied or the market stock performance caused a poor earnings announcement, the CEO's bonus was threatened and even his equity income would be wiped out. Therefore, in order to keep their income at a high level, the CEO and the CFO would prefer to state that the firm was running very well.

The outcome of their misstatement was serious, because the fraudulent earnings harmed the company and also had a significant social cost. Since Fannie Mae is a federal government sponsored enterprise, it received a bailout from the government of $103.8 billion during the financial crisis, but had not repaid anything by the end of 2011.[95] What was outrageous and surprising was the news that the then CEO, Raines, still had his equity options worth $7 million at the time he left the company.[96] Because there was a special provision in his payment contract he was able to retain his equity options, and he exercised these options years after departure (after the time when the company had poor stock prices because of being investigated and being required to pay a penalty).[97] Even more surprisingly, there was no requirement from the board for a claw-back because of his failure, and no board to compel him to exercise his options immediately on his departure,

[92] SEC, Cox, C. "Accounting Irregularities at Fannie Mae" (2006), testimony before the US Senate Committee on Banking, Housing and Urban Affairs, available at: http://www.sec.gov/news/testimony/2006/ts061506cc.htm last accessed, 13 July 2016

[93] L. Bebchuk & J. Fried, "Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay and Camouflage" (2005) 30 *Journal of Corporation Law* 807, p.810

[94] *Ibid*.

[95] W. Kolb, *The Financial Crisis of Our Time* (Oxford: Oxford University Press, 2011) pp.21-22

[96] *Ibid*.

[97] *Ibid*.

at which time he would have received a mere $215,000.

From the above it would seem that the failure of pay for performance is partly because of the undue influence of executive managers on boards and the deficient design of remuneration policy. The other reasons that can explain why pay for performance fails are in terms of markets, internal control over incentive plans and various cultures, and they will be explained as follows.

B. Fallacy of Relying on Markets

B. 1 Market problems

There are different markets with simultaneous effects on executive remuneration: the capital market, the product market, the market for corporate governance, and the labour market. In Villiers' view, the notion that markets can control corporate behaviour is a rather "sweeping" assumption, which means that simply using these market forces does not solve corporate problems effectively.[98] Another argument from Stokes suggests that no empirical demonstration has proved that markets have any effectiveness in terms of restraining the abuse of executive discretion, and the idea that the markets provide a neutral fair process for participants is also implausible.[99] Another concern of Villiers is that share prices may be affected by the nature of companies' conduct, thus jeopardising the normal functions of markets.[100] This has indeed been proved by the Enron case.

Enron was a company "laser focused on earnings per share", to the degree that during its final days the underlying business stopped doing everything except faking the impression of high share prices.[101] This company was initially a utility, principally a clearing house for energy futures. However, Enron expanded its

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[98] C. Villiers, "Executive Pay: Beyond Control?" (1995) 15 *Legal Studies* 260, pp. 274-5

[99] R. Morse, Jr, "Company Law and Legal Theory", Reviewed: L*egal Theory and Common Law* (Oxford, Oxford University Press by W. Twining) (1987) 85 *Michigan Law Review*, Survey of Books Relating to the Law 935, p.937

[100] *Supra,* n.98, C. Villiers, p.275

[101] S. Deakin, "Corporate Governance and Financial Crisis in the Long Run" (December 2010), *CBR Research University of Cambridge Working Paper* No. 417, p.11

business to provide intermediary market trades and other risk allocation devices, and these so-called “new markets” and “new corporate models” were studied by numerous business schools as the century’s most innovative case. However, they failed in the general stock market fall in the early 2000s.[102] In Deakin’s opinion, it was not the executive directors who manipulated their sky-high payments and who were to blame for the failure of Enron, and neither was it the other directors on the board who did not do their monitoring work, for which they were paid huge consulting fees while donating large amounts of money to schools and hospitals. Deakin suggests that Enron failed because the executive managers used the company’s rising share price to finance their off-balance sheet transactions, inflating their share prices by exaggerating the firm’s earnings.[103] Therefore, how did these markets lose their function in regulating managerial remuneration?

Explanations for how these markets can influence executive pay will be developed, and intrinsic problems of market effectiveness in regulating pay will be examined, in the next sections.

B.1.1 Product market

Competition from the product market provides implicit incentives determining the setting of executive compensation, and companies will adjust the level of compensation explicitly to reflect this.[104] Intrinsically, product competition can increase the sensitivity of pay for performance, since strong competition, where the elasticity of substitution among goods is high, provides steeper monetary incentives for managers to create strategies aimed at stealing market share from other firms.[105] However, a higher level of competition can also reduce the average profits of firms showing poor performance, and may thus increase their likelihood

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[102] *Ibid*.
[103] *Ibid*. p.12
[104] V. Cunat & M. Guadalupe, “Executive Compensation and Product Market Competition” (2004), CEPR *Working Paper for Centre for Economic Performance* No. 4425, p.16
[105] K. M. Schmidt, “Managerial Incentives and Product Market Competition” (1997) 64 *The Review of Economic Studies* 191, p.202.

of bankruptcy. [106] Therefore, generally the product market can influence remuneration through competition, rewarding the beneficial performance of executives.

Research by Aggarwal and Samwick has proved that within executive compensation contracts there is a positive connection between firm performance and executive pay. However, there is also a negative link between the same industry's performance and an individual firm's executive remuneration.[107] In a competitive product market executive directors can receive higher compensation if executives from other companies in the same industry bring lower returns for their firms.[108] However, this interaction between executive pay and performance in the imperfect competitive market has long been ignored by agency theory. Therefore, a potential problem is that although this interaction helps to reduce executive risk-taking in running businesses while not being concerned with a particular firm's loss, it does provide incentives for executives to lower the whole industry returns.[109] Although it will be nearly impossible for a few firms' executives to influence a whole industry under normal circumstances, companies regularly have strategic competitors, and compensation contracts with interaction evaluations will encourage executive directors to suddenly raise the share price or release good news at a certain time to influence their own firms that will benefit their pay while they are making strategic product market decisions.[110] Moreover, as mentioned in previous sections, there will be comparison with peer companies in terms of their executive compensation during a remuneration review in pay policy setting, and with weak governance of the board, sometimes managers with poor performance will still get paid at a high level to match the pay of other

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106 *Ibid*.
107 R. K. Aggarwal & A. A. Samwick, "Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence", (1999) 54 *Journal of Finance* 1999, p. 2008.
108 *Ibid*.
109 *Ibid*, p.2032
110 *Ibid*.

companies in the same industry, with the purpose of encouraging the managers to engage in greater efforts.

B.1.2 The Labour Market

Share prices, which are always perceived as the standard of a firm's current and future performance, can be used by shareholders as mechanisms for evaluating and monitoring the company.[111] If shareholders are not satisfied with the share price and weak management of the board, they can choose to simply exit from the company by withdrawing their investment. Firms that fail or which are likely to fail most of their shareholder's expectations will be subject to takeover bids or, if there is no third party intervention, perhaps a restructuring initiated by the existing management team.[112] Evidence from the UK and US studied by Conyon et al. has suggested that job losses from redundancy can lead to a decline in compensation which can last several years, and such dismissals can be harmful to the firm's accumulated human capital.[113]

The labour market, as described by Sherwin Rosen, has three important functions in regulating executive directors and their performance:[114] First, the labour market helps to ensure that control must be distributed and assigned among executive directors: the most talented managers are efficiently assigned to the control positions in the largest companies; Second, in the labour market executive contracts should provide enough incentives for executive directors to act in their shareholders' interests; Third, the market must identify new and talented groups of managers and reassign control over careers and positions from older executives to the younger generation. Rosen's research has also pointed out that competition

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[111] *Supra*, S. Deakin, n.100, p.13
[112] *Ibid*.
[113] M. Conyon, S. Girma, S. Thompson & P. Wright, "The Impact of Mergers and Acquisitions on Employment on Company Employment in the United Kingdom" (2002) 3 *European Economic Review* 31, p.47
[114] S. Rosen, "Contracts and the Market for Executives" (1990) *National Bureau of Economic Research, Working Paper*, No. 3542, pp.17-20

among executive directors for top positions and the diminishing incentive effect of future rewards with age implies that executive remuneration design should "increasingly tilt" rewards towards current performance over the course of a career.[115] However, the skill and talent emphasis of the labour market will lead to huge pay gaps between top executive managers and normal employees, since they have different tasks and risks to face at work which will lead to fairness and social insurance issues; these will be discussed later.

B.1.3 Capital market

Capital market failure is the most important issue in this section.

Option Value

The value of an option gives a general idea of how efficient and desirable the option is to executives from the capital market perspective.

Generally, there are two valuation models for stock options, the analytical Black-Scholes model and the lattice or binomial model, which uses a dynamic method to analyse the value of options.[116] These two valuation models both come from a general financial theory, which is called the Efficient Market Hypothesis.[117] This assumes that under an efficient market, in which there is a large amount of rational, profit-maximising competition and information available to all participants,[118] security prices can fully reflect all information to satisfy both investors and firms.[119] The Black-Scholes model is more popular as it is easier to understand. However, since these two models involve significant mathematical calculations described by their specific formulae, a detailed examination is outside the scope of this thesis.

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115 *Ibid*.
116 *Supra*, n. 35, R. Kolb, p. 69.
117 J. Cullen, *Executive Compensation in Imperfect Financial Markets* (Cheltenham, Edward Elgar, 2014) p.17
118 E. F. Fama, "Random Walks in Stock Market Prices" (1965) 21 *Financial Analysts Journal* 55, p.57
119 E. F. Fama, "Efficient Capital Markets: II" (1991) 46 *Journal of Finance* 1575, p.1589

The factors that are worth mentioning here are key inputs that can influence the models in analysing option values. According to Kolb, a financial scholar, these factors can be defined as follows:[120] (1) the stock price prevailing at the time the value is accounted; (2) the exercise price of the option; (3) the volatility of the underlying stock; (4) the risk-free rate of interest; and (5) an estimated dividend rate. Though the stock price on the market is likely to change, these optimal factors can be used to influence the intrinsic value of stock options and thereby change the level of an executive's income. It is possible to use these factors to have an impact on executive remuneration level. It has been pointed out that the critical consideration with regard to stock options is the difference between the cost to the firm of granting the option and the value to the executives who receive it.[121]

"Windfall"

The first factor is "windfalls" from the stock market. It has been noticed that even when the market's upward and downward movements and the industry sector levels are the same, the structure of stock options can still imply that negative moves will be unlikely to hurt managers as much as positive moves will benefit them.[122] More than that, Bebchuk and Fried suggest that negative shocks to the market can make executives' options worthless, but positive shocks can boost the value of their options to unlimited levels.[123] That is to say, the possibility of negative market or industry shocks reduces the value of stock options, but not as much as the possibility of positive shocks increases them.

However, in my opinion, Bebchuk and Fried may be too strict in criticising the stock option as an incentive to remuneration, since their ideal option plan is something near to requiring perfection. They propose that an option plan should be designed either to maximise incentives for the money spent, or to achieve a certain level of incentive at the lowest possible cost.[124] Their assertion is that when executives

[120] *Supra*, n.35, Kolb, pp.70-1
[121] *Ibid*.
[122] *Supra*, n.20, Bebchuk & Fried, pp.138–9.
[123] *Ibid*.
[124] *Ibid*, p.140

are rewarded for market- and sector-wide price movements unrelated to their efforts, shareholders' money is not well spent.[125] As would be expected, Bebchuk says that executive remuneration can be more effectively targeted at generating incentives if changes in the stock price, which are not the result of managers' own efforts, can be excluded from the compensation calculation.[126]

Looking at stock prices after the vesting period according to various remuneration contracts, there are three ways to set the exercise price of the options: at-the-money, in-the-money, and out-of-the-money.[127]

Incentive options in executive pay provides the opportunity for executive directors to purchase, hold and sell shares of their company. After a certain period set by the pay policy, executive directors will have the right to purchase or sell these shares, according to the exercise price set by the contract.

The at-the-money option is the most typical one among the three, requiring the exercise price of option to be the same as the stock option price at the time the contract is exercised. It is a general assumption that the exercise price of executives' stock options should be equal to the current stock price. The in-the-money option is the most unwelcome incentive in terms of tax rules, since this option's exercise price is below the grant-date market stock price which makes the intrinsic value of this option much higher. Some firms have introduced an out-of-the-money option to encourage executives to better perform, since this option has an exercise price higher than the grant-date stock price.

Bebchuk and Fried point out that although it is not possible to expect every firm to choose the same incentive option, vesting time and exercise date, opportunities still exist for executives to gain unreasonably high pay because the board may have sought the options that will benefit the executives the most, by manipulating

[125] *Ibid*, p.141
[126] L. A. Bebchuk, A. Cohen & H. Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008" (2010) 27 *Yale Journal on Regulation* 257, p.271.
[127] Macroption, "In the Money, At the Money, Out of the Money Options," available at: http://www.macroption.com/in-at-out-of-the-money-options/ last accessed, 12 July 2016

factors within the options.[128] Executives will always prefer the exercise prices of the options to be low, and research has shown that executives will award themselves with in-the-money options camouflaged as at-the-money options through their influence over boards and remuneration committees.[129]

Even if executives cannot make their options into in-the-money ones, there are still ways to benefit themselves not by performing well but by influencing other factors which can affect the intrinsic value of the stock options. Yermack finds that executives always want to be granted stock options after the release of favourable earnings results, which helps to increase stock prices dramatically.[130] Additionally, executives who cannot control when to have their options granted may find an opportunity to disclose some bad news, so as to reduce the stock price before their options are exercised.[131] Other studies have also shown that executives will tend to make income-decreasing accruals before the grant date of their options in order to depress stock prices.[132]

Research examining the executive remuneration of a sample of 572 companies, carried out by Aboody and Kasznik, found that executives do not only manipulate share prices for the purpose of increasing their financial incentive payouts, they also achieve this manipulation by releasing information that is unclear or confusing to the market and the public.[133] They pointed out that before they were due to issue stock options, companies whose executives receive options tended to release less optimistic earnings forecasts than other companies with no options to issue.[134] Also, after studying the earning announcements of those companies it was found that CEOs who receive stock options prior to announcements were

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[128] *Supra*, n.20, Bebchuk & Fried, p.142
[129] D. Yermack, "Good Timing: CEO stock option awards and company news announcements" (1997) 52 *The Journal of Finance* 449, p.453
[130] *Ibid*, pp.457-8
[131] D. Aboody & R. Kasznik, "CEO Stock Option Awards and Corporate Voluntary Disclosures" (2000) 29 *Journal of Accounting and Economics* 73, at p.83
[132] S. Balsam, H. L. Chen & S. Sankaraguruswamy, "Earnings Management Prior to Stock Option Grants" (January 2003), available at SSRN: http://ssrn.com/abstract=378440, last accessed, 13 July 2016
[133] Supra, n.131, D. Aboody & R. Kasznik, p.74
[134] *Ibid*, p.81

more likely to issue bad news forecasts and less likely to release good news beforehand, in comparison with those who would gain options after earning announcements have been made.[135] Because of pessimistic news and the low level of share prices when the stock options are issued, executives will gain more when they exercise their options with a higher price difference.

<u>Repricing options</u>

Apart from the ways mentioned above and used by executives to benefit themselves, the board will sometimes voluntarily provide executives whose options have become out-of-the-money with repricing options by resetting prices to a point lower than the stock prices. In some circumstances the repricing options may replace the old ones to satisfy executives' concerns about their income.

Firms' repricing behaviour is always controversial. Bebchuk and Fried hold the opinion that expectation from executives that firms will always engage in repricing to offset any loss can reduce the executives' incentives to perform.[136] They also suggest that the worst case scenario may be that executives will anticipate repricing and will engineer the decline the firm's stock price in the short term to lower the exercise price, which will affect the interests of the shareholders.[137] However, on the other hand, financial scholars note that firms do not carry out option repricing arbitrarily. They suggest that firms will consider two factors in granting new options – incentivising retention and incentivising future performance.[138] Kolb indicates that after realising that there is a potential loss in granting new options and keeping an executive in post, if the firm still wants to retain the executive the board will have to provide enough repriced options to keep him or her from moving to another company (incentivising retention).[139] Moreover, before repricing options the board will also have to make sure that there is a chance of the stock price exceeding the original exercise option price in the future

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135 *Ibid*, p.85
136 *Supra*, n. 20, Bebchuk and Fried, p.149
137 *Ibid*.
138 *Supra*, n. 35, Kolb, p.83.
139 *Ibid*.

(incentivising future performance).[140] If these two grounds cannot be satisfied, the firm should consider not repricing options and in fact removing the CEO or the executives instead. On the whole, economists do support the repricing of options as a retaining function in a context of mobile executives and increasingly diminished stocks.[141] However, supporters have to admit that repricing options do happen often in companies with weak governance, which again supports Bebchuk's managerial power approach.[142]

Reloading options

Another way of compensating and retaining executives with more equity options is reloading options. When executives exercise their stock options before the expiration date, some firms will offer these executives the opportunity to pay the exercise price for new stock options. Thus, if the executives accept the offer, they will receive not only shares from exercising their previously owned options, but also new options for each share tendered.

Reload options can encourage executives to exercise their options earlier and hold more shares in the company, thereby aligning them more closely with the company. However, opinions derived from managerial power theory hold that if the executives cannot sell the shares they receive on exercise, reload options will not necessarily guarantee the result. Bebchuk and Fried suppose that most executives will tend to sell the shares for cash if they are free to do so.[143]

Proposed by Hill and Yablon, the "positional conflict of interest" approach even suggests that contrary to the pay for performance system, under which managerial pay is controlled by the markets, the executive directors can control the markets

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140 *Ibid*, p.84
141 Articles such as: K. Murphy, "Explaining Executive Compensation: Managerial power versus the perceived cost of stock options" (2002) 69 *University of Chicago Law Review* 847, p.857; D. A. Rogers, "Managerial Risk-Taking Incentives and Executive Stock Option Repricing: A Study of US Casino Executives" (2005) 34 *Financial Management* 95, p.104; N. Subramanian, A. Chakraborty & S. Sheikh, "Repricing and Executive Turnover" (2007) 42 *Financial Review* 121, p.130.
142 *Ibid*, K. Murphy, p.860
143 *Supra*, n. 20, Bebchuk & Fried, p.174

themselves.[144] They discuss managers' "strategic superiority" within the firm, and the positional conflicts that may distort "goals and indicia" designed into the pay for performance system. Hill and Yablon propose that pay for performance, which was created as a way of aligning interests between the management and shareholders, has itself become a new cause of interest misalignment.[145] In this analysis, the autonomy and discretion that executive directors actually have in releasing corporate information is the key issue, while the positional conflict approach assumes that executives do have significant autonomy and discretion regarding disclosure.[146]

This section has introduced several factors that affect pay for performance: problems of pay inequity are caused by regulation of pay by the labour market, risk-taking and compensation comparison problems from the product market, and options repricing and reloading problems from the capital market. It can be concluded that influences from markets improve pay for performance, but manipulation from remuneration committees, boards and executive directors who utilise the effects of markets on remuneration can damage pay for performance. Thus, regulation from the markets is not effective in ensuring that executive remuneration is aligned to performance, as has been suggested by economists, and thus it cannot be relied on. It is contended that interventions from other parties, such as government policies and legislation, need to be introduced to deal with these problems.

III. Other Factors in Pay for Performance

A. The culture and psychology of executive remuneration

Besides formal rules, such as the influence from markets mentioned above, financial economists have found that "informal" constraints have also influenced

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[144] *Supra*, n. 42, J. Hill & C. Syblon, p.317
[145] *Ibid*.
[146] *Ibid*, p.318

executive remuneration. For example, according to a 2014 report from Belgium's Vlerick Business School, performance is not the most important determinant in executive pay; instead, the size of firms is a prior metric. It has been found that executive directors in larger sized public companies in Germany, the Netherlands, France, Belgium and the UK were rewarded higher levels of remuneration and more loaded pensions.[147] In order to have a comprehensive understanding of the executive compensation level, it is necessary to discuss these informal constraints.

Nash, Patel and Bryan suggest that culture matters in executive remuneration structures. Their research has shown that cross-national differences in compensation structures are tightly related to cross-national differences in culture.[148] They measure cultural factors by investigating social traits, such as individualism and uncertainty avoidance, in the contracting decisions surrounding executive compensation. Individualism is proposed with its comparison to collectivism, meaning a way of working that is done separately from other people.[149] Uncertainty avoidance is used to a conduct which an individual would tend to do (mostly escape) under an assumed risky situation.[150] They conclude that the factors affecting these decisions are significant determinants of the relative use of equity-based compensation.[151]

Nash et al. identify several issues as cultural factors that can influence the structure of executives' pay. They import ideas from Hofstede's theory of cultural value dimensions, finding factors which most directly affect agency problems.[152] Hofstede concluded that a society's individualism dimensions, while reflecting relations between individuals and groups, demonstrate the degree to which

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[147] Vlerick Business School, "Executive Remuneration in Europe", (2014), available at: https://www.vlerick.com/en/events/events/executive-remuneration-in-europe last accessed, 13 July 2016
[148] R.C. Nash, A. Patel & S. Bryan, "Culture and CEO Compensation" (2012) 15 *Organization Science* 657, pp.664-5
[149] *Ibid.* 658
[150] *Ibid*.
[151] *Ibid*.
[152] *Ibid,* p.667

individual interests can “prevail over collective interests”.[153] Thus, the higher that members of a society are in rank, the more inclined they are to pursue their own interests and the less attuned they are to the interests of the group.[154] Individualism, they have found, is significantly positively related to the use of equity-based compensation in both their full sample and also a subsample made up only of non-US firms.[155] On the other hand, a society’s level of uncertainty avoidance is another important cultural factor that can influence compensation structure. An uncertainty avoidance index is used to measure the degree to which people feel stressed or uncomfortable in risky situations. According to Hofstede’s research, societies that scored higher on this index will seek greater stability and are less tolerant of conflict and competition.[156] Nash et al. have found that uncertainty avoidance is negatively related in a significant way to the equity component of compensation for both their full sample and the subsample of only non-US firms. Additionally, Nash et al. identified other cultural elements that may influence the structure of executive remuneration, such as the mastery level of a language from Stulz and Williamson,[157] religion from Kwok and Tadesse,[158] and trust from Sapienza et al.[159]

Among the theoretical approaches, both optimal contracting theory, which is illustrated by agency theory on the one hand, and managerial power theory on the other, emphasise the importance of financial incentives in aligning the interests of executives and firms to improve their performance, although, as discussed in Chapter 2, these two theories strongly oppose each other regarding how the system of executive remuneration works to monitor executives. However, the

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[153] G. Hofstede, *Culture’s Consequences: Comparing Values, Behaviors, Institutions and Organizations Across Nations* (Thousand Oaks California: Sage Publications, 2001) p.223
[154] *Ibid*.
[155] *Supra*, n. 145, R.C. Nash, A. Patel & S. Bryan, p.668
[156] *Supra*, n. 153, G. Hofstede, p.225
[157] R. Stulz & R. Williamson, “Culture, Openness and Finance” (2003) 70, *Journal of Financial Economics* 313, p.345
[158] C. Kwok & S. Tadesse, “National Culture and Financial Systems” (2006) 37 *Journal of International Business Studies* 227, p.241.
[159] P. Sapienza, A. Toldra & L. Zingales, “Understanding Trust” (2010) *Working Paper, Northwestern University*, p.16

question here is why these theories take financial incentives to be a valuable tool in improving executives' performance. From this section it can be concluded that there are several deficiencies within the financial incentive system. First, incentives like equity stock options, and restricted stocks can often lead executives to maximise their own interests while failing to benefit or even damage those of the firm.[160] Examples such as share repricing regarding the dividends induced by the non-dividend-protected character of equity option stocks can always change a company's performance, while helping to increase executive income. Second, and more seriously, executives will always be induced to take too little risk because they can still gain a lot from malfeasance, which may involve ignoring beneficial investments, rejecting attractive mergers or not making valuable acquisitions.[161] Worst of all may be the situation where executives commit felonies in pursuit of personal aggrandisement,[162] as in the Enron case.

However, despite these negative effects of financial incentives on the pay for performance system, is there any other way to motivate the executives to perform? Or perhaps the question should be – do the shareholders prefer financial incentives? The effects of other ways to motivate executives are hard to investigate since there have been no other methods created since the 1930s. Nonetheless, research shows that shareholders do approve of financial means to compensate their executives.[163] Studies have confirmed that shareholders tend to bid up share prices right before a new equity option is issued to an executive director.[164] Therefore, since newer and better ways have not been found and shareholders (and society) have become used to the financial incentive system, this seems to leave the only practical choice of strengthening corporate governance. As

[160] *Supra*, n.35, Kolb, p.140
[161] *Ibid*, p.141
[162] *Ibid*, p.142
[163] *Ibid*, p.148
[164] M. Gerety, C.K. Hoi & A. Robin, "Do Shareholders Benefit from the Adoption of Incentives Pay for Directors?" (2001) 30 *Financial Management* 45, p.56; K. J. Martin & R. S. Thomas, "When Is Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation" (2005) 11 *Journal of Corporate Finance* 61, p.74; M. T. Billet, D. C. Mauer, & Y. Zhang, "Stockholder and Bondholder Wealth Effects of CEO Incentive Grants" (2010) 39 *Financial Management* 463, p.477.

mentioned several times already, methods such as enhancing the independence of boards, improving the shareholders' and board members' monitoring function, and increasing the disclosure of pay details would help. The following section provides a brief analysis of how legal intervention is working to improve corporate governance in regulating executive remuneration.

Since the "pay for performance" strand proposes that an executive remuneration plan should be created by an independent board using sufficient incentives in an arm's-length bargain in order to align the interests of executives and firms, no matter how high the remuneration is, this strand is relevant to the structure of executive remuneration. On the other hand, the "social responsibility" strand is also relevant to the level of executive remuneration since it focuses on excessive managerial pay and the fairness of social wealth distribution. Under some circumstances, changing the structure of executive remuneration may influence the level of it, since an efficient pay policy may help to decrease excessive levels. However, with modern corporations, certainly companies practicing Anglo-American corporate governance, developing and empowering shareholder value since the 1980s, political mechanisms lean more towards the "pay for performance" strand. Besides, the goal of the "social responsibility" strand, which is to achieve social justice through lowering the level of executive remuneration, is nearly impossible within corporate governance, and most of the policies aimed at lowering the level of remuneration only involve adjusting income tax rates. This fairness issue will be discussed further in Chapter 6.

B. Fairness

Plato once mentioned that if the income of those at the highest level in society is never more than five times that of the lowest, the system is fair.[165] Maybe that is too old; today, due to different backgrounds and contexts, a substantial disparity in income has to exist. In 2010 David Cameron suggested that a 20 times

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[165] Wagemark, "A brief history of wage ratios," available at: http://www.wagemark.org/about/history/ last accessed, 13 February 2017

difference in pay between the highest and the lowest is the maximum that will be tolerated in the general sector in the UK.[166] Nevertheless, according to the High Pay Centre (HPC), the 20 times figure may have reflected the pay ratio during the 1980s, but by 1998 it had increased to 60 times[167], 81 times in 2009[168], and in 2012 there was a factor of 162 separating the average CEO remuneration in FTSE 100 companies and the average pay of a full-time worker in the UK.[169]

It has been said that : "Disparity of income is both a virtue and a vice: the virtue of providing rewards for effort and generating economic growth must be balanced against the vice of inequality's manifest injustice."[170] However, the reason why any discussion of executive pay has to be included within any mention of fairness and pay gaps is that the high pay of managers may harm the welfare of other workers. Reports have shown that executive directors are rewarded with sky-high compensation at the expense of laying off what are regarded as low-level employees.[171] Examples can be found in the cases of Enron and Lehman Brothers, in which executive directors were chasing their performance outcomes for higher pay by maximising share prices and taking risky decisions, without having regard for their employees and other stakeholders.[172]

Pressure and outrage from the public and the media often grabs the attention of governments and institutions and urges them to re-think senior managers' pay. For example, in the UK the 1992 Cadbury Report and the 1995 Greenbury Report both

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[166] Guardian, C. Tilley, "For Fair Pay, see Plato: The bones culture has fostered mistrust in business. It is time to redress the balance" 3 June 2010, available at: http://www.theguardian.com/commentisfree/2010/jun/03/public-sector-pay-cameron-executive-bonuses last accessed, 13 July 2016

[167] The High Pay Centre, "Reform Agenda: How to Make Top Pay Fairer" 14 July 2014, available at: http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer last accessed, 13 July 2013, p.4

[168] *Supra*, n.166, Guardian,

[169] *Supra*, n.167, High Pay Centre, p.4

[170] Financial Times, Chris Giles, "Inequality is unjust-it is not bad for growth",19 August 2015

[171] Wall Street Journal, C. Hymowitz, "Does Rank Have Too Much Privilege?", Feb 2002, B1; also Newsweek, A. Sloan & A. Underwood, "The Hit Man", Vol. 127, Feb 1996.

[172] IMD, Arturo Bris, "The Lehman Brother Case: A corporate governance failure, not a failure of financial markets" May 2010, available at: http://www.thejakartapost.com/news/2010/06/16/a-corporate-governance-failure-not-a-failure-financial-markets.html last accessed 13 July 2016

reflected concerns over executive pay from the public and shareholders in relation to accountability and transparency.[173]

Angel Gurria, head of the Organisation for Economic Corporation and Development (OECD), has mentioned that "addressing high and growing inequality is critical to promote strong and sustained growth", while "contrary to conventional wisdom, the benefits of higher income are trickling up, not down".[174]

The High Pay Centre has argued that excessive levels of executive remuneration should be controlled and remuneration policies should be regulated more strictly, for three reasons. First, a high level of remuneration damages not only the reputation of UK companies, but also the nation: in a Eurostat report, only two of the UK's nine regions enjoyed higher GDP per person than the EU average standard in 2013.[175] Also in the OECD's figures, the poorest fifth of the UK population has much lower income then the poorest fifth from other North-Western European countries, but the UK's richest fifth are at the top of Europe's most wealthy people.[176] Second, high executive pay, according to the US experience, was the key driver in increasing inequality in incomes, and will increase society's distrust of public companies, especially since cases such as the Royal Bank of Scotland and Lloyds Bank during the 2008-2009 financial crisis has and still is influencing the attitudes of the media and the public towards rich CEOs, although it is doubtful whether these so-called talented CEOs can make any difference after the financial crisis.[177] Finally and most seriously, excessive inequality is harmful

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[173] See introduction of both Cadbury Report 1995, available at: http://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/cadbury-report; Greenbury Report 1992, available at: http://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/greenbury-report last accessed, 13 July 2016

[174] *Supra*, n. 170, Financial Times

[175] Eurostat, GDP per capita in the EU in 2013: Seven capital regions among the ten most prosperous May 2015, available at: http://ec.europa.eu/eurostat/en/web/products-press-releases/-/1-21052015-AP last accessed, 13 July 2016

[176] OECD, Better Life Index, http://www.oecdbetterlifeindex.org/#/11111111111 last accessed, 13 July 2016

[177] High Pay Centre, Full Text of Simon Walker's Speech: Simon Walker of the Institute of Directors said in a HPC conference in 2013, "what has done the most damage to the reputation of

to the UK economy because too much money is concentrated in the hands of a few wealthy people who will not spend in the productive economy, and which may provide fewer opportunities for others to raise their living standards. The richer people tend to spend money in the financial markets, which, compared to the product market, will have limited effects in improving the whole economy.[178] The High Pay Centre even suggests that if there is no regulation of incentive equity options in executive pay packages, the UK will never recover completely from the financial crisis.[179]

Conclusion

Although they take contrasting approaches to explaining the executive remuneration issue, the managerial power approach proposed by lawyers and the optimal contracting theory supported by economists have never denied the role that financial incentives can play in aligning the interests of executives and firms, which is the rationale of pay for performance. However, from the time when people realised they could use these incentives, problems have surrounded how to design them and how to implement the incentive contracts. However, we must recognise that it is not necessary that design and implementation should be perfect, since nothing is perfect in practice, and contracts are always incomplete due to information asymmetry mentioned in Chapter 2.

Boards and remuneration committees which are supposed to set executive compensation are not very accountable to shareholders in practice in terms of policy design and reporting, and furthermore they may use their power, along with managers, to utilise the influence of markets and reward under-performance among executives. The intrinsic effects of markets can be defeated by the extrinsic

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business and the free market in recent years? It hasn't been the G20 protests, or the Occupy tent cities. It has been the greed of those who demand and secure rewards for failure in far too many of our large companies." available at: http://highpaycentre.org/blog/simon-walker-iod-the-rights-and-wrongs-of-high-executive-pay last accessed, 13 July 2016

[178] *Supra*, n. 167, High Pay Centre, p.12

[179] *Ibid,* p.14

power from companies to produce inappropriate levels and structures of executive remuneration. From studies done by Murphy, Jensen or Kolb, even financial economists have already admitted that issues of executive compensation are in great need of social and maybe other kinds of solutions to improve them, and these problems cannot simply be alleviated by market forces. Hence, the next chapter will focus on the social solutions that have been proposed to solve these problems, and the lessons that have been learned.

Chapter Four

An Examination of Regulation Mechanisms for Executive Remuneration

Introduction

Chapter 3 has explained why the markets fail to solve the executive remuneration problem by their intrinsic influence and discussed various factors that can damage the pay for performance link designed for executive remuneration. With concluding that the markets alone cannot solve the problems of executive remuneration and other legal solutions shall be employed, Chapter 3 has answered the first research question mostly, which is whether executive remuneration shall be regulated. Chapter 4 will continue to answer the first research question and start to investigate the second research question, which is how remuneration shall be regulated properly. This chapter will explore solutions that have been produced by various governments in the developed countries and analyse their functions in adjusting the executive pay. An overview of various legislative solutions that have been applied to attempt to reduce the level and adjust the structure of executive remuneration will be introduced.

First, a brief history will analyse how the levels and structure of executive remuneration have changed and been influenced since 1935, during which time theories of modern corporations were developed. Additionally, problems caused by the development of executive remuneration will be put forward and discussed. Interventions from the US government, such as the cap regulation during President Nixon's time and the rescue solution promoted by President Clinton during 1992 and 1993, both characteristic US ways of providing remedies for the public, will be discussed and their relevant policies ascertained and their influence will be examined. However, as will be discussed later in this chapter, these solutions did not achieve their goals, with their negative effects always outweighing the positive results. Thus, in the context of these problems from US history, which are also pervasive in other developed countries, the

Chapter then examines what governments have done to try to regulate executive remuneration.

Section II will provide solutions collected from various legislation, government policies and the writings of scholars on executive remuneration practice. Among these solutions, the Australian two-strike rule, the Netherlands' regulation with increasing board independence, and Germany's code requiring employee representatives to vote on the board's decisions and especially on executive remuneration, will be examined, leading to a further discussion of remuneration legislation in the next chapter.

I. A History of US Executive Remuneration

This section will have a general review of the policies and regulations that have been applied in the US. Since the development of the US financial economy (which influences executive remuneration most directly) is representative of other developed countries,[1] a specific examination of the history of how the US has addressed executive remuneration will be valuable to investigate how policies and regulations have influenced the executive remuneration. This analysis will be divided into four periods as follows:

A. Before 1970

Before the twentieth century, there was no discussion of executive remuneration because most enterprises were, comparatively, small and run by managers who also held shares in the firms.[2] If managers were hired from outside the firm, they would be offered ownership interests on their recruitment or after the death of the firm's owners.[3] According to a study by Murphy, in the US between 1895 and 1904 nearly two thousand small manufacturing

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[1] B. Bernanke & M. Gertler, "Financial Fragility and Economic Performance" (1990) 105 *The Quarterly Journal of Economics* 87, p.90

[2] J. A. Landry, "Corporate Incentives for Managers in American Industry" (1995) 24 *Business and Economic History* 13, p.215

[3] H. Wells, "No Man Can Be Worth $1,000,000 a Year: The Fight over Executive Compensation in 1930s America" (2009) 44 *University of Richmond Law Review* 689, pp. 695-6

companies combined to form 157 large corporations, and managers in the majority of these new companies shifted from being owners to being professional executive directors because those running companies needed to possess management skills.[4]

Bonuses became common in the 1920s. Baker's survey of 100 large industrial companies found that by 1928 64% of them paid their executives some form of bonus, with most of these bonuses in cash in amounts linked to the firm's annual profits. According to Baker's data, in 1929 bonuses constituted 42% of executives' compensation packages from these 100 firms.[5]

A.1 Lack of disclosure

However, there is little available evidence on how executive compensation was set before the mid-1930s because information like this was not open to the public at that time.[6] Remuneration reporting was not mandated and companies tended to treat executive remuneration as proprietary information, which was unavailable even to their shareholders.[7] Legal checks on executive remuneration in large companies were also rare, and though executive managers were not allowed to set their own compensation they were free to fix the non-executive directors' pay, which sometimes led to a situation where executives could still decide on their own pay, albeit indirectly.[8] In the 1930s, cases like that of Bethlehem Steel thrust executive pay into the spotlight and led to a wave of reforms transforming executive compensation. Bethlehem president Eugene G. Grace received over $1.6 million as compensation in 1929, and the firm paid other senior executives millions of dollars in bonuses during the late 1920s, even it did not pay its shareholders any dividend during the same time.[9] This could occur because managers could set their own pay

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[4] K. Murphy, "Executive Compensation: Where we are and how we got there" (2012), *Handbook of the Economics of Finance*, edited by G. Constantinides, M. Harris & R. Stulz, North Holland: Elsevier Science., p.42

[5] J. C. Baker, *Executive Salaries and Bonus Plans* (New York: McGraw Hill, 1938), at p. 43

[6] *Supra*, n.3, Wells, p.697

[7] *Ibid*.

[8] H. W. Ballantine, "Voting Trust, Their Abuses and Regulation" (1942–1943) 21 *Texas Law Review* 139, p.168.

[9] New York Times, "Compensation and the I.R.S.: It's not the 'Good' Old Days", 1 December 2010, available at:

scales and shareholders knew nothing about executive pay. Reports of Grace's massively inflated income became front-page news and the shareholders of Bethlehem were astonished and infuriated.[10] Later, in 1930, a lawsuit against American Tobacco revealed that the company's president G. W. Hill was scheduled to receive nearly $2 million in compensation that year, mostly from bonuses and stocks, which the company's shareholders knew nothing about.[11] In *Rogers v Hill*,[12] the US Supreme Court held that this compensation bore no relation to the value of the services for which it was being given. Although at that time the court did not analyse why the level of executive compensation could be that high, cases like these drew the attention of the public, enough to push the government to implement reforms to calm the situation.

