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The Regulatory Framework of Executive Remuneration: Contributions from Shareholder Activism and Board Accountability

Professor Jingchen Zhao* and Dr. Zhihui Li**

INTRODUCTION

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.”¹ The High Pay Commission in the UK emphasized that excessively high pay is “a symptom of a wider market failure based on a misunderstanding of how markets work at their best.”² According to the Commission’s investigation, in 2011, even though economic growth was slow, executive remuneration in FTSE 100 companies³ had risen by 49% on average, compared with a 2.7% average increase in employees’ payments.⁴ It was suggested that the growing income gap between top executives and average employees might pose a threat to the companies’ long-term interests.⁵ To have a better understanding of the executive compensation problem, it is essential to undertake an in-depth analysis of the rationale for the awarding of

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1. Julia Finch, Jill Treanor & Richard Wachman, *Critics Unite over Executive Pay to Force the ‘Aliens’ of Business down to Earth*, THE GUARDIAN (Mar. 31, 2010), <http://www.guardian.co.uk/business/2010/mar/31/myners-urges-fsa-to-investigate-shareholders-role> [perma.cc/YTR9-6JGL].

2. The High Pay Commission, *Cheques with Balance: Why Tackling High Pay is in the National Interest*, HIGH PAY CENTRE (2012), http://highpaycentre.org/files/Cheques_with_Balances.pdf [perma.cc/HZ8B-CD5J].

3. *FTSE UK Index Series*, FTSE RUSSEL, <https://www.ftse.com/products/indices/uk> [perma.cc/8PTE-TL98] (defining FTSE 100 is the first 100 public companies listed in the LSE, and FTSE 250 is the companies listed from the 101st to 350th in the LSE).

4. *FTSE Statistics*, LONDON STOCK EXCHANGE, <http://www.londonstockexchange.com/statistics/ftse/ftse.htm> [perma.cc/Y7UM-239L].

5. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 261–62 (1990).

compensation. In the UK, the Corporate Governance Code (the “Code”) defines the board’s role as “to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed.”⁶ Directors owe fiduciary duties to their companies, as well as a duty of care.⁷ The duty to avoid conflicts in the scope of fiduciary duties⁸ 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,⁹ directors should not be the parties who decide on the amount of their own remuneration. They should neither permit someone who is dependent on the directors to decide on their remuneration, nor receive an “excessive and unreasonable” amount of money.¹⁰ 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 executive remuneration or on the risks imposed by the company’s remuneration practices.¹¹

From a contract perspective, when directors are employed by the company they are bound by the company’s the certificate of incorporation. Problems may then appear if the company seeks to amend the terms of a director’s remuneration without complying with the articles.¹² According to the Code, this problem can be resolved by introducing a claw-back provision to prevent rewards for failure.¹³ Despite the fact that topics related to the rationale and reasons for executive remuneration have been discussed, issues of how to regulate and the forms of regulation have been rarely examined. The article aims to fill this gap.

The article will focus on the measures and trajectory of executive remuneration regulation by addressing the following research question: if regulation is appropriate and the way forward, what form should it take to solve current executive remuneration problems? The article will offer a

6. Corporate Governance Code 2016, FRC, 2016/April, sec. A, ¶ 1 (Eng.).

7. See, e.g., Companies Act 2006, c.46, §§ 172, 174 (Eng.).

8. See Companies Act 2006, c.46, § 175 (Eng.).

9. Janice S. Miller, Robert M. Wilseman & Luis R. Gormez-Mejia, *The Fit Between CEO Compensation Design and Firm Risk*, 45 ACAD. MGMT. J. 745, 754 (2002).

10. Joseph Lee, *Regulatory regimes and norms for directors’ remuneration: EU, UK and Belgian law compared*, 13 EUR. BUS. ORG. L. REV. 599, 603 (2012).

11. *Id.* at 609.

12. *Id.* at 612.

13. FRC, *supra* note 6, 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”). Note, about Claw-back; see DAVID. L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY’S INVESTORS, 63 (3d ed. 2003) (“A claw-back is required when managers take a contractual share of early investment gains that are subsequently reduced by losses”).

comprehensive analysis of three concerns, including pay for underperforming executives, shareholders' difficulties in understanding pay reports, and the increasing pay gaps between executives and formal employees, followed by a critical analysis of possible solutions.

Looking at the current attempts at legislative reform in this arena, 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 to securitize executives' pay. To empower shareholders with more voice on directors' remunerations, a "say on pay" regime has become a global trend as an attempt to solve executive remuneration problems. However, this global trend is subject to a number of uncertainties, such as: Is shareholder empowerment in terms of a say on pay able to assure long-term productivity?¹⁴ If shareholder empowerment is not as useful as governments think, are there any other methods within the domain of corporate governance to ensure pay for performance? Will board accountability to shareholders in relation to executive pay be sufficient to improve pay design? We will address these questions in this article, in order to provide a comprehensive answer to the issue of how to regulate remuneration.

A functional and effective mechanism for setting executive remuneration will be proposed in a normative way. If agency theory and managerial theory can be used as theoretical bases to prove that pay for performance is the final goal of setting executive managers' remuneration, an effective way to achieve this final goal should be proposed. The focus of this article is on how to achieve this goal effectively and efficiently, together with the challenges of designing a more appropriate and workable remuneration system. The requirements for forming a good remuneration system will be discussed 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.

We will consider the central relationships that emerge from practical factors between executive pay and shareholder intervention, board accountability and shareholder participation. Good pay practices will be analyzed from the perspectives of the shareholders, the executive directors, the board, and employees.

