Executive Directors' Remuneration

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This issue of ECL deals with executive directors' remuneration, executive remuneration for short. Executive remuneration has developed into a key debate in corporate governance.[1] When looking at past opinions on executive remuneration, one particular trend emerges. This is the conflict between allowing executive directors to be remunerated adequately, whilst at the same time curbing possible excesses in remuneration levels. Adequately remunerating executive directors serves to attract capable board members, which benefits the companies they serve as well as the economy as a whole. Remuneration excesses, however, lead to outcries on the part of both the company's shareholders and the general public alike. This duality comes to the fore in both the UK Cadbury and Greenbury Reports of 1992 and 1995 respectively.

In 1992 the Committee on the Financial Aspects of Corporate Governance (chaired by Sir Adrian Cadbury) opened its Report[2] by stating that "The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. (…) This is the essence of any system of good corporate governance" (1.1). The Report identified several factors that had led to the formation of the Committee. These factors were primarily weaknesses in existing accounting standards, uncertainty about the framework to be used for corporate internal risk management and control systems, and the matter of auditor independence (2.1). The Report went into the issue of directors' remuneration also. According to the Report, board remuneration should be guided by openness. This implied that shareholders should be entitled to some measure of insight into the directors' remuneration. The Report argued that "*in disclosing directors' total emoluments and those of the chairman and highest-paid UK director*" attention should be given to both base remuneration and performance-conditioned remuneration, and that performance criteria should be explained (4.40). The Report regarded shareholder involvement in determining the concrete remuneration of directors as being not "workable" (4.43). It argued that the executive directors' remuneration should be set by the board. However, the Report developed the case for establishing remuneration committees to make recommendations to the board on executive remuneration (4.42). Of the nineteen provisions that made up the Code of Best Practice that was contained in the Report, three provisions were devoted to executive remuneration.

In 1995 the Study Group on Directors' Remuneration (chaired by Sir Richard Greenbury) issued its Report.[3] Now, the Study Group referred to both public and shareholder concerns that had been voiced on directors' remuneration as the basis for its work (1.1, 1.6-1.8, 1.11). According to the Report, these concerns might sometimes be exaggerated as the Report stated that on the whole companies in the UK took up the issue of directors' remuneration "in a sensible and responsible way" (1.9). Indeed, argued the Report, "the performance of our companies depends to an important extent on the Directors and senior executives who lead them. The remuneration packages UK companies offer must, therefore, be sufficient to attract, retain and motivate Directors and managers of the highest quality" (1.10). This did not stand in the way of the Study Group developing a Code of Best Practice devoted entirely to directors' remuneration. It consisted of 44 provisions. Code provision A1 recommended that corporate boards "should set up remuneration committees of Non-Executive Directors to determine on their behalf, and on behalf of the shareholders, (…) the company's policy on executive remuneration and specific remuneration packages for each of the Executive Directors". As for membership of these committees, the Report formulated independence criteria (code provision A4). Each year, the committee should make available to the shareholders (as part of or annex to the company's annual report and annual accounts) a remuneration report (code provision B1) on "the Company's policy on executive remuneration, including levels, comparator groups of companies. individual components, performance criteria and measurement, pension provision, contracts of service and compensation commitments on early termination" (code provision B2). The report should also provide "full details of *all elements in the remuneration package of each individual Director by name*, such as basic salary, benefits in kind, annual bonuses and long-term incentive schemes including share options" (code provision B4). Furthermore, the Report suggested that performance-conditioned remuneration should serve to align the interests of the company's directors and shareholders and should encourage high level performance (code provision C4), and suggested that performance criteria governing incentive schemes (including share option schemes) should consider the performance of the corporation against comparator companies in *e.g.* total shareholder return (code provision C8).

1 *Cf.* Cornelis de Groot, The level and composition of executive remuneration: a view from the Netherlands, in: ECL 2006/1, pp. 11-17 (12).
2 (www) ecgi.org > codes and principles > index of all codes.
3 (www) ecgi.org > codes and principles > index of all codes.

Following the Cadbury and Greenbury reports, the Committee on Corporate Governance (chaired by Sir Ronald Hampel) published the Final Report on corporate governance in 1998.[4] This Committee too dealt with executive remuneration. The Committee paid tribute to both the work of the Committee on the Financial Aspects of Corporate Governance and the Study Group on Directors' Remuneration for the fact that, as the Committee declared, "Public companies are now among the most accountable organisations in society. They publish trading results and audited accounts; and they are required to disclose much information about their operations, relationships, remuneration and governance arrangements" (1.1). The Committee supported the results of its predecessors for the most part (1.7) and therefore drafted only a small number of corporate governance principles (1.20, 2.1). It furthermore announced its intention to bring together the existing and its own conclusions on good corporate governance in a combined principles and code document (1.22-1.24). It did so in 2000, by issuing the Combined Code – Principles of Good Governance and Code of Best Practice. This document stood at the basis of the Combined Code on Corporate Governance of 2003, drawn up by Financial Reporting Council.[5] In 1998, the Committee stated the following principles on directors' remuneration:

I. The Level and Make-up of Remuneration. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of remuneration should be structured so as to link rewards to corporate and individual performance.
II. Procedure. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors.
III. Disclosure. The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

The Final Report referred (4.3) to market forces, including international markets, as the determining element in establishing executive remuneration. It argued that in such a situation, remuneration committees are best equipped to set remuneration levels. In the opinion of the Final Report (4.6), executive remuneration should seek linkage to the performance of the company. This could be achieved e.g. "by annual bonuses, share option schemes, or long-term incentive plans". Shareholders should have a right to information (4.3). However, the Final Report argued, disclosure as such may have an upward effect on remuneration (4.5). To this it added that, when disclosure becomes "excessively detailed", the situation might occur where only a few experts can understand its intricacies (4.16). Although the Final Report did follow the reasoning that disclosure of individual directors' remuneration could lead to a situation were non-national candidates would decline taking up a directorship in some cases, it was not convinced by this argument in the end: "We believe that shareholders have an equal interest in disclosure of the remuneration of all directors, regardless of nationality or residence" (4.17).

Readers of this issue of ECL will find it interesting to contrast the principles and ideas in the Final Report, that still hold sway, with the present state of regulation and with initiatives for new regulation in other countries. To that end, the articles and country reports in this issue give insight into the ongoing debate on executive remuneration in several jurisdictions. It seems that regulating executive remuneration can make use of a number of techniques. These include (1) giving remuneration committees, as specialized corporate bodies, the power to decide on executive remuneration, (2) disclosure requirements, (3) giving the shareholders' meeting the right to decide on some elements of executive remuneration, and (4) putting caps on the level of individual directors' remuneration. Throughout these techniques, the company's remuneration report has an important place. Drawn up by the remuneration committee, it can serve to explain the company's remuneration policy and to disclose individual executive remuneration based on that policy, and may help to guide the general meeting through the decisions reserved for its decision. Finally, it may spark debate among the shareholders as well as among the general public on the total level of executive remuneration and the need for introducing remuneration caps. To that extent, remuneration reports could play an important role in the balancing act of allowing executive directors to be remunerated adequately, whilst at the same time avoiding remuneration that is perceived as excessive by the company's shareholders or by the general public. These reports could thus be an important factor to counter possible reputational damage which companies might experience. And, avoiding reputational damage is in the best interest of both the shareholders who put first the shareholder value of the companies they invest in, and the economy as a whole.

4 (www) ecgi.org > codes and principles > index of all codes.
5 (www) frc.org.uk > corporate governance > combined code.