Interestingly, in the US the initial push for executive remuneration disclosure was from "New Deal" politicians who were outraged at the excessive levels of compensation, but not from shareholders whose interests had been seriously jeopardized by the Wall Street Crash and the Depression.[13] In 1933 Franklin Roosevelt became President, ushering in the New Deal to assist the country's recovery from the Great Depression.[14] By mid-1933 the Federal Reserve began investigating executive pay in its member banks, the government's Reconstruction Finance Corporation conducted a similar investigation for non-member banks, and the Power Commission investigated pay practice at public utilities.[15] In October 1933 the Federal Commission requested a disclosure of executives' basic salaries and the bonuses paid by all companies with capital and assets over one million dollars.[16] In December 1934 the Securities and Exchange Commission (SEC) issued a permanent ruling demanding that corporations disclose the names of their top three directors and all the compensation (salary, bonuses, stock options and other incentive plans)

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http://www.nytimes.com/imagepages/2010/12/01/business/01retrographic.html?ref=economy last accessed, 12 July 2016.

[10] *Ibid*

[11] ***Roger v Hill*** 289 U.S. 582 (1933)

[12] *Ibid*

[13] *Supra*, n.4, Murphy, pp.44-5

[14] *Ibid*

[15] *Ibid,* p.45

[16] New York Times, Robbins, "Inquiry into High Salaries Pressed by the Government" and "President Studies High Salary Curb" 29 October 1933

received by them.[17] The SEC also warned that companies not complying with this regulation by June 1935 would be removed from stock exchanges.[18]

A.2. During the Second World War

The Stabilization Act of 1942, implemented during World War II, froze the salaries and wages of both executive managers and common employees at the level they were at on 15 September 1942. (In the US the Stabilization Act expired in 1946 but was replaced by Salary Stabilization Boards during the Korean War, which was established in May 1951 as part of the Defense Production Act of 1951. Like the following limitation on executive compensation that was imposed later by the Nixon administration, the Korean War Salary Board set a 6% limit on compensation increases for all firm's executives, and these limits were lifted after the Salary Board was quietly disbanded in July 1952.)[19]

A.3. The golden age of capitalism

During the 1950s and 1960s, the executive remuneration problems were not very arrestive as the US executive directors did their jobs rather well and the economy was improving rapidly during this period.[20] On the income equity perspective, between 1959 and 1968 the compensation of a chief executive whose company with sales of $400 million or more rose 14%, compared to the normal manufacturing employees' compensation rising 39%.[21]

Generally, before 1970 it was a period when people started thinking about how executive compensation should be structured, but with little concern about the level of remuneration since it was not obviously excessive at that time.

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[17] N. Poser, "Why the SEC Failed: Regulators Against Regulation," (2009) 3 *Brooklyn Journal of Corporate, Financial & Commercial Law* 289, p.290
[18] *Ibid.*
[19] *Supra,* n.4, Murphy, p. 51
[20] S. Bank, B. Cheffins & H. Wells, "Executive Pay: What Worked?" (2016) *Legal Studies Research, University of Cambridge,* No. 38, p.7
[21] *Ibid.*

B. 1970–1990

Executive compensation began increasing at a faster rate in the mid-1970s, starting around 1973.[22] Before this rapid rise, however, there was a freeze on remuneration for American executives.

B.1 Failure of Nixon's wage-and-price control

In August 1971 President Nixon imposed a 90-day freeze on commodity prices and wages, including executive compensation.[23] This was triggered by the economic retreat at that time: at the end of 1969 inflation had topped 6%, the highest level since the Korean War, while in 1970 the US suffered unemployment of 6%, the highest figure since 1960, and dollars were threatened by Deutsche marks, yen and francs as Japan and European countries recovered from the Second World War.[24]

In December 1971, in Phase Two of the Nixon wage-and-price controls, the Pay Board established by the American Congress imposed an annual limit of 5.5% for increases in executive pay levels.[25] In particular, non-qualified stock options (which had not been exercised) were allowed only if the plan had been approved by the shareholders, if the aggregate number of options granted did not rise from the prior year, and if the price when exercised was at least 100% of the grant-date market price.[26] Non-qualified options were treated as wages and salaries and were valued at 25% of the fair-market value of the shares underlying the option.[27]

However, since the government only limited the pay rises applied to executives

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[22] C. Frydman & R. E. Saks, "Executive Compensation: A New View from A Long-term Perspective, 1936–2005" (2010) 23 *Review of Financial Studies*, Society for Financial Studies 2099, p.2106

[23] Bloomberg, Roger Lowenstein, "The Nixon Shock", August 2011, available at: http://www.bloomberg.com/bw/magazine/the-nixon-shock-08042011.html last accessed 13 July 2016

[24] *Ibid*

[25] Wall Street Journal, Hunt, "Board Agrees on Tightening of Standards on Executive Pay, Increases Topping 5.5%" 17 December 1971

[26] *Supra*, n. 4, Murphy, p.55

[27] Wall Street Journal, Calame, "Executives' Pay Faces Going-over by Wage Board" October 1972

as a whole, but not to individual managers, companies routinely raised their CEO's remuneration by deducting from the pay of lower-level executives.[28] In August 1973, to stop CEO pay rising above the 5.5% limit, the Nixon administration imposed the 5.5% limit on a more narrowly defined group of executive directors identified in corporation proxy statements.[29] These wage-and-price controls expired in May 1974, in spite of the administration's efforts to retain limits on executive compensation. After the expiration of the controls, CEO compensation rose significantly.[30] According to Murphy's data, the median continuing CEO in the Forbes 800 got an 11.1% increase in nominal cash compensation in 1974, doubling the average limit under the Nixon controls.[31] Murphy found that from 1972 to 1979 the median cash compensation for CEOs in the Forbes 800 increased by 12.2% each year, doubling from $162,000 to $324,000 and significantly exceeding the average annual inflation rate of 8.5%.[32] Evidence illustrates that in trying to reduce the level of executive remuneration, this wage-and-price control rule may have had the opposite effect.

On the other hand, executive remuneration policy in the 1970s provided few incentives for managers to pursue value-increasing reductions in excess capacity and the disgorgement of excess cash. Equity-based compensation, most of which was in the form of stock options, composed only a small fraction of CEO pay and the options were often "under water"[33] or expired, and were worthless.[34] Annual bonuses, as the dominant form of compensation incentives, were focused on beating annual budget targets (mentioned in Chapter 3) rather than creating long-term profits.[35] Performance-based terminations were almost non-existent and since the vast majority of CEO posts were filled by incumbents rather than someone hired from outside, the

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[28] *Supra*, n.25, Wall Street Journal
[29] Wall Street Journal, "Business Groups Oppose Nixon Control Plan, Intensify Their Efforts to Abolish Restraints," 1974
[30] *Ibid*
[31] *Supra*, n. 4, Murphy, p.56
[32] *Ibid*.
[33] Under Water meaning the trading price of executive managers' exercisable stocks is lower than the price that executives are going to pay for these stocks.
[34] *Supra*, n. 4, Murphy, p.60
[35] *Supra*, n. 27, Wall Street Journal

managerial labour market was similarly ineffective in disciplining poor performance.[36] Therefore, concerns derived from remuneration incentives that threatened the pay for performance system had already been noticed at that time.

B.2. Golden parachutes

Early studies like those carried out by Coughlan and Schmidt[37] and Warner et al.[38] concluded that there is an inverse relationship between a firm's market performance and the possibility of management turnover. Unlike nowadays, when hostile takeovers are often successful, executive directors in the 1970s and 1980s vigorously and often successfully fought takeovers by adopting anti-takeover provisions and by lobbying for political protection.[39] Warner *et al*. investigated 272 firms during the period from 1963 to 1978 and found only a single outright dismissal of CEOs, and ten cases in which poor performance was used as one of the reasons for dismissal. Weisbach, who examined 286 management changes in the period between 1974 and 1983, found only nine cases in which boards mentioned performance as a reason why the CEO was replaced.[40] Huson et al. divided their research sample into four periods (1971–76, 1977–82, 1983–88 and 1989–94), and found that frequencies of forced turnover and outside succession increased over time, and that internal monitoring by boards of directors had become more effective since the 1990s in spite of the decline in takeover activities.[41] Therefore, it was this trend in high levels of hostile takeovers during the 1970s and 1980s that helped with the development of golden parachute payments in executive directors' pay, with

36 *Supra*, n. 25, Wall Street Journal
37 A. Coughlam & R. Schmidt, "Executive Compensation, Management Turnover, and Firm Performance: An empirical investigation" (1985) 7 *Journal of Accounting and Economics* 43, p.65
38 J. Warner, R. Watts & K. Wruck, "Stock Prices and Top Management Changes" (1988) 20 *Journal of Financial Economics* 461, p.465
39 B. Holmstrom & S. Kaplan, "Corporate Governance and Merger Activity in the United States: Making sense of the 1980s and 1990s" (2001) 15 *Journal of Economics Perspectives* 121, p.123.
40 M. Weisbach, "Outside Directors and CEO Turnover" (1988) 20 *Journal of Financial Economics* 431, p.445.
41 M. Huson, R. Parrino & L. Starks, "The Effectiveness of Internal Monitoring Mechanisms: Evidence from CEO turnover between 1971 and 1994" (2001) 56 *The Journal of Finance* 2265, pp. 2288-9

the company goal of preventing unwanted takeover while using deferred cash or stock options to guarantee paybacks to managers and retain talent on the board. Extremely high parachute fees paid to the executives became common during the takeover era of the 1980s, and the US government reacted positively to this problem.

The American Congress attempted to reduce the use of golden parachutes by introducing section 280(G) and section 4999 into the tax code as part of the Deficit Reduction Act of 1984.[42] Section 280(G) states that, if change-in-control payments exceed three times the individual's base amount, then all payments in excess of the base amount are nondeductible against tax for the employer. Additionally, section 4999 imposes a 20% excise tax on the recipient of a parachute payment on the amount of payment above the base amount.[43] The base amount is typically calculated as the individual average total taxable compensation paid by the firm over the prior five years.[44] For example, if an executive director with a five-year average taxable remuneration of $1 million receives a golden parachute payment of $2.9 million, which is less than three times this $1 million amount,[45] the entire $2.9 million would be deductible by the firm, and should be taxable as ordinary income in the hands of the executive director.[46] However, if the golden parachute was $3.1 million, more than three times the $1 million base amount, under section 280(G) the firm would not be able to deduct $2.1 million of the $3.1 million parachute as a compensation expense, and under section 4999 the executive would owe $420,000 in excise taxes (20% of $2.1 million) in addition to ordinary income taxes on the full $3.1 million parachute.[47] This tax rule has been followed until the present, and is a good example to be considered when looking at providing regulations on decreasing golden parachutes.

B.3 Shareholder power

[42] H.R.4170 – 98th Congress (1983-1984), Deficit Reduction Act of 1984, available at: https://www.congress.gov/bill/98th-congress/house-bill/4170 last accessed, 13 July 2016
[43] *Ibid*.
[44] *Supra*, n. 4, Murphy, p. 67.
[45] *Supra*, n. 42, Deficit Reduction Act of 1984
[46] *Supra*, n. 4, Murphy, pp.67-8
[47] *Ibid*.

In 1985 Robert Monks founded Institutional Shareholder Services to provide proxy-voting services to institutional shareholders.[48] In 1986 the corporate raider T. Boone Pickens built up the United Shareholders Association focused on improving governance and compensation.[49] Shareholders started to realise that they should have more power over corporate governance, especially regarding boards' decisions on executive compensation. Voices from academia argued that traditional compensation incentives related to company size, stability and accounting profitability decreased in importance, while shareholders proposed that executive remuneration should be tied more closely to company value through increases in stock options and more forms of equity incentives.[50] These changes had an impact. After the mid-1980s, though non-equity-based executive compensation did not stop growing, it became a smaller fraction of total pay packages, and for the first time since 1950 stock options reemerged as the dominant form of incentive compensation.[51]

As Wells has commented, whether these reforms can be said to have been successful depends on what their goal was. Overall, the reforms did little to stop the level of executive remuneration from increasing rapidly. However, while shareholders and firms were setting equity incentives in remuneration, these reforms appeared to push companies to use more performance-linked pay policies. Studies such as that by Frydman and Saks, which focused on executives' long-term accumulation of equity and options, suggested that executive compensation has become increasingly sensitive to firm performance since 1980.[52]

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[48] Fortune, Marc Gunther, "Investors of the World Unite", June 2002, available at: http://archive.fortune.com/magazines/fortune/fortune_archive/2002/06/24/325201/index.htm last accessed, 13 July 2016

[49] D. Manry & D. Stangeland, "The United Shareholder Association Shareholder 1000 and Firm Performance" (2003) 9 *Journal of Corporate Finance* 353, p.366.

[50] L.A. Gordon & J. Pound, "Information, ownership structure, and shareholder voting: evidence from shareholder-sponsored corporate governance proposals" (1993) 48 *Journal of Finance* 697, pp.699-700.

[51] *Supra*, n.4, Murphy, p.70

[52] *Supra*, n.22, Frydman & Saks, p.2119

C. 1990s–2000s

C.1. Transparency

Between October 13th (known as 'Black Monday') and October 19th 1987 the Dow Jones Average dropped nearly 800 points from 2508 to 1738, losing 30% of its value in just a week.[53] Executives' stock options, which had recently become a large fraction of their pay, were suddenly worth almost nothing. Public companies responded by re-pricing existing options or significantly increasing the size of their post-cash option grants.[54] Although this crash was short-lived, since the capital market recovered quickly, it led to a populist attack on executive pay.[55] Large manufacturing companies downsized and laid off many of their workers for the benefit of their shareholders, while attracting the ire of Congress, the labour unions and the media:[56] ordinary employees with much lower pay were losing jobs while the executive directors kept their high compensation with well exercised stock options because firms re-priced these options after the crash. After the 1990–1991 recession, executive pay had become a topic of international prominence.[57]

In response to growing outrage in the US, legislation was introduced in the House of Representatives disallowing deductions for compensation exceeding 25 times the pay of the lowest-paid worker, and the Corporate Pay Responsibility Act was imposed in the Senate to give shareholders more rights to decide on their firms' compensation policies.[58] The Security and Exchange Committee (SEC) preempted the pending Senate bill in February 1992 by requiring public companies to include non-binding shareholder votes on executive pay in companies' proxy statements. There were also new rules imposed by the SEC in October 1992 related to the disclosure of top executive

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[53] The Bubble Bubble, Jesse Colombo, "Black Monday-the Stock Market Crash of 1987", August 2012, available at: http://www.thebubblebubble.com/1987-crash/ last accessed 13 July 2016

[54] P. J. Saly, "Repricing Executive Stock Options in a Down Market" (1994) 18 *Journal of Accounting and Economics* 325, p.337.

[55] M. Carlson, "A Brief History of the 1987 Stock Market Crash with A Discussion of the Federal Reserve Response" (2007) 13 *FEDs Working Papers*, pp.19-20

[56] *Ibid*

[57] *Ibid*.

[58] *Ibid*.

compensation in the annual proxy statement, requiring: [59] (a) a summary compensation table describing the major components of the compensation received by the CEO and other highly paid executives over the past three years; (b) tables describing option grants, option holdings, and options exercised in greater detail; (c) a chart showing the company's stock price performance relative to the performance of the market and their peer group over the prior five fiscal years; and (d) a report by the compensation committee describing the company's compensation philosophy.

C.2 Escalation of stock options

Core and Guay's sample of CEOs from the period from 1992 to 1996 showed that options contributed approximately one third of the value of the median CEO's equity portfolio, and roughly half of the median CEO's total equity incentives.[60] According to the evidence collected by Murphy, between 1992 and 2001 the median pay for CEOs in S&P 500 firms more than tripled, driven by an explosion in the use of stock options. [61] Executive incentive compensation in the early 1990s could be divided evenly between options and accounting-based bonuses.[62] By 1996 options had become the largest single component of CEO remuneration in S&P 500 firms, and the use of options was even greater in smaller companies, especially high-tech ones.[63] In the year 2000 stock options accounted for more than half of the total compensation for executives in S&P 500 firms.[64]

Murphy concluded that there are six main factors which may help to explain the US escalation of stock options in the 1990s and early 2000s:[65] (1) shareholder pressure for equity-based pay; (2) the SEC options holding rules; (3) President Clinton's $1 million deductibility cap; (4) accounting rules for equity options; (5) SEC option disclosing rules; and (6) NYSE listing requirements. The first four

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59 *Supra*, n. 4, Murphy, pp.71-2
60 J.E. Core & W.R. Guay, "Is CEO Pay Too High and Are Incentives Too Low? A Wealth-Based Contracting Framework" (2010) 24 *The Academy of Management* 5, pp.9-10
61 *Supra*, n. 4, Murphy, p.72
62 *Ibid*.
63 *Ibid*.
64 *Supra*, n.22, Frydman & Saks, pp.2120-1
65 *Supra*, n.4, Murphy, p.73

of these factors will be discussed below, while the latter two will be examined in the next main section of the Chapter.

C.2.1 Pressure from institutional Shareholders on equity-based pay

Shareholders, especially large state pension fund management firms, have since the 1980s, become a new breed of activists who demand increased alignment between executive pay and shareholder returns.[66] Many of these shareholders have united to form large investor associations, and have been influenced by a famous article written by Jensen and Murphy which stated that "It is not how much you pay, but how that matters";[67] therefore they asked investee companies for more disclosure of equity incentive settings in executive directors' pay packages.[68] Famous institutions such as the United Shareholders Association strongly suggested that boards provide more stock ownership and more extensive use of stock options in paying their executives.[69] However, Murphy was not satisfied with the outcome of boards' responses to shareholder activities, since companies just reported to shareholders several generous grants of stock options on top of the already competitive pay packages, without any reduction in other forms of compensation and showing little reaction to the resulting inflation in pay levels.[70] This situation, as he concluded, was too literally that they could not reflect the real pay outcomes.

C.2.2 SEC Share Holding Rules

According to the SEC rules, from the date of exercising their restricted stock options executives are required to hold shares for at least six months.[71] Executives can defer taxes during this six-month holding period, but they still

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[66] Harvard Law School Forum on Corporate Governance and Financial Regulation, J. Bacholder III, "Institutional Shareholders and Their Oversight of Executive Compensation", July 2012, available at: http://corpgov.law.harvard.edu/2012/07/23/institutional-shareholders-and-their-oversight-of-executive-compensation/ last accessed, 13 July 2016.

[67] M. C. Jensen & K. J. Murphy, "CEO Incentives: It is not how much you pay, but how" (1990) 68 *Harvard Business Review* 138

[68] *Supra*, n.4, Murphy, p. 72-3

[69] *Supra*, n. 49, D. Manry & D. Stangeland, p.370

[70] *Supra*, n.4, Murphy, p.74

[71] SEC, Securities Exchange Act of 1934, Rule 144, Selling Restricted and Control Securities, available at: http://www.sec.gov/investor/pubs/rule144.htm last accessed, 13 July 2016

owe tax on the gain from the exercise date, even if stock prices fall over the subsequent six months.[72] This rule means that executives cannot claim cash by selling shares received from stock options in a short term (six months), thus executives who have held their options have to have an eye on a longer period of the company's equity market performance. Before May 1991 the SEC defined the exercise of an option as a "stock purchase" reportable by corporate insiders within 10 days following the month of transaction, but after May 1st 1991, in response to demands for more transparency of option grants, the exercise was defined as a reportable stock purchase.[73] Consequently, the six-month holding period required by this "short-swing" profit rule now begins when options are granted, not when executives acquire shares upon exercise.[74] Therefore, so long as the options are exercised more than six months after they are granted, the executives are free to sell shares immediately upon exercise. This rule significantly increased the value of the option from the standpoint of the recipient. Obviously, this rule did not help to lower the level of executive compensation, since a mere six month's deferral will not definitely discourage managers from realising large amounts of cash by manipulating the share price. However, from the perspective of solving the problems mentioned in Chapter 3 that executives would sell their shares immediately when they can exercise the options and thus push the share price to a high level, this deferred selling rule provides a strategy to stop this improper behaviour. The extending of the period after a stock option's exercise point will be discussed in Chapter 6.

C.2.3 Clinton's Capping Rule

President Bill Clinton gave a promise during the 1992 presidential campaign to define remuneration paid to executives above $1 million per year as unreasonable, and non-deductible by the employer company in its tax return.[75] However, the rule was soft. It was included as part of the 1993 Omnibus Budget Reconciliation Act, section 162(m) of the Act's tax code regulated that

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72 *Ibid*.
73 *Ibid*.
74 Supra, n.4, Murphy, p.74
75 Bill Clinton for President 1992 Campaign Brochures, available at: http://www.4president.org/brochures/billclinton1992brochure.htm last accessed 13 July 2016

compensations of public companies' top five executives which can be defined as performance-based should be deductible.[76] Performance-based compensation, according to section 162(m), included "pay based on the attainment of one or more performance goals", with the goals determined by a compensation committee consisting of two or more independent directors and pay contract terms disclosed to shareholders and approved by them before the pay is released.[77] Murphy suggested that stock options with an exercise price no lower than the market price on the grant date are always considered to be efficient performance-based compensation.[78] On the other hand, base salaries, restricted stock options vesting only with time and options issued with an exercise price below the grant date market price cannot qualify as performance-based compensation.[79] Moreover, regarding bonuses, a bonus which has been approved by the shareholders based on a formula-driven objective performance measure can be defined as performance based, while a discretionary bonus based on an ex post subjective assessment is not considered to be performance based.[80] The $1 million cap rule is supposed to use the tax system to target highly-paid executives and shareholders who pay their CEOs unreasonable salaries, and thereby to decrease the level of CEO pay.

Ironically, the result of section 162(m) was a significant increase in CEO payments in the US since 1992. The reasons for this are obvious:[81] first, companies tended to pay executives with a larger fraction of stock options in their pay packages, since stock options were generally seen as performance-based pay; second, evidence shows that while several companies lowered their executive salaries which were over $1 million per year before section 162(m) was enacted, curiously, many other firms raised their executive salaries which were below $1 million before, bringing them to exactly $1 million for the purpose

[76] H.R.2264 – Omnibus Budget Reconciliation Act of 1993, available at: https://www.congress.gov/bill/103rd-congress/house-bill/2264 last accessed, 13 July 2016
[77] N. L. Rose & C. Woldram, "Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation" (2002) 20 *Journal of Labour Economics* 138, p.143.
[78] K. Murphy, "Executive Compensation", (1999) June *Handbook of Labor Economics*, edited by O. Ashenfelter & D. Card, North Holland 2485, pp.2506-7
[79] *Ibid*.
[80] *Ibid*.
[81] *Supra*, n.77, Rose & Woldram, p.166

of maximising the amount of stock incentives in the managers' pay; third, companies changed their bonus plans from sensible discretionary bonuses to performance-based awards, which provided another opportunity to increase the bonus level and not requiring it to stay within the $1m salary cap.

Clearly this $1 million cap in pay did not achieve the aim that it was intended to, just was was the case with Nixon's capping rule. This suggest that setting direct requirements regarding the level of executive remuneration is not an effective way for regulating pay, since companies will always find a way to bend the rules.

C.2.4. Accounting Rule

There was a lack of accounting in relation to the valuation of stock options, which meant that boards and compensation committees could not report how much stock they should distribute to the executive pay packages.[82] The US Financial Authority Standard Board (FASB) allowed companies to report under the rule, imposing an additional requirement that the value of option grants should be disclosed in a footnote to the financial statements. Under the soft accounting rules, it was not until accounting scandals broke in the early 2000s that a large number of companies voluntarily accounted for their options granted.[83] In December 1998 the FASB added a new rule concerning repriced options.[84] A treatment called "variable accounting" required firms to take an accounting charge every year for repriced options, based on the actual appreciation in the value of the option.[85] Companies with underwater options rushed to reprice these options in the twelve-day window between December 4th and December 15th 1998.[86] Evidence collected by Carter and Lynch shows that there was a dramatic increase in options repricing activities during this short period, which meant that the general prices of stock options granted to

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82 *Supra*, n.4, Murphy, p.78
83 *Ibid*, p.79
84 Application of APB Opinion 25 and FASB Interpretation No. 44 to an Indirect Repricing of a Stock Option, Discussion paper, available at: http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820914852&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs last accessed, 13 July 2016
85 *Ibid*.
86 B. Hall & K. Murphy, "The Trouble with Stock Options" (2003) *Harvard NOM Working Paper* No. 03-33, p.9

executives declined significantly during these twelve days. [87]

Though situations may vary between industries, overall, stock options and other performance-linked rewards became an increasingly significant element in executive remuneration through the1990s and into the twenty-first century. Despite their popularity, it is still not clear whether this use of equity incentive arrangements aligns executive pay more closely with firm performance. Moreover, as suggested by Wells, while changes in the tax code and the new SEC regulations may have had marginal effects on executive compensation, other policies attempting to lower the level of compensation largely failed.[88] Shareholder litigation proved to be of little influence on broader compensation trends, since courts still declined to become entangled in compensation disputes as long as there was no "blatant" self-dealing by executives.[89] The Disney case mentioned in Chapter 2 is a good example. The Chairman of Disney, Michael Ovitz, still received a very high goodbye payment notwithstanding the fact that he had served less than one year as chairman and his time was regarded as a failure. Shareholders who want to be empowered through legal mechanisms want to implement legislation because of their fear of situations like this occurring.

Despite improvements in the structure of executive remuneration led by government reforms, the level of remuneration has not stopped increasing, and neither has public criticism. The SEC six-month rule is far from enough to encourage executives to exert efforts for their companies' long-term success, because six months is too short a period for the realisation time of the stock options. Long-term incentive plans (LTIPs) and restricted options should be more widely used; an efficient way of using them will be discussed in Chapter 6.

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[87] M. Carter & L. Lynch, "An Examination of Executive Stock Option Repricing" (2001) 61 *Journal of Financial Economics* 207, p.219.
[88] P. J. Wells , "Executive remuneration: regulatory reforms in UK company law" (2015) 57 *International Journal of Law and Management* 300, p.309
[89] *Ibid*.

D. Scandals and solutions since 2000

Scandals involving executive remuneration mainly concern accounting issues, erupting across the world in the 2000s and destroying the reputations of firms such as WorldCom, Lucent, Arthur Anderson, Enron and Global Crossing.[90] In the US, the Congress quickly passed the Sarbanes-Oxley Act in July 2002 to set and expand standards for accounting firms, auditors and boards of directors of public companies. However, the Act was primarily focused on accounting irregularities, not on the compensation of executives. Executive pay did not stop rising in the period following 2003, and continued on an upward slope until the financial crisis of 2008–09. The Sarbanes-Oxley Act, passed in the wake of the Enron debacle, did make significant changes in respect of corporate governance, but it only tweaked executive compensation in terms of its accounting, especially in relation to the claw-back rules.[91]

Finally in 2011 the Dodd-Frank Act provided shareholders with an advisory vote.[92] Section 951 is the relevant provision, and it requires that shareholders will be asked to approve the company's executive compensation plans in a non-binding vote which occurs at least once every three years.[93] Shareholders have the right to choose to withhold their approval in relation to the executive compensation and golden parachute arrangements in connection with mergers, tender offers or private internal transactions. Statistics show that the

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[90] BBC, "Enron Scandal at-a-glance", 22 August 2002, available at: http://news.bbc.co.uk/1/hi/business/1780075.stm; Guardian, "WorldCom Accounting Scandal", 9 August 2002, available at: http://www.theguardian.com/business/2002/aug/09/corporatefraud.worldcom2; Telegraph, "Arthur Anderson Returns 12 Years After Enron Scandal", September 2014, available at: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11069713/Arthur-Andersen-returns-12-years-after-Enron-scandal.html; Fortune, "The Whistleblower and the CEO in the Lucent Scandal", July 2003, available at: http://archive.fortune.com/magazines/fortune/fortune_archive/2003/07/07/345538/index.htm; New York Times, "How Executives Prospered as Global Crossing Collapsed", February 2002, available at: http://www.nytimes.com/2002/02/11/business/how-executives-prospered-as-global-crossing-collapsed.html last accessed all, 13 July 2016

[91] A Guide to The Sarbanes-Oxley Act, available at: http://www.soxlaw.com last accessed,13 July 2016

[92] SEC, Specialised Corporate Disclosure, available at: https://www.sec.gov/spotlight/dodd-frank/speccorpdisclosure.shtml last accessed,13 July 2016

[93] SEC, Compensation Disclosure and Related SRO Rules, available at: https://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml last accessed,13 July 2016

shareholders of 98.5% of the 2532 companies reporting 2011 results by July 2011 approved their firm's pay plans, while over 70% of these companies received more than 90% favourable support.[94] In 2012, shareholders of 98.2% of the 1875 companies reporting their results by June approved the pay policies, with 72% of these companies having more than 90% favourable votes.[95] Except for companies with truly appropriate and sensible pay plan structures, shareholder approval did not demonstrate that the high level of pay had been affected by this new law. The reason why shareholder say on pay at that time did not stop the level of executive compensation from increasing was probably partly because these votes were highly correlated to company share returns, and partly because shareholders were not using their voting power seriously.[96] Record had shown that in 2010 the high level of shareholder support for executive compensation appeared commonly at financial firms that had poor performance during the financial crisis.[97]

As far as the issue of claw-back is concerned, section 954 of the Dodd-Frank Act provides that companies must implement and report policies for recouping payments to executive directors based on financial statements that are subsequently restated.[98] The SEC had neither adopted nor proposed rules regarding the recovery of executive remuneration by August 2012. However, Equilar (which is an organisation providing corporate governance data) reports that 86% of the Fortune 100 companies issuing proxy statements in 2012 had publicly disclosed claw-back arrangements; in half of the companies the claw-back triggers were related to financial restatement and ethical misconduct.[99]

There are also rules covering restrictions in the details related to compensation committee independence, information disclosure and proxy access, which are intended to solve the problems discussed in Chapter 2, such as remuneration

[94] R. Thomas & C. Van der Elst, "Say on Pay Around the World" (2015) 92 *Washington University Law Review* 653, p.660
[95] *Ibid*.
[96] *Ibid*. p.661
[97] *Ibid*.
[98] *Supra*, n.92, SEC
[99] Equilar, Dodd-Frank's Fifth Anniversary: In Retrospect and Prospect, available at: http://www.equilar.com/blogs/40-dodd-frank-fifth-anniversary.html last accessed,13 July 2016

policy making and the lack of disclosure to shareholders in resolution voting.[100]

Section 952 requires public firms to have compensation committees comprised purely of external independent directors, and to assess the independence of compensation consultants, accountants, attorneys and other advisors to the compensation committee, while sections 953, 955 and 972 require companies to report the ratio of CEO compensation to the median pay for all other company employees. Companies must analyse and report the relation between realised compensation and the firms' financial performance, such as stock prices.[101] Additionally, the Dodd-Frank Act also requires companies to disclose their policies and practices surrounding why the firm chooses either to separate the positions of chairman and CEO, or combine them. Section 971 gives shareholders the power to nominate their own candidate for director in the annual proxy statements.[102] The SEC delayed the implementation of this rule believing that it would distract management and advance special-interest agendas, which was concluded by the Business Roundtable and the US Chamber of Commerce on the basis of evidence from lawsuits. This requirement did not make it into the Dodd-Frank Act.

These new requirements show the methods that corporate governance can provide to regulate the design and implementation of executive pay. However, though aimed at lowering the level of executive remuneration, their effects seem to be not as obvious as might have been expected. From 2000 to 2009 the average CEO remuneration of S&P 500 firms fell by 36% from its highest point of $15 million to $9.6 million, while from 2009 to 2010 their average compensation rose by nearly 19% from $9.6 million to $11.4 million.[103] Kolb worries that this may have been because of the shift of restricted stock in the compensation structure. Thus, however detailed regulations may be, they cannot readily control financial incentives.[104]

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[100] *Supra*, n.93, SEC
[101] *Ibid*.
[102] *Ibid*.
[103] R. Kolb, *Too Much Is Not Enough: Incentives in Executive Compensation* (Oxford: Oxford University Press, 2012) p.156
[104] *Ibid*.

In summary, the level of compensation has not always been as highly correlated with the average market value of firms as it has been in recent years, which is a sign of a shift in the market for executives towards a model of competitive matching for their managerial talent. On the other hand, the incentives that were introduced for executives in the 1930s, 1950s and 1960s were not significantly weaker than they were in the 1980s, which indicates that other aspects of the market for executives in the past may resemble the situation in recent years.

Fryman and Saks employ four economic factors to explain the escalation of executive remuneration, namely: managerial rent extraction, the increasing scale of firms, the provision of incentives in pay, and the increasing return to general rather than specific skills.[105] Therefore, if the government can provide policies to stop these actions from happening, which is highly unlikely and perhaps impossible, the level of executive remuneration may certainly be lowered.

From US history, it can be seen that policies that intended to lower the level of executive remuneration directly usually failed to achieve their goals – for example, the Nixon cap and Clinton's $1 million rule. Politicians and common people are concerned about high levels of pay because the level is the easiest factor to observe. Providing policies to influence executive compensation level seems more to be a campaign promise or a strategy to calm outraged middle level income earners, rather than a serious attempt to solve the excessive level problem. On the other hand, financial economists and scholars are always excited about changing accounting rules (which can influence the structure and design of executive remuneration), since they acknowledge that under market forces, improving and monitoring the structure of executive remuneration is the right way to proceed (lowering the high level of remuneration to a reasonable level). Perhaps, in solving executive remuneration problems it is more important to adjust the structure of executive remuneration to the level of the market, rather than waiting for the market to fix them or trying to change the market

[105] *Supra*, n.22, Frydman & Saks, pp.2128-30

directly.

II. <u>Other Legislatitive Innovations Addressing Executive Remuneration</u>

After the financial crisis of 2007-08 certain large institutions started producing guidance on the practice of executive remuneration. Among those from the most developed economic systems are the Financial Stability Board, the G20, the Obama administration, the European Commission and the UK Financial Services Authority (abolished and divided into the Financial Conduct Authority and the Prudential Regulation Authority now).[106] Generally, the international reform agenda is concentrating on the alignment of executive pay and the interests of shareholders, still having faith in the financial incentive system.

Taking the US as an example, three main ways have been provided by Congress to address pay. In July 2010 the Dodd-Frank Wall Street Reform and the Consumer Protection Act was enacted, and several of their provisions were aimed at protecting public firms and regulating executive compensation. As well as shareholders' advisory votes on executive compensation plans on a three-year basis, there are also other mechanisms provided by these new regulations in relation to executive compensation and its incentives. First, to lower the level of executive pay, consumer law requires that the board should disclose the executive compensation and its relationship to the other employees' compensation.[107] Second, the Dodd-Frank Act states that all members of the remuneration committee should be independent directors, a measure which is aimed at decreasing the influence of managerial power in the process of compensation design and implementation.[108] Third, the Act also provided the

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[106] G. Ferrarini, N. Moloney & M. C. Ungureanu, "Executive Remuneration in Crisis: A critical assessment of reforms in Europe" (2010) 10 *Journal of Corporate Law Studies* 73, p.75

[107] United States Senate Committee on Banking, Housing, and Urban Affairs, "Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act" 2010, available at: http://www.cfainstitute.org/learning/products/publications/contributed/Pages/brief_summary_of_the_dodd-frank_wall_street_reform_and_consumer_protection_act.aspx?WPID=AlsoViewedProducts last accessed,13 July 2016

[108] *Ibid*.

SEC with rules directing the claw-back of executive remuneration.[109] These provisions, while clearly related to the idea that executive compensation should be limited as a response to public investors' outrage, are justified as being modest and suitable for corporate governance to improve the pay for performance relationship in executive compensation.[110] The claw-back rule, requirements for the independence of boards and improving disclosure standards are ranked as the most adoptable trend from a worldwide perspective on improving pay and performance alignment.[111]

A. UK regulation of executive remuneration

Prior to the advisory voting rights given to shareholders in the UK, there were several rules that aimed to achieve the pay for performance goal. The Cadbury Report in 1992 proposed splitting the roles of chairman and CEO.[112] Before 1997, UK literature relating to equity incentive compensation is difficult to find. This changed after the Greenbury Report was delivered.[113] Published in 1995, the Greenbury Report made two main recommendations,[114] of which the first was to create a remuneration committee on the board with more independent directors on it to set remuneration plans for executives. The second was to require the disclosure of executive compensation information and firms' pay policies in more specific detail. After these two suggestions were taken up by the London Stock Exchange's Listing Rules, the Combined Code on Corporate Governance, produced following the report of the Hampel Committee, absorbed them without substantial changes in 1999.[115]

However, the Combined Code's "comply or explain" principle did not help these rules to have substantive effects. Situations like escalating executive pay, pre-

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[109] *Ibid*.
[110] *Supra*, n.103, Kolb, pp.156-7
[111] *Supra*, n.94, R. Thomas & C. Van der Elst, p.667
[112] Cadbury Report, The Financial Aspects of Corporate Governance (1992) 1 *Corporate Governance* 124, p.125, section 1.2
[113] J. Gordon, "Say on Pay: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in" (2009) 46 *Harvard Journal on Legislation* 323, p.342
[114] Greenbury Report 1995, available at Hansard: http://hansard.millbanksystems.com/commons/1995/jul/17/greenbury-report last accessed,13 July 2016
[115] Committee Report on Corporate Governance 1998, available at: http://www.ecgi.org/codes/documents/hampel_index.htm last accessed,13 July 2016

planned golden parachutes for dismissed CEOs and data from FTSE 350 companies which showed that less than 5% of these firms had provided remuneration plan questions for shareholder's vote,[116] led to a proposal in 2002 on the UK Companies Act to regulate a more detailed disclosure of remuneration policy and a shareholder advisory vote on it The UK was the first country to adopt a non-binding vote for shareholders to decide on executive remuneration through the Directors' Remuneration Report Regulations.