This article is an original attempt to establish a more effective regulatory framework for executive remuneration problems through shareholder empowerment, board accountability, and executive

14. Robert S. Kaplan & David P. Norton, *The Balanced Scorecard – Measures That Drive Performance*, HARV. BUS. REV. Jan.-Feb. 1992, at 77.

remuneration design. Current executive remuneration problems are categorized into two perspectives: pay for underperformance and deficient remuneration structures. Building on existing research on current regulatory methods to solve remuneration problems and improve the system's effectiveness, this article makes some original contributions to establishing detailed proposals for better regulatory frameworks and legislative instruments in a few respects. These include adjusting shareholders' voting rights and participation in voting for executive remuneration policies, emphasizing the board's remuneration reporting and liabilities for directors' failures in negotiating remuneration design, and improving remuneration design by requiring longer holding periods of executive's incentive equities in the company.

The article is organized in three subsections. Section I will explore 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 company's long-term productivity. Arguments will be made to support the point that shareholders, as a whole, belong to a separate group in corporate governance that tends to focus on the company's long-term success. The advantages and disadvantages of shareholder empowerment will be discussed from the say on pay experiences of the UK and the U.S. This section will demonstrate 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 be subject to much, if any, interference from shareholders. This section will provide evidence that board accountability is not adequate to solve remuneration problems and to promote a company's long-term success without regulatory intervention. Problems and good examples of ways to solve these issues will be investigated, and several suggestions will be provided for how to improve accountability. Several principles will be suggested for how to improve the board's service when making remuneration reports.

Section III will provide proposals for improving executive remuneration pay plans. A summary of regulatory suggestions will provide guidance for how to adjust the pay structure to align pay and performance based on the spirit of company law and empirical evidence.

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 practical method to monitor executive pay, has not been recognized 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 be established. Some suggestions for how to achieve a broader scope of say on pay will be provided in Section IV.

I. SHAREHOLDER SAY ON PAY

A. SHAREHOLDER POWER AND LONG-TERM SUCCESS

Shareholder empowerment is a notion that legislation can adopt in order to provide investors with the power to monitor management issues in companies. However, a consensus has not been reached on the efficiency and effectiveness of shareholder intervention in companies. Evidence from the financial crisis 2008 showed that shareholders in the UK's public companies were provided with a greater scope of power under company law and corporate governance in comparison with the U.S. However, stock prices fell faster in the UK than they did in the U.S. during 2008, which led to a financial crisis in the UK as serious as that in the U.S.¹⁵ In terms of the history of UK company law legislation, it would be misleading to say that the basic features of modern companies, such as their separate personality, centralized management, limited liability, and the free transfer of shares, have evolved together to form today's corporate model.¹⁶ Nonetheless, these basic features were generated by law at different times and adjusted to later environments.¹⁷

The two most common approaches created by company law legislations to enable shareholders to intervene in the management of companies include the exit channel and the voting channel.¹⁸ In public companies, shareholders can express their dissatisfaction and subsequently make an impact on managerial decisions by threatening to sell their shares, which may lead to a drop in the share price. This threat to sell may not only influence the value of stocks held by the executive directors from their compensation, but also has negative effects on the reputation of the company¹⁹ and ultimately on the reputations of the executives. The other way is for shareholders to express their opinions by voting against certain board

15. Brian Cheffins, *Did Corporate Governance "Fail" during the 2008-9 Stock Market Meltdown?*, 124 ECGI L. Working Paper 6 (2009).

16. Simon Deakin, *Corporate Governance and Financial Crisis in the Long Run*, 417 U. OF CAMBRIDGE WORKING PAPER CTR. FOR BUS. RES. 6 (2010)

17. *Id.*

18. Konstantinos Stathopoulos & Geoigios Voulgaris, *The Impact of Shareholder Activism: The case of say-on-pay*, 24 CORP. GOVERNANCE: AN INT'L REV. 359, 360 (2015).

19. Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 THE J. OF FIN. 2481, 2493 (2009); *see also* Anat R. Admati & Paul Pfleiderer, *The Wall Street Walk and Shareholder Activism: Exit as a form of voice*, 22 REV. OF FIN. STUD. 2445, 2476-77 (2009).

decisions or directors at shareholders' meetings.²⁰ The shareholders' say on pay is one factor in the second channel.

In addition to agency theory, the high liquidity of capital markets also has a huge impact on the trajectory of corporate law and governance development.²¹ The 2008 financial crisis generated huge concerns that the increasing liquidity of capital markets changed the ownership pattern of public companies—from family members to institutional shareholders through widely diversified pension funds and mutual funds.²² Furthermore, there is a trend towards shares to be held for relatively short periods, including those owned by institutional shareholders such as hedge funds, insurance policies, and securitized instruments.²³ With the rapid increase of equity liquidation, the use of shareholder power can become complicated. Since these shareholders make the presumption that their investments will only stay for a short time in one company, it is doubtful whether they will focus on the companies' long-term interests when they vote on corporate policies, being more likely to sell their shares and terminate their interest in the company.

Say on pay reforms, which enhanced shareholders' powers to improve board accountability in the 1970s and the early 1990s, may have already conferred too much power on the shareholders.²⁴ It has been suggested that these reforms may be erroneous in regulating shareholders' power. For example, institutional shareholders, who were more likely to make informed decisions, tended to see their equity capital contribution decline during the financial crisis. Moreover, providing them with more power for intervention in management may cause other problems²⁵ such as short-term rent-seeking behaviors and sudden extractions. Nonetheless, it may be too arbitrary to deny the necessity for regulations giving shareholders powers to influence public companies. This can be explained by exploring the methods by which shareholders can intervene in the management of companies.

Despite the fact that shareholder empowerment has been questioned in terms of whether it can be used to promote long-term productivity, it is accepted that shareholder engagement can be helpful in preventing companies from pursuing short-term success. Roger Barker, Director of Corporate Governance of the Institute of Directors of Corporate Governance (IoD), when commenting on new

20. 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*, 47 J. OF FIN. & QUANTITATIVE ANALYSIS 567, 573 (2012).

21. See Deakin, *supra* note 16, at 8.

22. *Id.*

23. Leslie Hannah, *The Divorce of Ownership from Control 1900: Re-calibrating Imagined Global Historical Trends*, 49 BUS. HIST. 404, 411 (2007).