Walid Alissa describes this amendment clearly in the following way:

> "Companies publish a directors' compensation report as a part of their annual reporting cycle; disclose within the report details of individual directors' compensation packages, the company's forward-looking statement on the compensation policy, and the role of the board and compensation committee in this area; and the compensation report to a non-binding (or advisory) shareholder vote at the Annual General Meeting of the quoted company."[117]

In 2003, the first year after the introduction of the advisory vote, shareholders at GlaxoSmithKline became the first to veto their firm's remuneration report by a slim margin of 50.72%.[118] Their shareholders also voted down the inclusion of an estimated $35 million golden parachute in the package of a new CEO. However, between 2003 and 2009 only nine FTSE 350 companies had their executive remuneration plans voted down.[119] Most of the shareholders were in favour of the pay reports presented by their companies, and between 2002 and 2007 only 64 of 596 reporting companies received more than 20% dissenting

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[116] Department of Trade and Industry & Pricewaterhouse Coopers (PwC), "Monitoring of Corporate Aspects of Directors' Remuneration"1999

[117] W. Alissa, "Board's Response to Shareholders' Dissatisfaction: The case of shareholder's say on pay in the UK" (2015) 24 *European Accounting Review* 727, p.730

[118] S. Deane, "What International Markets Say on Pay: An investor perspective" (2005) *Institutional Investors' Services*, April, p.7

[119] J. R. Delman, "Structuring Say on Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation" (2010) *Columbia Business Law Review* Issue No. 2, 583, p.614.

votes.[120]

Empirical evidence shows that, overall, this say on pay regulation was accompanied by positive equity price reactions in companies with controversial pay practices, which weaken penalties for poor performance and are consistent with the views of investors who perceive say on pay as a valuable governance mechanism.[121] After comparing the major elements of CEO pay from 2000 to 2002 with the same elements after 2002 (between 2002 and 2005), Ferri and Maber found no evidence of changes in the level or growth rate of CEO pay.[122] However, given that calls for less reward for failure were one of the prompting factors behind the advisory vote, they did find an increase in the sensitivity of CEO pay to poor performance, especially in companies with controversial CEO pay policies.[123]

Studies on shareholders' reactions suggest that shareholders dissent when pay and performance are mismatched.[124] Moreover, a statistically significant correlation between excessive remuneration and shareholder veto has been proved. Similarly, Carter and Zamora suggest that shareholder disapproval will be much higher when: (1) CEO compensation increases; (2) pay for performance sensitivity is lower; and (3) there is greater potential dilution from equity incentive compensation.[125] Additionally, Sheehan concludes that institutional shareholders often use their negative votes as threats to enforce firms' compliance.[126]

Company responses to this advisory vote are complicated. Evidence found by Ferri and Maber shows that firms responded to shareholder dissent by removing controversial provisions in pay packages such as those criticised as

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[120] *Ibid*.
[121] F. Ferri & D. Maber, "Say on Pay Vote and CEO Compensation: Evidence from the UK" (2013) 18 *Review of Finance* 527, at p.534
[122] *Ibid*.
[123] *Ibid*.
[124] *Supra*, n.117, Alissa, p.735
[125] M. Carter & V. Zamora, "Shareholder Remuneration Votes and CEO Compensation Design" (2009) *AAA 2008 MAS Meeting Paper*, at p.24
[126] K. Sheehan, "Say on Pay and the Outrage Constraint" (2010) September *The Executive Remuneration Reporter*, p.29

rewards for failures.[127] Moreover, Alissa's research indicates that boards will reduce excessive compensation to address shareholder's dissatisfaction, and if shareholder pressure is high enough boards will dismiss the CEO.[128] However, a study by Conyon et al. shows little evidence that boards are responsive to shareholder dissent: they find no evidence proving that CEO compensation will be decreased after shareholders apply any voting pressure.[129] Ferri and Maber explain this situation by offering an insight according to which many boards will remove controversial provisions before the meeting and the vote to avoid a shareholder veto, which is consistent with some institutional shareholders' preference for bargaining in the shadows.[130]

Besides these, two additional visible effects of the non-binding vote on executive remuneration governance are summarised by Gorden as follows:[131] first, communication has increased between companies and large shareholders, especially with the leading institutional investor and with the proxy service companies such as Research, Recommendation and Electronic Voting (RREV). This communication between firms and shareholders had been changed from a perfunctory status to a more serious one. The second effect is the wider influence of the leading association of institutional investors: The Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) have both extended their governance influence on remuneration by using a set of guidelines.[132] These guidelines provide the standard of best practice for executive pay, and are often used by shareholders to vote on pay policies.

B. Australian regulation of executive remuneration

Reforms related to executive remuneration in Australia provide an interesting model for solving pay problems. Like other developed countries, from 1993 to 2008 executive compensation in Australia increased dramatically, showing the

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127 *Supra*, n. 121, Ferri & Maber, pp.540-1
128 *Supra*, n.117, Alissa, pp. 733-4
129 M. Conyon, J. Core & W. Guay, "Are U.S. CEOs Paid More Thank U.K. CEOs? Inferences from Risk-Adjusted Pay" (2011) 24 *The Review of Financial Studies* 402, p.429
130 *Supra*, n.121, Ferri & Maber, p.546
131 *Supra*, n.113, Gordon, pp.17-8
132 *Ibid*

largest growth between the mid-90s and the 2000s.[133] This growth demonstrated the contribution of equity incentives. In 2008–09 the compensation of CEOs of the top twenty companies averaged approximately $7.2 million in total.[134] Although this remuneration was lower than a cross-section of US and UK peer groups, it was 50% higher than the next twenty largest firms and equaled 110 times average pay.[135] The Australian government inserted section 250R(2) into the Corporations Act 2001, providing shareholders with a non-binding vote on the executive pay plans of all public companies as a response to general unease among shareholders and the public towards excessive executive compensation.[136] After the financial crisis Australia's Productivity Commission made several practical amendments after reviewing the history and regulatory framework of executive remuneration regulations. On June 20, 2011 the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act was passed by the Senate, including substantial changes to prior provisions (especially in sections 249 and 250).[137]

These substantial changes brought new provisions for the process of executive remuneration policy-making, widely known as the "Two Strike Rule". The Two Strike Rule provides shareholders an opportunity to "spill the board" if the company remuneration report receives negative reception at two consecutive AGMs.[138] The first strike occurs when a company decision about compensation policy is vetoed by 25% or more of the shareholders.[139] If this happens, the company's subsequent remuneration report must explain the board's response and propose action or inaction.[140]

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[133] *Supra*, n.94, Thomas & Van der Elst, p.669
[134] Australian Government Productivity Commission, "Executive Remuneration in Australia: Productivity Commission Inquiry Report" (December 2009), No.49.
[135] L. Chapple & B. Christensen, "The Non-Binding Vote on Executive Pay: A review of the CIERP 9 reform" (2005) 18 *Australia Journal of Corporate Law* 263, p.270.
[136] Australian Government, Explanatory Memorandum "Corporations Amendments (Improving Accountability on Directors and Executive Remuneration) Act 2011" (2011), available at https://www.legislation.gov.au/Details/C2011A00042 last accessed,13 July 2016
[137] *Ibid*.
[138] *Ibid*. section1.4
[139] *Ibid*. section 1.9
[140] *Ibid*.

At the next year's AGM, if there is a second veto on remuneration policy by 25% or more of the shareholders, the shareholders will be required to vote on a "spill resolution" at the same AGM.[141] This spill resolution means that some directors on board will be subject to a vote and might be re-elected or removed. If the spill resolution receives 50% or more of the eligible shareholder votes cast, a separate spill meeting must be held within ninety days.[142] The second strike and the spill resolution are intentionally separated to ensure that shareholders will not be discouraged from voting against the remuneration plan for fear of director removal, since they are given an opportunity to decide at another meeting whether to remove or not.[143] Moreover, it provides a free expression and clear signal of shareholders' opinions of the company's remuneration plan. Notice plays an important role in this new regime.[144]

To ensure the effectiveness of the spill resolution after the first strike, in a firm's meeting papers for their next AGM the firm must provide notice to the directors of a potential spill resolution at that AGM, in case a second strike triggers such a resolution.[145] Additionally, following the passage of a spill resolution, a company must still provide the minimum notice period required by both of the sections in the Corporations Act and any self-imposed notice set out in the company constitution, to ensure that shareholders are able to nominate and endorse board candidates for the special re-election meeting, which is the spill meeting.[146] At this meeting, all of the directors (except the managing director), who have failed to reply to shareholders with a new pay policy for resolution, must stand for re-election.[147] Furthermore, these directors will cease to hold positions on the board at that time unless they are re-appointed by the shareholders.[148] Section 250X effectively prevents a complete board spill, requiring that at least the managing director and two directors who receive the

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141 *Ibid*. section 1.10
142 *Ibid*.
143 *Ibid*. section 1.14
144 *Supra*, n.94, Thomas & Van der Elst, p.673
145 *Ibid*.
146 *Supra*, n.136, Memorandum, section 1.17
147 *Ibid*.
148 *Ibid*. section 1.16

highest re-appointment votes at the spill meeting remain on the board.[149]

If the spill meeting does not convene by the end of the ninety-day period, each director in office at the end of this period will be strictly liable.[150] Section 249 of the Corporations Act empowers any director of a listed company to call a meeting of the company's members, to ensure that every director has the practical ability to avoid spill offences.[151] Section 250U has a resetting mechanism within which the law only allows consideration of a spill meeting at every second AGM.[152]

The Two Strike Rule was applied to public companies' executive remuneration reports on July 1, 2011, allowing a spill resolution to be triggered only where both strikes occur after that day.[153] One year after the enactment of the Two Strike Rule, twenty-eight companies from the ASX 200 and 106 ASX companies overall had received a first strike, making them susceptible to a dangerous second strike in the same proxy season.[154] These figures generated a wide range of responses from commentators, with investor groups "warmly welcoming" the new rule, although the Australian Institute of Company Directors described it as a "heavy-handed black letter law approach that would produce unnecessary red tape".[155] Australian firms and their executive directors have forgone a few of their bonuses, raises and incentive compensations, perhaps due in some part to weak shareholder returns and fear of the Two Strike Rule. In some firms CEOs and boards have enforced cuts and freezes to fixed salaries for top executives, and other companies have already promised to restrain pay policies even despite their rising income.[156]

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[149] *Ibid*. section 1.21
[150] *Ibid*. section 1.20
[151] *Ibid*. section 1.22
[152] *Ibid*. section 1.23
[153] M. Orsagh, ""Say on Pay" in Australia: Two Strikes and You're Out, CFA INSTITUTE" September 012, http://blogs.cfainstitute.org/marketintegrity/2012/09/26/say-on-pay-in-australia-two-strikes-and-youre-out/ last accessed,13 July 2016
[154] *Ibid*.
[155] Business Insider, "Australian Shareholders to Get More Say on Pay" March 2011, available at: http://www.businessinsider.com/australian-shareholders-to-get-more-say-on-pay-2011-3?IR=T last accessed,13 July 2016
[156] Stephanie Daveson & Annette O'Hara, "Executive Remuneration: Results of Spill Meetings Put Effectiveness of Two Strikes in Question" 7 March 2012, C*ORRS CHAMBERS WESTGARTH*, available at http://www.corrs.com.au/thinking/insights/executive-remuneration-

This Australian say on pay has provided a good example of increasing the communication between shareholders and the board. The increasing engagement of shareholders provided them with more opportunities to express their opinions, and this legislation also has forced the board to show more willingness to listen to investors' concerns.

However, in the three years following the introduction of the Two Strike rule , only 5% of the ASX 500 companies received a first strike, and many of these companies revised their remuneration policies after shareholder disapproval.[157] Sydney-based law firm Mallesons Stephen Jaques doubted the effectiveness of the Two Strike Rule in an annual publication drawn from their 2011 client director survey:

> "the reform appears to have drawn the attention of boards away from matters of greater strategic value to organizations and have largely been used as a punitive mechanism by disgruntled shareholders frustrated by challenging market conditions, rather than as a means of communicating shareholders' assessment of executive remuneration."[158]

Empowering shareholders may damage the effectiveness of remuneration policy processing. A 2012 Melbourne Institute and Global Proxy Solicitation study indicated that 53.2% of shareholders were "more likely to vote against" a remuneration report in that year if their company had received a first strike at the previous AGM.[159] Furthermore, 68.4% of shareholders were more likely to

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results-of-spill-meetings-put-effectiveness-of-two-strikes-in-question/ last accessed,13 July 2016

[157] Tower Waston, "Why There Is Not Much to Learn From Australia's Approach to Say on Pay" Feb 2013, available at: https://www.towerswatson.com/en-AU/Insights/Newsletters/Global/executive-pay-matters/2013/Why-Theres-Not-Much-to-Learn-from-Australias-Approach-to-Say-on-Pay last accessed,13 July 2016

[158] Mallesons Stephen Jaques, "Directions 2012: Current Issues and Challenges Facing Australian Directors and Boards" 2011, available at: http://www.kwm.com/en/au/knowledge/downloads/directions-2012-current-issues-and-challenges-facing-australian-directors-and-boards-20120201 last accessed,13 July 2016

[159] University Of Melbourne, Faculty of Business & Economics, "The Global Proxy – Melbourne Institute Shareholder Confidence Index 3" 2012, available at: https://www.melbourneinstitute.com/miaesr/publications/indicators/global-proxy.html last accessed,13 July 2016

veto the board's re-election following the second strike.[160]

Therefore, by enhancing the transparency of executive pay and increasing board accountability to its shareholders, the Australian Two Strike Rule it might be argued that it has created a good model for shareholder say on pay; any lack of efficiency in revising pay policies and improving the structure of pay cannot be ignored.

C. Other European countries' policies towards executive remuneration

The European Union (EU)'s first two major initiatives on executive pay were the Commission's 2004 Recommendation on Directors' Remuneration and the 2005 Recommendation on the Role of Non-Executive Directors.[161] After the 2008 financial crisis some European countries have created regulatory rules to amend previous recommendations.

A new and more detailed corporate governance code was published by the Italian government in March 2006 specifying remuneration committee duties, and this code was revised in 2014.[162] In Spain the Unified Corporate Governance Code was proposed in 2006 to provide that a remuneration report should be submitted to the annual general meeting for a non-binding vote of shareholders, and there should be an individualised disclosure of directors' compensation in the report.[163]

The German government strengthened the responsibility of the supervisory board on management compensation issues in their 2008 amendment to Germany's Corporate Governance Code.[164] In 2009 Germany adopted "radical"

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[160] *Ibid*.

[161] G.A. Ferrarini, N. Moloney & M. C. Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis" (2009) *ECGI – Law Working Paper*, No. 126, p.11

[162] 2014 Comitato per la Corporate Governance, available at: http://www.borsaitaliana.it/comitato-corporate-governance/homepage/homepage.htm, last accessed,13 July 2016

[163] CNMV, Revised in 2015, into The Good Governance Code of Listed Companies, available at: http://www.cnmv.es/portal/Legislacion/COBG/COBG.aspx?lang=en last accessed,13 July 2016

[164] The Deutsche Corporate Governance Kodex (German Corporate Governance Code) 2015, available at: http://www.dcgk.de/en/home.html last accessed,13 July 2016

reforms in their new German Stock Corporation Act on Management Board Compensation.[165] More will be said about the German approach later. The Belgian government amended their corporate governance code in 2009 to achieve complete transparency on executive pay policies.[166] In 2013, as mentioned before, the British and Swiss governments both gave shareholders a binding vote on executive pay policies by adding new provisions into their Companies Acts, which will be investigated and analysed more in the next chapter.

C.1 France

In France, public limited liability companies have the right to choose between a one-tier board structure and a two-tier board structure in their articles of association, and a great majority of companies adopt the one-tier board form. Under the French Commercial Code and French Company Law, it is the shareholders' right to approve the directors' total annual remuneration for a one-tier board and the total annual supervisory board remuneration for a two-tier board.[167] However, shareholders cannot decide on executive directors' pay plans, although they can decide on non-executives' service payments. For many years until 2005 French shareholder power with respect to directors' pay lay in their decision over the total compensation for the board. In 2005 the industry-based MEDEF/AFEP Code, which is the French national corporate governance code incorporating the "comply or explain" principle, provided that shareholders must approve two parts of the executive remuneration: termination plans and additional retirement plans.[168] The 2005 Breton Law regulated that any agreement or changes entered into regarding these two

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165 JonesDay, "Germany: New Developments in Management Board Compensation" (November 2010), available at: http://www.mondaq.com/x/116734/Directors+Officers/New+Developments+in+Management+Board+Compensation last accessed,13 July 2016

166 Belgian Corporate Committee, 2009 Corporate Governance Code, available at: http://www.corporategovernancecommittee.be/en/about-2009-code/2009-belgian-code-corporate-governance last accessed,13 July 2016

167 French Commercial Code, available at: http://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations last accessed,13 July 2016

168 The AFEP-MEDEF Corporate Governance, available at: http://www.societegenerale.com/en/about-us/governance/afep-medef last accessed,13 July 2016

types of payment must be subject to the same shareholder approval process. Any director who fails to perform cannot receive any termination fee. In the following year the French Corporate Governance Code issued two executive compensation recommendations aiming to enhance disclosure and provide guidelines to align remuneration with company strategy and long-term profits.[169]

Finally, in June 2013 the Code introduced a say on pay vote for shareholders, although it still allows companies to choose between complying and explaining why they do not provide this vote for shareholders. For companies who introduce the say on pay, shareholders have an advisory vote to determine every executive director's pay package, with information such as stock options, performance shares, golden parachutes, retirement benefits and other bonuses disclosed.[170] If shareholders vote against one pay package, the board must discuss this plan with the remuneration committee at one of its next meetings while studying the implications of the shareholder vote, and publish the actions they intend to take to improve their pay policies.[171] This say on pay power is weak, and needless to say there are many public companies choosing not to comply with this rule.

These reforms, while having the same goals as those in the US (namely to increase transparency, align performance to pay and empower shareholders over pay policies), are intended to deepen capital market liquidity and support industry competitiveness.[172] Ferrarini et al. suggest that the latter were influenced by the EU's 2004 and 2005 recommendations.[173]

C.2 The Netherlands

Regulations around executive remuneration in the Netherlands are unique. Since 2004 the Dutch Civil Code has empowered shareholders to decide on

169 *Ibid*.
170 *Ibid*.
171 *Ibid*.
172 *Supra*, n. 94, Thomas & Van Der Elst, p.684
173 *Supra*, n. 3, Ferrarini, Moloney & Ungureanu, p.32

new executive pay plans and big changes in existing plans.[174] This unique regulation is that shareholders may have a binding vote to decide these issues. From January 1st 2013 Dutch public companies can choose between one-tier and two-tier boards; before that date they were forced to organise with two-tier boards.[175] Under the two-tier board system the Dutch Corporate Governance Code requires the supervisory board to draft pay policies and send them to the employees' council and the general meeting of shareholders. The employees are able to make comments to the general meeting of shareholders. New executive remuneration policies must have shareholder approval to be implemented. Additionally, if there is any amendment to policies in later years, shareholders have the power to veto the amendments.[176]

However, these regulations are not as clear as had been expected. First, the law, in the Dutch Civil Code, does not indicate clearly which board should draft new pay policies. The Corporate Governance Code states that the supervisory board should create the policies, but, perhaps, unfortunately, under the "comply or explain" principle, companies can allow the management board to make pay plans for executives themselves. Second, the law contains no definition of what should constitute an amendment, which means it is not clear enough to ascertain how new changes of executive remuneration should be handed to the shareholders for their approval, or in what way the management board can just get new payments.[177] Third, shareholders have the power to decide on the pay policy of every director, including the supervisory board members, at the general meeting, unless the articles of association change this power. Usually Dutch companies' articles of association will delegate the power to the supervisory board, making it rare for the shareholders to have a binding say on pay.[178] However, shareholders in the Netherlands tend to argue the binding

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[174] Dutch Corporate Governance Code, Article 135 and Article 145 of Book Two, available at: http://commissiecorporategovernance.nl/dutch-corporate-governance-code last accessed,13 July 2016

[175] Mondaq, "Netherlands: New Dutch Company Rules Effective 1 July 2013" July 2013, available at: http://www.mondaq.com/x/248594/Corporate+Governance/New+Dutch+Company+Law+Rules+Effective+1+July+2013 last accessed,13 July 2016

[176] L. Van Vliet, "The Netherlands-New Developments in Dutch Company Law: The Flexible Close Corporation" (2014) 7 *Journal of Civil Law Studies*, Article 8, 271, p.279

[177] *Supra*, n. 94, Thomas & Van Der Elst, p.702

[178] *Ibid*

vote back, especially on the remuneration policy of the managing board member.[179]

C.3 Germany

The German corporate governance framework provides for a two-tier system, with a management board and a supervisory board. It provides an example of having employees on the supervisory board. Different from the UK's shareholder primacy regulations and one-tier board structures among its listed companies, Germany provides its employees with more power and consideration because this country has a stronger workforce through its unions. The Industrial Union of Metalworkers (IG-Metall), a member of the German Confederation of Trade Unions, is the largest trade union in Germany[180] and also the largest European industrial union.[181] Employee representatives on supervisory boards can be either selected from inside the firm or recommended from German trade unions. [182] Whether a company is public or a closed one (private), as long as the company has 500-2000 employees, it should have its supervisory board with one third of positions held by employees; and in companies with 2000 or more, half of the supervisory board is constituted by employee representatives.[183] IG-Metall has expanded the presence of union representatives who are active non-executives on supervisory boards at companies such as Porsche, BMW and Siemens, in line with the "co-determination" system.[184] Not only has this union supported its representatives to participate in supervisory board decisions, it has also helped the workers to

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179 *Ibid*

180 E. Kirschbaum, "Moderate head of powerful German union steps down unexpectedly", Reuters, 8 June, 2015, available at: http://www.reuters.com/article/2015/06/08/germany-union-metall-leader-idUSL5N0YU42020150608?feedType=RSS&feedName=everything&virtualBrandChannel=11563 last accessed,13 July 2016

181 Reuters, H. Sackmann, "German IG Metall, employers confirm 4.3 percent wage deal" 18 May 2012, available at: http://www.reuters.com/article/2012/05/19/us-germany-wages-deal-confirmation-idUSBRE84I01N20120519 last accessed,13 July 2016

182 Worker-Participation.eu, "Board Level Representaion", available at: http://www.worker-participation.eu/National-Industrial-Relations/Countries/Germany/Board-level-Representation last accessed,13 July 2016

183 *Ibid.*

184 *Supra,* n.182, Worker-Participation.eu

lobby for wage increases.[185] However, in other industries, such as banking and consultancies, unions have never been as strong as in manufacturing sector.[186]

The Deutsche Bank and Volkswagen (VW) supervisory boards have provided examples of reducing the high pay level of their CEOs. In 2011 Martin Winterkorn, the chief executive of VW, received €17 million as his total pay, which was the highest pay in Germany in that year of austerity this attracted significant public attention.[187] In line with his pay policy, Mr Winterkorn would have been paid €20 million in 2013, but after a long debate between the supervisory board and executives, this amount was reduced to €14 million.[188] Although the executives argued that the original amount was justified according to the firm's income and performance, the employees and representatives from trade unions thought that the ratio between his pay and that of the lowest-paid employees was too high, exceeding a ration of 340 to 1, which was set by Mr. Meine, who is a union representative at both VW and Continental, the tyre and car components company.[189]

However, the reason why Mr Winterkorn would not leave VW after this reduction in pay was that only VW could provide a job managing a huge German general motor business. Cases like this will seldom happen in countries such as the UK and the US, since generally executives who are subject to a reduction in pay will not stay as there are alternative employment opportunities elsewhere. Also, it is not to say that having employees participating in executive pay decisions will effectively reduce the level and adjust the structure of compensation, other discussions around this situation will be discussed more in Chapter 6.

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[185] Reuters, I. Wissenbach, "UPDATE 1-Germany's IG Metall union agrees 3.4 pct wage rise" 24 Feb 2015, available at: http://www.reuters.com/article/2015/02/24/germany-wages-igmetall-idUSL5N0VY07320150224 last accessed,13 July 2016

[186] The High Pay Centre, "Workers on Boards: Interviews with German Employee Directors" September 2013, available at: http://highpaycentre.org/pubs/workers-on-boards-interviews-with-German-employee-directors p.6, last accessed,13 July 2016

[187] Bloomberg, "VW's Winterkorn Earns $23 Million as Best-Paid German CEO" 12 March 2012, available at: http://www.bloomberg.com/news/articles/2012-03-12/vw-s-winterkorn-earns-23-million-as-best-paid-german-ceo last accessed,13 July 2016

[188] *Supra*, n.186, the High Pay Centre, p.8

[189] *Ibid*.

C.4. Analysing Innovations

Compared to the US government's concerns and the regulations on executive remuneration that it has imposed, similar rules from European countries seem rather immature. In Chapters 2 and 3 it was acknowledged that pay for performance has significant obstacles in compensation structure and practice, and only focusing on the level of pay is not the right way to solve problems. Increasing the engagement between shareholders and the board has resulted in some improvements because of improved scrutiny of the board and management, and this can help to control the level of pay, but as others often note regarding remuneration, the devil lies in the detail. It is the structure of remuneration design that should concern regulation. The US, although it has attempted to implement some ineffective policies related to capping pay and indirectly lowering basic salaries, it has provided some ideas about regulating pay structures and reducing rent-seeking behaviour of the board while also promoting better governance. Methods such as suspending executives' equity-holding periods and mandatory disclosure of repricing options have shown that the government has taken pay problems seriously and thought deeply about how to regulate.

However, though various ways have been provided in different countries, currently the most popular trends are in two areas of corporate governance: increasing shareholder engagement in remuneration practice, and promoting the independence of the remuneration committee and the board in policy setting. There will probably not be a one-size-fits-all regulatory model, since under different cultures there will be different conditions of corporate governance; for example, the UK, and Switzerland, which belong to the group of shareholder-friendly countries, will provide more scrutiny power for their investors in order to attract investments, while in Germany, with large and powerful labour unions interfering in the business of listed firms, executive compensation will be retained at a reasonable level. However, it will be necessary to set a goal to regulate executive compensation, since besides cultural differences, various theories explaining remuneration, as mentioned in Chapter 2, also provide their own approaches regarding how to ensure pay for performance.

In order to investigate how these remuneration policies and regulations have worked in practice, experts examined 300 of the largest listed companies from 16 countries, 14 of which are from the EU.[190] Their analysis was based on these companies' annual financial statements or corporate governance reports for the financial year ending December 2007 or March 2008.[191] This data should reflect firms' compensation policies just before the financial crisis, and show how companies have responded to each state's regulation of executive pay. Generally they found that firms tend to apply only the basic requirements of national practice codes or rules.[192] When the requirements are on a "comply or explain" basis, firms tend to engage in only partial compliance.[193] Firms pay attention mostly to basic disclosure requirements, while recommendations concerning detailed information relating to terms of pay contracts and qualitative information regarding performance links are not widely followed. This phenomenon, according to the experts, is because of market pressure – in other words, keeping commercial secrets from their competitors.[194]

Due to corporate governance codes' soft nature, 60% of the firms comply with the individualised disclosure and pay policy disclosure criteria.[195] However, the remuneration committee has been proved to be the most "amenable" to transplantation across EU corporate governance, with over 70% of the firms complying with its related criteria.[196] Regarding disclosure criteria, firms in the UK, Ireland (which are traditionally countries with dispersed ownership companies and jurisdictions where disclosure is required in their mandatory rules) and the Netherlands, give the highest levels of compliance with individualised disclosure requirements, averaging between 90% and 100%.[197] However, firms from Belgium (30%), Spain (20%), Austria (20%) and Greece (5%), which are all traditionally block-holding countries, achieved much lower

190 *Supra,* n. 3, Ferrarini, Moloney & Ungureanu, p.57
191 *Ibid*.
192 *Ibid*. p.58
193 *Ibid*.
194 *Ibid*. pp.59-60
195 *Ibid*.
196 *Ibid*. p.61
197 *Supra,* n. 94, Thomas & Van Der Elst, p.708

levels of individualised disclosure.[198] Germany, although a traditional block-holding country, has firms with much higher compliance with individualised disclosure (60%) because of certain laws regulating this criterion.[199]

C.5. Harmonisation

Due to efforts to regulate from a financial industry perspective, legislative harmonisation seems to have occurred. Early in 1999 the Financial Stability Forum (FSF) was founded by Finance Ministers and Central Bank Governors from the G7 countries (Canada, the US, the UK, Japan, France, Germany and Italy), with the purpose of enhancing international finance cooperation and promoting international financial stability.[200] In 2009 the FSF was transformed to the FSB, the Financial Stability Board, with its members boosted from the G7 to the G20 group.[201] In September 2009 a G20 leaders' meeting stated:

> "we are committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take. Standards for large global financial firms should be commensurate with the cost of their failure. For all these reforms, we have set for ourselves strict and precise timetables".[202]

In the US, to stop financial companies from taking unnecessary and excessive risks the government introduced the American Recovery and Reinvestment Act

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198 *Ibid*. pp.712-3
199 *Ibid*.
200 Financial Stability Board, "Our History", available at: http://www.financialstabilityboard.org/about/history/ last accessed,13 July 2016
201 Now including Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
202 G20 Information Centre, "G20 Leaders Statement: The Pittsburgh Summit" 24 to 25 September 2009, available at: http://www.g20.utoronto.ca/2009/2009communique0925.html last accessed,13 July 2016

in 2009[203] and the Troubled Asset Relief Program.[204] Moreover, the House of Representatives passed the 2009 Corporate and Financial Institution Compensation Fairness Act to improve shareholder voting rights on the pay and compensation structure of executives in the financial sector; although it was rejected by the Senate,[205] the later Dodd and Frank Act amendments actualised the implementation of empowering shareholders on executive pay.

The EU has provided a Capital Requirements Regulation and Directive (CRR/CRD IV), thereby helping to form a sounder and safer financial system in the EU zone,[206] while additionally, the FCA in the UK, with its aim of ensuring alignment between executive remuneration and risk-taking to promote the long-term profits of financial organisations, introduced the Remuneration Code for banks, building societies and large investment funds.[207]

Not only has the world realised how important it is to introduce regulations into the financial industries as response to financial crisis, many countries have provided shareholder say on pay through their company legislation to cure concerns around executive compensation. It has formed a global trend of providing shareholders with voting power on executive pay, the form as follows can be used to have a general understanding of this trend:

COUNTRY	YEAR	FIRMS	VOTE	OTHER INFORMATION
AUSTRALIA	2005	Listed	Mandatory& advisory	Boards are required to explain their response to voting dissent higher than 25%. There is also a Two Strike Rule, where the board has to stand for re-election if dissent is higher than 25% for

[203] The Recovery Act 2009, available at: https://www.irs.gov/uac/the-american-recovery-and-reinvestment-act-of-2009-information-center last accessed,13 July 2016

[204] The TARP, available at: http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx last accessed,13 July 2016

[205] H.R. 3269 (111th): Corporate and Financial Institution Compensation Fairness Act of 2009, available at: https://www.govtrack.us/congress/bills/111/hr3269 last last accessed,13 July 2016

[206] European Commission, Banking and Finance, Capital requirements regulation and directive – CRR/CRD IV, available at: http://ec.europa.eu/finance/bank/regcapital/legislation-in-force/index_en.htm last accessed,13 July 2016

[207] FCA, Remuneration Code, available at: https://small-firms.fca.org.uk/remuneration last accessed,13 July 2016

				two consecutive years.
BELGIUM	2012	Listed	Mandatory& advisory	
CANADA	2012	Listed	Mandatory& advisory	Companies have the option to ask for an advisory vote on remuneration package and policy
DENMARK	2007	Listed	Mandatory& binding	
FINLAND	2007	Listed	Mandatory& binding	
FRANCE	2014	Listed	Mandatory& advisory	
GERMANY	2010	Listed	Mandatory& advisory	Proposals for a binding vote were rejected by the German Parliament in 2013
ITALY	2011	Listed	Mandatory& advisory	Votes are binding for banks
JAPAN	2005	Listed	Mandatory& binding	
NETHERLANDS	2004	Listed	Mandatory& binding	Voting is required only when there are changes in the remuneration policy
SOUTH AFRICA	2009	Listed	Mandatory& advisory	
SPAIN	2011	Listed	Mandatory& advisory	
SWEDEN	2005	Listed	Mandatory& binding	
SWITZERLAND	2007	Listed	Mandatory& binding	Switzerland introduced voluntary and advisory say-on-pay regulation in 2007. Following a referendum in 2013, the nature of the vote changed in 2015
UK	2002	Listed	Mandatory& binding	The nature of the vote was mandatory and advisory until October 2013
US	2011	Listed	Mandatory& advisory	Introduced as part of the Dodd-Frank Act 2010

Table taken from “The Importance of Shareholder Activism: The case of say-on-pay”[208]

[208] K. Stathopoulos & G. Voulgaris, “The Importance of Shareholder Activism: The Case of Say-on-Pay” (2015) 24 *Corporate Governance: An International Review* 359, p.362

However, as discussed above, though shareholder say on pay is currently the most popular mechanism that governments have provided for excessive executive remuneration, there are still several deficiencies of this legislative design, such as reducing the efficiency of board decision process, increasing the pay gaps between employees and managers, and shareholder voting recklessly due to lack of information and professional knowledge. Concerns from scholars have led to contentions that, shareholder empowerment may increase the firm's focus on short-term success.[209] As mentioned in Chapter 3, because shareholders will vote on remuneration reports according to the conditions of share prices and the firm's recent performance, managers tend to focus more on short-term productivity and even manufacture the impression that the firm is running well, though these management activities will jeopardise the firm's long-term success. "Remuneration is a matter of culture within corporations. Cultures in which it is every man for himself are faulty. The culture of every man for himself wins through."[210] Nonetheless, other suggestions propose that shareholders, especially institutional investors, can influence management and firm's decisions from their effective activities and with more shareholders realising their power and influence, they may vote on pay policies from a long-term perspective.[211]

It can be observed that the phrase 'long-term productivity' has appeared in almost every reform regulating executive remuneration. Although this aim seems generalised and vague, certain characteristics of executive compensation can be aligned closely with it while pursuing the pay for performance standard. Whether or not shareholders can help with a firm's long-term success is a crucial factor in justifying the say on pay legislations. A detailed analysis will be provided in Chapter 6.

<u>Conclusion</u>

Brian Cheffins has noted that "executive pay is a topic where it is much easier

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[209] C. Villiers, "Executive Pay: A socially-oriented distributive justice framework" (2015) 6 *Company Lawyer* 139, at p.139
[210] D. Arsalidou, "The Regulation of Executive Pay and Economic Theory" (2011) 5 *Journal of Business Law* 431, pp.449-50
[211] *Supra,* n.208, Stathopoulos & Voulgaris, p.361

to find problems than solutions."[212] What is more, solutions may be much easier to design in comparison with testing how the solutions are working, and the testing is easier compared to finding the right measures for a good executive pay plan.

After analysing the history of adjusting executive remuneration and why the market and previous corporate governance attempts have failed to ensure that positive aspects are stronger in applying financial incentives, it is clear that existing legislation has failed to rectify problems with executive pay and it should be improved and new rules should be considered and introduced.

The worldwide examples above have shown that even though enhancing corporate governance is supposed to be an effective way to minimise the negative influence of financial incentives (e.g. the regulations about claw-backs, shareholder advisory votes and disclosures), their contributions in lowering levels and adjusting the structure of executive remuneration can still be improved. However, with more pressure from institutional shareholders and increasing outrage from the public, it is not only the remuneration committees of listed firms that have been prompted into action to address negative reactions executive pay;[213] governments are also providing more rules regulating executive pay. While the Chapter might paint a pessimistic impression, Gordon has an optimistic attitude towards new regulations related to executive pay, stating that the battle is "half-won, not lost."[214]

This, therefore leads us to: what methods can be used further? This will be addressed in the next chapter.

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[212] B. R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Oxford University Press, 1997) p.132
[213] PwC, T. Gosling, Our Reward Insights, available at: http://www.pwc.co.uk/human-resource-services/executive-pay-insights.jhtml, last accessed,13 July 2016
[214] Financial Times, Sarah Gordon, "Outrage Over Executive Pay Shows the Battle Is Half-Won, Not Lost", 10 September 2015.

Chapter Five

Binding Say-on-Pay Regulation: Design and Influence

Introduction

In previous chapters it has been established that executive remuneration problems, especially the deficient design of incentivised remuneration and the influence of executives on the practice of remuneration policy, cannot be solved simply by markets and inner corporate control. Therefore, various legislations from several developed countries have been introduced to intervene into the executive remuneration issues, mainly through providing binding or non-binding voting rights to shareholders to decide on how the pay policy should be. However, is the provision of a non-binding vote to shareholders an effective strategy to address these problems with executive remuneration?

In the light of a summary in Chapter 4 drawn from an examination of US legislative history and other regulations, it is contended that these problems cannot be resolved efficiently by soft laws, judging by the continued outrage from the public and dissatisfaction among shareholders about excessive pay levels and deficient pay plan structures. This chapter will explore governments' new regulations and how they have worked to change executive pay. The arguments will be developed as follows.

In section I there will be a general evaluation of the new 2013 UK law and a consideration of evidence for how the shareholders' binding vote has influenced governance issues and the level and structure of executive pay after a fiscal year. The Swiss binding say on pay will be considered as well, and several comparisons will be made between the UK reform and the Swiss law. The merits of the UK binding say on pay will be introduced and discussed. On the other hand, more importantly, the problems that still exist seriously after the enactment of the say on pay reform will be mentioned and analysed, for further discussion in the next chapter.

Section II provides an investigation as to why the UK and Swiss governments gave shareholders a binding say on pay. This will be embarked on from a political perspective, starting with a summary of how institutional investors have influenced the economy and their increasing power in corporate governance issues. As the reform did not deal with certain problems, such as stopping pay for underperformance and difficulties with shareholders understanding, and the multiple design of stock options in executive pay packages, additional regulations will be provided and analysed in Chapter 6.

This chapter answers the first research question shall we have regulations on remuneration through analysing the effects of shareholder say on pay reform, proposing that this reform does have brought some merits in solving the problems of executive remuneration. Chapter 5 also helps to answer the second research question, by suggesting that there are also concerns left in the reform and space for improvements in say on pay regulations.

I. The Binding Say on Pay in the UK and Switzerland

A. Empowering shareholders on executive remuneration

Generally, because of shareholders' weaknesses in corporate governance issues that have been mentioned in previous chapters, such as information asymmetry and a lack of professional knowledge about what managers are doing, shareholders' voting rights are always valued by shareholders themselves, for example in director elections, mergers and acquisitions, and the replacement of CEOs.[1] Shareholders' concerns with executive remuneration levels and design has been intensified, due to a series of accounting scandals, or what some American scholars refer to as a financial

[1] D. Yermack, "Shareholder Voting and Corporate Governance" (2010) 2 *Annual Review of Financial Economics* 103, p.115; P. Fischer, J. Gramlich, B. Miller & H. White, "Investor Perceptions of Board Performance: Evidence from uncontested director elections" (2009) 48 *Journal of Accounting and Economics* 172, p.180; J. Cai, J. Garner & R. Walkling, "Electing Directors" (2009) 64 *Journal of Finance* 2389, p.2390.

crisis[2] during the early 2000s,[3] Since the 2000s, not only had the institutional investors argued for investing activism in the company's governance, but also the economic and political climate had made intervening easier for active shareholders.[4]

As mentioned in Chapter 4, from the advisory vote given to shareholders by the governments of Germany, the US and France, to the binding vote provided in the UK, Switzerland and the Netherlands, there should be a rationale that can be explained in empowering shareholders to solve the executive remuneration problems.

Explanations should be started from agency theory, which we used to illustrate theories and problems of executive remuneration in Chapter 2. Due to the increasing concerns towards relationship between agent and principal, shareholders have had an increasing interest in controlling executives in recent decades, particularly in appointing and paying directors to manage their companies and business. Furthermore, shareholders' participation in the business does have an effect on the company's management. If companies have a large and dispersed shareholding structure, they will have weaker monitoring and thus a reduction in pay for performance sensitivity.[5] On the other hand, in companies where shareholders have a close holding and greater monitoring influence over the governance, not only the level of executive pay will be reduced, but also several of director's self-dealings can be prevented.[6]

Under this understanding, the UK and Switzerland have their legislations as resolutions after the financial crisis to solve excessive remuneration problems. Both of the two countries have empowered their shareholders with binding say

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[2] See articles from Cleveland, available at: https://www.clevelandfed.org/en/Our%20Research/Financial%20Markets%20and%20Banking.aspx, last accessed, 13 July 2016
[3] S. Bhagat & R. Romano, "Reforming Executive Compensation: Focusing and committing to the long run" (2009) 374 *Yale Law & Economics Research* Paper, p.8.
[4] Barrons, K. Squire, "A Golden Age for Activist Investing", February 2009, available at: http://www.barrons.com/articles/SB123457667407886821, last accessed, 13 July 2016.
[5] *Ibid*.
[6] Tosi & Gomez-Mejia, "The Decoupling of CEO Pay and Performance: An agency theory perspective" (1989) 34 *Administrative Science Quarterly* 169, p.180.

on pay. The following will have an input into the analysis of their reforms and how the reforms have influenced executive remuneration. Whether the empowerment of shareholders will have a positive effect on the level and structure of executive pay will be discussed in due course.

B. UK law and its implementation

The binding shareholder say on pay is regulated as a part of the UK's Enterprise and Regulation Reform Act 2013. The British government published this Act to encourage long-term economic growth and simplify regulations.[7] This reform Act was supposed to boost the economy and increase Britain's competitiveness and business confidence.[8] Its contents include provisions on the UK Green Investment Bank, Employment Law and the Competition and Markets Authority, the abolition of the Competition Commission and the Office of Fair Trading to amend the Competition Act 1998 and the Enterprise Act 2002. The reform Act also makes provision for the reduction of legislative burdens, copyright, and payments to company executive directors.[9] Sections 79 to 82 of the Act provide important amendments mainly to sections 226, 421, 422 and 439 of the Companies Act 2006 in order to regulate executive directors' pay and its reporting.[10]

Every public company should hold its annual general meeting in each period of six months beginning with the day following the accounting reference date.[11] According to the general rules,[12] shareholders of public companies will vote on written resolutions on a vote per share basis, after the reports on the executive

[7] UK Government Legislation, Enterprise and Regulation Reform Act 2013, available at: http://www.legislation.gov.uk/ukpga/2013/24/contents, last check on July 26th, 2016
[8] Hansard Common debate, available at: http://services.parliament.uk/bills/2012-13/enterpriseandregulatoryreform/stages.html last accessed, 13 July 2016
[9] Hansard Common debate, available at: http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm120523/debtext/120523-0002.htm#12052368000011 last accessed, 13 July 2016
[10] UK Government Legislation, c.24, Part 6, Payments to directors of quoted companies, Enterprise and Regulating Reform Act 2013. Legislative amendments available at: http://www.legislation.gov.uk/ukpga/2013/24/part/6/crossheading/payments-to-directors-of-quoted-companies last accessed, 13 July 2016
[11] Section 336 (1), Companies Act 2006.
[12] Section 284, Companies Act 2006.

directors' remuneration have been provided by the board. Under the 2013 reform, all quoted companies were required to put their executive remuneration policy to a shareholder vote at an annual general meeting in the first year after the Act's enactment date, which was October 1st 2013.

From this date, any director's remuneration report must include three main elements: a statement made by the chair of the remuneration committee; a remuneration policy for the coming years, which has to be renewed at least every three years; and a report on how the remuneration policy has been implemented in the previous financial year.[13] Additionally, whenever an executive director is to leave the firm the board needs to publish a statement declaring the payments that this director has received and is to receive in the future.[14]

The law applies to the same companies as the old regime, which are "UK-incorporated companies listed on the London Stock Exchange, an EEA exchange, the New York Stock Exchange, or NASDAQ".[15] Also, "non-UK incorporated companies listed on the London Stock Exchange" will have to consider to what extent and how to comply with the new regime, although in many cases they are already complying with it under the current directors' pay disclosure rules.[16]

According to the Department for Business, Innovation and Skills ("BIS"), these new rules are intended to promote long-term success for both public companies and the whole economy.[17] This outcome can be achieved via a routine of

[13] BIS, Directors' Remuneration Reforms, Frequently asked questions, March 2013, available at: https://www.gov.uk/government/publications/directors-remuneration-reforms-frequently-asked-questions p.4, last accessed, 13 July 2016
[14] *Ibid*.
[15] UK Government Legislation, The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, available at: http://www.legislation.gov.uk/uksi/2013/1981/contents/made last accessed, 13 July 2016
[16] Linklaters, available at: http://www.linklaters.com/News/LatestNews/2013/Pages/Executive-Pay-Most-significant-rules-directors-pay-decade-come-force-1October.aspx last accessed, 13 July 2016
[17] BIS, "Executive Pay: Consultation on enhanced shareholder voting rights, summary of responses" June 2012, available at: https://www.gov.uk/government/consultations/executive-pay-consultation-on-enhanced-shareholder-voting-rights p.4, last accessed, 13 July 2016

increasing information transparency, empowering shareholders and lowering monitoring costs. By March 2015 almost all the public firms in the UK had completed their first resolution under this new law. The following seeks to examine these changes, determine what they are likely to mean for remuneration in the UK, and assess whether they will rectify some of the problems that have been identified in this thesis.

B.1 Reform and case

Generally, a firm's remuneration report will contain four parts: a statement from the chair of the remuneration committee; a brief summary of the whole remuneration policy; a remuneration policy for the future; and an annual report on the implementation of the previous policy. The provisions of the 2013 regulation can be concluded as follows.[18]

B.1.1 Binding vote for shareholders

The proposed "forward-looking" remuneration policy, which will inform a binding vote for shareholders, will be included in the annual report when shareholders are asked to vote at the annual general meeting, and will include the matters raised below.[19]

There must be a pay policy table setting out the key elements of directors' remuneration and information regarding each element under the following headings: [20]

- Purpose (how each element supports the achievement of the company's short and long-term strategies)
- Operation (how each element operates, including whether claw-backs

[18] *Supra,* n.10, Payments to directors of quoted companies, Enterprise and Regulating Reform Act 2013.
[19] *Ibid,* c. 24, Part 6 Miscellaneous and general, article 79, section 421, section 422 A and section 439 A of the Companies Act 2006.
[20] Companies Act 2006, section 439A (7) (8), section 226A, explained by PricewaterhouseCoopers (PwC), "Executive Remuneration: simple, practical proposals for implementing the new disclosure requirement", available at: http://www.pwc.co.uk p.8, last accessed, 13 July 2016

or malus adjustments are possible)

- Opportunity (maximum potential value)
- Performance Metrics (including relative weightings and time period), and
- Changes to Policy (what is proposed and why)

Besides this, the pay policy may also include: information on executive employment contracts in general; scenarios showing what directors would get paid for performance that is above, on and below target; information on the percentage changes in the company's profits and dividends and in the company's overall spend on remuneration; the principles on which exit payments will be made, including how they will be calculated, whether the company will distinguish between types of departure or the circumstances of exit and how performance will be taken into account; and material factors that have been taken into account when setting the remuneration policy, specifically employee remuneration and shareholder views.[21]

There is an obligation on the board to subject a new remuneration policy for each executive director to the shareholders' approval every three years.[22] If there is any change in the pay policy or if it is necessary to implement a new pay policy within three years, the board has to submit a new one to its shareholders for resolution.[23] However, the revised pay policy does not necessarily need to be presented only at AGMs: section 422A provides an opportunity for the board to present it for shareholder resolution between annual meetings.[24]

Failure to pass the remuneration plan will leave the firm with three options: the first is to continue applying the last policy that shareholders approved; the second is to implement the last policy while making a revision to the new policy for shareholder approval; and third, the board may call a general meeting

[21] *Ibid*
[22] Section 422A, Companies Act 2006
[23] *Ibid*
[24] *Ibid*

specifically for passing a new remuneration policy.[25] Companies must call a general meeting if there is no previous pay policy after the reform.

This binding regulation may help in warning the remuneration committee to be careful with pay policy design, and also in preventing unnecessary costs by seeking consultation with investors' advisory groups before the new pay policy is delivered to the shareholders for voting.

The BG Group provides a clear example in explaining this function of the binding say on pay. All of their main investor advisory bodies expressed serious concerns about a new pay policy formulated for BG's future chief executive, Helge Lund, at the end of November 2014, and before the shareholders' final voting on this policy.[26] The BG board chose to revise this pay package according to their previous policy that had been made and approved by shareholders in May 2014.[27] The controversial factor in Lund's pay package was his long-term incentive plan. Pressure from shareholder voting consultancies stopped the board from granting him shares with a value equal to £12 million.[28] Instead, Lund had his "golden hello" reduced to £10.6 million in equity.[29] If the firm's performance met targets he could expect a share award of around £4.7 million within a year, rather than the £10 million from the new pay policy.[30]

However, from another perspective, although the binding vote is designed to empower shareholders over decisions on executives' income, studies have shown that the law and shareholders may be chasing different goals regarding executive pay policy. Shareholders are concerned about the firm's substantive

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[25] Section 439A (2)-(6), Companies Act 2006

[26] The Guardian, "BG Group Faces Shareholder Revolt Over £25 Pay Deal for New Boss", 28 November, 2014, available at: http://www.theguardian.com/business/2014/nov/28/bg-group-shareholder-revolt-pay-deal-new-boss-helge-lund-oil last accessed, 13 July 2016

[27] BG Group, BG Group Revises Chief Executive Remuneration Packages, December 2014, available at: http://www.bg-group.com/~/tiles/?tiletype=pressrelease&id=740 last accessed, 13 July 2016

[28] The Guardian, "BG Group Cuts Helge Lund's Golden Hello After Shareholder Pressure", 1 December, 2014, available at: http://www.theguardian.com/business/2014/dec/01/bg-group-cuts-helge-lund-golden-hello last accessed, 13 July 2016

[29] *Ibid*

[30] *Supra,* n.27, BG Group

historic pay practices or other policy issues in the future when deciding to vote in favour or against, while the spirit of the law is aimed at detailed and prescriptive disclosure requirements for executive remuneration reports.[31] The UK's 2013 reform provides a good direction on how to make up this difference between current say on pay regulation, by providing shareholder another voting right on the implementation report of executive's pay. The implementation report of executive director's pay will provide a general review of how the previous pay policy has been practiced in a short term, while satisfying shareholder's need to understand a company's pay practice from a historical aspect to some degree. This say on pay power will be discussed as follows:

B.1.2 Advisory vote of shareholders on implementation report

According to the summary from PwC and Report Leadership, which is a multi-stakeholder group on corporate reporting, the following factors are required by legislation related to pay implementation reports for each executive director:[32] salaries and fees payable for a financial year; all taxable benefits and expense allowance; the full amount of annual bonuses, including bonuses that will be earned under certain conditions in the future; the long-term incentive plan and other options vested according to a certain standard of performance at the end of the financial year; the pension plan; and other additional content.

Although the vote of shareholders does not determine the implementation report, if a firm fails this advisory vote in a year while the future remuneration policy is not provided for either, this failure will require the board to provide a new pay policy for the next year's shareholder vote.[33] If the implementation

[31] Herbert Smith Freehills LLP, P. Ellerman, M. Ife, G. Roberts & C. Shutkever, "Directors' Remuneration Reports: Key themes to emerge", July 2014, available at: http://webcache.googleusercontent.com/search?q=cache:I2EHADb6_ccJ:www.herbertsmithfreehills.com/-/media/Files/ebulletins/2014/20140703%2520-%2520UK%2520corporate%2520governance%2520update%2520%2520Remuneration.htm+&cd=1&hl=en&ct=clnk&gl=uk&client=safari last accessed, 13 July 2016

[32] *Supra,* n.20, PwC, "Executive Remuneration: simple, practical proposals for implementing the new disclosure requirement", p.33

[33] Section 226D, Companies Act 2006

report fails when the pay policy is passed by the shareholder vote, the pay policy will not need to be presented for resolution at the next annual meeting.[34]

The requirement to revise failed implementation reports so they can be reviewed by the shareholders next year can certainly prevent the board from paying executives in a non-transparent way, and will help to satisfy shareholders in monitoring the compensating behaviour of the company. Also, since the reform has drawn significant attention to giving a binding say on pay to UK shareholders, the vote and review of shareholders on the implementation pay report is rather important. There are many uncertain factors surrounding new pay policies, and the flexibility and discretion in the implementation report reflect how far the board and remuneration committee can be trusted in drawing up new pay policies. The vote, one would think, enables the board and the remuneration committee to have an appreciation of what the shareholders are willing to accept.

There are concerns left in relation to both of the pay policy report and the implementation report. The transparency and disclosure requirements not only increase the burden of the board in making the remuneration report, but also the burden of shareholders in reading the report. According to PwC's research on investors' views of the new law, "excruciating" is the word used to describe the shareholders' experience in reading and commenting on executive pay reports.[35] Based on this survey, the length of pay reports from the FTSE 100 companies has increased by an average of 38% since 2012, with the average report running to twenty pages in length.[36] Shareholder's tiredness in reading and understanding the remuneration report may lead to a voting result that is not as modest as the transparency requirements have expected.

Second concern, is that there is no definitive guidance on how to report the components in the pay policy and in the pay report. The requirements to report

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[34] *Ibid.*

[35] PwC, "Remuneration Reporting-A year on, Considerations for 2014-2015 remuneration reports", available at: http://www.pwc.co.uk/human-resource-services/issues/remuneration-reporting-a-year-on.jhtml last accessed, 13 July 2016

[36] *Ibid*.

the maximum level for each pay component in remuneration packages have been tackled in various ways by different firms. Generally, in a pay policy, there will be several maximum requirements for each component of executive pay, and this is done by setting a fixed sum requiring there will be no higher amount paid to the director, or a maximum percentage increase in his or her incentive pay plan. In a pay implementation report, the factors which have influenced the scope and the maximum requirements will be listed and specified. Some companies simply avoided these requirements and did not state any maximum requirement set for the increase rate of executives remuneration in their pay policy reports, while others provided a maximum figure that was nearly impossible to achieve.[37]

Thirdly, because there are no clear guidelines and shareholders cannot observe the alignment of pay with performance, investors tend to rely on the opinions of advisory groups in making their decisions at annual meetings. This may lead to dissatisfaction among the board and executive directors with company investors, since they would tend to blame shareholders for being lazy and reluctant to read and think carefully of the remuneration report. After taking advice from the ISS, the institutional shareholder service, JP Morgan's institutional shareholders expressed serious dissatisfaction about the compensation of their CEO, Jamie Dimon.[38] Dimon's $20m, which included $7.2m in cash, was voted against by 38.1% of the shareholders. Although JP Morgan drew up their executive pay policy based mainly on ISS guidelines, the big proportion of dissent in the voting caused confusion for the compensation committee. JP Morgan's board was concerned about their international shareholders "automatically" outsourcing their investigations to ISS, and Dimon even called the shareholders "lazy" and "irresponsible".

[37] P. Ellerman, M. Ife, G. Roberts & C. Shutkever. Directors' Remuneration Reform, 2014, available at Lexology: http://www.lexology.com/library/detail.aspx?g=0285c9a2-70bc-4811-b4f0-675b78739725, last accessed, 13 July 2016

[38] The Guardian, "JP Morgan takes advice from firm that its chief attacked" 15 June 2015, available at: http://www.theguardian.com/business/2015/jun/15/jp-morgan-advice-jamie-dimon-voting last accessed, 13 July 2016

The former UK Business Secretary Vince Cable expressed his dissatisfaction in excessive level of executive pay at a meeting with the biggest firms' remuneration committee chairmen, criticising that these companies have observed the law but ignored its spirit.[39] If companies and investors did not cooperate responsibly, Dr. Cable (now Sir Vince Cable) threatened that: "under such circumstances, I would consider options including stricter regulatory oversight of pay reports and policies, a requirement on shareholders to disclose how they have voted on pay, or a requirement to consult employees on pay. This is the time for companies, and investors, to show they can act responsibly."[40] However, since his Party has lost being part of the government and Dr. Cable is no longer a Minister, stricter regulation may now be off the agenda, and it is still too early to tell whether shareholders are "lazy", since the new reporting requirements have not improved that much.

B.1.3 New restrictions relating to unauthorised remuneration and loss of official payments

If a company makes a payment or operates a pay policy without the approval of the shareholders, this payment should be held on trust by the recipient, and either the directors on behalf of the company or the shareholders pursuing an action in court may have the right to recover this payment from the recipient.[41] If recovery is not possible, the directors who authorised the payment will be liable for this amount of money, but the directors may be relieved of liability by the court if they made the payments on an honest and reasonable basis.[42]

New restrictions are provided by the reform to ensure that the shareholder say on pay will be secured and the firm will not need to pay for unnecessary recruitments and failures. After 1st October 2013, remuneration payments and any monetary loss of the firm that is inconsistent with the approved

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[39] International Business Times, L. Brinded, "Cable Warns FTSE 100 Firms: Curb Execs' Pay or We'll Do it For You", April 2014, available at: http://www.ibtimes.co.uk/ftse-100-firms-pay-bonuses-under-political-threat-1445660 last accessed, 13 July 2016
[40] *Ibid.*
[41] Sections 260, 226B, 226E (2), Companies Act 2006.
[42] Section 226E, Companies Act 2006.

remuneration policy are not lawful.[43] These restrictions are set to prohibit golden hellos, golden goodbyes and any compensation for executive failure. According to section 226B of the Companies Act 2006, public companies in the UK may not give any remuneration to a person who "is, or is to be or has been, a director of the company", unless this payment is listed in the approved pay policy or this payment has been approved by a resolution of the shareholders.[44]

However, golden goodbyes seem not so easy to eliminate. In June 2015, one of the UK's leading supermarket firms, Morrisons, experienced a shareholders' revolt with 35.6% of them voting against the bonus paid to the dismissed CEO Dalton Phillips.[45] Even though Phillips was sacked in January 2015 because of Morrisons' decline in sales and profits in the supermarket industry, he was still able to have his compensation including a £850,000 salary, a £213,000 pension payment and other personal benefits worth £28,000.[46] Morrisons' chairman stated that this additional £1m bonus rejected by 35.6% of the shareholders was compensation for Phillips' loss of his restricted share options.[47] As mentioned in Chapter 3, this restricted equity option is set to prevent managers from losing their position in the short term. The extra bonus designed by the Morrisons board has made this restricted share option meaningless. Nonetheless, Morrisons' shareholder revolt over this issue still failed to stop their former CEO from taking his bonus, because a veto by only one third of the shareholders, even though unusually high, was still not enough to make the board change its policy.

Tesco, the biggest supermarket in the UK, still lawfully gave its former CEO nearly £10m for equity options and bonus, at its 2015 annual meeting.[48] During

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[43] Sections 226B, 226C, Companies Act 2006.
[44] Section 226C, Companies Act 2006.
[45] The Guardian, "Morrisons' Shareholders Protest Over £1m Bonus for Sacked Former CEO" 4 June 2015, available at: http://www.theguardian.com/business/2015/jun/04/morrisons-shareholders-protest-bonus-sacked-chief-executive last accessed, 13 July 2016
[46] *Ibid*.
[47] *Ibid*.
[48] CMI, "Six Bosses Who Were Rewarded for Failure" July 2015, http://www.managers.org.uk/insights/news/2015/july/six-bosses-who-were-rewarded-for-failure-and-why-it-is-so-dangerous, last accessed, 13 July 2016

the meeting, an accounting scandal was still being investigated and the worst company profits in the past forty years had been reported under this CEO's leadership.[49] The reason why the huge amount of share payback and bonus could be paid for failure is the same as in the Morrisons case above – although shareholders were given the power to veto the pay policy, the extent of the revolt was not enough to stop the pay.[50] According to the revised UK Corporate Governance Code 2016, which will be discussed later in this chapter, any pay policy that has gained a serious proportion of dissenting votes will require an explanation by the board for how they are planning to deal with the situation.[51] However, since the Code is based on "Comply or Explain", which means that principles of this Code is not compulsorily applied by companies, this requirement applies only if it raises concern over a firm's reputation. One serious outcome that may happen from a ruined reputation of the board, as Bebchuk described, is the "outrage cost" stemming from the devaluation of a firm's reputation in the markets.[52] Bebchuk suggests that the outrage cost will act as a warning for other managers and companies, stopping others from deviating from optimal pay policies that satisfy both investors and the public. Further effects from the shareholder engagement and board reaction perspectives will be mentioned later.

B.2 The new law's popularity and its implementation in companies

B.2.1 Merits

Generally, in the first year of the binding say on pay, nearly every firm listed on the London Stock Exchange passed both their company's pay policies and

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[49] *Ibid.*
[50] The Guardian, "Tesco Faces Shareholder Unrest Over Executive Pay" 26 June, 2015, http://www.theguardian.com/business/2015/jun/26/tesco-sales-drop-13-but-outperform-market-expectations last accessed, 13 July 2016
[51] FRC, the UK Corporate Governance Code 2016, available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx, last accessed, 13 July 2016
[52] L. Bebchuk & J. Fried, "Paying for Long-term Performance" (2010) 158 *University of Pennsylvania Law Review* 1915, p.1940

implementation reports.[53] Kentz, a Jersey incorporated company which was going to face a takeover after its 2013 annual meeting,[54] suffered the very first shareholder defeat on an executive remuneration report among all of the FTSE 350 companies after the implementation of the voting reform, with only 42.4% in favour of its executive remuneration report.[55]

In March 2015, the Department for Business, Innovation and Skills ("BIS") published a research paper on how the listed companies in the UK and their shareholders have responded to the new say-on-pay legislation in the first financial year since the enactment of the law. BIS based their study on the level of compliance with the regulation in a variety of UK incorporated public firms selected from listings on the London Stock Exchange.

First, in terms of shareholder voting results, BIS found that generally, shareholders were more likely to vote against remuneration policies in 2014 than they had been five or six years previously, except for the year of 2012, which was the so-called "shareholder spring".[56] Moreover, shareholders have shown a higher level of dissent about future remuneration policies than about remuneration implementation reports.

On the aspect of the level of executive pay, the research shows that the increase in pay "radically slowed" during the years of 2013 and 2014. Evidence provides that, in the five years before the year 2015, the increase in the median level of executive pay peaked in 2010 in all of the listed companies, with figures

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[53] Towers Watson and Willis, "Corporate Governance and Executive Compensation in the UK and Europe", September 2014, available at: https://www.towerswatson.com/en-GB/Insights/Newsletters/Europe/HR-matters/2014/09/Corporate-governance-and-executive-compensation, last accessed, 13 July 2016

[54] CTV News, "Shareholders of U.K.-based Kentz say yes to SNC-Lavalin takeover deal" August 2014, available at: http://www.ctvnews.ca/business/shareholders-of-u-k-based-kentz-say-yes-to-snc-lavalin-takeover-deal-1.1954894, last accessed, 13 July 2016

[55] Financial News, "Kentz suffers first-ever binding defeat on executive pay", May 2014, available at: http://www.efinancialnews.com/story/2014-05-16/kentz-first-ever-binding-defeat-executive-pay-agm?ea9c8a2de0ee111045601ab04d673622 last accessed, 13 July 2016

[56] BIS, "How Companies and Shareholders Have Responded to New Requirements on the Reporting and Governance of Directors' Remuneration" March 2015, Research paper No. 208, p.8

varying between 8% and 15%.[57] In 2013, the median executive pay level showed no increase at all in the FTSE 100 companies, with increases of only 3% to 4% in AIM, Small-Cap and Mid-Cap firms.[58] Additionally, BIS introduced research done by MM&K which referred to statistics that show that the average total remuneration level of the FTSE 100 companies' executive manager fell by 5% in 2012 and fell by 7% in 2013, however increased in the year of 2014.[59] The MM&K report further points out that the increase in the average level of FTSE 100 companies' executive pay in 2014 was because of recent share price improvements, which shows the alignment between pay and performance.[60]

The third aspect of the BIS report which should be mentioned is the changes in the structure of executive remuneration design. According to its surveys on executive compensation, BIS proposes that basic salary and cash bonuses are increasing at an observable rate. The FTSE 100 executives' median salaries and bonuses increased by between 2% and 2.7% in 2013 and 2014, compared to their median salaries and bonuses increasing by 7% in 2009 and 17% in 2010, though there was a decrease of 5% in 2012.[61] Among the smaller companies, the AIM firms show a median executive salary increase from 2% to nearly 4% in 2013 with no increase in bonus since 2008, while Small-Caps and Mid-Caps firms increased basic salary by 3% in 2014, and increased bonuses by 3% and 16% respectively.[62] Since the increasing level of salary and bonus payments is low compared to the total level of median income, it is clear that the median level of executive pay is increasing due to the increasing level of financial incentives. Also, according to the BIS report, the larger the firm is, the larger the proportion of its long-term incentive plans (the "LTIP") increases in relation to the whole remuneration.[63] However, BIS did not mention the increasing rate of equity incentives compared to the previous values of equity income. Financial options and LTIPs are measured in comparison to salaries in the corresponding year; for example, the FTSE 100 executives' median

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[57] *Ibid*. p.59
[58] *Ibid*.
[59] *Ibid*.
[60] *Ibid*. p.63
[61] *Ibid,* pp.60-1
[62] *Ibid*.
[63] *Ibid,* p.63

financial pay was above 200% of their salaries, but this figure reduced to 150% in 2013.[64]

BIS concludes that on average the legislation on shareholders' binding vote has helped the UK public companies in reducing the total value of new remuneration rewards to their directors over the years of 2013 and 2014.[65]

However, there are some concerns raised from the BIS study. The figures for executive pay levels that BIS used to reflect the changes caused by the binding say on pay, and its conclusion that the value of average executive income has been reduced, are quite different from the figures that can be found in other organisations' reports. Reports from Deloitte and KPMG both have shown that the executive directors of FTSE 350 companies still enjoyed their income increasing since the enactment binding say on pay reform, with the pay gap between executives and formal employees also increased.[66] The methods that BIS used to describe changes in the level of pay and other financial incentives in pay, did not adequately explain why the value of equity payments and other long term incentive plans have been reduced since the introduction of the new law. Furthermore, the outcome of the survey seems too optimistic in stating that the reform has worked well in dealing with shareholder requirements and helping to promote the success of public firms. However, from the time perspective, it is too early to say that a binding say on pay will bring any huge merits on improving the structure of pay and reducing the level of pay. It is also too early to conclude that the new regulations will fulfill their goal of securing the relation between pay and performance, whatever methods the government may use to embellish their results. The date of this report was before Vince Cable stepped down as secretary of BIS, which makes it a little suspicious that

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[64] *Ibid*
[65] *Ibid*. p.8
[66] Deloitte, "Your Guide: Directors' remuneration in FTSE 100 companies", p.10, October 2015; "Your Guide: Directors' remuneration in FTSE 250 companies", October 2015, p.8, available at: http://www2.deloitte.com/uk/en/pages/tax/articles/executive-pay-publications.html last accessed, 13 July 2016; KPMG, "KPMG's Guide to Director's Remuneration 2015", p.19, available at: https://home.kpmg.com/uk/en/home/insights/2015/09/kpmgs-guide-to-directors-remuneration-2015.html last accessed, 13 July 2016.

there is nothing but positive evaluation of the new regulation which was proposed by Dr. Cable.

B.2.2 Three Big Concerns

Pay for Underperformance

Collected from the reports of other consulting institutions, although the average pay level is not increasing rapidly, underperformance is still being rewarded, sometimes even richly.[67] According to the Chartered Management Institute (CMI), in the year of 2015 nearly 30% of directors of UK listed companies were still paid with a high annual bonus for their underperformance, and this figure rose to 45% of the executive directors, with the average bonus paid to these executives standing at £8,873 per year and the highest of them paid £44,687.[68] Despite the general criteria set for bonus design described in Chapter 3, that bonus should be paid for certain performance of the firm and the manager, "the biggest and most significant indicator of whether someone will get a bonus this year is whether or not they got one last year. The longer that goes on, the more people come to rely on the money and the harder it is to stop paying it".[69]

Complicated Pay Reports

From the shareholder satisfaction perspective, a study by PwC has shown that, despite more information provided in the pay implementation report, the quality of communication between shareholders and firms has declined since the link between director's pay and company strategy was felt to be "poorly addressed".[70] Consultations among investors have shown that a summary

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[67] The Guardian, "Managers' rich rewards for poor performance" 3 June 2015, available at: http://www.theguardian.com/business/2015/jun/03/managers-rich-rewards-for-poor-performance last accessed, 13 July 2016

[68] CMI, "Underperforming, Yet Still Paid A Bonus: 2015 national management salary survey results" 2016, available at: http://www.managers.org.uk/insights/news/2015/june/underperforming-yet-still-paid-a-bonus-2015-national-management-salary-survey-results last accessed, 13 July 2016

[69] *Ibid*.

[70] PwC, "Remuneration reporting-a year on: Considerations for 2014/15 remuneration reports" November 2014, p.14

written after the chairman's statement, which could provide a link between pay and firm strategy, the pay report table and the outcomes of performance measures, is needed to enable better communication for shareholders, who will need something that is easier for them to read and understand.[71] Also, as nearly half of the FTSE 100 companies did not have their financial targets for annual bonuses reviewed by shareholders on grounds of commercial sensitivity, from the PwC report it would seem that the shareholders felt that firms should put effort into more detailed disclosure of the bonus plan, while retrospective bonus targets are also welcomed.[72]

Concerning the narrowing of reporting issues discussed in the binding say on pay, in 2012, BIS published their draft provisions for large and medium-sized companies in accounting and reporting regulations, requiring detailed and modernised reports drawn up by the board for shareholder resolution at annual meetings.[73] This regulation aims at improving transparency and corporate governance through providing a more strategic report instead of various and complicated business reviews that were shown to the investors. Under this regulation the company must provide information about each director's shareholding, including shares held outright, share awards and options subject to performance conditions, share awards and options subject to service conditions, and vested but not exercised options.[74]

<u>The Increasing Pay Gaps</u>

Several ways to regulate executive remuneration have been provided by various organisations concerned about different interests. The High Pay Centre suggests that the government should pay attention to the comparison between

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[71] *Ibid*. p.16
[72] *Ibid*.
[73] UK Government Legislation, The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, available at: http://www.legislation.gov.uk/ukdsi/2013/9780111100318/introduction last accessed, 13 July 2016
[74] UK Government Legislation, The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, http://www.legislation.gov.uk/uksi/2013/1970/contents/made last accessed, 13 July 2016

executives' and employees' pay packages. They propose that there should be a cap for executive compensation, set at a fixed multiple of the pay of the firm's lowest-paid employee.[75] According to their report, executive remuneration in the UK has increased from 60 times that of the average worker in the late 1990s to nearly 180 times, and the average level of executive pay has grown from £4.1 million in 2012 to 4.7 million in 2013.[76] The gap between executives and normally paid employees continues to grow.[77] For example, in the US the Corporate and Financial Institution Compensation Fairness Act 2010 requires a disclosure of the pay gap between the remuneration of directors and that of the ordinary employees in the company. Additionally, organisations including the Local Authority Pension Fund and the Pensions and Investment Research Consultants (PIRC) have expressed their opinion to the Financial Reporting Council (FRC) that many companies have failed to explain why they did not take the wider workforce into consideration when they set the executive compensation.[78]

From all of above, the reform of binding say-on-pay has brought several changes in the executive remuneration design and implementation. With the FTSE 350 companies' high application of the regulation towards this reform in reporting remuneration policy and report, shareholders are able to vote on these policies and reports based on a broader consideration. The binding say on pay has provided a warning for the remuneration committee and the board in setting the level and the structure of executive pay. According to the feedback study obtained by BIS, the increasing rate of the executive pay level in the years of 2013 and 2014 has been slowed down by this binding say on pay. However, certain problems still remain unsolved. The biggest issue among them is pay for failure. Despite the fact that the press is always reporting cases concerning

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[75] High Pay Centre, "Reform Agenda: How to make top pay fairer" (July 2014), available at: http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer last accessed, 13 July 2016
[76] *Ibid*
[77] *Supra*, n.132, Petrin, p.204
[78] FRC, Responses to Consultations, available at: https://frc.org.uk/Our-Work/Response-to-external-consultations.aspx last accessed, 13 July 2016

pay for failure in an acerbic tone, the reform is still unable to stop those golden goodbyes from happening.

C. The Swiss law

C.1 Corporate Governance Background

There are twenty-six states and four main governing political parties in the Swiss federal government. The Swiss constitution covers the majority of public issues, including foreign relations, the army, railways, and general legislation on the economy.[79] Switzerland is one of the most important financial centres in the world, providing an ideal environment for international-based corporations.[80] In Switzerland, listed companies have the choice of structuring their boards on a one-tier or two-tier basis.

Before the binding say on pay was passed as a new legislative requirement for executive pay in Switzerland, the Swiss Code of Best Practice provided several general recommendations around this corporate governance issue.[81] Some of the Code rules, such as the requirement that executive remuneration should include fixed and variable components concerning the medium and long-term sustainability of the firm, incentive plans should be reduced or eliminated if targets are not met, and stock options should be exercised above their market value on the grant date and not be subject to any retesting,[82] showed no material difference from other European countries.[83] However, in 2013 Switzerland became the fourth nation on the European continent to provide shareholders with a binding vote on executive pay, after the Netherlands (which implemented a binding vote in 2004), Norway and Sweden.

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[79] Swiss Government, information available at: https://www.admin.ch/gov/en/start.html last accessed, 13 July 2016

[80] Direct information from: http://swiss-economy-business.all-about-switzerland.info, whose information is supported by https://www.admin.ch/gov/en/start.html last accessed, 13 July 2016

[81] Swiss Code of Best Practice, Section 4, appendix one, available at: http://www.economiesuisse.ch/en/Pages/default.aspx l last accessed, 13 July 2016

[82] *Ibid*.

[83] *Ibid*.

With the aim of improving the Swiss economy, private property, and to protect their shareholders, several devices known as "Mind Initiative" or "against rip-off salaries" were provided under article 95 of the Swiss Constitution.[84] However, there is a two-year period before these provisions become legislative enactments and are put in force: they will remain optional for public firms to choose from changing or remaining their pay policies in a period from January 2014 to January 2016.[85]

The provisions in article 95 include significant requirements around the independence of the board, the disclosure rules for directors' pay, and shareholder approval for corporate changes, including the capital management of the firm.[86]

The binding vote referred to above is primarily based on the Swiss Code of Obligations, which has been part of the Swiss federal law since 1911. If there is any conflict in applying the Code of Obligations as well as the transitional provisions mentioned above, it will be the transitional provisions that take priority. It is necessary to emphasise that the Minder Initiative rule under the transitional provisions requires public companies to specify prospective or retrospective binding shareholder votes on executive pay in their articles of association.[87] Prospective votes concern the maximum budget payable to managers during the next fiscal year, while retrospective votes approve the levels of remuneration based on executive directors' performance.

It has been one and a half years since the enactment of the revised Code of Obligation and the Minder Initiative were passed, but no significant changes

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[84] Federal Constitution of the Swiss Confederation 1999, Article 95 (3): "For the protection of the economy, private property and shareholders, and to guarantee sustainable corporate governance, the law shall regulate Swiss companies limited by shares listed on stock exchanges in Switzerland or abroad in accordance with the following principles…"

[85] Glass, Lewis & Co., "Guidelines-2014 Proxy Season, An over view of the Glass Lewis approach to proxy advice", available at: http://www.glasslewis.com last accessed, 13 July 2016

[86] *Supra*, n.84, Federal Constitution of the Swiss Confederation

[87] *Supra*, n.85, Glass, Lewis & Co.

have appeared in their implementation. According to a PwC survey, only 14% of the companies in their sample stated that they had fully prepared for the implementation of the ordinance, while nearly 75% of the companies were still engaging in preparatory work for the new law.[88]

C.2 Swiss Binding Say on Pay

In contrast to the UK, Swiss government chose to regulate their binding shareholders' say on pay under Swiss constitutional law, specifically section 7 (The Economy), article 95(3). Swiss law is much briefer in explaining the say on pay than that in the UK. There are three main factors that can be concluded from the provisions.

First, the shareholders receive an annual binding vote on all of remuneration policies of the members of the board, including non-executive and executive directors and advisors.[89] Institutional investors in pension funds must disclose all the information explaining how they voted and their decisions about the pay policies.[90]

Second, executive directors are not allowed to be compensated in a variety of situations, such as bonuses earned from company purchases and sales, or consultant work done for other companies within the same group. Executive remuneration is strictly within the scope that is regulated by the articles of the association, while golden goodbye and golden hello agreements are prohibited.[91]

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[88] PwC Switzerland, Initial Trends Regarding the Implementation of the Minder Rules, 2014, p.7

[89] *Supra*, n.84, Federal Constitution of the Swiss Confederation 1999, article 95 (3)(a): "the general meeting votes on an annual basis on the total amount of all remuneration (money and the value of benefits in kind) given to the board of directors, the executive board und the board of advisors. It elects on an annual basis the president of the board of directors, the individual members of the board of directors and the remuneration committee, and the independent representatives of voting rights…"

[90] *Ibid*, article 95 (3)(a): "Pension funds vote in the interests of their insured members and disclose how they have voted."

[91] *Ibid*, article 95 (3)(b): "the governing officers may not be given severance or similar payments, advance payments, bonuses for company purchases and sales, additional

Third, article 95 (3)(d) provides the consequences of violating the above provisions. Any person who disobeys these regulations will receive a custodial sentence of less than three years, and a monetary penalty which is no larger than six times his/her annual remuneration.[92] This "person" maybe non-executive director or executive director under this provision's circumstance.

There are three major differences in the Swiss binding say on pay compared to the UK regulations.

The first is that in Switzerland shareholders are required to vote on executive pay policies on an annual basis, while UK shareholders only need to vote once in a three-year period for their binding say, and their annual voting rights on the pay implementation report stay at an advisory level. There are no explanations from either of these countries about why companies should submit their pay policies to shareholders for approval on a three-year or an annual basis. However, it is hard to know whether the binding vote may suffer from decreased efficiency from being held every year. Furthermore, the stricter rule in Switzerland might be intended to show respect to international shareholders, by providing the annual binding vote on remuneration policy to ease their concerns around executive pay.