24. Biagio Marino, *Show Me the Money: The CEO Pay Ratio Disclosure Rule and the Quest for Effective Executive Compensation Reform*, 85 FORDHAM L. REV. 1355, 1362 (2016).

25. Deakin, *supra* note 16, at 9.

2014 EU proposals for shareholders' rights²⁶ said that the IoD would agree with the commission's overall objective of enhancing long-term, constructive engagement of institutional investors with listed companies.²⁷

Long-term success and long-term productivity are phrases that appear in almost every reform document on executive compensation.²⁸ The World Economic Forum defines long term success as a company that is an attractive long term investment for potential shareholders, who can invest with the expectation of "holding an asset for an indefinite period of time."²⁹ It may also be the main reason why governments choose to give shareholders the power of say on pay. The UK's binding say on pay was provided because of pressure from institutional investors and the outrage of the public.³⁰ Nevertheless, the long-term success of public companies and the equity market still primarily relies on all the factors which influence regulations, and also the same goals that governments and shareholders are expecting.

The goal of long-term success is the reason why executive remuneration is often equity-based. Tying executives' pay packages to a company's stock price incentivize executives to work hard for the interest of the company and the shareholders with the focus on the company's long-term success.³¹ If executive compensation is only a base salary, there is no incentive to remain at that company; an executive could easily jump ship to a more lucrative company, without losing any unvested equity in their current role.³² However, compared with directors, shareholders are more long-term focused. A survey by Graham, Harvey and Rajgopal suggested that 78% of executives would sacrifice the company's long-term success to meet short-term earnings targets to attract more investment.³³ Even for those shareholders who are more likely to have a short-

26. See Press Release, European Commission, *European Commission proposes to strengthen shareholder engagement and introduce a "say on pay" for Europe's largest companies* (Apr. 9 2014), http://europa.eu/rapid/press-release_IP-14-396_en.htm?locale=en [perma.cc/4RT4-XU4B].

27. Trade Union Congress, *Beyond Shareholder Value: The reasons and choices for corporate governance reform*, <https://www.tuc.org.uk/sites/default/files/BSV.pdf> [perma.cc/PLF4-LAW5] at 17.

28. See, e.g., Dept. for Bus., *Energy & Industrial Strategy, Directors' pay: revised remuneration reporting regulations* (June 27, 2012), <https://www.gov.uk/government/consultations/directors-pay-revised-remuneration-reporting-regulations> [perma.cc/J2YL-C9WM]; Dept. for Business, Innovation & Skills, *Executive pay: consultation on enhanced shareholder voting rights*, (Mar. 14, 2012) <https://www.gov.uk/government/consultations/executive-pay-consultation-on-enhanced-shareholder-voting-rights> [perma.cc/GR2H-RH2B]; Luis A. Aguilar, *The Ceo Pay Ratio Rule: A Workable Solution For Both Issuers and Investors*, SEC (Aug. 5, 2015), <http://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html> [perma.cc/H944-YGV6] at 8.

29. World Economic Forum, *Global Agenda Councils, Long-term Investing* (2012), <http://reports.weforum.org/global-agenda-council-2012/councils/long-term-investing/> [perma.cc/CZ9E-EVG8].

30. 163 Parl Deb HC (13th ser.) (2012) col. 4 (UK).

31. Michael Jensen & Kevin Murphy, *CEO Incentives – It's Not How Much You Pay, But How*, 22 J. APPLIED CORP. FIN. 64, 70 (2010).

32. *Id.*

33. John Graham, Campbell Harvey & Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 4 (2005).

term outlook, such as hedge fund investors who hold shares for a period of one or two years, their perspective focuses on the long-term profits of the company, since they only buy shares when the price is relatively cheap.³⁴

Shareholders who focus on the long-term interests of the company will help to increase the corporate value. Edmans noted that shareholders with a considerable holding of shares can influence a public company's management through market efficiency.³⁵ Contrary to the traditional view of corporate governance, he argued that shareholders can improve corporate value even by using the exit channel, namely threatening to sell their shares.³⁶ For shareholders, especially shareholders with a relatively large holding of shares—the “blockholders” referred to by Edmans—a large holding of shares increases their intervention and monitoring incentives. A new way of thinking about shareholders was proposed by viewing them as informed traders instead of controlling entities.³⁷ These shareholders would collect more information about the companies, not only internally but also from the markets.³⁸ This information will help them to establish more accurate and informed opinions about the value of the company. If their voices are ignored at meetings or their share value decreases, shareholders will trade in their shares. Having several blockholders trade in their shares at the same time may be dangerous and harmful for companies if the share price drops quickly and there is a significant reputation loss.³⁹ Pressure like this will force the board to listen to shareholders and may help to enhance corporate value indirectly.

Moreover, this difference in short-term and long-term focus between directors and shareholders leads to agency costs.⁴⁰ To stop the directors, especially executive directors, from using the information or power available to them due to their position to satisfy their own interests, companies may incentivize directors with remuneration packages involving equities, in order to align their interests with those of the shareholders. On the other hand, shareholders need to use their voting power on executive remuneration, which may involve out-of-pocket expenses 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 in terms of corporate governance issues.⁴¹ First, because agency theory has been justified by reforms in corporate governance since the 1990s, it is now the shareholders' right and their duty to ensure that executives are making the right decisions on issues in relation to companies cash flow, while the

34. *Id.*

35. Edmans, *supra* note 19, at 2438.

36. *Id.*

37. *Id.*

38. Xuemin (Sterling) Yan & Zhe Zhang, *Institutional Investors and Equity Returns: Are short-term institutions better informed*, 22 REV. OF FIN. STU. 893, 897 (2009).

39. Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. OF FIN. ECON. 23, 30 (2014).

40. *Id.*

41. *See Deakin, supra* note 16, at 8.

shareholders' standard of capital returns is usually stricter than the board's when they are monitoring projects to make sure the firm reaps benefits and can provide stable employment. Second, shareholders may have a "rent-seeking" purpose, tending to use the liquidity of capital at their disposal to "extract" benefits from the company's business. Similar to directors' rent-seeking behaviors, 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 policymaking, the second important question is whether these shareholders are sincerely interested in interfering in executive remuneration. In addition to the shareholders' willingness and incentives to interfere with executive remuneration, shareholder intervention in management policies has not been optimistically regarded 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 boards and CEOs, shareholders will put little effort into changing these policies.⁴²

Therefore, in relation to problems surrounding shareholder empowerment, it is uncertain whether the regulation is still valid in providing shareholders with the right to interfere in remuneration policy, and it is questionable whether the use of shareholder voting will be beneficial for the company's long-term productivity. These questions will be analyzed next.

Myners proposed in his report that although institutional shareholders had claimed the predominant place in the UK, these investors were still reluctant to intervene in their investee companies even when the companies were underperforming.⁴³ 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 on how to make the best of situations.⁴⁴ Under Myners' logic, shareholders can be active in voting and making decisions for companies if they are empowered with a proper design for their intervention. Sheehan 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".⁴⁵ Moreover, the following statement in the Impact of Assessment of Improvement of Transparency of Executive Remuneration emphasizes the importance of providing shareholders with more power on remuneration:

42. Flip Chart Fairy Tales, *Will Shareholder Empowerment Curb the Executive Pay?*, (May 28, 2018, 12:33 AM), <https://flipchartfairytales.wordpress.com/2012/02/02/will-shareholder-empowerment-curb-executive-pay/> [perma.cc/RD48-E4EN].

43. Paul Myners, *Myners Review of Institutional Investment in the UK, The Government Response*, HM Treasury & The Department for Work & Pension, 2001, at 11.

44. *Id.*

45. Kym Sheehan, *The Regulatory Framework for Executive Remuneration in Australia*, 31 SYDNEY L. REV. 273, 278 (2009).

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.⁴⁶

In October 2014 the Department for Business, Innovation & Skills (now replaced by Department for Business, Energy & Industrial Strategy) published a report on the implementation of the Kay Review, with the purpose of building a sustainable 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 increasing shareholder involvement in company issues.⁴⁷ In addition, the FRC offered their Stewardship Code to improve institutional shareholders' stewardship responsibilities and their monitoring activities.⁴⁸ This is a new era 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 agents for other entities.

Furthermore, the remuneration principles set out by these giant investors, including the National Association of Pension Funds ("NAPF"), Hermes Equity Ownership Services, the BT Pension Scheme, RPMI Railpen Investment, and USS Investment Management, 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 via the ownership of shares over the long term, with "ownership obligations increasing with seniority."⁴⁹ With efforts from both investors and government, the empowerment of shareholders in voting will promote the healthier development of pay practice and long-term success for companies in relation to executive remuneration. This is supported by the following reasons.

The first reason why shareholders are provided with power over executive pay is that one important purpose of setting remuneration is to align the interests of

46. Department for Business, Innovation & Skills, *Impact Assessment (IA), Improved Transparency of Executive Remuneration Reporting*, 2012, REF 12/889, at 7.

47. Department for Business, Innovation & Skills, *Kay Review of UK Equity Markets and Long-Term Decision Making: Implementation progress report*, 2014, REF: BIS/14/1157, at 8.

48. FRC, UK Stewardship Code, September 2012.

49. NAPF et al., *Remuneration Principles for Building and Reinforcing Long-term Business Success*, http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0351_remuneration_principles_for_building_and_reinforcing%20longterm_business_success_nov2013.aspx.

principal and agent, while decreasing the risks of investors' shareholdings. There are reasons to be suspicious of shareholders' influence on long-term productivity. Institutional shareholdings 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. They normally have few incentives to rein in any excessive risks that executive managers may take (for the purpose of increasing directors' pay);⁵⁰ in voting on the resolutions of the company, they are "reluctant activists."⁵¹ These investors have no direct relationship with the investing company and therefore will not initiate proposals as regularly as other investors. On the other hand, the goal of fund managers is likely to be 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.⁵² 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 company, the other large institutional shareholders will provide a trend in favor of voting on resolutions for these investors to follow.⁵³ From another perspective, shareholders are not that dissatisfied about current executive remuneration designs, which contain bonuses, equity options, pensions, and other benefits for managers.

Moreover, evidence from Institutional Shareholder Services (ISS), an international shareholders' voting agency which provides services to nearly 1,600 institutions globally and is "a leading provider of proxy advisory and corporate governance solutions to financial market participants,"⁵⁴ shows that shareholders pay attention to remuneration policy making and reporting, and with certain perspectives developing from this attention, they can promote the companies' long-term profits.

In the ISS's 2014 survey of pay for performance alignment opinions among 105 institutional shareholders from the UK, the U.S., continental Europe, Canada, and the Asia-Pacific region, the findings revealed some of the shareholders' opinions when they voted on executive pay reports.⁵⁵ Their survey focused on issues of company performance goal setting, executive pay level, investors' say on pay, and managers' income comparison in the same industries.

50. John Coffee, *Liquidity Verses Control: The Institutional Investors as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1333 (1991).

51. Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., 148 (Jan-Feb, 1994).

52. EMILIOS AVGOULEAS, MECHANISMS AND REGULATION OF MARKET ABUSE: A LEGAL AND ECONOMIC ANALYSIS, 78 (2005).

53. Lucian Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1796 (2006).

54. ISS, *2014-2015 Policy Survey Summary of Results*, (Sept. 2014), <http://www.issgovernance.com/iss-releases-results-annual-global-voting-policy-survey/> [perma.cc/8R3H-Q44D].

55. *Id.* at 5, 10.