Second, it is not an offence in the UK if there is violation of any of the company law regulations on say on pay, but the Swiss government provides that it is an offence and prescribes both custodial sentences and monetary punishments for violation. Although directors in the UK who make an unauthorised payment may be held liable for this payment, their only punishment is to compensate the

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contracts as consultants to or employees of other companies in the group. The management of the company may not be delegated to a legal entity;"

(3)(c): "the articles of association regulate the amount of credits, loans and pensions payable to governing officers, their profit-sharing and equity participation plans and the number of mandates they may accept outside the group, as well as the duration of employment contracts of members of the executive board"

[92] *Ibid*, article 95 (3)(d): "Persons violating the provisions under letters a-c are liable to a custodial sentence not exceeding three years and to a monetary penalty not exceeding six times their annual remuneration."

firm. The Swiss regulation may have more efficient effects in warning managers not to disobey binding rules, and the shareholders' power would be ensured. However, the possibility of introducing custodial sentences in the UK is rather low, since UK does not have a tradition in sentencing directors because of executive compensation issues and criminal prosecutions are often based on company's or employee's fraud and bribery behaviours[93]. This thesis will not have further discussions around custodial sentencing directors because of executive pay.

Third, shareholders in Switzerland have the right to veto the remuneration not only of executive directors but also of non-executives, while in the UK there is no direct requirement regulating that remuneration of the directors other than executives on the board. This vague definition of whose pay can be voted on by shareholders has been explained by BIS in a "frequently asked questions" section: that shareholder's voting on the non-executive directors' remuneration policy are optional for public companies.[94] Swiss regulation does a better job from the agency theory perspective, since the shareholders have the power to veto the remuneration of non-executive directors who create pay policies for themselves and the executives; non-executive directors will tend to be more cautious or else their pay policy may be rejected and their pay level may be lowered due to shareholders' dissatisfaction towards their work in designing pay packages of the executives. In the UK, certain legislation towards other members on the board is needed: not only should there be regulations requiring that non-executive compensation should be subject to shareholder approval, but also the guidelines for how to incorporate a remuneration committee with all the members be independent non-executive directors.[95] This legislation suggestion will be discussed further in the next chapter.

[93] J. Grimes, R. Niblock & L. Madden, "Corporate Criminal Liability in the UK: The introduction of deferred prosecution agreements, proposals for further change, and the consequences for officers and senior managers", available at: http://uk.practicallaw.com/4-547-9466?q=&qp=&qo=&qe=#a500135 last accessed, 13 July 2016
[94] *Supra,* n.17, BIS, p.12
[95] FRC, The UK Corporate Governance Code 2016, D.2.1: "The board should establish a remuneration committee of at least three, or in the case of smaller companies, two independent non-executive directors". Thus,

Overall, because of the different political regime in Switzerland, the Constitution merely gives the above general requirements, with detailed regulations implemented by individual states within the federation.

As the Swiss binding say on pay was not fully applied until the end of 2015, its outcome is still not very clear. A concern about the influence of strict rules on large financial institutions has been raised. Although Switzerland has held the top position in the World Economic Forum Ranking for seven years till 2015,[96] the binding say on pay will make it harder for international banks to attract, retain and motivate their managers, which may lead to a decrease in competitiveness on the financial markets in the future.[97] Certain complaints came from some high-profile business leaders, such as the CEO of Nestle SA, Paul Bulcke, stating that changes in corporate governance and company law had given shareholders too much power, and Sergio Ermotti, the chairman of Switzerland's biggest Bank, UBS, suggesting that regulations on remuneration and companies should be meaningful and useful and the Swiss laws are not.[98] The concern on economic competitiveness helps to explain why Swiss voters turned down a referendum vote to cap executive pay to under twelve times that of ordinary employees,[99] so as not to lose the country's global standing as an important financial centre.

II. Behind the Regulation

[96] Bloomberg Business, "Switzerland Beats Singapore, U.S. in Competitiveness Ranking" September 2015, available at: http://www.bloomberg.com/news/articles/2015-09-29/switzerland-beats-singapore-u-s-to-top-competitiveness-ranking last accessed, 13 July 2016

[97] BreakingViews, "Minder Surprise" April 2015, http://www.breakingviews.com/swiss-say-on-pay-bodes-ill-for-rainmaker-wallets/21192553.article last accessed, 13 July 2016

[98] BloombergBusiness, "ABB, UBS Chiefs Say Red Tape Threatens Switzerland's Success" January 2016, available at: http://www.bloomberg.com/news/articles/2016-01-22/abb-ubs-chiefs-say-red-tape-threatens-switzerland-s-success last accessed, 13 July 2016

[99] The Guardian, "Switzerland votes against cap on executive pay" 24 November 2014, http://www.theguardian.com/world/2013/nov/24/switzerland-votes-against-cap-executive-pay last accessed, 13 July 2016

A. Institutional and Overseas Shareholders in the UK

The UK government's shareholder primacy policy[100] has been growing under the influence of its institutional and overseas shareholders. As Professor Christine Mallin concluded, in 1963, 54% of the UK public shares were in the hands of individual investors, but by 1989 this ratio had dropped to under 21%, and in 2006 it had decreased further to only 13%. Meanwhile, the fraction of shares owned by institutional shareholders (mainly insurance companies and pension funds) saw their shares rise from 17% in 1963 to 30% in 2006.[101] At the same time, the percentage held by international shareholders grew from 7% in 1963 to 40% in 2006.[102]

Banks, pension funds, insurance companies and several labour unions own shares in British public companies, with currently only a few FTSE 100 firms' shares being held by UK's private investors.[103] According to statistics collected in December 2012, in general 54.5% of the FTSE 100 companies' shares were held by overseas shareholders, while 36.5% of them were held by institutional shareholders and only 9% by individual investors.[104] In 2014, data show that the broad fraction of share ownership in the UK stock market remains almost the same as it was in the end of 2012, with international shareholding increasing to 54% and individual shareholding growing to 12%.[105]

With such a large percentage of shares concentrated in their hands, the power and influence of shareholders who are institutional and overseas cannot be ignored. Four important corporate governance reports[106] have shown that

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[100] Hansard, Enterprise and Regulatory Reform Bill, section 2012-13, http://www.publications.parliament.uk/pa/cm201213/cmpublic/enterprise/120717/pm/120717s01.htm last accessed, 13 July 2016

[101] C. A. Mallin, *Corporate Governance*, 4th (Oxford, Oxford Press, 2013) p.106

[102] *Ibid*.

[103] E. Ndzi, "Director's Excessive Pay and Shareholder Derivative Action" (2015) 144 *Company Lawyer* 144, p.145

[104] *Ibid*.

[105] Office for National Statistics, "Ownership of UK Quoted Shares: 2014", available at: http://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02#pension-funds-holdings-of-uk-shares-by-value last accessed, 13 July 2016

[106] Cadbury Report 1992, Greenbury Report 1995, Hampel Report 1998, Myners Report 2001.

these shareholders are taken seriously by the UK government, and are also expected to have a positive influence on the firms they have invested in.[107] Also, principles laid down by institutional shareholders themselves, such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), have provided guidelines which deal with the relationship between institutional shareholders and firms to ensure long-term investments and profits, under certain provisions of the UK Corporate Governance Code. Significant cooperation was achieved in 2002 when the ISC (the Institutional Shareholder's Committee) (now the IIC, the Institutional Investors Committee[108]) was formed by the ABI, the NAPF and other two big institutions.[109] The ISC provides recommendations for shareholders about how to provide clear statements on how firms will be monitored, how institutions will deal with any conflict of interests, and the circumstances under which institutions will intervene in the business of the investee companies.[110] One of the ISC's statements of principles, published in 2007, concerned voting disclosures which may contribute to shareholders' reviews of voting policies on previous company issues. On executive remuneration issues, this voting disclosure may help to remind shareholders of the pay reports they have voted for or against, since investee public firms may choose to have their pay policies renewed for voting every three years, according to the new law.

Institutional shareholders are powerful and important to the UK economy, the reason why the Government has provided a binding say on pay may not be simply because of the excessive remuneration level of the executives, but also from the concern towards the satisfaction of its institutional shareholders. If the

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[107] Cadbury Report 1992: "We look to the institutions in particular, to use their influence as owners to ensure that the companies in which they have invested comply with the Code," available at: http://cadbury.cjbs.archios.info/report, such comments also are mention in the other three reports. Specifically in the Myners Report published by HM Treasury, institutional shareholders' trusteeship are emphasised; available at: http://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/myners-report last accessed, 13 July 2016

[108] Institutional Investor Committee, http://www.iicomm.org/index.htm last accessed, 13 July 2016

[109] These two are the AITC, the Association of Investment Trust Companies, and the IMA, the Investment Management Association.

[110] The ISC Code, available at: https://www.uss.co.uk/news/all-news/2014/03/uss-and-the-new-stewardship-code last accessed, 13 July 2016

introduction of a binding say on pay is because of the satisfaction of shareholders in expressing their disagreement with remuneration policies, the binding vote may not help in improving the accountability of the board or pay practices as the law intends it to if institutional shareholders are "reluctant to just vote no".[111]

B. From Advisory to Binding: Satisfying the Shareholders?

In the UK this binding vote is provided by the Enterprise and Regulatory Reform Act 2013, which made amendments to the Companies Act 2006. There were concerns about this voting right at all stages of the discussion of the Bill. The provision for regulating executive pay while giving shareholders a binding vote is more like a "gesture" from the British Government to investors, especially institutional investors, to indicate that they are willing to provide shareholders with more power in governance and extend the 2012 "shareholder spring", even though few foreign institutional shareholders have any general idea of UK corporate governance.[112]

Before the proposal of a binding say on pay, in 2011 Dr. Vince Cable, the then Secretary of BIS suggested:

> "Britain does have some world-class executives and one of the real privileges of my job is dealing with them. But let's not forget that, using the FTSE 100 as a benchmark, investors have barely seen a return since the turn of the century. For most of that time, they would have been better off investing in government bonds."[113]

He also emphasised the pay gap between managers and other employees: "in 2010, the average total pay for FTSE 100 chief executives

[111] K. M. Sheehan, *The Regulation of Executive Compensation: Greed, Accountability and Say on Pay* (Cheltenham, Edward Elgar Publishing Ltd, 2012) p.29
[112] *Supra*, n. 103, E. Ndzi, p.147.
[113] The Telegraph, "Vince Cable attacks executive pay levels", June 2011, available at: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8592727/Vince-Cable-attacks-executive-pay-levels.html last accessed, 13 July 2016

was 120 times that of the average UK employee. Back in 1998, the multiple was 45."[114]

In January 2012, Dr. Cable told the House of Commons that "we cannot continue to see chief executives' pay rising at 13% a year while the performance of companies on the stock exchange languishes well behind."[115] Cable said the companies would be required to publish "more informative remuneration reports" for shareholders, and "the Government planned to focus on greater transparency over pay deals, giving shareholders tougher powers, creating more diverse boards and remuneration committees, and sharing business best practice."[116] From the speeches that Cable gave in favour of reform in executive pay, it can be concluded that the government was seeking to reduce the level of executive remuneration, increase the alignment of pay and performance and guarantee the transparency of pay policies and reports. However, these three aims have not been completely fulfilled.

Early in the First Reading stage of the Bill, Vince Cable promised that "the measures in the Enterprise and Regulatory Reform Bill will help make Britain one of the most enterprise-friendly countries in the world."[117] In an early resolution debate he stated that to prevent the shareholder spring from being a seasonal phenomenon, it would be necessary to provide a guarantee to investors to keep directors accountable.[118] Although he mentioned fairness in pay as an important factor in director compensation, he implicitly ignored another MP's (Simon Hughes) question about putting employee representatives on boards of public companies to give them power as far as a say on pay is concerned.[119] Moreover, he did not provide any answer in relation

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[114] *Ibid*.
[115] The Telegraph, "Vince Cable: shareholders should hold binding votes on executive pay" (January 2012), available at: http://www.telegraph.co.uk/news/politics/9033594/Vince-Cable-shareholders-should-hold-binding-votes-on-executive-pay.html last accessed, 13 July 2016
[116] *Ibid*.
[117] UK Parliament, Bill Stages, Enterprise and Regulatory Reform, 2012-13, available at: http://services.parliament.uk/bills/2012-13/enterpriseandregulatoryreform/stages.html last accessed, 13 July 2016
[118] Hansard, Money Resolution, 11 June 2012, Column 72, available at: http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm120611/debtext/120611-0002.htm#12061114000001 last accessed, 13 July 2016
[119] *Ibid*.

to how to ensure that all shareholders had adequate notice of proposals made by companies, in order to provide them with enough information for them to make decisions. It seems that for BIS and also the UK government, fairness is a reason for them to regulate in favour of a stricter shareholder say on pay, but it is not the object of this reform; there is no evidence to suggest that the binding vote is intended to reduce the level of excessive pay as against the earnings of other workers, although Cable mentioned before his proposal that there was an urgent need to stop executive pay from growing too rapidly.

During a Commons debate, witness Katja Hall, the chief policy director of the Confederation of British Industry (CBI), emphasised her opinion that the amendments surrounding executive remuneration would be a key test of the reform Act. They would satisfy the shareholders' need to hold the board to account "without undermining the corporate governance structure in the UK".[120]

On 17th July 2013 the House of Commons debated the new legislative provision on director's pay and the motion to have employee representatives on boards.[121] Norman Lamb, an MP who strongly advocates employee ownership of public firms, suggested that "if one can find ways of engaging employees, and if possible giving them a stake in the enterprise where they work, there can be very impressive results".[122] Advocates proposed that the reason why the UK has no employees on board, and even past Labour government had not passed regulation in favour of employees, is not only because it is too difficult for many large public firms in the UK to select their employee representatives, but also because Britain only has companies with one-tier boards.[123] Countries with employee representatives on boards, such as Germany, always have two-tier boards, placing employees on the supervisory board. MPs agreed that it is not possible for employee representatives to take the full responsibilities of a

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[120] Hansard, 19 June 2012, Column 4, available at: http://www.publications.parliament.uk/pa/cm201213/cmpublic/enterprise/120619/am/120619s01.htm last accessed, 13 July 2016
[121] Hansard Common debate, 17 July 2012, available at: http://www.publications.parliament.uk/pa/cm201213/cmpublic/enterprise/120717/pm/120717s01.htm last accessed, 13 July 2016
[122] *Ibid*.
[123] *Ibid*.

director.[124] They also agreed that it is not the government's role to "micro-manage" the level of pay, for it is in the company's and the shareholders' interests to make pay levels accountable.[125] Therefore, after the debate they voted down the government's new clause 18 on its first reading, which proposes that public companies should have employee representatives on board to participate in setting executive director's pay plans.[126]

In September 2013, Thomas Docherty, a Labour MP, presented a bill requiring that companies' remuneration committees should have employee representatives. The Bill was rejected by Parliament,[127] but there was no surprise, since a similar bill suggesting putting employee representatives on boards had already failed in June 2012.[128]

From the shareholder voting right perspective, ministers did not even raise the "super majority" shareholder voting rate on pay reports in the new clauses, simply because requiring votes from over 75% of shareholders will cause "gridlock" and is unnecessary.[129]

From the above discussion around the legislative background stories, it can be said that the aims of governments in proposing new regulations are not aimed at reducing the level of executive pay and the pay gap. Rather, their first concerns are mostly around how to attract and satisfy the investors, for sky-high level of executive remuneration can not only cause the outrage of the public, but also the dissatisfaction of the investors. It is not to say that the government is wrong in setting legislative priorities like this. To ease and overcome the public concerns during or after a bad economy period,

[124] *Ibid*.
[125] *Ibid*.
[126] *Ibid*.
[127] UK Parliament, Bill Stages, Executive Pay and Remuneration Bill 2013-14, available at: http://services.parliament.uk/bills/2013-14/executivepayandremuneration.html last accessed, 13 July 2016
[128] UK Parliament, Bill Stages, Executive Pay and Remuneration Bill 2012-13, available at: http://services.parliament.uk/bills/2012-13/executivepayandremuneration.html last accessed, 13 July 2016
[129] *Supra,* n.118

government always tend to provide regulations to empower the investors in stating that the government is making efforts to solve problems.[130]

The salaries of the normal employees and the ratio of the pay difference between the executive managers and the employees are an important social issue when the government will consider while legislating regulations. However, this issue is not substantial enough for the government to provide employees any power of say on pay. Although voices from various groups are pointing out the unfair income, pay inequity is not the main pressure when governments create policies. Sometimes, institutional shareholders and governments would rather increase the pay gap if executives are performing well for firms and helping to boost the economy. It will be helpful to observe how governments reacted after the financial crisis, in order to understand their aims in providing a binding say on pay.

Moreover, the separation of the different powers of shareholders in voting on future pay policies and the implementation report may be another explanation for why governments are not concerned about pay levels. After the above analysis of the reform, because of the lack of observable alignment between pay and performance for shareholders to vote on, voting based on predictions from advisory bodies and trust in the remuneration committee may reduce the monitoring function of shareholders. Because it is not voted on every three years but every year, it is the implementation report on remuneration that influences more practical issues. However, shareholders only have an advisory vote on this report. A famous case from 2014 was the revolt from investors regarding the pay report of Burberry's CEO, Christopher Bailey, with 52% of them voting no to Bailey's £10 million annual remuneration.[131] Because it was an advisory vote, although there was huge dissatisfaction among the shareholders, Mr. Bailey still got paid.

130 Mises Institute, P. St. Onge, "Government Regulation and Economic Stagnation", May 2015, available at: https://mises.org/library/government-regulation-and-economic-stagnation, last accessed, 13 July 2016

131 BBC, "Burberry shareholders vote against remuneration report" July 2014, available at: http://www.bbc.co.uk/news/business-28261916 last accessed, 13 July 2016

According to BIS, the aim of this new say on pay is to make a contribution to boosting the economy, but this regulation may also have a negative impact on business in the UK by reducing competiveness in the labour market. Executive directors may find the UK a less attractive place to work,[132] since having more disclosure and stricter requirements surrounding their pay and its relationship with the performance of their firms will place more pressure on executives. Whether stricter rules towards companies should be applied to increase board accountability while not reducing business competiveness will be discussed in more detail in Chapter 6.

On the aspect of remuneration policy making process, the binding vote makes shareholder bear more responsibility compared to the advisory vote.[133] With shareholder's legal obligation strengthened in monitoring pay policy and their legal position emphasising in voting, there is no requirement of how they should perform their duties or sanction towards their failures to perform. Although the UK government is not providing shareholder with the binding say on pay to prevent investor's potential inactivity in their monitoring role, perhaps under the binding say on pay, shareholders should understand their duty and the importance of their positive engagement in policy making. Details will be discussed in the next chapter.

C. The UK Corporate Governance Code

The Financial Reporting Council (FRC) announced their revised UK Corporate Governance Code in September 2014 to emphasise the importance of the board, improve transparency and prevent group thinking.[134] Specifically, Section D and Schedule A of the Code provide detailed guidelines on how to

[132] M. Petrin, "Executive Compensation in the UK: past, present and future" (2015) 36 *Company Lawyer* 195, p.196.
[133] Y. Hausmann & E. Bechtold-Orth, "Corporate Governance: Is Switzerland Outpacing Europe? A Comparative Legal Analysis of Current Developments" (2013) 13 *European Business Organization Law Review* 353, p.552
[134] FRC, available at: https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/September/FRC-updates-UK-Corporate-Governance-Code.aspx last accessed, 13 July 2016

design executive remuneration and promote the firm's long-term success[135] (rather than the old reasoning, which was "to attract, retain and motivate directors"[136]). New provisions were added in the general principles of Section D: First, the remuneration committee should make a proper comparison with other companies in the same industry on the issue of executives' remuneration level and avoid unnecessary pay.[137] Second, the committee also should pay attention to conflicts of interest when executive directors provide their opinions of the design of their compensation.[138] Third, claw-back rules are introduced if certain performance standard has not been reached by executive directors.[139] Another interesting provision is E 2.2, which adds an explanatory duty for the board to explain what they intend to do next if their report is voted against by a significant proportion of shareholders at any general meeting.[140]

These provisions, through requiring a comparison with other companies' executive pay level, introducing claw-back rules and increasing communicaitons with shareholders, show a directive to stop rising salary levels within certain industrial groups and eliminate managerial influence over the board (see Chapter 2, discussion around Bebchuk and Fried's Managerial Influence Approach). These new provisions in the Code have shown that the attitude of the government, or at least the FRC, has been aimed at satisfying

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[135] *Supra*, n.134, FRC, Principle D.1 added with deletion of the old para: "Executive directors' remuneration should be designed to promote the long-term success of the company. Performance related elements should be transparent, stretching and rigorously applied."
[136] Linklaters, Companies to publish viability statements as part of the updated UK Corporate Governance Code, September 2014, available at: http://www.linklaters.com/Publications/Publication1005Newsletter/UK-Corporate-Update-25-September-2014/Pages/Companies-publish-viability-statements-UK-Corporate-Governance-Code.aspx last accessed, 13 July 2016
[137] *Supra*, n.134, FRC, Principle D.1: "The remuneration committee should judge where to position their company relative to other companies … and should avoid paying more than is necessary."
[138] *Ibid*, FRC, "The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals."
[139] *Ibid*, FRC, Principle D.1.1: "In designing schemes of performance-related for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. 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."
[140] *Ibid*, FRC, Provision E.2.2: "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."

investors rather than executive directors. The new code was enacted in October 2014, so it is not yet clear whether the changes have affected, or will affect, the competitiveness of UK companies in the labour market.

Additionally, Schedule A of the Code has lots of revisions aimed at regulating the share-based portion of remuneration, suggesting that remuneration committees should consider cutting the amount of shares granted to executives and preventing pay for failure by expanding the equity options' vesting periods.[141] The revised provisions provided the remuneration committee with stronger requirements to stop paying for underperformance, with many provisions concerned with compensating executives for non-financial criteria deleted, and new provisions added, such as the idea that annual bonuses should also be mentioned in implementing the pay policy. Nonetheless, cases such as Morrisons and Tesco mentioned above have provided that even with restrictions in implementing pay policy, pay for failure or underperformance cannot simply be ruled out.

In January 2016, the FRC published its research on the developments in the UK regulations on corporate governance and the public companies' compliance from the year of 2015.[142] It states that, in 2015, nearly a quarter of FTSE 350 companies submitted their new remuneration policy at AGMs for shareholder resolution, although the binding vote legislation allows them to refrain from submitting the revised policies until 2016.[143] On the perspective of the newly added regulations from Section D, Section E and schedule A, FRC is satisfied with the reflection from the FTSE companies and holds an optimistic view on the future compliance with the Code. On the compliance of Section D, it is reported that by the beginning of 2016, 51% of the FTSE 100 companies has provided their incentive remuneration policies with longer period of equity

[141] *Ibid*, FRC, Schedule A: "For share-based remuneration the remuneration committee should consider requiring directors to hold a minimum number of shares and to hold shares for a further period after vesting or exercise, including for a period after leaving the company … Longer periods may be appropriate."
[142] FRC, "Developments in Corporate Governance and Stewardship in 2015", 2016, available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx last accessed, 13 July 2016
[143] *Ibid.*

holding plans, in part or in whole, comparing the figures of 37% in the beginning of 2015 and 20% in 2013.[144] From the aspect of section E 2.2, on the engagement of shareholder, the report states that at the AGMs held in 2015, 54 of the FTSE 350 companies had over 20% of their shareholders voting for no on the remuneration policies, while in the year of 2014, this figure was 77 among the FTSE 350 companies.[145] FRS considers the 20 percent as an indicative and high threshold of opposition among shareholders in the public companies.[146]

Two views can be concluded from those results: First, with more shareholders voting for not just simply a yes on executive remuneration policy, it can be observed that shareholders may not always be playing a passive role in policy voting procedure. Shareholders are probably trying to transform their role to a more active one. Cases happened in 2016 from WPP and BP can provide a practical explanation: in WPP, 33.5% of shareholders voted for no on the chief executive Martin Sorrell's pay report;[147] almost 60% of shareholders of BP voted against the pay package of the chief executive, Bob Dudley.[148] A director of the Institute of Director stated that, with more shareholders realising how to use their voting right and how much the level of executive pay is unreasonable, companies and their boards should be more careful with pay setting and increase their communication with shareholders.[149] However, since shareholders only have advisory voting rights on executive implementation remuneration report, these revolts' effects would only be that boards revise pay policy and submit it for shareholder's voting at the annual meeting next year. Excessive pay for the CEOs can still be implemented. Further discussions on shareholder's role changing and voting power will be provided in Chapter 6.

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[144] *Ibid.*
[145] *Ibid.*
[146] *Ibid.*
[147] The Guardian, "Sir Martin Sorrell at Sharp End of Investor Revolt at WPP AGM," 8 June 2016, available at: https://www.theguardian.com/business/2016/jun/08/sir-martin-sorrell-pay-deal-faces-investor-revolt-at-wpp-agm, last accessed, 13 July 2016
[148] The Guardian, "BP Shareholders' Revolt against CEO's £14m Pay Package," 14 April 2016, available at: https://www.theguardian.com/business/2016/apr/14/bp-pledge-shareholder-anger-ceo-bob-dudleypay-deal last accessed, 13 July 2016
[149] *Ibid.*

Second, with a fair compliance of the revised code and its certain provisions, the code is influencing executive remuneration from a good direction in regulating board's behaviours and encouraging dialogue between board and shareholders.
However, the "Comply or Explain" standard in regulating the public companies for the corporate governance code of the UK has made this code's functions lean more on the reflection and reporting of the companies' governance side, than on the monitoring of stewardship and controlling the companies' governance side.

In 2016, FRC updated the UK's Corporate Governance Code to comply new EU regulations on auditing issues,[150] while regulations towards executive remuneration has not been changed. Certain effects of the UK Corporate Governance Code 2016 will be interesting to see.

Conclusion

As mentioned in Chapter 4, increasing shareholder monitoring and board independence are the main resolutions that corporate legislation can provide to help solve executive remuneration problems. In a short time from the year 2013 the UK binding say on pay has helped in stopping executive pay levels from increasing dramatically as they did during the 2000s. However, on the other hand, several cases during these years have shown that problems such as pay for performance reporting and pay for underperformance still remain. Also, without absolute majority voting, shareholder dissatisfaction, for example even with 30% voting against a pay policy, have not be efficiently answered.

There is a significant increasing corporate compliance with the 2013 executive remuneration reform and the corporate governance regulations, however, on the other side, specific cases surrounding the failure of the shareholder's veto

[150] FRC, "Statement from Stephen Haddrill, Chief Executive of the Financial Reporting Council, regarding the implementation of the EU Audit Regulation and Directive", June 2016, available at: https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/June/Statement-from-Stephen-Haddrill,-Chief-Executive-o.aspx, last accessed, 13 July 2016

power have shown that this compliance has not fulfilled the purpose of legislation on remuneration issues. Although shareholders now have a higher level of power over pay decisions, complicated explanations in pay strategies provided by the board and the extensive detail in long remuneration incentive reporting means that the accountability of board is to be questioned.

From the background story of the UK government discussing the binding say on pay, it can be concluded that the primary purpose of the government in providing remuneration reform is to attract and satisfy investors, especially institutional investors. However, the results of implementing the 2013 reform are also obvious in showing that shareholder power is not that workable as pay for underperformance still largely exists. Also, the complexity of remuneration reporting did not make the engagement of shareholders quite easy, and shareholders are not satisfied with the accountability of board. Therefore, what would be appropriate adjustments provided for shareholders within corporate governance and company law to solve executive remuneration issues? Questions waiting to be solved by Chapter 6.

The third concern left by the 2013 reform is the increasing pay gap. It has been suggested that empowering investors with regard to executive pay may be the wrong direction for promoting pay for performance, pursuing better firm performance and social justice.[151] As an alternative, Charlotte Villiers suggests that employees should be given the same opportunity as shareholders to be involved in board and remuneration committee decisions for the purpose of monitoring the level of executive pay.[152] In Kent Greenfield's analysis, empowering shareholders to have a say in executive remuneration simply makes companies focus on short-term benefits. According to Greenfield:

> "Executive compensation has become the carrot that shareholders use to entice management to focus primarily on shareholder value (and consequently to disregard other stakeholders). When

[151] C. Villiers, "Controlling Executive Pay: Institutional Investors or Distributive Justice?" (2010) 10 *Journal of Corporate Law Studies* 309, p.311
[152] *Ibid*.

> executives are called on to justify their high salaries, they point not to the value of the company in creating jobs or providing useful goods and services, but to shareholder gain."[153]

On the other hand, Greenfield suggests that government support for shareholder primacy will lead to deeper income and wealth inequalities.[154] Regulations only set for the interests of shareholders will benefit those who are already financially well-off, partly since capital wealth is controlled by a tiny fraction of the population, and partly because it encourages cost-cutting and downsizing, usually at the expense of employees lower down the corporate hierarchy.[155] Therefore, questions such as whether to set a ratio between executive pay and employees' pay or whether an absolute shareholder binding vote on the design of executive remuneration should be mandatory in law will be discussed later in this thesis.

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[153] K. Greenfield, "Reclaiming Corporate Law in a New Gilded Age" (2008) 2 *Harvard Law & Policy Review* 1, p.14.
[154] *Ibid.*
[155] *Supra* n.151, Villiers, p.335

Chapter Six

The Recognition and Regulation of Executive Remuneration

Introduction

From Chapters 4 and 5, it can be concluded that the aims of governments in reforming executive remuneration practice are to promote long-term success for their public companies and economies, using the method of providing shareholders with stronger powers in terms of scrutiny of pay for executives. To empower shareholders with a say on pay has become a global trend as an attempt to solve executive remuneration problems. Is shareholder empowerment in terms of a say on pay able to assure long-term productivity? If the empowerment is not as useful as governments think, are there any other methods that may be provided by corporate governance to make sure of pay for performance? Will the accountability of the board to shareholders in terms of executive pay be enough to improve pay design? These questions will be analysed and answered in this chapter, on the basis of which suggestions on how to regulate remuneration will be provided later.

What could be a good design for executive remuneration will be discussed in a normative way in this chapter. In Chapter 2, agency theory and managerial theory were discussed to prove that pay for performance is the final goal of setting executive managers' remuneration. How to achieve this goal will also be discussed in this chapter. The requirements for forming a good remuneration system will be provided from several perspectives, such as the vesting period design of long-term incentive plans, the balance between motivation and punishment, and non-financial incentives in executive pay.

Chapter 6 will consider the central relationships that emerge from practical factors and which have existed between executive pay and shareholder intervention, board accountability and shareholder participation. Good pay practices should be analysed from several perspectives, including the perspectives of the shareholders, the executive directors, the board and normal employees.

Section I will emphasise the rationale for having a shareholder say on pay. It will suggest that having shareholder power over remuneration policy making will not be harmful to the firm's long-term productivity. Certain arguments will be made and propose that, shareholders, as a whole, are a separate group in corporate governance that tends to focus on the firm's long-term success. The advantages and disadvantages of shareholder empowerment will be summarised from the say on pay experiences of the UK and the US. This section will prove that shareholder intervention has a positive influence over issues of executive remuneration. This section will also provide several suggestions for shareholders about how to improve their intervention.

Section II will provide a discussion about the need for board accountability. Contrary to shareholder empowerment, director primacy suggests that executive remuneration should not have much, if any, interference from shareholders. This section will prove that without regulatory intervention, board accountability is not enough to solve remuneration problems and to promote a firm's long-term success. Problems and good examples for how to solve these issues will be investigated, following which several suggestions will be provided for how to improve accountability. Along with the suggestions provided in Section I, several principles will be put forward for how to improve the board's service when making remuneration reports.

After these discussions, Section III will provide some proposals for how to improve executive remuneration pay plans. Based on the spirit of company law and empirical evidence that has been used to explain the current situation of executive remuneration, a summary of regulatory suggestions will provide guidance for how to adjust the pay structure to align pay and performance.

Additionally, fairness issues in pay will be investigated. There will be a discussion around employees participating in executive pay design and practice. The shareholders' say on pay, as a comparatively more practical method to monitor executive pay, has not been recognised as the only way to solve compensation problems. The notion of having an employee say on pay has been mentioned by many scholars, although a workable method is difficult to find. In Section IV there will be some suggestions for how to have a broader scope of say on pay.

This chapter will answer the second research question by figuring out what kind of regulations should be used to solve executive remuneration problems. After the introduction of the UK's binding say on pay reform that discussed in Chapter 5, there are still three concerns left on the executive remuneration issue: pay for underperformance of executives, shareholder's difficulties in understanding of pay reports and pay gaps increasing between executives and formal employees. Sections in this chapter will have a further analysis on these concerns and provide solutions in detail.

Before the discussion, it will be helpful to mention that this thesis is not setting out to emphasise that shareholder primacy is the theoretical value we should utilise in terms of executive remuneration. This thesis does not mean to say that remuneration issues should be regulated by shareholder value. It is all about how to use shareholder power granted by legislation to affect remuneration decisions. Also, this is not to say that directors cannot be trusted at all on remuneration issues, but rather, to reflect on how they could improve their accountability under current legislative conditions.

I. <u>Shareholder Say on Pay</u>

A. Shareholder Power and Long-Term Success

Shareholder empowerment has long been recognized as a tool that legislation can provide for investors in monitoring management issues in firms. A rationale should stand behind various regulations that have been discussed in Chapters 4 and 5 in empowering the shareholders in developing managers' pay policies, and in the following it will be analysed from an empirical perspective.

A book called *Developing a Winning Partnership*, written by Paul Myners, has proposed that although in 1995 institutional shareholders had claimed the predominant place in the UK, these investors were still reluctant to intervene in their investee companies even when the firms were underperforming.[1] However, Myners later suggests that, if shareholders were given the power to intervene in decisions about managers' pay, they would be capable of making decisions and how to make the best of situations.[2] Under Myners' logic, shareholders can be active in voting and making decisions for the companies if they are empowered with a proper design of intervention. Is this hypothesis of shareholder intervention workable?

The efficiency of shareholder intervention in firms can be debatable. Evidence from the financial crisis period during 2007 to 2009 has shown that shareholders in the UK's public firms were provided with a greater scope of power under company law and corporate governance than in the US, while stock prices fell faster than they did in the US during 2008, which led to a banking crisis in the UK as serious as that in the US.[3] In terms of the history of UK company legislation, it would be misleading to say that the basic features of modern firms, such as their separate personality, concentralised management, limited liability, and free transfer of shares, have evolved together to form today's corporate model.[4] Nonetheless, these basic features were generated by law in different times and adjusted to later environments.[5]

Normally, there are two ways created by legislation that shareholders can use to intervene in the firm's management: the exit channel and the voting channel.[6] In public firms, shareholders can show their dissatisfaction and try to have

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[1] Department of Trade and Industry, P. Myners, "Developing a Winning Partnership: How Companies and Institutional Investors are Working Together", 1996, p28.
[2] P. Myners, Myners Review of Institutional Investment for HM Treasury, 2001, p.11
[3] B. Cheffins, "Did Corporate Governance "Fail" during the 2008-9 Stock Market Meltdown?", (2009), *ECGI Law Working Paper*, No. 124/2009, p.6
[4] S. Deakin, "Corporate Governance and Financial Crisis in the Long Run" (December 2010), *CBR Research Programme on Corporate Governance*, p.6
[5] *Ibid.*, S. Deakin.
[6] K. Stathopoulos & G. Voulgaris, "The Impact of Shareholder Activism: The case of say-on-pay" (2015) 24 *Corporate Governance: An International Review* 359, p.360.

impact on managerial decisions by threatening to sell their shares, which will cause the stock price to drop. This may not only make the managers concerned about their incentive equity compensation, but also have negative effects on the reputation of the company,[7] and ultimately on the reputations of the managers. The other way provided for shareholder intervention is to express their opinions by voting against certain board decisions or directors at shareholders' meetings.[8] The shareholders' say on pay is one factor in the second channel.

Why are shareholders provided with these two ways to intervene? How can shareholders influence public companies and even the whole economy using these two channels?

Deakin proposed that it is not only agency theory that adjusts corporate governance and company law; also the high liquidity of capital markets can have a huge impact.[9] The financial crisis, which began in 2007 and emerged during 2008–09, caused large concerns that the increasing liquidity of capital markets had already changed the ownership of public firms from family members to institutional shareholders through widely diversified pension funds and mutual funds.[10] Also, there is a trend for shares to be held in short-term ownership, such as by hedge funds, share lending and securitized instruments.[11] With the rapid increase of equity liquidation, the use of shareholder power can become complicated. Since their investments will stay for a shorter time in one company, will shareholders focus on the firm's long-term profits while they vote on corporate policies, or sell their shares to terminate their interest in the company?

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[7] A. Edmans, "Blockholder Trading, Market Efficiency, and Managerial Myopia" (2009) 64 *The Journal of Finance* 2481, p.2493; A.R. Admati & P. Pfleiderer, "The Wall Street Walk and Shareholder Activism: Exit as a form of voice" (2009) 22 *Review of Financial Studies* 2445, pp.2476–77.

[8] R. Ashraf, N. Jayaraman & H.E. Ryan. Jr. "Do Pension-related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation" (2012) 47 *Journal of Financial and Quantitative Analysis* 567, p.573.

[9] *Supra*, n.5, S. Deakin, p.8

[10] *Ibid*.

[11] L. Hannah, "The Divorce of Ownership from Control 1900: Re-calibrating Imagined Global Historical Trends" (2007) 49 Business History 404, p.411

It was mentioned in Chapter 4 that say on pay reforms, which enhanced shareholders' power to improve directors' accountability in the 1970s and the early 1990s, have already conferred too much power on the shareholders. It has been suggested that these reforms may be erroneous in regulating shareholder power, because even institutional shareholders tend to see their contribution of equity capital to the firm's finance declining during financial crises, and providing them with more powers for intervention in management may cause other problems[12] such as short-term rent-seeking behaviours and sudden extractions.

Nonetheless, none of these concerns should stop regulations from developing shareholder powers to influence public companies. This can be explained in terms of the ways shareholders can intervene in the management of firms.