According to this survey, 60% of the shareholders would still be concerned about the company's report on pay levels, even if the company's performance was better than other peer companies in the same industry. Nineteen percent would prefer an absolute limit on the pay level. Fourteen percent would support proportional limits on remuneration in relation to the company's absolute performance.⁵⁶ 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 about the policy they have voted for.⁵⁷ With respect to European institution respondents, 83% of the respondents expressed their interest in peer group pay level comparison.⁵⁸

The following table represents some of the results of the survey and shows the attitudes of the shareholders and companies towards corporate goals and remuneration design. Forty-three percent of the shareholders thought that if the directors' performance targets were lowered their compensation levels should change in line with performance targets, and only 19% of shareholders were willing to pass pay packages without performance linked to them in order to attract talented executives.⁵⁹

Q: Which of the following best reflects your institution's idea of the relationship between goal setting and award values?	<u>Shareholder</u>	<u>Board</u>
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%

Source: ISS, 2014-2015 Policy Survey Summary of Results

The ISS report did not give their conclusion and comments on this survey, but from these statistics, a large proportion of institutional shareholders from various countries indicated their concerns 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

56. *Id.* at 5, 10.

57. *Id.* at 5, 10.

58. *Id.* at 5, 11.

59. *Id.* at 9.

general scale, some guidelines drawn up by large institutional shareholders to promote best practice in terms of executive compensation will be analyzed later. With the influence from this large proportion of shareholders who are sympathetic to promoting pay for performance, Bebchuk's previous assumption that the voting ideas of several active institutional shareholders can influence other shareholders and change their ideas in voting may be proved correct, even if other short-term shareholding investors may hold different voting opinions on remuneration reports before annual meetings.⁶⁰ Thus, emphasizing investor power in pay policy making and reporting may be a trustworthy method of improving compensation governance.

The second reason for empowering shareholders in terms of executive pay is that legislation may be an easier route to empower shareholders, since it is hard to ensure board accountability on executive remuneration. The details of remuneration reports and policies which are presented for resolution must be emphasized, which reflects the general requirements of various regulations on compensation and transparency. Although there are concerns over whether shareholders will be qualified by the law to make decisions in relation to corporate governance, Bebchuk suggests that the legislative choice is always between giving shareholders powers to influence the running of the company, or leaving the boardroom to maintain its "indefinite" control, with executives having managerial influence over the board.⁶¹ We are convinced that the former should be considered as the preferred choice for legislation on executive remuneration, providing the shareholder with powers to review and supervise the board on executive remuneration policies. Empirical evidence to be explored in the following section will illustrate that allowing shareholders to review and supervise the board in remuneration policy making will help to reduce the undue influence of executives over the board. Additionally, some problems related to shareholders' say on pay in practice will be summarized to allow for further discussion.

B. SHAREHOLDERS AND EXECUTIVE REMUNERATION: EXPERIENCES OF THE U.S. AND THE UK IN APPLYING ADVISORY VOTES

Investors in UK listed companies perceive 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.⁶² With the international trend towards empowering shareholders in terms of managers' remuneration issues and the globalized flow of capital, this shareholder voting influence on executive compensation shows general

61. *Id.*

62. Fabrizio Ferri & David Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. OF FIN. 527, 555 (2013).

similarity across developed countries.⁶³

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 companies during the period from 2002 to 2007.⁶⁴ According to their research, it is rare among shareholders to show absolute dissent to executive remuneration reports, with only seven to 10% demonstrating total dissent across five years.⁶⁵ Shareholders in the UK were satisfied with companies' pay policies; over 90% voted in favor of the reports, and moreover this approval increased over the period.⁶⁶ Nonetheless, in comparison with other proposals such as nomination and non-pay policies proposed by the board, shareholders demonstrate a higher level of dissent in relation to remuneration reports.⁶⁷

Evidence showed a negative correlation between shareholders' positive votes and the level of executive remuneration, which proposed that boards reacted quickly to shareholders' concerns about provisions such as rewards for failure after the enactment of the UK advisory shareholder say on pay in 2002.⁶⁸ More significantly, poor performance by executive managers was more strongly correlated with steep penalties.⁶⁹ However, boards responded to shareholders' dissatisfaction by adjusting the total level of executive pay, but not the structure of it,⁷⁰ which still remains a potential issue since the level will influence one year's pay but the structure, especially an equity pay design, will affect pay over the longer term.

Concerning shareholder advisory votes, Ferri and Maber investigated seventy-five public companies that experienced a more than 20% shareholder veto on executive pay reports.⁷¹ The boards of these companies provided their revised pay policies with changes mainly introduced in two areas: existing executive contract's notice periods, and executive pay's performance-based conditions.⁷² After the shareholders showed their dissatisfaction towards the pay plan, sixteen companies reduced the executives' notice period from twenty-four months to twelve months, while managers' golden goodbyes were reduced to nearly half of the original

63. Nuno Fernandes, Miguel Ferreira, Pedro Matos & Kevin Murphy, *Are US CEOs Paid More? New International Evidence*, 26 REV. OF FIN. STUD. 323, 325 (2013).

64. Martin Conyon & Graham Sadler, *Shareholder Voting and Director's Remuneration Report Legislation: Say On Pay in the UK*, 18(4) CORP. GOV.: AN INT'L REV. 296, 297 (2010).

65. *Id.* at 301, 303.

66. *Id.* at 308–09.

67. *Id.* at 22.

68. Mary Carter & Valentina Zamora, *Shareholder Remuneration Votes and CEO Compensation Design*, AAA 2008 MAS Meeting Paper, at 24 (Nov., 2007); *see also* Walid Alissa, *Boards' Response to Shareholders' Dissatisfaction: The Case of Shareholders' Say on Pay in the UK*, 24 EUR. ACCT. REV. 727, 750 (2015).

69. Ferri & Maber, *supra* note 62, at 534.

70. Alissa, *supra* note 68, at 728.

71. Ferri & Maber, *supra* note 62, at 536.

72. *Id.*

amount.⁷³ The findings of this research confirmed that boards tend to reduce levels and other obvious factors in pay plans if there is strong dissatisfaction among shareholders.