Though shareholder empowerment has been questioned in terms of whether it can be used to promote long-term productivity, it is accepted that if it can be improved, shareholder engagement can be helpful in preventing firms from pursuing short-term success. In the words of Roger Barker, from the Institute of Directors of Corporate Governance (IoD), in terms of the new 2014 EU proposals on shareholders' rights[13] he mentioned that: "while we may not agree with every aspect of the proposal, the IoD shares the commission's overall objective of enhancing long-term, constructive engagement of institutional investors with listed companies".[14]

Long-term success or long-term productivity is an interesting phrase that appears in almost every reform document on executive compensation.[15]

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[12] *Supra*, n. 4, Deakin, p.9
[13] European Commission, "European Commission proposes to strengthen shareholder engagement and introduce a "say on pay" for Europe's largest companies", April 2014, available at: http://europa.eu/rapid/press-release_IP-14-396_en.htm?locale=en last accessed, 26 July 2016
[14] IoD, "Shareholder say on pay is vital for long-term success of companies-says IoD", April 2014, available at: http://www.iod.com/influencing/press-office/press-releases/shareholder-say-on-pay-is-vital-for-long-term-success-of-companies last accessed, 26 July 2016
[15] Such as the UK BIS's regulation draft and revision paper, available at: https://www.gov.uk/government/consultations/directors-pay-revised-remuneration-reporting-

According to the World Economic Forum, in a healthy market, a public company's long-term success is defined as meaning that can be invested with the expectation of "holding an asset for an indefinite period of time by an investor with the capability to do so." [16] It is also the main reason why governments choose to give shareholders the power of say on pay. Although in Chapter 5 it was acknowledged that the UK binding say on pay was provided because of pressure from institutional investors and the outrage of the public, nevertheless the long-term success of public companies and the equity market still relies in the first place on all the factors which influence the regulations, and also the same goals that governments and shareholders are expecting.

As was mentioned in Chapter 2, the goal of long-term success is why executive remuneration has been defined as equity based. If the managers are given a fixed compensation, such as their basic salary plus an annual bonus, they will focus on short-term success since they only need to ensure that they can have their pay continued. However, compared to directors, shareholders are more long-term focused. A survey done by Graham, Harvey and Rajgopal suggested that to attract more investments, 78% of executives would sacrifice the firm's long-term success to meet short-term earning targets.[17] "A chief executive may run the show for a few years; but a shareholder has an interest in the full lifetime of the company, since today's share price is in principle determined by the discounted value of all future profits."[18] Even for those shareholders who are relatively short-termist, such as hedge fund investors who hold shares for a period of one or two years, their perspective is still focused on the long-term profits of the company, since they only buy shares when they are priced cheaply.[19]

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regulations; https://www.gov.uk/government/consultations/executive-pay-consultation-on-enhanced-shareholder-voting-rights ; and the US SEC recent CEO pay ratio rule: http://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html last accessed, 26 July 2016

[16] World Economic Forum, Global Agenda Councils, Long-term Investing, 2012, available at: http://reports.weforum.org/global-agenda-council-2012/councils/long-term-investing/ last accessed, 26 July 2016

[17] D. Graham, C. Harvey & S. Rajgopal, "The Economic Implications of Corporate Financial Reporting" (2005) 40 *Journal of Accounting and Economics* 3, p.4.

[18] Financial Times, Opinions, S. Mallaby. "Shortsighted Complaints about Short-Term Capitalism", 6 August 2015.

[19] *Ibid*

Shareholders who focus on the long-term productivity of firms will help to increase the firm's value. In Edmans' paper, he notes that shareholders with a considerable holding of shares can influence a public firm's management through market efficiency. Contrary to the traditional view of corporate governance, he proposes that shareholders can improve firm value even by threatening to sell their shares, though they have no other channels to intervene in management.[20] For shareholders, especially shareholders with a relatively larger holding of shares (the "blockholders", as Edmans refers to them in his paper), a large holding of shares increases their intervention and monitoring incentives. In his paper Edmans provides a new way of thinking about shareholders, studying them as informed traders but not as controlling entities. Such shareholders would like to gather more information about firms from the markets and from inside the firms.[21] The more information they have, the more accurate are their opinions about firm value. If the firms ignore their voice at meetings or keep decreasing value, shareholders will trade in their shares. Having several blockholders trade their shares together can be dangerous for firms, since the share price will drop quickly and other shareholders holding a smaller fraction of shares may sell theirs as well, which will harm the firm's value.[22] Pressure like this will force the board to listen to shareholders and may help to increase the firm's value indirectly.

Moreover, this difference in short-term and long-term focus between directors and shareholders leads to agency costs.[23] To stop the directors, especially executive directors, from using the firm to satisfy their own interests, which may be harmful to the company, firms need to make sure that those directors are paid with equities that align their interests with those of the shareholders. As mentioned in Chapter 2, to design incentive equity plans and other various elements in managers' pay to align pay for performance, companies need to

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[20] *Supra,* n.7, Edmans, p.2438.
[21] X. Yan & Z. Zhang, "Institutional Investors and Equity Returns: Are short-term institutions better informed?" (2009) 22 *Review of Financial Study* 893, p.897
[22] A. Edmans, "Bolckholders and Corporate Governance" (2014) 6 *Annual Review of Financial Economy* 23, p.30.
[23] *Ibid.*

pay for the costs of hiring compensation consultants and other members of the remuneration committee, which should come from shareholders' income. On the other hand, the shareholders need to use their voting power on executive remuneration, which will also cost their payout if they have to obtain expertise from professional institutions to understand remuneration reports and make decisions.

Deakin provides two reasons why current reforms are empowering shareholders on corporate governance issues, though their contributions to firms' financing might be now declining:[24] first, because agency theory has been justified by reforms in corporate governance since the 1990s, it is now the shareholder's right and also their duty to ensure that executives are making the right decisions as far as the firm's cash flow is concerned, while the shareholders' standard of capital returns is usually stricter than the board's when they are monitoring projects to make sure the firm reaps the benefits and can provide stable employment; second, shareholders may have a "rent-seeking" purpose, tending to use the liquidity of capital under their disposal to "extract" benefits from the firm's business. Similar to directors' rent-seeking behaviours, shareholder rent-seeking, such as that undertaken by hedge fund managers, may destroy a company's long-term success and be detrimental to other constituencies.

Even if we disregard the first concerns around short-term shareholding influences on investors in corporate policy making, the second important question is, are these shareholders interested in interfering in executive remuneration? Also, there is always a concern about shareholders intervening in management policies because of information asymmetry problems. It has been suggested that shareholders are reluctant to intervene in management issues, and while voting outcomes are ignored by board and CEOs, shareholders will put little effort into change these policies.[25]

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[24] *Supra*, n.4, S. Deakin, p.8
[25] Flip Chart Fairy Tales, "Will Shareholder Empowerment Curb the Executive Pay?" Feb 2012, available at: https://flipchartfairytales.wordpress.com/2012/02/02/will-shareholder-empowerment-curb-executive-pay/ last accessed, 26 July 2016

Therefore, in the context of these problems concerning shareholder empowerment, should the regulation still hold its direction in providing shareholders with the right to interfere in remuneration policy, and moreover, can the use of shareholder voting be beneficial for the company's long-term productivity? These questions will be analysed next.

Sheehan has mentioned that "there is an iterative process in the regulation of executive remuneration practice and thus the potential for evolution in executive remuneration practice influenced by evolutions in the activities of disclosure, engagement and voting."[26] Also, in the Impact of Assessment of Improvement of Transparency of Executive Remuneration, there is the following statement:

> "shareholder empowerment lies at the heart of the UK's corporate governance framework and the proposed reforms are consistent with that approach. Shareholders will be in a stronger position to promote a clearer link between pay and performance, ensuring that companies act in the best interests of their ultimate owners and contributing to a better functioning corporate sector more generally."[27]

In October 2014 the BIS published a report on the implementation of the Kay Review, mainly concerning how to build a good environment for long-term equity investment in the UK. From the perspectives of encouraging effective engagement and stewardship, improving narrative reporting, forming trust-based relationships between investors and companies and fixing the misalignment of incentives that would undermine this trust, this report aims at

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[26] K. Sheehan, "The Regulatory Framework for Executive Remuneration in Australia"(2009) 31 *Sydney Law Review* 273, p.278

[27] BIS, "Impact Assessment (IA), Improved Transparency of Executive Remuneration Reporting", June 2012, available at: https://www.gov.uk/government/publications/improved-transparency-of-executive-remuneration-reporting-impact-assessment, p.7, last accessed, 26 July 2016

increasing shareholder involvement in company issues.[28] In addition, the FRC offered their Stewardship Code to improve institutional shareholders' stewardship responsibilities and their monitoring activities.[29] It is a new age for corporate governance, especially from the perspective of shareholder intervention. Investors, especially institutional shareholders, tend to focus more on the companies' long-term business. Institutional shareholders are also agencies for the other entities.

In the remuneration principles set out by the National Association of Pension Funds (NAPF), Hermes Equity Ownership Services, the BT Pension Scheme, RPMI Railpen Investment and USS Investment Management, these giant investors suggest that management should make a material long-term investment in the shareholders of the businesses they manage, and the best way to align the interests of shareholders and executives is the ownership of shares over the long-term, with "ownership obligations increasing with seniority".[30]

Thus, with realizations from both of the investors and the government, the following will argue that from the perspective of executive remuneration, the empowerment of shareholders in voting will promote the healthier development of pay practice and the firm's long-term success.

The first reason why shareholders are always provided with power over executive pay is that one important purpose of setting remuneration is to align the interests of principal and agent, while decreasing the risks of investors' shareholdings. There are reasons to be suspicious of shareholders' influence

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[28] BIS, Kay Review of UK Equity Markets and Long-Term Decision Making: Implementation progress report, 27 October 2014, available at: https://www.gov.uk/government/publications/kay-review-of-uk-equity-markets-and-long-term-decision-making-implementation-progress-report p.8, last accessed, 26 July 2016

[29] FRC, UK Stewardship Code, available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx last accessed, 26 July 2016

[30] Remuneration Principles for Building and Reinforcing Long-term Business Success, published by Hermes, NAPF et al, Feb 2013, available at: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0351_remuneration_principles_for_building_and_reinforcing%20_longterm_business_success_nov2013.aspx last accessed, 26 July 2016

on long-term productivity, as mentioned previously. Institutional shareholdings such as mutual funds, which pool money from investors and entrust this wealth to an asset company while the investing contracts are made by investors, mutual fund managers and the company, will have few incentives to rein in any excessive risks that executive managers may take (for the purpose of increasing directors' pay);[31] in voting on the resolutions of the company, they are "reluctant activists."[32] Investors like this have no direct relationship with the investing company and therefore will not initiate proposals as regularly as other shareholders. On the other hand, the goal of fund managers is rather short-term, since the performance valuation of the fund is based on annual comparison with peer groups, and thus they seldom have incentives to interfere in corporate governance issues, let alone the executive remuneration policy, of the investing company.[33] Nonetheless, this indirect relation does not stop investors like this having more power over voting, and intervening in executive pay policy and reports. Bebchuk proposes that although mutual funds are not a good basis for investors and fund managers to initiate management of the firm, the other large institutional shareholders will provide a trend of voting on resolutions for these investors to follow.[34] From another perspective, generally speaking, shareholders are not that dissatisfied about current executive remuneration design, which contains bonuses, equity options, pensions and other benefits for managers.

Moreover, evidence has shown that contrary to what scholars have suggested, shareholders pay attention to remuneration policy making and reporting, and with certain perspectives developing from this attention, they can promote the firm's long-term profits.

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[31] J. C. Coffee, "Liquidity Verses Control: The institutional investors as corporate monitor", (1991) 91 *Columbia Law Review* 1277, p.1334

[32] R.C. Pozen, "Institutional Investors: The Reluctant Activists", (1994) *Harvard Business Review*, Jan-Feb Issue 140, p.148

[33] E. E. Avgouleas, *Mechanics and Regulation of Market Abuse: A legal and economic analysis* (Oxford, Oxford University Press, 2005) p.78

[34] L.A. Bebchuk, "Letting Shareholders Set the Rules", (2006) 119 *Harvard Law Review* 1784, p.1796

Institutional Shareholder Services (ISS), an international shareholders' voting agency which provides services to nearly 1,600 institutions globally, is "a leading provider of proxy advisory and corporate governance solutions to financial market participants".[35] In their 2014 survey of pay for performance alignment opinions among 105 institutional shareholders from the UK, the US, continental Europe, Canada and the Asia-Pacific region, ISS revealed some of the shareholder's opinions when they vote on executive pay reports.[36] Their survey focuses on issues of company performance goal setting, executive pay level, investors' say on pay and managers' income comparison in the same industries.

According to this report, in terms of the level of executive pay, 60% of the shareholders would still be concerned about the firm's report on pay levels even if the company's performance was better than the other peer firms in the same industry, 19% of them would prefer an absolute limit on the pay level, and 14% would support proportional limits on remuneration in relation to the firm's absolute performance.[37] As for the say on pay issue, 63% of the shareholder respondents indicated that if there were positive changes in the implementation of pay policy in the second and third years, they would be less concerned and more enthusiastic towards the policy they have voted for.[38] With respect to European institution respondents, 83% of the respondents expressed their interest in peer group pay level comparison.[39]

The following table was made for their survey report and shows the shareholders' and companies' attitudes towards firms' business goals and remuneration design. 43% of the shareholders thought that if the directors' performance targets were lowered their compensation levels should change with performance targets, and only 19% of shareholders were willing to pass

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[35] ISS, 2014-2015 Policy Survey Summary of Results, available at: http://www.issgovernance.com/iss-releases-results-annual-global-voting-policy-survey/ last accessed, 26 July 2016
[36] *Ibid,* p.3
[37] *Ibid,* p.4
[38] *Ibid*, p.5
[39] *Ibid*.

pay packages without performance linked to them to attract talented executives.[40]

Q: Which of the following best reflects your institution's idea of the relationship between goal setting and award values?	Shareholder	Board
1. If performance goals are significantly reduced, target award levels should be commensurately modified to reflect the expected lower level of performance.	43%	3%
2. Performance goals should be set independently of target awards, which must be maintained at competitive levels in order to attract and retain top quality executives	19%	25%
3. The compensation committee should have broad discretion to set both goals and target awards at levels deemed to be appropriate under the circumstances	26%	67%
4. Other	12%	5%

Form from ISS, 2014-2015 Policy Survey Summary of Results

The ISS report does not give their conclusion and comments on this survey, but from these statistics, a large proportion of institutional shareholders from various countries have indicated their concern with the level of pay, the alignment between pay and performance, the implementation of pay policy, and also comparison in terms of pay levels within peer groups. Although these concerns are presented on a general scale, the guidelines drawn up by large institutional shareholders to promote best practice in terms of executive compensation will be analysed later. With the influence from this large proportion of shareholders whose attitude to compensation is sympathetic to promoting pay for performance, even though other short-term shareholding investors might hold voting opinions differently on remuneration reports before annual meetings, Bebchuk's previous assumption that voting ideas of several active institutional shareholders can influence the other shareholders and change their ideas in voting may be achieved. Thus, emphasising investor

[40] *Ibid*. p.9

power in pay policy making and reporting can be a trustworthy method of improving compensation governance.

The second reason for empowering shareholders in terms of executive pay is that legislation is an easier route to provide shareholders with power, while it is hard to ensure board accountability on executive remuneration. Also, the details of remuneration reports and policies which are presented for resolution must be emphasised, which reflects the general requirements of various regulations on compensation and transparency. Although there are always concerns over whether shareholders will be qualified by the law to make decisions for the company's governance, Bebchuk suggests that the legislative choice is always between giving shareholders power to influence the running of the firm, or leaving the boardroom to maintain its "indefinite" control over governance, with executives having managerial influence over the board.[41]

In this thesis, the former should be considered as the choice for legislation on executive remuneration. Empirical evidence to be explored in the following will illustrate that allowing shareholders to engage in remuneration policy making will help to improve the previously described situation. Additionally, problems of shareholders' say on pay in practice will be summarised to allow for further discussion.

B. Shareholders and Executive Remuneration

-----Experience of the UK and the US in applying advisory votes

Generally speaking, investors in UK listed companies perceived the say on pay as a valuable monitoring mechanism and have successfully used this power to stop executive remuneration levels from growing rapidly while increasing the sensitivity of pay to poor performance.[42] With the international trend towards

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[41] *Supra,* n.34, Bebchuk, p.1790
[42] F. Ferri & D. A. Maber, "Say on Pay Votes and CEO Compensation: Evidence from the UK" (2013) 17 *Review of Finance* 527, p.559

empowering shareholders in terms of managers' remuneration issues that was discussed in Chapter 4 and the globalised flow of capital, this shareholder voting influence on executive compensation shows a general similarity among developed countries.[43]

In 2009, Conyon and Sadler published a report on how shareholders reacted to the UK's regulatory shareholders' non-binding vote, investigating a large sample from nearly 50,000 voting resolutions of quoted firms during the period from 2002 to 2007.[44] According to their research, it is rare among shareholders to show absolute dissent to executive remuneration reports, with only 7% to 10% total dissent across those five years.[45] Shareholders in the UK were satisfied with companies' pay policies; over 90% of them voted for the reports, and moreover this approval increased over this period.[46] Nonetheless, compared to other proposals such as nomination and non-pay policies proposed by the board, shareholders show a higher level of dissent in relation to remuneration reports.[47]

Evidence from other scholars, which was discussed in Chapter 3, found a negative relation between shareholders voting in favour and the level of executive remuneration.[48] Research proposed that after the UK advisory shareholder say-on-pay was enacted in 2002, boards reacted quickly to shareholder dissent about provisions such as rewards for failure. More significantly, poor performance of executive managers was more highly correlated with steep penalties.[49] Additionally, however, boards responded to shareholders' dissatisfaction by adjusting the total level of executive pay, but

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[43] N. Fernandes, M. Ferreira, P. Matos & K. Murphy, "Are US CEOs Paid More? New International Evidence" (2013) 26 *Review of Financial Studies* 323, p.325

[44] M. J. Conyon & G.V. Sadler, "Shareholder Voting and Director's Remuneration Report Legislation: Say On Pay in the UK", (2009) *Compensation Research Institute*, p.5, available at: http://digitalcommons.ilr.cornell.edu/cri/2 last accessed, 26 July 2016

[45] *Ibid.* p.23

[46] *Ibid*, p.21

[47] *Ibid,* p.22

[48] M.E. Carter & V.L. Zamora, "Shareholder Remuneration Votes and CEO Compensation Design", (November, 2007), *AAA 2008 MAS Meeting Paper*, p.24; W. Alissa, "Boards' Response to Shareholders' Dissatisfaction: The Case of Shareholders' Say on Pay in the UK" (2015) 24 *European Accounting Review* 727, p.750

[49] *Supra,* n.42, Ferri and Maber, p.534

not the structure of it,[50] which still remains a potentially threatening issue since the level will influence one year's pay while the structure, especially the equity pay design, will affect pay over a longer term.

In Ferri and Maber's research on shareholder advisory votes, they investigated seventy-five public companies that experienced a more than 20% shareholder veto on executive pay reports.[51] The boards of these firms provided their revised pay policies, within which changes were mainly in two areas: the existing executive contract's notice periods, and executive pay's performance-based conditions.[52] After the shareholders showed their dissatisfaction towards the pay plan, sixteen firms reduced the executives' notice period from twenty-four months to twelve months, while managers' golden goodbyes were reduced to nearly half of the original amount.[53] This research has confirmed in an empirical way that boards tend to reduce the level and other obvious factors in pay plans if there is strong dissatisfaction among shareholders.

Although shareholders' voting activities show an optimistic attitude towards most companies' pay plans since the 2002 advisory vote was introduced, the financial crisis which began in 2008 definitely raised the alarm for shareholders and governments, not only reminding them of nonfeasance of boards, but also hastening legislation to provide an efficient solution.

In the US, except of several provisions of the Dodd-Frank Act that would definitely come into force in 2011, the impact of the remaining areas was uncertain. "Many companies are hedging their bets and will respond in more detail once the SEC confirms the rules," said Gregg Passin, a partner in Mercer's Executive Rewards team in the US.[54] Meanwhile, institutional shareholders continue to "exert a strong influence on pay discussions but with around 98 percent of US companies having passed their say-on-pay

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[50] *Supra*, n.48, Alissa, p.728
[51] *Supra,* n.42, Ferri and Maber, p.536
[52] *Ibid.*
[53] *Ibid.*
[54] The HR Director, "Shareholder Spring Goes Global", 12 October 2012, available at: http://www.thehrdirector.com/features/miscellaneous/shareholder-spring-goes-global/ last accessed, 26 July 2016

resolutions in 2011 and 2012, it is fair to say that progress is being made."[55] Moreover, Mark Hoble, a partner in Mercer's Executive Rewards team in the UK, commented that :

> "companies are considering the appropriateness of their historic pay decisions through the lenses of current public perception and economic performance. We are seeing companies undertake scenario modeling for their planned pay policies. This is an essential and sensible part of corporate risk and reputation management."[56]

Although the advisory say-on-pay was not implemented until 2010 in the US, shareholder proposals for transparency in executive pay, especially from institutional shareholders, had already increased significantly. Research has shown that from 2002 to 2007, 134 firms whose shareholders voted no to the boards' executive pay proposals in their annual general meetings had their CEOs' pay reduced by $7.3 million in total.[57] Optimistically, concerns about the structure and equity design component of executive pay from institutional shareholders were also revealed, even before the introduction of the Dodd-Frank Act.[58] One goal of the US say on pay regulation is to foster more transparent executive compensation and better alignment of CEO incentives with the interests of shareholders.

Studies show that say on pay has helped with this goal. According to Kronlund and Sandy's research, having a say on pay vote can make firms change how they pay executives.[59] However, despite the law's intention to improve executive pay practices, the say on pay mandate has not "unambiguously"

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[55] *Ibid.*
[56] *Ibid.*
[57] Y. Ertimur, F. Ferri & V. Muslu, "Shareholder Activism and CEO Pay", (2009) 24 *Review of Financial Studies* 535, pp.544-5
[58] F. Ferr & T. Sandino, "The Impact of Shareholder Activism on Financial Reporting and Compensation: The case of employee options expensing", (2009) 84 *The Account Review* 433, p.453
[59] M. Kronlund & S. Sandy, "Does Shareholder Scrutiny Affect Executive Compensation? Evidence from say-on-pay voting", (October 2014), available at: http://ssrn.com/abstract=2358696 p.3, last accessed, 26 July 2016

resulted in more reasonable CEO compensation.[60] Contrary to the goal of the say on pay regulation to reduce executive pay, the net result of these changes may be to raise, not lower, the total compensation. The fact that firms change pay practices between years, with or without shareholders voting again, is evidence that pay practices are not always perfectly optimal. If they were, whether a vote is held or not should be irrelevant for pay.

In the US, the shareholders of 2,173 public companies "overwhelmingly" approved their firms' compensation reports in 2013.[61] 97% of the US public firms received shareholder votes affirming the CEOs' pay, while only 57 companies experienced a shareholder advisory veto on their pay proposals.[62]

Evidence from the US advisory vote has shown that when there is increased shareholder scrutiny, the board does alter executive pay policies: salaries are lower while grants of restricted stock are higher.[63] Compensation practices that are opposed by activist investors, such as golden parachutes, are reduced or eliminated. These changes are consistent with improving the transparency of pay and complying with proxy advisory firms' guidelines, which may help firms to ensure that the say on pay vote passes. However, despite these changes, the net effect of these changes is a higher overall level of pay. Additionally, companies make greater use of less scrutinized forms of executive pay, such as pensions and golden goodbyes, if there is increased shareholder monitoring.[64]

Say on pay is not a complete panacea. For instance, in the US there is a crucial shortcoming in the say on pay legislation. The Dodd-Frank rule requires firms to have a shareholder vote on pay policies in every second or third year, but it also enables firms to "strategically shift pay" across years to keep compensating executives in the same way that they used to while also gaining

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60 *Ibid.*
61 J. Carney, "Why Say on Pay Failed and Why That's a Good Thing", July 2013, available at: http://www.cnbc.com/id/100860959# last accessed, 26 July 2016
62 *Ibid.*
63 *Supra,* n.59, M. Kronlund & S. Sandy, p.10
64 *Ibid.*, p.19

shareholder support, thereby potentially undermining the goals of the regulation to decrease the level of executive pay.[65]

Therefore, from above it can be concluded that overall the advisory say on pay regulations in the UK and the US have brought several good changes in executive remuneration, not only in the boards' reaction to shareholder dissatisfaction but also in the general level of it, although the particular structural design of pay is still in great need of improvement and scrutiny.

From the shareholder's perspective, although regulations have given a say on pay to improve board accountability to shareholders, the board or the remuneration committee can still find opportunities to undermine shareholder engagement. As mentioned above and in Chapter 3, shareholders' negative responses to a pay policy will be delivered before this policy is taken to resolution, but under most circumstances these negative responses may not be turned into revisions because of game-playing between these two parties. The concern from the US say on pay experience would be that more engagement and increased transparency in pay will not definitely lead to improvements in board accountability and shareholder diligence to influence a change in the pay policy.[66]

Providing shareholders with voting power to decide on executive pay policy has been accepted and implemented as a useful tool by governments as a warning and monitoring mechanism, while empirical evidence has shown that this voting power has several effects in improving the practice of managers' compensation plans and reporting. However, certain shortcomings described above, which have also been discussed in Chapters 4 and 5, are that: (1) shareholders tend to be dissatisfied when boards change the level of executive remuneration, but they always ignore the structure of pay plans, and sometimes it is difficult for shareholders to understand the pay structure; (2) shareholders' voting powers have not stopped pay for failure, and golden goodbyes and golden hellos can

[65] *Ibid.*
[66] K. Sheehan, *The Regulation of Executive Compensation: Greed, Accountability and say on pay*, (Cheltenham, Edward Elgar, UK Remuneration Practice, 2012) p.76

be camouflaged in other ways by the board; (3) too often the government has focused on the voting power of the shareholders, neglecting to examine how to increase the engagement of shareholders in the pay setting progress, and how to enhance conversations between shareholders and boards. The following suggestions will deal with these problems.

C. How to improve shareholder intervention

It is always easy to regulate listed companies and their boards to act in certain ways to serve their shareholders, with few regulations requiring or encouraging shareholders to do anything. However, from the perspective of executive remuneration, shareholders may need some instruction from the regulations. From the discussion above, shareholders would like to pay more attention to remuneration reports at AGMs because they are about how the payouts of the firm are set, which could have been their money if it was not paid to the managers.

To encourage shareholders to participate better in remuneration decisions with firms and to improve boards' accountability to their shareholders, current legislation and corporate codes from various governments have paid significant attention to regulating pay transparency and the disclosure of details in pay policy. From the pay policy disclosure and the shareholder understanding of problems discussed in Chapter 5, it is perhaps not the time to emphasise the quantity of pay transparency, but rather the quality of such transparency. From the shareholders' perspective, they will be responsible for understanding pay structures and single elements of each pay plan, and engaging better in discussions with firms.

From the above, it can be seen that it is time for the development of stewardship codes, which regulate what shareholders how they approach their roles in corporate governance. Except for remuneration guidelines drawn up by several institutional shareholder groups mentioned above, organisations such as the FRC in the UK and the ICGN (International Corporate Governance Network) based in the US have provided their stewardship codes to guide institutional shareholders in relation to how to participate better in corporate issues.[67] Feedback and improvement of these codes have been ongoing; details will be discussed in the following.

C.1. Participation and Understanding

It is really difficult for most individual investors to understand or even read the remuneration reports. Even many chief executives and other managers struggle to understand their pay packages containing equity plans, long- and short-term targets and earning per shares to total shareholder returns.[68] Shareholders, especially small group investors, should be more active in reading remuneration reports and communicating with directors. Institutional shareholders who have their own experts analysing remuneration reports and providing advice, such as the GC100 group, the ABI and NAPF, always renew their guidelines for executive pay reporting. These guidelines provide details of how the remuneration reports should be formed and what contents should be used to explain every element of directors' pay packages. Individual investors should be encouraged to read these guidelines if they have difficulty understanding remuneration reports.

There are various forms and data in the remuneration reports, and shareholders should use their discretion to determine whether the pay policy or the implementation report is fair and reasonable. With the help of the ISS and other consultancies, institutional shareholders can easily arrive at a general understanding of executive pay plans and reports.

From the voting perspective, stewardship codes have provided a good foundation to encourage institutional investors to share their voting policies and results, letting the other shareholders have a general understanding of how

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[67] FRC, Stewardship Code, available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx ; ICGN, Global Stewardship Code, available at: https://www.icgn.org/policy/stewardship-codes last accessed, 26 July 2016

[68] Financial Times, Executive Pay: The battle to align risks and rewards, 30 April 2015.

better informed and more expert shareholders consider the pay plan and vote on it. The ICGN's Global Stewardship Code suggests that institutional investors should disclose and develop their actual voting policies and records, seeking to explain to companies the reasons underlying why they voted against any pay policies before the shareholders' meeting.[69] Also, this stewardship code contains an innovative but maybe not very practical idea, proposing that investors should be open to joining and collaborating with other investors from both domestic and overseas arenas to leverage the voice of minority shareholders and exert influence over the corporate decisions.[70] This is a good idea to improve relationships and communication among various shareholders. Concerns can be left from this idea: timing is a huge issue, since not all shareholders are able or willing to have discussions about decisions before the resolution at a firm's AGM. Also, the cost of gathering the shareholders are considerable, with agency cost increasing from a new perspective. However, compared to the influence of shareholders' misunderstanding upon remuneration reports, perhaps the time and costs might be undermined.

This thesis proposes that in order for a majority of shareholders to have a better understanding of the remuneration plan and report, shareholders should have a meeting before the resolution and voting on any executive pay report.

Another issue comes from the institutional shareholders. Institutional shareholders, e.g. pension fund managers, banks, insurance companies and so on, are also companies built upon the interests of their beneficiaries. The UK Stewardship Code suggests that institutional investors should report periodically on their stewardship and voting activities to their clients or beneficiaries as to how they have discharged their responsibilities.[71] In a meeting held by the ICGN, Professor Stout proposed that pressure from beneficiaries can make institutional investors concerned about their investment, and under certain circumstances they may hold shares in firms for a rather short

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[69] *Supra,* n.67, ICGN, Global Stewardship Code, principle 4, Exercising voting rights in an informed and responsible manner.
[70] *Ibid.,* principle 5, Engaging companies and collaborating with other investors.
[71] *Supra,* n.67, FRC, Stewardship Code, principle 7.

period and sell them in a liquid market, though institutional shareholders are supposed to be long-term focused.[72] Although institutional shareholders have great influence over public firms' governance (as mentioned above), the fact is that concern about their clients' benefits and paybacks will decrease their impact as valuable investors providing good guidance for small shareholders. However, this question is not within the scope of stewardship, but in the scope of corporate governance codes and company law. It is for the board of investee companies to provide certain methods to retain their institutional shareholders in the long term, such as increasing their voting power or paybacks according to their length of investment in the company.

These methods, which are called time-weighted voting or time-weighted dividends, have been proved to be effective in attracting investors to keep their investment in a firm for a long time and lead them to focus on the firm's long-term interest. A recent study suggests that time-weighted voting, which provides shareholder with more votes per share if they invest in the firm for longer than three years, can empower long-term investors and may improve the firm's value.[73] The empirical evidence shows that compared to the dual-class shareholding which lets investors hold two different classes of shares to vote, time-weighted voting is a better choice for the companies and shareholders to prevent "myopic" or short-term focused behaviour among managers.[74]

As mentioned above, from a shareholder's perspective, if companies can provide efficient methods to retain their investment or help them to focus on a long-term view, shareholders may be able to influence companies positively and use their two intervention channels to help companies to create remuneration policies and reports reflecting long-term value.

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[72] ICGN, Share Ownership in A Global Context-Is stewardship working? Available at: https://www.icgn.org/share-ownership-global-context-stewardship-working-0 last accessed, 26 July 2016

[73] L. L. Dallas & J. M. Barry, "Long-term Shareholders and Time-phased Voting" (2015) 40 *Delaware Journal of Corporate Law* 541, pp.552–3.

[74] *Ibid.*, p.550.

C.2. Principles

This thesis provides that from aspect of shareholder empowerment on executive pay, promoting long-term investment and better engagement of shareholders should be emphasised.

Taking the UK Stewardship Code as an example, it is not enough to require that institutional shareholders should disclose their voting policy and records, or be willing to act collectively with other investors.[75] With the improvement of transparency in various reports at AGMs, especially in remuneration reports, shareholders need more time to analyse and understand the reports. Absorbing opinions from each other is important. Thus, principle 5 of this code should perhaps be written as: “Institutional investors should be willing to meet with other investors before resolution and act collectively with other investors where appropriate.”

In promoting the long-term success of the company, the UK Corporate Governance Code provides in the first section that it is the board’s role to provide effective controls and methods to ensure this objective.[76] However, none of the other sections provide specifically how this should be done. In section E, the Code requires that the board should ensure a satisfactory dialogue with shareholders.[77] Perhaps in this section, there should be a section E.3, proposing a new method for how to retain shareholders’ investment for long-term periods.

Again, improving the shareholder monitoring function during the creation of executive remuneration policies and reports does not necessarily mean that shareholder primacy or shareholder maximisation is the only goal while setting managers’ pay. Boards may also take other issues into consideration when planning and implementing pay policies. These factors will be discussed further in section IV.

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[75] *Supra,* n.76, FRC, Stewardship Code, principle 5&6.
[76] FRC, Corporate Governance Code 2016, section A.1.
[77] *Supra*, section E.1.

II. Remuneration Practice and Board Accountability

From the history of executive remuneration, as examined in Chapter 4, it can be seen that with the development of modern corporate theories, shareholders have long been seen as passive, or even irrelevant to the running of companies.[78] Shareholder value was even neglected during the middle decades of the twentieth century, since what shareholders did to exercise their ownership was vote at AGMs which were mostly formalities, while the board had the power to delegate management to executives who were professionals but had no stocks in the company.[79] However, other arguments around shareholder empowerment also suggest that increasing shareholder involvement will shift the balance between the board's authority and its accountability. It is easy for the shareholders to set guidelines on what an effective remuneration policy should be. However, the shareholders are not efficiently informed about what is happening in the boardroom.

Since the Greenbury Report proposed in 1995 that executive pay should comprise more long-term incentives to promote pay for performance, the percentage of equity incentives in pay packages, such as restricted equity options and long-term incentive plans, have been increasing, until in 2015 the average of the FTSE 100 CEOs' equity options value was 240% of their salary level. In 2014 this figure was 210%.[80]

However, emphasising long-term incentives and more equity options in pay packages cannot efficiently accomplish the perfect dream of agency theory, i.e. pay for performance. As mentioned in Chapter 2, normally equity options are set to align the interests of shareholders and executives, and to retain and motivate managers to provide good performance. The reason why

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[78] S. Deakin, "Corporate Governance and Financial Crisis in the Long Run" (December 2010) *Center for Business Research, University of Cambridge,* No. 417, p.3

[79] *Ibid*., Deakin, pp. 3-4

[80] PwC, "Raising the Bar: The state of executive pay in 2015," April 2015, p.5, available at: http://www.pwc.co.uk/services/human-resource-services/insights/raising-the-bar-the-state-of-executive-pay-in-2015.html last accessed, 26 July 2016

remuneration practice cannot achieve this alignment is that the board and the design of equity options in executive pay may sometimes be harmful to the firm's long-term success.[81] As discussed in Chapter 3, executive directors will use their managerial power to influence the board and its members, such as using the power of promotion and awarding independent directors who are executives in another firm with non-executive posts and/or hiring these executives as members of their remuneration committee. Under this managerial influence, boards and remuneration committees may show some rent-seeking behaviours in using explicit influence of capital markets and products on executives' equity holdings and bonuses to increase the final rewards of executive directors. Mechanisms to stop this from happening are now considered.

A. Board Primacy?

The director primacy approach proposes that with a centralised authority and good use of accountability, there is no need for shareholders to approve certain detailed resolutions, since generally they are not able to make informed decisions. Interestingly, other arguments, either from supporters of director primacy who suggest that the board is reliable in making decisions, or from proponents of having employees on the board in order to make executive pay fairer, are both against the idea of using shareholder voting rights to solve executive remuneration problems. Early in the 1990s, Professor Villiers already pointed out that because of information asymmetry, shareholders face various obstacles if they wish to interfere in corporate management and accounting reports,[82] such as a lack of information concerning comparative groups' income from remuneration consultants, or confusion about the criteria that remuneration committees write into the pay report relating pay to performance. According to conclusions in Chapter 3, there may be various long-term incentive plans with different conditions in a single executive's pay package.

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[81] J. K. McClendon, "Bringing the Bulls to Bear: Regulation Executive Compensation to Realign Management and Shareholders' Interest and Promote Corporate Long-Term Productivity" (2004) 39 *Wake Forest Law Review* 971, p.994

[82] C. Villiers, "Executive Pay: Beyond Control?" (1995) 15 *Legal Studies* 260, p.271

Bainbridge states that empowering shareholders in the corporate decision-making process might disrupt the vesting of authoritative control from the board in their firms.[83]

Moreover, Bernard Sharfman even proposes that empowering shareholders will not enhance decision making, but will instead increase errors and lead to "a shift of agency costs from management to shareholders that overcomes whatever benefit is received from a reduction in management agency costs".[84] Even worse, the more successful shareholder activities are, the more damaging those activities are likely to be to the economy.[85]

From the director primacy point of view, some proponents even suggest that the rapidly growing executive remuneration is not a problem at all. According to Professor Bainbridge's understanding of the capital market, investors will not purchase stocks from companies which provide executives with excessive remuneration, and creditors also will not lend money to such companies if they have knowledge of their lack of executive director accountability.[86] Therefore, the cost of issuing stocks will rise for these companies while their income will fall. As a result, firms like this will be more vulnerable to hostile takeovers and management reconstruction,[87] which will bring more instability to both firms and shareholders. This will mean that managers are removed and not readily employed elsewhere.

The reason why Bainbridge underestimates the problems of executive remuneration is because he thinks that the key point of effective corporate governance requires the decision making authority to be vested in a small, discrete central agency, rather than in a large diffuse electorate.[88] He does not think the idea of board accountability can sustain. And he even proposes that,

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[83] S. Bainbridge, "Is 'Say on Pay' Justified?" (2009) 32 *Regulation: Corporate Governance* 42, p.46

[84] B. Sharfman, "What's Wrong with Shareholder Empowerment?" (2012) 37 *Journal of Corporate Law* 903, p.907

[85] *Ibid*., p.908

[86] *Supra*, Bainbridge, p.46

[87] *Ibid.*

[88] *Ibid*., p.47

if shareholders are intelligent enough to realize how much it will cost for them to get hold of adequate information and how serious the problems will be if they interfere for no good reason, they will keep their distance and refrain from making every decision themselves, leaving most issues to the board. Thus, do we need to emphasise the board's accountability on executive remuneration issues?

Details of the board's function should be studied before director primacy is admitted. As discussed before, there are three main functions of board members: the first is a monitoring role, which requires them to select, compensate, and make decisions about the retention of chief managers while overseeing the process of accounting, financial reporting and auditing, to help shareholders with these disclosures in order for them to make assessments of the company.[89] The second function is a protective/restorative role, meaning that the board should assist the company in claiming and protecting its resources. The third function of the board is to formulate strategy under the direction of senior managers in order to serve the shareholders in their interests with more information.[90] It can be understood clearly that executive remuneration design is within the first, monitoring function. Nonetheless, the third function, related to the board's accountability to shareholders, should also be emphasised when considering remuneration issues.