Although shareholders' voting activities show an optimistic trajectory towards company pay plans since the 2002, the 2008 financial crisis definitely caused alarm for shareholders and governments, not only reminding them of the nonfeasance of boards, but also hastening legislation to provide an efficient solution.⁷⁴

In the U.S., except for several provisions in the Dodd-Frank Act enforced 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.⁷⁵ Meanwhile, institutional shareholders continue to "exert a strong influence on pay discussions but with around ninety-eight percent of US companies having passed their say on pay resolutions in 2011 and 2012, it is fair to say that progress is being made."⁷⁶ 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.⁷⁷

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, shareholders in 134 companies voted negatively on the boards' executive pay proposals in their annual general meetings, leading to \$7.3 million deduction in CEOs' pay overall.⁷⁸ 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.⁷⁹ One goal of US

73. *Id.*

74. See STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* (2012).

75. Viola Lloyd, *Shareholder Spring Goes Global*, *THE HR DIRECTOR* (Oct. 12, 2012), <http://www.thehrdirector.com/features/miscellaneous/shareholder-spring-goes-global/> [perma.cc/MRS6-SGA9].

76. *Id.*

77. *Id.*

78. Yonca Ertimur, Fabrizio Ferri & Volkan Muslu, *Shareholder Activism and CEO Pay*, 24 *REV. OF FIN. STUD.* 535, 544–45 (2009).

79. Fabrizio Ferri & Tatina Sandino, *The Impact of Shareholder Activism on Financial Reporting and Compensation: The case of employee options expensing*, 84 *THE ACCT. REV.* 433, 453 (2009).

regulation is to promote more transparent executive compensation and better alignment of CEO incentives with shareholders' interests.⁸⁰

Studies have shown say on pay played a positive role in achieving this goal. According to Kronlund and Sandy, having a say on pay vote can make companies change how they pay executives.⁸¹ However, despite the law's intention to improve executive pay practices, the say on pay mandate has not unambiguously resulted in more reasonable CEO compensation.⁸² Contrary to the regulation's goal to reduce executive pay, the net result of these changes may raise total executive compensation. The fact that companies change pay practices between fiscal years, with or without shareholders voting again, is evidence that pay practices are not optimal. If they were, whether a vote is held or not should be irrelevant for pay.

In the U.S., shareholders of 2,173 public companies "overwhelmingly" approved their companies' compensation reports in 2013.⁸³ Ninety-seven percent of the U.S. public companies received shareholder votes affirming the CEOs' pay, while only 57 companies experienced a shareholder advisory veto on their pay proposals.⁸⁴ Evidence from the U.S. 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.⁸⁵ Compensation practices that are vetoed by activist investors, such as golden parachutes, are reduced or eliminated.⁸⁶ These changes are consistent with the trajectory of improving the transparency of pay and complying with proxy advisory companies' guidelines, which may help companies to ensure that the say on pay vote passes. However, despite these changes, the net effect is still a higher overall level of pay.⁸⁷ Additionally, companies make greater use of less scrutinized forms of executive pay, such as pensions and golden goodbyes, if there is increased shareholder monitoring.⁸⁸

Say on pay is not a complete panacea. For instance, there is a crucial shortcoming in the say on pay legislation in the U.S. The Dodd-Frank Act requires companies to have a shareholder vote on pay policies every second or third year.⁸⁹ However, it also enables companies to "strategically shift pay" across years to continue compensating executives in the same way that they used to while also

80. See Stathopoulos & Voulgaris, *supra* note 18.

81. Mathias Kronlund & Shastri Sandy, *Does Shareholder Scrutiny Affect Executive Compensation?* (Dec. 3, 2018), <http://ssrn.com/abstract=2358696> [perma.cc/2NDZ-45QJ].

82. *Id.*

83. John Carney, *Why Say on Pay Failed and Why That's a Good Thing*, CNBC (July 3, 2013, 6:03AM), <https://www.cnbc.com/id/100860959> [https://perma.cc/2E4A-Y5B5].

84. *Id.*

85. See Kronlund & Sandy, *supra* note 81.

86. *Id.*

87. Gretchen Morgenson, *Shareholder's Votes Have Done Little to Curb Lavish Executive Pay*, N.Y. TIMES, May 16, 2015.

88. See Kronlund & Sandy, *supra* note 81, at 19.

89. Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173), § 951.

gaining shareholder support, thereby potentially undermining the goals of the regulation to decrease the level of executive pay.⁹⁰

Therefore, it can be concluded that overall the advisory say on pay regulations in the U.S. and the UK have brought several positive changes in executive remuneration. These changes were not only reflected in the boards' reaction to shareholder dissatisfaction but also in the general level of it, although the 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. Shareholders' negative responses to a pay policy will be delivered before the policy is taken to resolution, but these negative responses may not be turned into revisions because of game-playing between shareholders and the remuneration committee. The concern from the U.S. say on pay experience would be that more engagement and increased transparency in pay may not necessarily lead to board accountability and shareholder diligence to influence a change in the pay policy.⁹¹

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. Empirical evidence has also shown that this voting power has several effects in improving the practice of managers' compensation plans and reporting. However, it is also worth mentioning three main shortcomings, as follows: (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 be camouflaged in other ways by the board; and (3) governments have too often focused on the voting power of the shareholders, neglecting to examine how to increase the engagement of shareholders in the pay setting process, and how to enhance conversations between shareholders and boards. The following suggestions will deal with these problems.

C. MEASURES TO IMPROVE SHAREHOLDER INTERVENTION

It is comparatively easier to regulate listed companies by requiring their boards to act to serve the interests of shareholders, with few regulations requiring or encouraging shareholders to do anything. However, from the perspective of executive remuneration, shareholders may need further instructions and guidelines from regulation. From the discussion above, shareholders would like to have strong involvement in remuneration reports at AGMs, because remuneration

90. See Kronlund & Sandy, *supra* note 81 at 19.

91. KYM SHEEHAN, THE REGULATION OF EXECUTIVE COMPENSATION: GREED, ACCOUNTABILITY AND SAY ON PAY 76 (2012).

reports detail how the payouts of the companies are set, which or part of which could have contributed to shareholders' dividends.