The board can develop its monitoring work in three ways: employing structure (different committees, such as remuneration or nomination committees, in one boardroom), composition (having expertise on different committees and independent directors to ensure unbiased decisions), and practice (concerning how to manage the firm to establish the board's role).[91] Research has proven that regulation has relatively little to do with the evolution of the board's structure and practice; rather, it is the market and social forces that improve

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[89] D. Langevoort, "The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability"(2000) *Georgetown University Law Centre*, Working Paper in Business, Economics and Regulatory Law, No. 241402, p.5
[90] *Ibid.*, Langevoort, p.6
[91] L. Dallas, "Development in US Boards of Directors and the Multiple Roles of Corporate Boards" (2003) 40 *San Diego Law Review*, p.20

these elements.[92] Thus, a more appropriate way for legislation to improve the board's accountability and the monitoring function of the board is from the composition aspect, by putting more independent directors into functional committees. Under Langevoort's analysis, it is the law which should continue to insist, or should insist more rigorously, on increasing the independence of boards to solve conflicts between agent and owner. However, Langevoort has also pointed out that if the law becomes too aggressive it will ruin the social dynamic of the board and result in a less effective working group.[93] As discussed in Chapter 2 and Chapter 4, having more independent directors on executive committees will not have much influence on executive pay design; this is explained as follows.

Delegation of various power to the committees of board does not function well. Mitchell has concluded that the board's problems have existed from the very beginning, since the time boards were created to solve agency problems.[94] Although the board was designed to fulfill a monitoring function with periodic intervention by experts as a means of allowing outsiders, i.e. independent directors, to monitor aspects such as nomination, compensation and auditing, it has developed primarily for the purpose of shielding executive managers from liabilities,[95] since there is only a direct norm from legislation to indicate what is right and what is possible in practical activities.[96] As lawyers are usually the ones who interpret law to companies, the directors' understanding of legislative norms is second- or even third-hand,[97] not to mention that lawyers may sometimes deliver information after being influenced by executives, as mentioned in Chapter 2.

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[92] M. Eisenberg, "Corporate Law and Social Norms" (1999) 99 *Columbia Law Review* 1253, p.1267; E. Rock & M. Wachter, "Islands of Conscious Power: Norms and the Self-governing Corporation" (2001) 149 *University of Pennsylvania Law Review* 1619, p.1623
[93] *Supra*, n.89, Langevoort, p.8
[94] L. E. Mitchell, "The Trouble with Boards", (2005) *GWU Legal Studies Research Paper* No. 159, pp.6-7
[95] *Ibid.*, Mitchell.
[96] *Supra,* n.89, Langevoort, p.11
[97] *Ibid*.

However, several scholars have noted that the companies that failed during the 2007–09 financial crisis, despite being defined as having inadequate governance, did have independent boards, separate positions of chair and CEO, and enough defence against hostile takeovers.[98] If legislation is still deficient in regulating the practice of boards, maybe shareholder empowerment will constitute an appropriate remedy in a corporate governance context. Although scholars such as Bainbridge and Sharfman are in favour of directors running corporations and minimizing shareholder intervention, director primacy is not the most suitable approach when dealing with executive remuneration issues. Bebchuk and Fried, whose book was introduced in Chapter 2 to explain how executive managers use their influence in the boardroom to gain excessive compensation, have fully explained how executives and board members can benefit each other through remuneration practice. It is also one aspect of Chapter 3's conclusion that without intervention or regulation, the independence of boards and remuneration committees cannot be trusted while making remuneration policies and reports.

Therefore, from the above arguments two points can be concluded: (1) director primacy is not perfect in dealing with executive remuneration issues, because merely employing more independent directors to improve board accountability is not enough; and (2) there should be other ways to improve the board's accountability within its monitoring and strategic functions. Shareholder empowerment is used through the say on pay to influence the pay practice indirectly, but it is the remuneration committee and the board who have the most direct impact on pay. Hence, how should they be guided to improve their accountability?

B. Practice in order to Improve Accountability?

Guidelines, principles and various codes of conduct have been created for directors and remuneration committees to promote and ensure their function in

[98] *Supra,* n.3, Cheffins, p.6

remuneration design and implementation. However, as Cullen argues, the traditional and non-descript language characteristics of these codes and guidelines rely to a large extent on executives and other directors working towards the overarching goal of shareholder value by using words such as "structure", "performance objectives" and "disclosures".[99] However, these terms are too general and do not provide explicit requirements.

In fact, the GC100 and Investor Group guidance, published in 2013 and amended in 2014,[100] shows that guidelines from institutional shareholders are sometimes not as general as some financial scholars have thought. These are detailed requirements, regulating the aims of remuneration committees in designing executive pay, the design of various financial incentives criteria and reporting structures, and even how the committee will communicate with shareholders if they have concerns about the pay policy. Nevertheless, guidelines cannot guarantee full compliance, not to mention following the best practice of remuneration design. However, the GC100 principles have made a good start in improving guidelines from shareholders and ways to promote the accountability of remuneration committees. Further discussion will be provided later in this chapter.

Remuneration committees, as noted in Chapter 3, do not need to have expert knowledge about how to design pay. Instead they need to negotiate with remuneration consultants and make decisions using informed judgment. As Professor Keay notes, with shareholders having more power to influence remuneration policy, the board, especially the remuneration committee, must increase their accountability while being required to justify their decisions.[101] The IoD, whose members are directors from various business sectors and even CEOs from large organisations, provides a detailed introduction of the regular

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[99] J. Cullen, *Executive Compensation in Imperfect Financial Markets,* (Cheltenham, Edward Elgar, 2014) p.202

[100] GC100 and Investor Group, "Directors' Remuneration Reporting Guidance", 2013&2014, available at: http://uk.practicallaw.com/groups/uk-gc100-investor-group; http://uk.practicallaw.com/groups/uk-gc100-investor-group last accessed, 26 July 2016

[101] A. Keay, *Board Accountability in Corporate Governance,* (Abingdon, Routledge, 2015) p.230

work of remuneration committees in setting pay policy.[102] First, they have to have a good knowledge of the business their company is running so as to ensure the compensation is set at the right level of basic salary in comparison with peer companies; second, they need to think of financial factors and the markets, which will help them with setting pay for performance criteria associated with shareholder returns, including annual bonuses and incentive plans; and third, the company's culture must be taken into account, since remuneration may reflect the organisation's value and culture, and the remuneration committee members, especially the independent directors, need to recognise the values that are related to successful performance and avoid cutting bonuses and risking the firm's competitiveness.

Therefore, how do these considerations work in practice?

B.1. The power of the advisory vote

Based on previous chapters, governments tend to provide shareholders with a say on pay to intervene in remuneration practice by improving board and remuneration committee accountability. Under the principles produced by NAPF and other institutional investors on remuneration report, there is a full explanation of the pay plan, a deeper analysis of company performance and a well debated decision based on a broader comparison with peer companies, which will help to build trust between investors and the remuneration committee.[103]

However, only in some circumstances may the remuneration committee respond to a negative vote result, but a few cases have shown that the remuneration outcome may be affected by the voting alone.[104] Nonetheless, institutional shareholders should and have already shown interest in seeing

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[102] IoD: "The Remuneration Committee Role", March 2015, available at: http://www.iod.com/guidance/briefings/cgbis-the-role-of-the-remuneration-committee last accessed, 26 July 2016

[103] *Supra,* n.30, NAPF, Hermes et al., "Remuneration principles for building and reinforcing long-term business success", p.3

[104] *Supra,* n.66, Sheehan, p.83

remuneration committees build their authority while negotiating pay, and improve their will to undertake difficult tasks to punish underperformance among executives.[105]

The cases of Burberry in 2014 and BG Group in 2015 are worth analyzing to investigate the remuneration committee's accountability. As discussed in Chapter 5, the Burberry remuneration committee provided their CEO with £28 million for his first year compensation, which precipitated a high level of revolt from their shareholders, with 52% of them voting against. This was at the time the highest veto figure in UK company history.[106] On the other hand, the board of BG Group voluntarily gave up their £25 million pay deal for the new CEO after shareholders showed their strong disapproval before the resolution day.[107] The different decisions of these two boards and remuneration committees are interesting.

At Burberry the golden hello, which was worth £7.5m in shares for the new CEO, had already received a veto from 18% of their shareholders' in 2014,[108] whose concerns were not unreasonable: the new CEO, Christopher Baily, a designer who had previously held the position of Burberry's chief creative officer, was new to the CEO post. In 2015, the big fall in retailing caused the share price to fall by 4%, slashing the board's pay decision and Mr. Baily's high bonus, golden hello and incentive stock pay.[109]

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[105] *Supra,* n.30, NAPF, Hermes et al., "Remuneration principles for building and reinforcing long-term business success", p.3

[106] The Guardian, "Burberry shareholders revolt over Christopher Bailey's pay package", 11 July 2014, available at: http://www.theguardian.com/business/2014/jul/11/burberry-shareholders-revolt-christian-bailey-pay-package last accessed, 26 July 2016

[107] The Guardian, "BG Group shareholders rebel against Helge Lund pay deal", 5 April 2015, available at: http://www.theguardian.com/business/2015/may/05/bg-group-shareholders-rebel-against-helge-lund-pay-deal last accessed, 26 July 2016

[108] Telegraph, Andrew Tritman, "New Burberry CEO Christopher Bailey Handed £7.5m Golden Hello," May 2014, available at: http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/10832465/New-Burberry-CEO-Christopher-Bailey-handed-7.5m-golden-hello.html last accessed, 26 July 2016

[109] Bloomberg Business, Andrew Roberts, "Burberry to Slash CEO Baily's Pay Amid Chinese Sales Slump", 15th October 2015, available at: http://www.bloomberg.com/news/articles/2015-10-15/burberry-to-slash-ceo-bailey-s-pay-amid-chinese-sales-slump last accessed, 26 July 2016

Because of the high level of veto on the 2014's remuneration of the CEO, which was the highest pay among the FTSE 100 companies that year, the board provided a new pay policy in the following year.[110] With 92.8% of shareholder voting for yes, the revised pay in 2015 meant a reduction in Mr. Baily's income to £7.9m.[111] High satisfaction among the shareholders was due to the board's efforts in discussing executive pay plans with the majority of their fifty biggest investors after the previous year's huge revolt.[112] Thus, though there were also other problems with the executive remuneration policy in Burberry, such as several unexplainable vested equity options in the pay structure for Christopher Bailey which were set before he held the chief executive position, the lesson to be learned here is that the regulation can be used to warn boards and it should be used to improve the board's accountability. Remuneration committees and boards should always show a voluntary willingness to increase communication with shareholders on remuneration issues. The case of the BG Group also provides a good example of having a conversation with investors before a vote on pay policy to avoid embarrassment. Transparency in executive pay is not only about putting cold statistics in front of the shareholders at the annual meeting, which may increase misunderstanding between the board and shareholders. A process of negotiating and exchange of opinions will improve the board's accountability and enable there to be a transparent executive remuneration process.

The UK 2013 reform of executive remuneration design divides the firm's pay implementation report from the firm's future remuneration policy. As mentioned in Chapter 5, if the previous year's pay implementation report was rejected by a majority of shareholders this year, the board and remuneration committee should present a new pay policy in the next year's annual meeting for shareholders to vote and their vote is binding. This regulation is valuable to corporate governance since it helps to increase the engagement of shareholders in policy making and urges boards to enhance their

[110] The Guardian, "Burberry Investors Approve Chief Executive's Pay," 16 July 2015, available at: http://www.theguardian.com/business/2015/jul/16/burberry-christopher-bailey-investors-approve-pay last accessed, 26 July 2016
[111] *Ibid.*
[112] *Ibid.*

communication with investors, especially institutional investors, and thereby improve their accountability. The process of how a board might carry out a major review of compensation policy in practice can be illustrated in the following form:[113]

Obtained from Sheehan "*The Regulation of Executive Compensation*" p.91

It was discussed in Chapter 5 that remuneration committees should engage in a regular review of executive pay implementation reports, and major reviews of any new remuneration policy. As shown above, after a failure to pass the shareholders' advisory vote on a remuneration report, the remuneration committee will examine the terms of the previous policy, collect data from a wider perspective and re-value the equity holdings of executives to provide a new calculation of the executive rewards. More importantly, they will increase

[113] Supra, n.66, Sheehan, p.91.

the pre-voting negotiation opportunities with shareholders in case this policy also faces a revolt because the previous rejected remuneration report may have made a bad impression on investors. The UK Corporate Governance Code requires that "the chairman of the board should ensure that the committee chairman maintains contact as required with its principal shareholder about remuneration."[114] As mentioned in Chapter 3, the voting procedure would not be the only opportunity for shareholders to express their opinion on executive pay policy; negotiations before or after shareholder voting on pay can increase the quality of the board's accountability

How to balance the needs of shareholders and executive managers is always a central question for board. In the current legislation environment, the board can use various regulations as good opportunities to communicate with shareholders and managers. The importance of dialogue between the board and executive directors about their pay will be discussed in the following.

B.2. Independence and Negotiation with Executives

From a board independence perspective, there is no regulation that can directly influence this independence. From the discussion in previous chapters, we can see that the independence of the board is influenced by the relationship between non-executives and executive directors. Although personal factors will have a good deal of influence over the remuneration committee's judgement, independence can still be built upon these non-executives' analysis of the executives' behaviour and the non-executives' pursuit of decisions which may benefit both the firm and the executives.[115] However, regarding the executive remuneration issue, the accountability of the board is not sufficient; "the directors on remuneration committees also need to be competent."[116] Under most circumstances, executive remuneration policy is primarily the outcome of negotiations between boards and their executive managers, or managers-to-

[114] FRC, UK Corporate Governance Code 2016, D.2 Disclosure, Supporting Principles.
[115] *Supra,* n.66, Sheehan, The Regulation of Executive Compensation, p.94
[116] *Ibid.*, Sheehan.

be.[117] Before the negotiation with shareholders mentioned above, the pay policy has already been drawn up under the guidance of the managers. Thus, how to develop the dialogue with managers in order to arrive at a rational pay policy is very important for boards and remuneration committees.

The Yahoo case in 2016 is helpful to explain how this negotiation can occur in practice. In 2012, soon after Marissa Mayer, the former vice-president of Google, was hired as Yahoo's CEO, she was contacted by another Google president, Henrique de Castro.[118] Ms. Mayer told the board of Yahoo that she was negotiating with a talented person who would fit the position of COO (chief operating officer) perfectly, but she needed an attractive pay package in order to negotiate.[119] However, the board of Yahoo had no idea who was this person because Ms. Mayer did not identify him.[120] The new CEO provided Yahoo's remuneration committee with a pay plan for the new COO herself, and after just one day she had a meeting with the committee.[121] In a meeting lasting half an hour the committee agreed to this pay plan, but stipulated that if any material change was made to this plan, only the committee had the authority to approve the change.[122] After this meeting the Yahoo board suspected that Mr. de Castro was the person with whom their CEO was negotiating.[123] After one month Mr. de Castro was hired as the new COO at Yahoo; many changes had been made to his pay plan without the consent of the remuneration committee, but the remuneration committee did not take any action.[124] After Mr. de Castro was terminated from his position at Yahoo due to underperformance in 2014, he took his severance pay, valued at nearly $60 million, with $40 million of this in cash.[125] Nonetheless, the equity options he chose to exercise before his

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[117] The Economists, "Executive Pay: Neither rigged nor fair" 25 June 2016, p.20.
[118] ***Amalgamated Bank v. Yahoo! Inc.***, 132 A.3d 752 (Del. Ch. 2016), at 760.
[119] *Ibid.*, p.761.
[120] *Ibid.*
[121] *Ibid.*, p.762.
[122] *Ibid.*, p.762.
[123] *Ibid.*
[124] *Ibid.*, p.763.
[125] Business Insider, Yahoo's COO Walks Out with $20 Million Stock Bonus Plus $40 Million for just 15 Month's Work, 15 January 2014, available at: http://www.businessinsider.com/yahoo-coo-enrique-de-castro-has-stock-bonus-pay-package-2014-1 last accessed, 26 July 2016

departure were only worth $51 million at the time he left the company.[126]

It is no longer shocking to see underperforming executives take away huge amounts of money after they have resigned or been terminated. However, it is shocking that the independence of boards and remuneration committees has always been emphasised by various legislation globally, but it is still being so deficient in practice. Perhaps Yahoo was just an extreme case where the board ignored the negotiation process, but it does raise questions about why big firms like Yahoo are so eager to attract directors on big salaries. As mentioned in Chapter 3, one of the reasons why executives may receive unreasonably high levels of pay can be explained by the labour market of senior managers. First, executive managers have a general idea themselves about what level of pay they can expect, based on comparison with their peers working in the same industry. Second, the higher a management position is in a public firm, the smaller the pool of talented and skilled candidates from which the firm can hire and choose within one industry. The firm has to offer an attractive pay plan to hire new managers and retain existing ones. Thus, another issue that may be worthy of consideration by boards and remuneration committees is a peer group pay analysis and for the committee to hear from the remuneration consultants who carry out this analysis.

On the subject of remuneration consultants, according to Chapter 2, it is their duty to provide market data from peer group companies. Generally there is no exclusive requirement for the accuracy of their market advice, but rather in terms of their independence and care; these consultants should provide opinions to the remuneration committee fairly and responsibly.[127] The UK provides a good example of coordinating consultants' services, creating a remuneration consulting group in 2009 and producing a Code of Conduct in 2011. Revised in 2014, this Code of Conduct aims at clarifying the role of

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[126] J. E. Bachelder, Hiring and Firing a Key Executive at Yahoo, 22 June 2016, Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: https://corpgov.law.harvard.edu/2016/06/22/hiring-and-firing-a-key-executive-at-yahoo/ last accessed, 26 July 2016

[127] *Supra,* n.66, Sheehan, The regulation of executive compensation, p.75

remuneration consultants in providing information, analysis and advice on the level and structure of executive pay, ensuring they are making the most informed decisions according to an organisation's strategy, financial situation and pay philosophy.[128]

With general regulations in the Anglo-American system paying too much attention to conflicts of interest between consultants and firms,[129] other practical concerns should also be considered in setting standards for selecting comparative peer groups, the selection of equity incentive measures, and benchmarking for bonuses. Regulation and other rules for these consultants have only defined their roles and the nature of their services; the independence of remuneration consultants must not influence their selection of peer groups and measures.[130]

C. Suggestions

From the above, there are three concerns in relation to the accountability of boards and remuneration committees. First, with legislative requirements for the transparency of pay increasing over the years, boards and remuneration committees must ensure that various data will not be difficult to understand and leave investors confused. Second, the shortcomings of pay policy design are still obvious, and pay for underperformance and even failure still exists in various industries. Third, with the help of legislation, boards and remuneration committees should learn how to negotiate better with both shareholders and directors with regard to pay design.

C.1. Reporting

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[128] Voluntary Code of Conduct in Relation to Executive Remuneration Consulting in the United Kingdom, January 2014, available at: http://www.remunerationconsultantsgroup.com last accessed, 26 July 2016

[129] B. Cadman, M. Carver & S. Hillegeist, "The Incentives of Compensation Consultants and CEO Pay" (2010) 49 *Journal of Accounting and Economics* 263, p.265; K. Murphy & T. Sandino, "Executive Pay and Independent Compensation Consultants" (2010) 49 *Journal of Accounting and Economics* 247, pp.249–50.

[130] *Supra,* n.66, Sheehan, The regulation of executive compensation, p.76

As mentioned in Chapter 5, with the fraction of equity incentives increasing significantly in executives' total pay and structure, the complexity of the pay policy always leaves shareholders confused, and makes them rely more heavily on advisory groups for their voting decisions. This phenomenon not only has brought inconvenience to the shareholders, but has also allowed directors to form the opinion that shareholders are voting irresponsibly, such as in the JP Morgan case.[131] A good pay plan or pay report should ensure that shareholders have sufficient information to vote upon, knowing what to expect in the following year and avoiding the risk of unexpected outcomes in future pay reports.[132] In the UK Corporate Governance code, it is the board's responsibility to present "fair, balanced and understandable" reports to shareholders and other stakeholders.[133] However, in practice, the guidelines made by NAPF et al. suggest that although many listed firms have long-term incentive plans and deferred bonuses designed for their executives, since there are usually several kinds of financial incentive appearing in the remuneration policy and report, with various different performance conditions set for them, shareholders are not able to read and understand the multiple equity options and bonus schemes.[134]

Tesco's 2015 remuneration report provides an example of this. It had several shortcomings. First, in its single total figure for each executive director's remuneration, though it provides every element of pay clearly in a table, the report shows no data on how many shares each executive has been granted.[135] Even though these long-term share options are still vested to be claimed after a proper period, shareholders need to have a general view of the quantities of shares that may be held by executives, together with their salaries, bonuses

[131] Guardian, "JP Morgan takes advice from firm that its chief attacked", 15 June 2015, available at: http://www.theguardian.com/business/2015/jun/15/jp-morgan-advice-jamie-dimon-voting last accessed, 26 July 2016
[132] *Supra*, n.67, GC100 and Investor Group, "Directors' Remuneration Reporting Guidance", p.5
[133] FRC, UK Corporate Governance Code 2016, Section C, Accountability, C.1 Main Principle, "The board should present a fair, balanced and understandable assessment of the company's position and prospects"
[134] *Supra,* n.30, NAPF, Hermes, et al., "Remuneration principles for building and reinforcing long-term business success", p.4
[135] Tesco PLC Annual Report and Financial Statements 2015, p.50, available at: https://www.tescoplc.com last accessed, 26 July 2016

and other figures. This then provides an overall picture. Second, in the loss of company section (also called “the loss of office”), there is no form to explain how much in total the firm is going to pay its departing executives, with only a few paragraphs explaining why its former CEO would be granted various payments and benefits.[136] Compared to the 2013–2014 remuneration report which received only a 1.38% revolt from its shareholders, this 2014–2015 implementation report led to nearly 19% of the shareholders to vote no.[137] Besides shareholders’ dissatisfaction about Tesco’s share price drop during 2014 and 2015, part of the reason for this revolt was that the implementation report was not able to persuade the shareholders.[138] Deficiencies in remuneration reports have not only caused confusion and dissatisfaction among investors, but also led to concerns on boards about future remuneration policy making and the reputation of the company.

Apart from the regulating procedure of remuneration practice, it would be better if there were some requirements, or at least guidelines, from the government about how to draft remuneration reports.

Take the UK Corporate Governance Code for example: in section D Remuneration, there should probably be a subsection (D.3 Conciseness) to set out how the board and remuneration committee should explain their pay policy and its implementation. This is a way to explain the policy and show how managers are paid. This would help shareholders to be able to understand to know how to vote. Presently reports tend only to achieve the cold and rigid goals set by legislation.

C.2. Flexibility

In the cases of Morrisons and Tesco, mentioned in Chapter 5, in which departed CEOs were still highly paid for their underperformance, the remuneration

[136] *Ibid.,* p.55.
[137] Guardian, Tesco faces shareholder unrest over executive pay, 26 June 2015, available at: https://www.theguardian.com/business/2015/jun/26/tesco-sales-drop-13-but-outperform-market-expectations, last accessed, 26 July 2016
[138] *Ibid.*

committee should also have paid attention to the flexibility of the pay policy design. Boards need to ensure that their pay policy arranges various elements of remuneration subject to appropriate adjustments at the discretion of the remuneration committee.[139] Although shareholders have an advisory vote on the compensation implementation report, this power is not able to stop pay for failure. In 2016, cases from BP, JPMorgan, Citibank and Volkswagen have again emphasised the importance of how the remuneration design is implemented in practice. For example, BP's CEO Bob Dudley had his pay increased by 20% in 2016 for his performance in 2015, although BP experienced the worst loss in the oil industry in 2015.[140] The main rise in his remuneration was from his pension savings, which increased due to a change in retirement benefits, and his annual bonus which increased by 40% according to the bonus target set by his remuneration policy, even though BP made a loss of $5.2 billion in 2015.[141]

To stop pay for failure, shareholders should have a binding vote on pay for executives who leave the company in the next fiscal year after the AGM. It is creative and wise of the UK 2013 remuneration reform to separate the power of shareholder say on pay on between remuneration policy and the remuneration implementation report. However, as mentioned in Chapter 5, the implementation of the policy for executives leaving for poor performance and loss of company may need more attention.

Another country is considering adding a similarly flexible method of shareholder voting. In France, recent public outrage towards the motor giant Renault's ignorance of their shareholders' revolt over the compensation of the firm's CEO Carlos Ghosn has reached the French government. On 10 June 2016 France's lower house of parliament passed the Finance Minister's measure providing a stricter and binding shareholders' say on pay for the remuneration of chief

[139] *Supra*, n.67, GC100 and Investor Group, "Directors' Remuneration Reporting Guidance" p.5
[140] Financial Times, BP Revives Investor Fury on Executive Pay, oil company faces questions about its handling of shareholder revolt, and how it responds, 14 April 2016
[141] *Ibid*

executives in public companies.[142] The reason why the French government reacted so quickly and decisively to the Renault situation was partly because the French state has a considerable shareholding (20%) in this company, and the state voted no to the CEO's pay.[143] It seems emotional for the French government to propose new legislation against public companies' ignorance of shareholder power in such a short term. However, this reflects a significant corporate issue. The intrinsic reason here was the lack of accountability of the board, disregarding 54% of the shareholders' veto over this pay deal.[144] The French government is proposing to move further on shareholders' say on pay than the UK reform, requiring that shareholders have the power to vote on the remuneration implementation reports every year, on a binding basis.[145] Surprisingly, this reform has been supported by some French institutions and proxy groups, who were against legislation providing too much power to the shareholders.[146] It seems that the current excessive pay for failure really has caused serious concerns.

Remuneration policy is important, because it will influence how the remuneration will be set in the future and how to align pay for performance. Perhaps that is why shareholders are given voting powers globally on this issue, making them feel that they are making decisions for companies over the next three years or so. On the other hand, however, implementation reports must not be underestimated. From a practical view, it is the implementation report which finally decides how much executives are to be paid. Shareholders will not be satisfied with a merely advisory vote on this report, and it is crucially important from the point of view of board accountability that the board feels obliged to hear the shareholders' voice in implementing directors' pay,

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[142] Financial Times, 'French Shareholders Win Say on Executive Pay, Legislation follows dispute pitting Renault against shareholders', 10 June 2016.

[143] Guardian, 'Why the revolt against executive pay is not going away', 22 May 2016, available at: https://www.theguardian.com/business/2016/may/22/why-the-revolt-against-executive-pay-is-not-going-away, Financial Times, French Government Leads Shareholder Revolt against Renault, 29 April 2016. last accessed, 26 July 2016

[144] *Ibid.,* Financial Times.

[145] French Assemblee Nationale, Amendment No. 14 to the French Commercial Code, available at: http://www.assemblee-nationale.fr/14/amendements/3757/AN/14.asp last accessed, 26 July 2016

[146] *Supra,* n.143, Financial Times, n.141

especially departing executives who have had oversight over a loss to the company. Although it is strict and tough for remuneration committees and boards to design the variable factors in executive pay every year, this French proposal confirms the direction for legislation in other countries in relation to a way to stop pay for underperformance.

The revised section 430 (2B) of the UK Companies Act 2006, which was introduced in the 2016 reform, provides:

> "If a person ceases to be a director of a quoted company, the company must ensure that the following information is made available on the website on which its annual accounts and reports are made available – (a) the name of the person concerned, (b) particulars of any remuneration payment (within the meaning of Chapter 4A of Part 10) made or to be made to the person after ceasing to be a director, including its amount and how it was calculated, and (c) particulars of any payment for loss of office (within the meaning of that Chapter) made or to be made to the person, including its amount and how it was calculated."

This provision requires that public companies should post on the internet a statement of any director leaving office, including how to calculate this director's remuneration according to her pre-agreed pay policy before the loss of office payment. This transparency requirement, together with other requirements in relation to loss of office payments from section 226, is quite helpful for shareholders to obtain general information about the departing director. However, a symbolic non-binding vote does not provide shareholders with enough power to stop pay for failure.

C. 3. Negotiation and Responsibility

From the shareholders' perspective, as summarised above, the way that the UK reform separates the power of the shareholders' say on pay should be noted by other legislative regimes and governments. The binding vote on the future remuneration policy, as discussed in Chapter 5, did have some effects in slowing the rapidly increasing trend of executive pay. However, due to different political, economic and cultural backgrounds, a binding say on pay might not be suitable for every country – for example Germany, which already has strong trade union representation on the supervisory boards of large firms to monitor managers and their pay.

The design of the UK advisory vote on remuneration implementation reports increases communication between shareholders, and improves the accountability of the board towards their shareholders. As mentioned above, if boards and remuneration committees in the UK do not wish to provide another remuneration policy within a three-year period, they must have discussions with shareholders, especially large institutional shareholders, before resolution, to gain a general idea of how they will vote on the implementation report. This positive communication between boards and shareholders may improve the quality of shareholder engagement and the efficiency of remuneration reporting. An efficient legislative directive may be better than a straightforward but not very effective requirement in the corporate governance code, such as "the chairman of the board should ensure that the committee chairman maintains contact as required with its principal shareholder about remuneration."[147] The reason why several large UK companies upset their shareholders in relation to their implementation report for executive remuneration was because the directors were leaving their companies and their future pay policy would not be revised in the next fiscal year. This is also another reason for introducing a binding say on pay for departing managers as mentioned above, to stop pay for failure.

Learning from the Yahoo case, and other empirical evidence about board independence from CEOs and other executive managers as discussed in previous chapters, there are still improvements we can make to the negotiations between boards and executive directors. It may be said that negotiations between boards and managers are easy, compared to those

[147] FRC, the UK Corporate Governance Code 2016, Section D.2: Procedure

between boards and shareholders, but it is hard for boards and remuneration committees to keep their independence during this negotiation. According to the managerial power approach, Bebchuk and Fried suggest that executive managers are able to increase their own remuneration by using their considerable power over boards and other independent directors on the remuneration committee. Especially when companies are running well, these non-executive directors usually choose to cooperate with management teams within their social networks.[148] Even though various countries' corporate government codes require non-executive directors on the remuneration committee, evidence from Chapters 3 and 4 shows that there is barely any possibility for remuneration committees to obtain independence from executive directors as they are intended to. Moreover, a study collecting data from FTSE 350 companies between 1996 and 2005 has shown that the composition of remuneration committees has no statistical impact on the level of executive pay; the independence of the remuneration committee cannot guarantee that executive remuneration remains at a reasonable level.[149]

Perhaps it is time to emphasise the responsibility of the chairman of the board and the head of the remuneration committee. Legislations may provide for appraisals for every director of a remuneration committee in order to evaluate their performance.

C.4. Principles

Suggestions for legislation regulating remuneration committees and boards can be summarised as follows:

1. Provide guidelines for corporate governance, encouraging companies to provide concise remuneration reports to increase the efficiency of shareholder voting and the board's work;

[148] L. Bebchuk, J. Fried & D. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 *The University of Chicago Law Review* 751, p.784.
[149] I. Gregory-Smith, "Chief Executive Pay and Remuneration Committee Independence" (2012) 74 *Oxford Bulletin of Economics and Statistics* 510, p.522.

2. Make the shareholders' vote on the remuneration report for departing executive managers binding in order to prevent pay for failure;
3. Pursue the responsibility of the members of the board and remuneration committee for any lack of negotiation during the creation of the remuneration policy and report.

III. Remuneration Design: How to improve pay for performance

In relation to the Australian provisions on pay it has been said that : "A variety of legal persons are targeted by the regulation: listed companies, boards of directors, remuneration committees, individual executives/directors, institutional investors and shareholders."[150] According to Sheehan, the law does not provide a sufficient description of what a good remuneration outcome looks like, but instead gives guidelines for progress which executive managers and the board can easily hide behind. Thus, attention is still needed in terms of remuneration policy design.

The International Corporate Governance Network, which was proposed in 2006, suggests that there should be three factors to test executive remuneration practice: transparency, accountability, and pay for performance. Transparency means that shareholders and the public are able to obtain detailed information and monitoring rights with regard to the remuneration of executive directors, a matter discussed in the first section in this chapter. Accountability of the board and remuneration committee to shareholders on the practice of executive compensation, which should be improved, was analysed in the second section. However, these former factors are both set to achieve the third goal, which is pay for performance.

As shown in Chapter 2, pay for performance is the ultimate goal of executive remuneration practices under various theories that have been proposed to

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[150] *Supra,* n.26, Sheehan, The Regulatory Framework for Executive Remuneration in Australia, p.33

explain remuneration. In Chapter 3, the reasons behind pay for performance systems were investigated, suggesting that the markets alone are not able to solve these problems. The following will analyse briefly how pay is aligned to performance in practice, and summarise the difficulties of regulating pay for performance from a legislative perspective.

A. Pay setting for Performance

Normally, most executive pay policies are set on an ex ante basis, where the level and structure of managers' compensation packages are influenced by business conditions and the size of firms. It has been suggested that executive remuneration levels and firm performance may be conditional on the firm's investment opportunities. [151] Because managers' actions are seldom observable to shareholders, shareholders have to make investments or offer to hire executive directors based on measures they can observe, aligned to firm performance. Normally, with the ability to observe executives' actions decreasing, incentive compensation, which indicates market performance, increases.[152] Developing from these empirical investigations, a study by Baber et al. found that shareholders' investments are associated with the firm's market-based performance, rather than its accounting-based performance, while the executive directors' stock incentive compensation is a crucial consideration in the investors' judgements.[153] Because shareholders invest in the firm based on information about its managers' stock income, there may be situations where executives increase their pay level or manipulate share prices to attract investment opportunities. Baber et al. infer from their research that the influence of market-based performance factors on shareholders' investment will encourage cynical executive action to attract shareholder interest.[154]

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[151] C. Smith & R. Watts, "The Investment Opportunity Set and Corporate Financing, Dividend and Compensation Policies" (1992) 32 *Journal of Financial Economics* 263, pp.280-1

[152] J. Gaver & K. Gaver, "Additional Evidence on the Association Between the Investment Opportunity Set and Corporate Financing, Dividend and Compensation Policies", (1993) 16 *Journal of Accounting and Economics* 125, p.155.

[153] W. R. Baber, S. N. Janakiraman & S-H. Kang, "Investment Opportunities and the Structure of Executive Compensation," (1996) 21 *Journal of Accounting and Economics* 297, p.315.

[154] *Ibid*

Interference from legislation and government, as mentioned above, may provide several methods to solve or at least reduce situations such as this. If there is little legislative intervention endowing shareholders with voting rights and regulating an independent remuneration committee, there may be certain misalignments between executive compensation and performance. Klapper and Love engaged in a study of 495 public companies from various countries across twenty-five emerging markets and eighteen sectors with the purpose of investigating the relation between country-level shareholder rights and the nation's judicial efficiency. The researchers found that firms in countries with weak legal systems normally have lower governance rankings in the international data, and under those weak legislative situations, a firm's good performance is more positively correlated with better market-based performance and accounting performance.[155] As discussed in Chapters 2 and 3, with weak regulations and poor governance, directors' managerial power can easily influence pay policy, leading to a misalignment of pay and performance.

However, there is little guidance from legislation about how to evaluate remuneration policy design. Regulations about managers' compensation should also consider the influence of both market-based performance and accounting-based performance standards for executive remuneration policy. Market-based performance is measured according to the firm's stock market return, while accounting-based performance is about the accounting return on the firm's equities. Executives' income is explicitly tied to stock-price performance through performance-related changes according to the value of their stockholdings, restricted stock options and long-term stock options. As analysed in Chapter 3, pay-performance sensitivities represent the executives' share of the value that they have created. When shareholders' wealth increases by £1, the value of the executives' restricted and unrestricted stockholdings will increase by the executives' ownership of their firm's shares.[156] Additionally,

[155] L. F. Klapper & I. Love, "Corporate Governance, Investor Protection and Performance in Emerging Markets", (2004) 10 *Journal of Corporate Finance* 703, p.723
[156] K. Murphy, "Executive Compensation: Where we are and how we got there" (2012) *Handbook of the Economics of Finance*, edited by G. Constantinides, M. Harris & R. Stulz, North Holland: Elsevier Science, p.25

these two performance standards do influence each other. Executive income is indirectly tied to stock-price performance through accounting based bonuses, which reflecting the correlation between accounting returns and stock-price performance, and also through annual adjustments of salary levels and target bonuses. [157]

Earlier studies have confirmed theoretical assumptions that there is a linear relationship between executive compensation and performance from market and accounting perspectives. [158] In Lambert and Larcker's comparative research, they propose that cash remuneration exhibits a stronger positive time-series relation with accounting-based performance, while market-based performance only has a modest time-series influence on cash pay.[159] They also suggest that firms that are developing quickly tend to place relatively more emphasis on the executives' market-based performance than their accounting-based performance.[160]

It has been proposed that apart from executive directors' management behaviour, other factors which are uncontrollable will decrease the relative weight that these two performance factors have on executive compensation levels.[161] Such uncontrollable factors can be illustrated under two perspectives: (1) under the force of the stock market, calculating pay-performance sensitivities from the executives' option holdings aspect is more difficult than for stock holdings, since option values do not change dollar-for-dollar with changes in share prices; [162] (2) financial incentives in pay are created depending on various factors, including the executive's portfolio and the firm's future risk preference.[163] Argarwal and Samwich suggest that the level of firm

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[157] *Ibid.*
[158] B. Holmstrom, "Moral Hazard and Observability" (1979)10 *Bell Journal of Economics* 74, pp.89-90; R. Banker & S. Datar, "Sensitivity, Precision, and Linear Aggregation of Accounting Signals" (1989) 27 *Journal of Accounting Research* 21, pp.34-5
[159] R. Lambert & D. F. Larcker, "An Analysis of the Accounting and Market Measures of Performance in Executive Compensation Contracts", (1987) 25 *Journal of Accounting Research* Studies on Stewardship Uses of Accounting Information 85, p.113
[160] *Ibid*. pp.114-5
[161] *Ibid.*
[162] *Supra,* n.156, Murphy, Executive Compensation, p.37
[163] *Ibid.*

risk, which is also known as the firm return variance, is an important determinant of the level of remuneration for executives, and it is "robust" across the other measures of firm risk.[164] According to these financial studies, failure to allocate firm risk to compensation incentives will underestimate the real pay for performance relation.[165]

In terms of the above, even with regulations providing shareholders with voting rights and requiring the independence of boards and remuneration committees, previous situations such as excessive pay for failures and wrongful incentive design to encourage executives to take unreasonable risks, as discussed in Chapters 4 and 5, can be all explained according to these two uncontrollable factors which are always ignored by regulations. Therefore, in this section these situations will be investigated and various methods that legislation can utilise will be discussed.