To encourage shareholders to participate in remuneration decisions with companies to a greater extent, and to improve boards' accountability, current legislation and corporate codes from various governments have paid significant attention to regulating pay transparency and the disclosure of details in pay policies. In terms of pay policy disclosure and shareholder understanding of problems, it may be wiser to prioritize the quality of pay transparency over its quantity. Shareholders will be responsible for understanding pay structures and single elements of each pay plan, in order to facilitate better communications with companies.

From the discussions above, it is time for the development of stewardship codes, which regulate shareholders in terms of how they approach their roles in corporate governance. Except for some remuneration guidelines drawn up by institutional shareholder groups mentioned above, organizations such as the FRC in the UK and the ICGN (International Corporate Governance Network) based in the U.S. have provided stewardship codes to give guidance to institutional shareholders so that they can participate more effectively in corporate issues.⁹² Feedback and improvement of these codes is ongoing and will be discussed in the following section.

i. Participation and Understanding

It is difficult for most individual investors to understand remuneration reports. Even board members and other managers may find it difficult to understand their pay packages, which may contain equity plans, long- and short-term targets, earnings per share or total shareholder returns.⁹³ Shareholders, especially small group investors, are encouraged to play a more active role in scrutinizing remuneration reports and communicating with directors. Institutional shareholders with in-house experts who can analyze remuneration reports and provide advice, such as the GC100 group, the ABI and NAPF, always renew their guidelines for executive pay reporting. These guidelines provide details on the formation and content of remuneration reports 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 and business judgment 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 reach a general

92. FRC, *supra* note 48; *see also* International Corporate Governance Network, *Global Stewardship Principles* (May 28, 2018), <http://icgn.flpbks.com/icgn-global-stewardship-principles/#p=1> [perma.cc/Y5BR-YZWH] [hereinafter ICGN].

93. Michael Skapinker, *Executive Pay: The battle to align risks and rewards*, FIN. TIMES, Apr. 30, 2015.

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 better informed 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.⁹⁴ The 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 corporate decisions.⁹⁵ Despite its positive impact to improve relationships and communication among various shareholders, this idea involves a few reservations that need further consideration. Timing could be a thorny issue, since not all shareholders may be able or willing to have discussions about decisions before a resolution at a company's AGM. Moreover, the cost of gathering the shareholders may be considerable, with additional agency costs, especially in jurisdictions with dispersed ownership such as the U.S. and the UK.

Institutional shareholders, e.g., pension fund managers, banks, insurance companies and so on, are 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 in terms of how they have discharged their responsibilities.⁹⁶ In a ICGN meeting, Stout proposed pressure from beneficiaries could make institutional investors concerned about their investments. Under certain circumstances, they may hold shares for a rather short period and sell them in a liquid market, though institutional investors are supposed to be long-term focused.⁹⁷ Although institutional investors have great influence over corporate governance public companies, concern about their clients' benefits and paybacks will decrease their impact as valuable investors providing good guidance for small shareholders. However, rather than falling within the scope of the stewardship code, this question relates to corporate governance codes and company law legislations in general. It is for the boards of investee companies to provide methods to retain their institutional shareholders in the long term, such as increasing their voting power or paybacks according to their length of investment

94. ICGN, *supra* note 92, at 18 (Principle 5, Exercising voting rights in an informed and responsible manner).

95. *Id.* at 16 (Principle 4, Engaging companies and collaborating with other investors).

96. FRC, *supra* note 48 at *Stewardship Code*, Principle 7.

97. Interview by Peter Montagnon with Stephen Haddrill, Rahki Kumar, Lynn Stout, and Motoyuki Yufu, *Share Ownership in A Global Context Is Stewardship Working?*, ICGN (May 28, 2018), <https://www.icgn.org/share-ownership-global-context-stewardship-working-0> [perma.cc/AZ3L-NQ8D].

in the company.

These methods, which are called time-weighted voting or time-weighted dividends, have been proved to be effective in attracting long term investors and lead investors to focus on the long-term interests of the company. A recent study suggested time-weighted voting, which provides a shareholder with more votes per share if they hold shares for at least three years, can empower long-term investors and may improve corporate value.⁹⁸ The empirical evidence shows that compared with dual-class shareholding which lets investors hold two different classes of shares to vote, time-weighted voting is a better choice for companies and shareholders to prevent “myopic” or short-term focused behavior among managers.⁹⁹

As mentioned above, if companies can provide efficient methods to retain shareholders’ investments or help them to focus on a long-term view, shareholders may be able to influence companies positively from their perspective and use their two intervention channels to help companies to create remuneration policies and reports reflecting long-term value.

ii. Principles

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.¹⁰⁰ With the improvement of transparency in various reports at AGMs, especially in remuneration reports, shareholders need more time to analyze and understand the reports. Absorbing opinions from each other is important. Thus, principle 5 of this code could be revised to: Institutional investors should be willing to meet with other investors before resolution and act collectively with other investors where appropriate.

In order to promote the long-term success of the company, the UK Corporate Governance Code provides that it is the board’s role to provide effective controls and methods to ensure this objective.¹⁰¹ However, there is no follow-up section that provides detailed measures for how this should be done. Section E the Code merely requires that the board should establish a satisfactory dialogue with shareholders.¹⁰² A stronger addition should propose a new method to retain shareholders’ investment for long-term periods.

Improving the shareholder monitoring function during the creation of executive remuneration policies and reports does not necessarily mean that shareholder value is the only goal that should be considered while setting

98. Lynne Dallas & Jordan Barry, *Long-term Shareholders and Time-phased Voting*, 40 DEL. J. OF CORP. L., 541, 552–53 (2015).

99. *Id.* at 546–47.