B. Pay Structure

B.1. Long-term Equity Option Vesting Period

The most serious problem with the realisation of executive directors' equity options, especially with long-term incentive plans (LTIPs), is that there are no requirements in law about how long the post-exercise period will be.[166] According to the discussion in Chapter 3, there are several issues in relation to long-term equity options that remuneration committees should pay attention to: a long vesting period, usually lasting five to ten years; an exercise point at which the executive directors can claim their ownership of the shares; a post-exercise period during which the director will hold the shares; and finally a transferability point at which they can sell the shares for cash. Because there is no limitation on the holding period, under most circumstances executives will use their

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[164] R. K. Aggarwal & A. A. Samwick, "Executive Compensation, Strategic Compensation, and Relative Performance Evaluation: Theory and Evidence" (1999) 54 *The Journal of Finance* 1999, p.2032.
[165] P. Gregg, S. Jewell & I. Tonks, "Executive Pay and Performance in the UK", (2010) *AXA Working Paper*, Series No, 5, Discussion Paper No. 657, p.9
[166] *Supra,* n.81, JK McClendon.

power to push the share prices to a high level and sell the shares immediately after the exercise point. Managers' behaviour focusing on short-term profits in this way will certainly jeopardise companies' long-term success and shareholders' long-term interests.

Also as mentioned in Chapter 3, equity markets and product markets may sometimes help with pay for underperformance. Under good industrial performance or if the firm has previously performed badly, the equity options of executive managers will increase dramatically without any effort on their part due to long-term incentives, such as improvements in the company's share prices.[167] There is a method that the remuneration committee can use to avoid paying executives for under-performance: the peer group review. This includes a review of the level and structure of executive pay given by comparative firms in the same industry, and the analysis is carried out by the remuneration committee, remuneration consultants and sometimes even by the managers.[168] The reason why the company and remuneration consultants pay attention to this comparison (referred to by Bebchuk and mentioned in Chapter 3) is that shareholders, especially institutional shareholders, already recognize peer group reviews as a general performance measure for long-term incentive plans.[169]

Perhaps long-term incentive plans may work better if corporate governance codes or even legislation such as the Companies Act were to require that these equity options must be exercisable after at least three to five years after the vesting period. Particularly for executives who have left companies with their work accomplished, these long-term vested equities prove that they have contributed to the companies' long-term productivity. Even though they are not able to claim their money, they would not lose too much because the companies will have certainly provided them with other bonuses, short-term incentives and

[167] Dallas Morning News, D. DiMartino, "Are CEOs Hiding Behind Long-term Awards? Trend Towards Incentives Opens Another Chapter in Compensation Debate", 1 June 2003
[168] *Supra,* n.66, Sheehan, pp.124-5
[169] ABI, Association of British Insurers, 2008, Executive contracts and Severance Guidelines from ABI and NAPF, available at: https://www.abi.org.uk/News/News-releases/2008/02/Executive-contracts-and-severance-Guidelines-from-ABI-and-NAPF last accessed, 26 July 2016

benefits. If executives are dismissed or resign because of underperformance, companies will probably cancel their long-term incentive plans, as mentioned in Chapter 3.

For example, the UK Corporate Governance Code states that:

> "for share-based remuneration the remuneration committee should consider requiring directors to hold a minimum number of shares and to hold shares for a further period after vesting or exercise, including for a period after leaving the company, subject to the need to finance any costs of acquisition and associated tax liabilities. In normal circumstances, shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exercisable, in less than three years. Longer periods may be appropriate. Grants under executive share options and other long-term incentive schemes should normally be phased in rather than awarded in one large block."[170]

According to Deloitte's study on the executive remuneration reports of FTSE 350 companies, 51% of the FTSE 100 companies and 32% of the FTSE 350 companies now have their long-term incentive equity plans with further holding period after exercise of the options.[171] It can be observed that Schedule A has provided a good example in encouraging public companies to adopt longer holding period of the long-term incentive plans. This improvement has also shown that under a good directive of regulation, it is possible to develop and adjust the structure of executive remuneration policy, even though the regulation is seemed as a soft law.

Also, if governments consider that this legislation has intervened too much in the governance issues of public firms, institutional shareholders can strongly

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[170] FRC, UK Corporate Governance Code 2016, Schedule A
[171] Deloitte, "Your Guide: Directors' remuneration in FTSE 100 companies", p.10, October 2015; "Your Guide: Directors' remuneration in FTSE 250 companies", October 2015, p.8, available at: http://www2.deloitte.com/uk/en/pages/tax/articles/executive-pay-publications.html last accessed, 13 July 2016.

recommend in their remuneration guidelines for their investee companies to provide longer vesting period equity incentives.

This thesis proposes that, perhaps next step to promote a longer holding period of exercisable shares is that, certain regulations can force remuneration committees to provide reasons in the remuneration policy, together with the expertise of consultants from peer group analysis, as to why the holding period should be shorter than three years under special circumstances.

B.2. Short-term incentive options

The HSBC case is worth discussing since it raises several interesting points concerning pay policy design. In 2011 the HSBC remuneration committee proposed that to benefit the long-term profits of the company, top executives would only be able to sell their equity options after their retirement.[172] From the remuneration structure discussion mentioned above, it seems better if these top bankers maintain their equity holdings for a longer time. The HSBC remuneration committee designed their long-term incentive plan with five years as a vesting period to promote the firm's future success. This policy has influenced the level of pay of HSBC's CEO, Stuart Gulliver: in 2011 his pay was £12.5 million, but from 2012 to 2015 his remuneration was £7.5 million, £7.4 million, £8 million and £7.6 million respectively.[173]

However, shareholders were confused by the criteria suggested by John Thornton, the chairman of the remuneration committee at that time, measuring the share awards in a way that was not based on the firm's share returns.[174]

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[172] Financial Times, M. Serdarevic & P. Jenkins, "HSBC Proposes Pay Shake-Up", 22 March 2011.

[173] Data collected from: Mirror, "HSBC boss earns 500 times more than bank's lowest paid workers last year", March 2013, available at: http://www.mirror.co.uk/money/city-news/hsbc-boss-stuart-gulliver-earns-1743018; and Wall Street Journal, "Here's What HSBC's Best-Paid Executives Earned", 24 February 2014, available at: http://blogs.wsj.com/moneybeat/2014/02/24/heres-what-hsbcs-best-paid-executives-earned/ last accessed, 26 July 2016

[174] The Guardian, J. Treanor, "Investors split over HSBC plans to shake up executive bonuses", 21 March 2011, available at: http://www.theguardian.com/business/2011/mar/21/hsbc-executive-bonuses-proposals last accessed, 26 July 2016

Also, in 2015 nearly 30% of shareholders voted against the CEO's pay report, compared with 16% in 2014 and 11% in 2013, because of some misconduct in investing and a sudden increase in Gulliver's basic salary.[175] The increase in the shareholder veto in 2014 was due to the newly introduced EU executive bonus cap rule, as mentioned in Chapter 4, whereby executive bonuses and other financial incentives cannot be more than 100% of their salary or 200% with the shareholders' approval. Gulliver's salary increased by 70%, from £2.5m to £4.2m, and he complained that "we had a compensation plan here that the shareholders liked but sadly because of the EU directive we've had to change it. This isn't something we would have wanted to do. … It's much more complicated."[176]

Thus, although long-term incentives are now the most contentious issue in executive pay packages, other elements such as bonus plans and other short-term incentives are also influencing the total pay levels and shareholders' attitudes towards pay reports.

With the use of restricted share options and long-term equity plans increasing rapidly since the late 1990s and during the 2000s, managers took "unnecessary and excessive" risks to enhance the share prices up to 2008, which attracted the attention of the public and governments to managers' compensation.[177] In 2010, long-term incentive options made up 47.8% of the total pay of the US Fortune 500 companies, compared to 44.7% in 2006; in the UK, FTSE 350 executives received their remuneration with long-term incentives comprising 49.6% in 2010 and 39.7% in 2006.[178] As discussed above, proposals such as increasing the periods for long-term equity plans, recovering deferred bonuses and reducing golden parachutes had already been realised before the financial

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[175] Financial Times, Martin Arnold, "Almost a third of investors refuse to back HSBC pay," March 2015

[176] The Independent, "HSBC Stuart Gulliver to get 70% pay rise – taking his salary to £4.2m a year", Feb 2014, available at: http://www.independent.co.uk/news/business/news/hsbc-stuart-gulliver-to-get-70-pay-rise--taking-his-salary-to-42m-a-year-9150504.html last accessed, 26 July 2016

[177] Wall Street Journal, P. Dvorak & J. S. Lublin, "Bailout's Bid to Limit Executive Pay Will Be Tough to Realize", 6 October, 2008.

[178] data was from The Conference Board, "The US Top Executive Compensation Report" and Income Data Services, "Directors' Pay Report".

crisis.[179] Their role in linking performance and pay, and how to regulate them in law, will be analysed next:

In Chapter 3, it was acknowledged that short-term incentives, normally annual bonuses and restricted equity options, will be granted to executive managers after a conditional period, which is shorter compared to long-term incentive options. These short-term incentive plans are more heavily influenced by the firm's business strategy and financial status compared with long-term incentive plans, which are mainly designed to promote long-term relationships with executives. Executives tend to sell all of their shareholdings after the vesting period, so it is in their own interest to boost the share prices before selling, or focus excessively on short-term prices for those options while neglecting the long-term performance of the firm.[180] This phenomenon has been recognized not only in academic papers, but also in institutional shareholders' principles.

In my opinion, the rules for reporting short-term incentive pay should be regulated in the corporate governance code, under the "comply or explain" principle in section D.3 Concision, which was suggested in section II of this chapter. As mentioned in Chapters 2 and 3, under Murphy's theory the economic cost of companies granting equity options should be emphasised and calculated as if the companies did not grant those shares to its managers. Murphy suggests that remuneration committees and boards should calculate how much the company's income would be if its executive managers were not granted short-term share plans and include these figures in the firm's remuneration report, or even show what the company has spent on granting shares to managers instead of selling them to outside investors.[181] This requirement will improve the transparency of the pay reporting, and promote the long-term success of the company through shareholder engagement and

[179] Sonnenschein Nath & Rosenthal LLP, "Congress Passes New Limits on Executive Compensation Paid by Troubled Financial Institutions", 3 October 2008, available at: http://web.archive.org/web/20081209094043/http://www.sonnenschein.com/pubs/e-alerts/Congress_Passes_New_.html last accessed, 26 July 2016;
and also *Supra* n. 186, Wall Street Journal
[180] J. M. Fried, "Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosures" (1998) 71 *South California Law Review* 303, p.365.
[181] *Supra,* n.156, K. Murphy, p.149.

monitoring.

NAPF's institutional shareholders alliance principle on executive remuneration suggests that there has been too much debate between firms and investors around short-term or medium-term compensation designs.[182] They suggest that the current average three-year period of equity vesting in executive pay is not the best way to promote long-term success, particularly for the largest and most complex companies such as those listed in the FTSE 100.[183] Studies of executive compensation from the financial industry suggest that to stop executive managers focusing on short-term profits and gaining excessive pay because of wind-ups such as inflated asset prices, incentive plans should be extended to five to ten years, not only for long-term equity plans but also for restricted share options.[184]

To promote the firm's long-term success, Bhagat and Romano even propose that financial incentives in executive pay should all be changed into restricted stock or long-term stock options.[185] The condition they suggest for financial incentives is that after the vesting period executive directors should wait for two to four years after their resignation or last day in office to sell the shares they already owned.[186]

From the perspective of financial incentive development, perhaps short-term incentives should be merged slowly into long-term incentive plans, because shareholders prefer to invest in companies where executive remuneration is based more on long-term share plans.[187] However, due to the comparative advantages of short-term options over long-term incentives, such as attracting new executive managers to join the business and paying managers for short-

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[182] *Supra,* n. 30, NAPF, Hermes et al., "Remuneration principles for building and reinforcing long-term business success", p.3

[183] *Ibid.*

[184] *Supra,* n.99, J. Cullen, "Executive Compensation in Imperpect Financial Markets", p.97

[185] S. Bhagat & R. Romano, "Reforming Executive Compensation: Focusing and Committing to the Long-Term" (2009) Y*ale Law and Economics Research Pape*r No. 374, pp.380-1

[186] *Ibid.*, S. Bhagat & R. Romano.

[187] J. Brickley, S. Bhagat & R. Lease, "The Impact of Long-Range Managerial Compensation Plans to Shareholder Wealth" (1985) 7 *Journal of Accounting and Economics*115, p.120.

term performance by encouraging their long-term passion, current investors still approve of short-term plans.[188] Thus, perhaps this is not the time to remove this pay element from the executive remuneration structure.

IV. <u>Fair Pay?</u>

A. Fairness in Regulation

The central question in regulating in relation to pay inequality pay should be how far the government can intervene in fairness issues. Are the gaps between rich and poor, and the redistribution among them an aspect of the rationales behind the regulation of executive remuneration?

This following analyses inequality in pay in the business sector. First, how do pay gaps and inequality between executive directors and employees in a company influence the lower level employees' performance and the firm's long-term productivity? Second, is inequality considered by directors when they are making pay decisions? If so, under what circumstances should regulation towards fairness occur?

There have been several studies showing that increasing dispersion in pay in a company leads to lower productivity, less cooperation, and larger threats to turnover.[189] In 1963 Hicks discussed the importance of the psychology of workers, noting that "it is also necessary that there should not be strong feelings of injustice about the relative treatment of employees since these would diminish the efficiency of the team."[190] Additionally, research has also indicated that with less dispersion in pay, firms will perform better because the employees

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[188] R. Kolb, *Too Much Is Not Enough: Incentives in Executive Compensation* (Oxford: Oxford University Press, 2012) p.160.

[189] M. Bloom & F. G. Michel, "The Relationships among Organizational Context, Pay Dispersion and Managerial Turnover" (2002) 45 *Academic Management Journal* 33, p.38; J. Pfeffer & N. Langton, "The Effect of Wage Dispersion on Satisfaction, Productivity and Working Collaboratively: Evidence from College and University Faculty" (1993) 38 *Administration Science Quarterly* 382, p.400.

[190] J. Hicks, *The Theory of Wages*, (New York St Martin's Press,1963) p.112

are less resentful towards the executives and more willing to contribute to the company.[191]

Therefore, since this question has already been investigated, it can be concluded here that there is a negative correlation between compensation of executives and employees, and the performance of employees and even the whole firm. Then the next essential question will be, how will directors consider this situation and deal with existing pay inequality?

After studying 122 public firms over a five-year period, research done by Wade, O'Reilly and Pollock proposed that, first, CEO compensation is correlated positively with the lower level employees' pay, and second, CEOs are concerned with fairness as well as their own self-interest, and while they are negotiating to increase their own payment they will also think about their subordinates and, if possible, the employees as well.[192]

In August 2015 the US government provided a disclosure requirement on the ratio between the pay of regular employees and that of top executives. A new section 953(b) of the Dodd-Frank Act regulates that a public company's pay policy needs to give a record of the ratio of the total remuneration of its CEO to the median total compensation received by the rest of its employees, which will promote board accountability to shareholders in relation to executive compensation practices.[193] As noted by the SEC Chair Mary Jo White, this rule

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[191] O. Faleye, E. Reis & A. Venkateswaran, "The Effect of Executive-Employee Pay Disparity on Labour Productivity," 2010, available at: http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.615.3427 p.5; P. Martins, "Dispersion in Wage Premiums and Firm Performance", (2008) 8 *Centre for Globalisation Research*, Vol.8, available at: https://ideas.repec.org/p/cgs/wpaper/8.html p.5, both last accessed, 26 July 2016; also D. Cowherd & D. Levine, "Product Quality and Pay Equity between Lower-level Employees and Top Management: An investigation of distributive justice theory" (1992) 37 *Administrative Science Quarterly* 302, pp.316-7.

[192] J. B. Wade, C. A. O'Reilly, III & T. G. Pollock, "Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation" (2006) 17 *Organization Science* 527, p.539.

[193] SEC, L. Aguilar, "The CEO Pay Ratio Rule: A Workable Solution for Both Issuers and Investors", 5 August 2015, available at: http://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html last accessed, 26 July 2016

"provides companies with substantial flexibility in determining the pay ratio, while remaining true to the statutory requirements."[194]

From the SEC's statements, this new provision aims to promote board accountability for executive remuneration and flexibility in pay policy design by providing shareholders with clear pay ratio information in annual reports, proxy statements and even registration statements. From this perspective, though it touches on the topic of reporting pay ratios in the pay report, this new rule says nearly nothing about fairness in pay, or narrowing the pay gap between CEOs and employees. Although "think tanks" in the US and the UK have both suggested that the pay ratio should be used to decrease pay gaps and inequality in the work place,[195] this amendment does not seem to draw attention to these issues. The rationale behind this disclosure requirement for pay ratios may be found in the SEC's proposal for amendments to section 953(a) of the Dodd-Frank Act, which requires listed companies to provide a clearer description of the relationship between the executive compensation paid to the managers and the shareholders' total share return. It also requires a description of the relationship between the firm's total share return and the share return of its comparative peer group companies over the most recent five years, chosen by the compensation committee.[196] This proposed amendment, along with the BIS reform mentioned in Chapter 5, will help shareholders by providing detailed remuneration reports containing more information for voting on remuneration issues. As discussed in Chapter 4, the US shareholder say on pay stays on the advisory level. Requiring a pay ratio to be reported in the pay statement may provide shareholders with a more general view of CEO pay levels, but it rarely provides way to decrease pay gaps. Governments in the UK and the US are still focusing on attracting investment in their public companies, apparently by

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[194] SEC, SEC Adopts Rule for Pay Ratio Disclosure, "Rule Implements Dodd-Frank Mandate While Providing Companies with Flexibility to Calculate Pay Ratio", 5 August 2015, available at: http://www.sec.gov/news/pressrelease/2015-160.html last accessed, 26 July 2016

[195] Such as: Institute for Policy Studies (IPS), "2014 Executive Pay Reform Scorecard: Institute for Policy Studies; and High Pay Centre, "Reform Agenda: How to Make Top Pay Fairer", p.22, available at: http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer last accessed, 26 July 2016

[196] SEC, Pay Versus Performance, proposed rule, 6 July 2015, available at: https://www.sec.gov last accessed, 26 July 2016

providing shareholders with more detailed information and the power to decide on pay policy and reports. If any solution through regulation is possible, probably it would relate to redistribution, tax regulation, or draw from another corporate governance model, for example the German model that was discussed in Chapter 4. Providing shareholders with power may not be the right way to stop inequities in pay.

B. Having Employees on the Board?

Thus, is there any opportunity to have employee representatives on the board? The German model will certainly not fit all the corporate governance legislation in the world. Nonetheless, it provides some useful lessons. The Volkswagen case shows that to stop pay for underperformance, it is not enough merely to have employees on the board. After the German auto giant's emission scandal in 2016, the management board members' bonuses were cut by 30%.[197] However, this reduction in executive pay did not assuage the dissatisfaction of its shareholders.[198] TCI, an aggressive UK-based activist investor with £993 million invested in Volkswagen, published a letter to the company's management and supervisory boards about the shareholders' requirements for executive remuneration reform.[199] In this letter, this hedge fund investor suggests that the reason why managers in Volkswagen could be paid for underperformance was that they spent lots of their efforts to save unnecessary jobs and increase employees' wages.[200] Because the company has employees representing the German Labour Union on its supervisory board, and because these employee representatives have the power to decide how to pay management teams, it becomes important for executives to care much more about employee's benefits in order to keep their compensation level. After an

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[197] Reuter's, "VW Management Accepts Bonus Cuts of at least 30 percent: source", April 13th, 2016, available at: http://www.reuters.com/article/us-volkswagen-uaw-idUSKCN0XA1WU, last accessed, 26 July 2016
[198] The Motley Fool, "Volkswagen Shareholders Are Fuming Over Executive Pay", 15 May 2016, available at: http://www.fool.com/investing/general/2016/05/07/will-volkswagen-face-a-shareholder-revolt.aspx, last accessed, 26 July 2016
[199] Financial Times, "TCI Launches Campaign Against Executive Pay at Volkswagen," 6 May 2016.
[200] Financial Times Statics, TCI Fund Management letter, p.2.

evaluation of Volkswagen's recent cash-flow and payouts, TCI also points out that shareholders should have the power to monitor executive pay practice by annual voting on the remuneration report, and intervention from investors can be a good way of reforming executive pay practice.[201]

Besides this letter, governance experts have also expressed their concerns about having employees on the board. Their first concern is the accountability of the board. Under German law half of the supervisory board seats are reserved for employees who lack professional knowledge, which may mean that the board lacks accountability to shareholders. Since 2002 the chairman of Volkswagen has first discussed business issues with the workers' council and agreed a position, and then brought it to the shareholders –not like the situation in the UK, where the chairman arrives at a common position with the shareholders first and then talks with the board.[202] A former Volkswagen executive once said that "the board was really a show."[203] Although having employee representatives on board, these representatives seem not active in doing their monitoring and supervising job as expected. Current and former employee representatives of Volkswagen supervisory board stated that they knew nothing of the company's emissions cheating and had never discussed engine issues with any other director ever before.[204]

The second concern comes from the board's interaction. To ensure that employee representatives are willing to allow a generous pay package, executives may place too much attention on gaining employees' favour and support, neglecting payback for shareholders and the whole firm's interests. Charles Tilley has noted that to regain the public's trust on executive remuneration, it is necessary to ensure that a pay policy is "embedded with a strategy for delivering long-term sustainable corporate growth".[205] As mentioned before, it is the firm's long-term productivity that should be set as

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201 *Ibid.*, p.3.
202 Financial Times, "Volkswagen: System failure," 4 November 2015.
203 *Ibid.*
204 *Ibid.*
205 The Guardian, C. Tilley, "For Fair Pay, See Plato", June 2010, available at: https://www.theguardian.com/commentisfree/2010/jun/03/public-sector-pay-cameron-executive-bonuses last accessed, 26 July 2016

the main goal of remuneration design and practice, not the balance among the interests of shareholders, managers and employees. Increasing the employee monitoring function is aimed at improving the independence of the board and the remuneration committee. However, if employee representatives start leaning towards increasing managers' pay for underperformance, the problem will probably be the same with non-executive independent directors, or even worse, for independent directors who do not have that a strong relationship with the firm. One lesson learnt from Volkswagen is that perhaps governments should think twice before providing any legislation that puts employee representatives on the board.

There have been several other suggestions, such as having more employees holding the equity of the firm; "broader capital ownership would curb income and wealth inequality, expand investment and employment, and reduce the demand for redistribution through the state."[206] It may be a wise option for the company to benefit and retain valued employees. However, from the legislation perspective, it is not the duty of the Companies Act or a corporate governance code to intervene that much. On the other hand, if benefitting and retaining employees should draw the attention of regulation, learned from the German companies, perhaps regulations like this may not bring improvement for executive remuneration.

Reports about an increase in general income and the recovery of pay in the public sector may mean that the UK government refrains from thinking about adding regulation in favour of fairness at the present time. Perhaps this overall increase was the reason why the UK parliament turned down the pay ratio reporting law and placing employee representatives on boards to negotiate

[206] Financial Times, "Get Profits Share to Support a More Equal Income Distribution", 21 August 2015.

payment issues.[207] The UK is still a shareholder primacy country.[208] Additionally, while the worker's wage is increasing at its fastest rate for six years[209] and in the context of the UK's smooth economic recovery, which has decreased unemployment and inflation since 2011,[210] there will be fewer opportunities to regulate for a pay cap in this country.

Pay inequality can be controlled by corporate governance, but if long-term firm productivity is not affected by the pay gap, then inequity problems probably will not be regulated by law.

Conclusion

An article in the Financial Times suggested that executive remuneration should be simplified in structure, and reforms should push companies to reduce the complexity of their reports.[211] However, this suggestion for simplifying pay structures probably stems from only a partial understanding of pay structure and practice. Complexity in executive pay cannot be avoided since it derives from the variation incentives set for managers, although the aims of those incentives can be stated simply and clearly in pay reports and policies. Also, it is the job of remuneration committees and boards to make those aims accountable to shareholders for resolution. Since the shareholder say on pay movement has become a popular legislative approach it has been seen that this power has proved to have some difficulties to implement, so current regulations should be developed upon the present foundations to improve the

[207] Proposals suggesting having employees representatives in remuneration committee have been declined twice in the UK, in June 2012 1st reading in House of Commons, Bill 41: and in September 2013, 1st reading in House of Commons, Bill 105: http://services.parliament.uk/bills/2013-14/executivepayandremuneration.html last accessed, 26 July 2016

[208] D. Collison, S. Cross, J. Ferguson, D. Power & L. Stevenson, "Shareholder Primacy in UK Corporate Law: An exploration of the rationale and evidence," ACCA (Association of Chartered Certificated Accountants) Report 2015, available at: http://www.accaglobal.com/us/en/technical-activities/technical-resources-search/2011/september/rationale-and-evidence.html p.41, last accessed, 26 July 2016.

[209] Financial Times, E. Cadman, "Earnings Grow at Fastest Rate for Six Years", 17 September 2015.

[210] Financial Times, "UK's Enviably Smooth Economic Recovery", 17 September 2015.

[211] Financial Times, K. Burgess, "Complex Executive Pay Schemes under Fire", 16 September 2015.

quality of shareholder monitoring.

Due to differing cultures and industries, each government has unique methods of regulating remuneration practice. This chapter only provides suggestions for legislations that are useful under general regulatory conditions.

On the perspective of shareholder voting power, this chapter proposes that to improve understanding of the complexity of remuneration report, shareholders should have a meeting before they vote on executive remuneration report at annual meetings; to prevent pay for underperformance of executive directors, shareholder should have a binding vote on the implementation pay report of executives who are going to leave the company.

On the perspective of board's accountability, suggestions have been made that to better communicate with shareholders, there should be a concision requirement on remuneration reporting content and structure, from the regulation, such as from the corporate governance code; also, to promote the independence of board members and their negotiation with executive directors upon executive remuneration, certain legislation should be provided in pursing liability of the members who did not fulfil their duty of care.

From the perspective of pay for performance, to promote a company's long-term productivity through adjusting the structure of executive remuneration, regulations should encourage companies to enhance the executives' share holding period after these shares have been exercised; also encourage firms to disclose the economic cost in issuing restricted share options to executive directors.

These proposals cannot ensure that executive compensation levels will be reduced after they have been enshrined in legislation. However, they may make remuneration practice, such as shareholder engagement in reports and remuneration committee accountability, become and more efficient.

There still is huge concern about shareholder engagement in the shareholding meetings and their passivity in relation to corporate governance, especially in terms of international hedge funds who should be interested in what is going on as long as the company is running well. However, with the shareholder say on pay becoming a globally adopted corporate governance measure to align pay with performance, evidence has shown that there is a trend towards participating in pay resolutions among international mutual funds, pension funds, hedge funds and individual investors.[212] Although providing shareholders with a say on pay is not guaranteed to lead to pay for performance and promote the firm's long-term success, with more investors who are knowledgeable about and willing to engage in remuneration practice, shareholder intervention may develop in a positive direction.

Additionally, from the point of view of executive directors' incentive design, in Chapter 3 it was suggested that besides financial incentives in executive pay packages, there are also several metrics designed to award managers for their leadership, community skills and teamwork performance, as long as the performance can bring effective management. Financial performance measures are usually calculated on a quantitative basis, but these non-financial performance criteria are qualitative.[213] Probably it is not practical to provide rewards like this in the real world. The standards for paying managers for their non-financial performance may be quite subjective compared to financial incentive schemes. As mentioned above, current concerns towards the relationship between remuneration committees and executive managers make it even harder for legislation to provide appropriate methods to pay directors for their efforts, ethics and reputations.

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[212] PwC, Shareholder Activism: Who, what, when and how? March 2015, available at: http://www.pwc.com/us/en/governance-insights-center/publications/shareholder-activism-is-your-company-prepared.html p.5, last accessed, 26 July 2016.

[213] T. L. Albright, C. M. Burgess, A. R. Hibbets & M. L. Roberts, "Four Steps to Simplify Multimeasure Performance Evaluations Using the Balanced Scorecard" (2010) *Journal of Corporate Accounting & Finance*, July-August, p.63

Chapter Seven

Conclusion

The oldest Chinese philosophy book, I Ching (also “the Classic of Changes”) says that there are three principles that can be used to understand everything in the world: a. Principle of Changes, which means that nothing is unchangeable while everything is developing in its own way; b. Principle of Simplicity, saying that though everything is changing, there is nothing that cannot be simplified after it has been analysed and understood; c. Principle of Immobility, suggesting that there is only one true authority existing in the world that never changes.[1]

The former two principles can be applied to nearly every piece of research and this is the case with the issues of executive remuneration. Executive remuneration, as a social issue relates to corporate finance, corporate governance, legislation, politics, and the economy, can be understood and simplified after careful analysis:

The executive remuneration issue is developing and changing ever since it had been created. The creation of executive remuneration comes from the agency theory, under which the agent is paid by the principal in exchange of the agent’s work. Influenced by and developed with various factors, such as capital market, labour market, product market and corporate governance, executive remuneration is no long simply about setting pay based on the negotiation between the principal and the agent.

Changes in the structure of executive pay and the way which public company uses to produce the remuneration policy has made executive remuneration more complex. Excessive level and deficient structure of executive pay has

[1] Chu Hsi, translated by Joseph A. Alder, *Introduction to the Study of the Classic of Change,* (Global Scholarly Publications, New York, 2002) p.24; also Chinese handouts site in http://www.quanxue.cn/CT_NanHuaiJin/YiJing/YiJing01.html last accessed on July 13th 2016

existed for more than a decade, though it was after the financial crisis during 2007-09 had the public put attention to this problem. After realising that the problem of executive remuneration cannot be solved simply by markets and corporate governance, various regulations towards remuneration from governments appeared.

There are two research questions leading this thesis. First is, shall we regulate executive remuneration. Second is, what type of regulation we can use to solve the problems caused by remuneration issues.

To answer these two questions, Chapter 2 provided explanation from various theories considering what is executive remuneration and how to understand its problems. With the separation of management and ownership in corporate governance, it is the duty of board and remuneration committee to produce executive pay policy and report. Shareholders will pay executive directors under the policy and report. This interaction has concluded by the optimal contracting theory developed from the concept of agency cost proposed by the agency theory. The optimal contracting theory suggests that, the main function of executive pay should be encouraging and rewarding executives for better performance. However, under the managerial theory mentioned in Chapter 2, the internal relationship between board members and executive managers have made this design of pay complicated. Companies with poor governance may have their remuneration policies and reports manipulated by executive directors, which may lead to paying for underperformance and harm of the companies. Thus shareholder should interfere in the pay setting process. Also, economists have proposed that the financial elements in executive remuneration is also very important in understanding and setting the pay policy. Thus remuneration committee should emphasise the economic cost in issuing equity options in executive pay. Furthermore, theories from other scholars even suggest that directors can deal with all of the social and economic issues quite well in practices, thus shareholders realising they have the problems of information asymmetry should rely on the decision of board and remuneration committee in remuneration setting. Various theories provide various perspectives in understanding executive remuneration and various solutions in solving the problems it has caused, there is one principle they all admit upon. Chapter 2 functions in elaborating that this basic principle in understanding executive remuneration is that executive pay should be set according to their performance, namely pay for performance.

Chapter 3 explained how to align pay with performance and how this alignment fails because of various reasons. From the structure of executive pay, it can be summarised that elements of this pay is influenced deeply by the markets. Markets, which include labour market, product market, capital market and corporate governance, have always been relied upon to influence executive remuneration and solve its intrinsic problems, such as issues of incomplete contracting and undue influence of the executive directors over boardroom. However, investigated in Chapter 3, the influence from the markets can be easily used by executive directors to manipulate their own pay. Lessons learned from the financial crisis have also confirmed this failure of the markets. Thus, certain interference from the government is needed in this issue, since the markets have lost their positive functions.

The first research question thus was answered. Executive remuneration problems, with its problems cannot be solved efficiently with the markets, are in need of other forms of interference. Next discussion will be focused on what form of this interference should be:

There is an over 70-year history of governments adjusting executive pay since the separation of management and ownership of public firms.[2] Chapter 4 first analysed the history of the US government in interfering with the executive remuneration issues. After this analysis, it proposed that through all those regulation and political efforts in adjusting the level and improving the structure of executive pay, it is shareholder's voting power in pay that not only have been designed reasonably, but also have contributed to solving certain problems of executive remuneration. This voting power, is called shareholder say on pay.

[2] S. A. Banks, B. Cheffins & H. Wells, "Executive Pay: What worked?" (2016) *University of Cambridge Legal Studies Research Paper Series* No. 38, p.5

Chapter 4 then listed the legislative interference through providing shareholders with say on pay from various nations, concluding that shareholder say on pay has formed a worldwide trend in remuneration regulations. However, since several countries already introduced shareholder say on pay before the financial crisis of 2007-09, why the regulations did not stop the remuneration from growing excessively? Were these say on pay regulations not strong enough?

Chapters 5 and 6 together answered the second research question. Chapter 5 provided a general evaluation of the UK binding say on pay reform which was introduced in the Companies Act to empower shareholder's monitoring function in the setting of executive remuneration. This shareholder binding say on pay was provided to attract investment in the UK and to promote the long-term productivity of public companies, under the legislative intention of the UK government. Certain merits of this reform have been summarised by this thesis, such as the design of shareholder annual advisory voting on the implementation report of executive directors, and the introduction of claw-back requirements. However, more importantly, this thesis proposes that, this reform still leave several big problems of executive remuneration unsolved. Such as pay for underperformance, complexity for shareholders in reading and understanding remuneration reports and the increasing gap between executive directors and employees. Chapter 5 collected evidence and pointed out that, part of the reasons why there are still concerns left was because the UK government did not intend to provide legislation to decrease the pay gap and reduce the level of executive pay. The concern of the UK government was how to attract more investments in this country for a long-term productivity. This binding say on pay reform entertains shareholders with providing stronger monitoring power as a showcase to suggest that the government is trying to solve the remuneration problems. Nonetheless in practice, this reform makes the power of shareholders still difficult to control the executive pay.

Based on the study of Chapter 5, this thesis provided several opinions towards how shall we regulate the issues of executive remuneration in Chapter 6, to answer the second research question. Chapter 6 proposed that, improvement in regulations can be made through three perspectives: shareholder empowerment, board accountability and pay design.

1. From the shareholder aspect: a. shareholders should be encouraged by corporate governance code or stewardship code to meet and discuss about how to vote on new remuneration policy, before they attend annual meetings for voting; b. shareholders should be given a binding vote from company law on the remuneration report of executive directors who is departing from the company.
2. From the board accountability aspect: a. corporate governance code should add a concision section to require board and remuneration committee to provide a more understandable remuneration report with high standard of transparency; b. legislation should be designed specifically (not only under the fiduciary duty) to pursue the liability of board members who fail to negotiate executive remuneration package with either the executive directors or the other board members.
3. From the perspective of improving pay design: a. corporate governance code should have clear provisions of encouraging, and even requiring longer holding period of shares that executive directors would own after they purchase their long-term incentive options in the pay package; b. regulations of corporate governance should also pay attention to short-term incentive options in remuneration report: Certain requirements should be made for remuneration committee to report and explain the economic costs of the company in granting these short-term options to executive directors.

Besides answering the research questions, this thesis also proposes that, there is hardly any objective standard to justify what is a good executive remuneration design. From the discussions in Chapters 2 and 3, it can be observed that executive remuneration is quite a complex issue, and the problem of it is related to various factors. With many theories trying to explain and solve the problems of executive remuneration from different perspective, no certain valuation has been given to answer if there is any standard to tell what is a good remuneration design or not.

Executive remuneration is still being influenced largely by the markets, with the level of it increasing and decreasing dramatically according to the condition of economy.[3] Besides the intrinsic influence from the markets, other relationships, such as the negotiation between board and executive directors, the interference of the shareholder say on pay, and different corporate cultures affecting the pay level and structure, can also change executive remuneration directly. There is no priority among these various factors in influencing executive remuneration. Therefore, there is no prediction towards what will be a good remuneration policy. What can be certain is that the more tightly pay is aligned with performance, the better the remuneration policy and report is designed. Thus, pay for performance is currently the only standard in justifying executive remuneration design.

There are also some limitations in this thesis:

1. This thesis proposes its thinking of regulation that can help to improve remuneration report from normative perspective. Those proposals of regulation stay at a very original level, without investigating the practical possibility of implementation.
2. This thesis does not discuss about the cost that empowering shareholder say on pay will cause to shareholders and firms. The cost may include the potential spending of time and monetary cost that shareholders would pay when: consulting with voting advisory service, negotiating with board and remuneration committee that may happen during the pay policy making process, meeting and discussing with other shareholders around voting issues before their attendance of the annual meeting.
3. No new element that can be added into executive remuneration structure have been proposed by this thesis. Proposals from scholars, such as requiring executive directors to hold debts of their firms as part of remuneration,[4] and increasing the proportion of non-financial rewards, are

[3] EPI Economic Policy Institute, "CEO Pay Continues to Rise as Typical Workers Are Paid Less", 12 June 2014, available at: http://www.epi.org/publication/ceo-pay-continues-to-rise/ last accessed, 12 October 2016
[4] A. Edmans & Q. Liu, "Inside Debt", (2011) 15 *Review of Finance* 75, pp.83-4.

developing. Today's executive pay design is far from perfection. However, it is hard to imagine what would be in the executive pay packages if we excluded all of the current pay elements, such as restricted share options and long-term incentive plans. Studies show that shareholders, though dissatisfied with pay for underperformance, generally approve of current forms of executive pay.[5] The new ideas of adding new elements in executive pay might be used several years later if they have been proved to be useful in aligning pay with performance and earned their popularity.

Overall, this thesis contributes in two factors for further research on executive remuneration:

1. Understanding executive remuneration: this thesis proposes that to understand executive remuneration and its problems, elements from three perspectives shall be analysed: a. the surface: the level of and structure of executive pay; b. the intrinsic influential elements: capital market, product market, labour market, and corporate governance; c. the governmental interference: regulations made under company law and corporate governance. It also proposes that certain regulations made by the government have solved several remuneration problems, while leaving several concerns.
2. How to regulate executive remuneration: this thesis provides legislative methods to solve current executive remuneration problems through three aspects: how to empower shareholder say on pay; how to increase the accountability of board and remuneration committee; how to improve the design of remuneration policy to align pay with performance.

Word Count: 87,070

[5] J. Brickley, S. Bhagat & R. Lease, "The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth" (1985) 7 *Journal of Accounting and Economics* 115, p.123; R. DeFusco, R. Johnson & T. Zorn, "The Effect of Executive Stock Option Plans on Stockholders and Bondholders" (1990) 45 *Journal of Finance* 617, p.621

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