100. FRC, *supra* note 48 at *Stewardship Code*, Principles 5–6.

101. FRC, *supra* note 6 at *Corporate Governance Code 2016*, S A.1.

102. *Id.* at section E.1.

managers' pay. Boards may also take other issues into consideration when planning and implementing pay policies.

II. REMUNERATION PRACTICE AND BOARD ACCOUNTABILITY

Historically, shareholders have long been seen as passive, or even irrelevant to the running of companies in the development of modern corporate theories.¹⁰³ 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 stock in the company.¹⁰⁴ Another argument around shareholder empowerment suggests increasing shareholder involvement will shift the balance between the board's authority and its accountability.¹⁰⁵ Despite the fact that it may be easier for the shareholders to set guidelines for an effective remuneration policy, under most circumstances they would still not be efficiently or adequately informed about what is happening in the boardroom.

Following the 1995 Greenbury Report's proposal that executive pay should comprise more long-term incentives to promote the notion of "pay for performance," the percentage of equity incentives in pay packages, such as restricted equity options and long-term incentive plans, has increased. The average of the FTSE 100 CEOs' equity option value was 240% of their salary level in 2015, compared to 210% in 2014.¹⁰⁶ However, emphasizing long-term incentives and more equity options in pay packages cannot effectively bring about an optimal scenario by following agency theory, i.e., pay for performance. Normally, equity options are set to align the interests of shareholders and executives and to retain and motivate directors for competitive performance. Remuneration practices cannot achieve this alignment because the board power and equity option's design in executive pay may sometimes be harmful to the company's long-term success.¹⁰⁷ Executive directors will use their managerial power to influence the board and its members; for example by using the power of promotion and awarding independent directors who are executives in another company with non-executive posts, and/or hiring these executives as members of their remuneration committee. Under this managerial influence, boards and remuneration committees

103. Deakin, *supra* note 16, at 3.

104. Deakin, *supra* note 16, at 3–4.

105. See generally Jay Lorsch, *Empowering the Board*, HARV. BUS. REV., (Jan-Feb. 1995).

106. PwC, *Raising the Bar: The state of executive pay in 2015* (May 28, 2018), <http://www.pwc.co.uk/services/human-resource-services/insights/raising-the-bar-the-state-of-executive-pay-in-2015.html> [perma.cc/9NNR-XLTD].

107. Janice McClendon, *Bringing the Bulls to Bear: Regulation Executive Compensation to Realign Management and Shareholders' Interest and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 994 (2004).

may show some rent-seeking behaviors in using the explicit influence of capital markets and products on executives' equity holdings and bonuses, in order to increase the final rewards of executive directors. Mechanisms to stop this from happening are now considered.

A. DIRECTOR PRIMACY?

The Director Primacy approach proposes that centralized authority and good use of accountability mechanisms, eliminates the 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 not overly enthusiastic about the idea of using shareholder voting rights to solve executive remuneration problems. Early in the 1990s Villiers pointed out that because of information asymmetry, shareholders face various obstacles if they wish to interfere in corporate management,¹⁰⁸ such as a lack of information concerning comparative groups' income from remuneration consultants, or confusion about the criteria that remuneration committees write into pay reports relating pay to performance. For example, there may be various long-term incentive plans with different conditions in a single executive's pay package, a confusing set of conditions for shareholders to comprehend fully. Bainbridge posits that empowering shareholders in the corporate decision-making process might disrupt the vesting of authoritative control from the board in their companies.¹⁰⁹

Moreover, Sharfman argued that instead of enhancing decision making, empowering shareholders will 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."¹¹⁰ Even worse, the more successful shareholder activities are, the more damaging those activities are likely to be to the economy.¹¹¹

From the Director Primacy point of view, some proponents suggest that the rapidly growing executive remuneration is not a problem. According to Bainbridge's understanding of the capital market, investors will not purchase stocks from companies which provide executives with excessive remuneration, and creditors will not lend money to companies which lack executive director accountability.¹¹² Therefore, the cost of issuing stocks will rise for these companies while their income falls. As a result, these companies will become

108. Charlotte Villiers, *Executive Pay: Beyond Control*, 15 LEGAL STUD. 260, 261 (1995).

109. Stephen Bainbridge, *Is 'Say on Pay' Justified*, 32 REG. CORP. GOV. 42, 46 (2009).

110. Bernard Sharfman, *What's Wrong with Shareholder Empowerment*, 37 J. CORP. L. 903, 907 (2012).

111. *Id.* at 908.

112. Bainbridge, *supra* note 109, at 45.

more vulnerable to hostile takeovers and management reconstruction,¹¹³ which will bring more instability to both companies and shareholders.

The problems of executive remuneration rest on the key point that effective corporate governance requires the decision-making authority to be vested in a small, discrete central agency, rather than in a large diffuse electorate.¹¹⁴ Bainbridge is not convinced that the idea of board accountability can be sustained.¹¹⁵ He even proposes that, if shareholders realize the cost of getting hold of adequate information and the seriousness of unreasonable interference, they will keep their distance and refrain from making every decision themselves, leaving most issues to the board.¹¹⁶ Thus, we are wondering to what extent we need to emphasize the notion of board accountability to promote the efficiency and effectiveness of 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 boards. 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.¹¹⁷ The second function is a protective/restorative role, indicating that the board should assist the company in claiming and protecting its resources. The third function is to formulate strategy under the direction of senior managers, in order to serve the shareholders in their interests with more information about their responsibilities while remaining accountable to these responsibilities.¹¹⁸ Executive remuneration design is within the first, monitoring function. Nonetheless, the third function, related to the board's accountability to shareholders, should be also emphasized 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).¹¹⁹ Research has proven that regulation has relatively little to do with the evolution of the board's structure and practice. It is the market and social forces that improve these elements.¹²⁰ Thus, a

113. *Id.*

114. *Id.* at 47.

115. *Id.*

116. *Id.*

117. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 801–02 (2001).

118. *Id.* at 802–03.

119. Lynne Dallas, *Development in US Boards of Directors and the Multiple Roles of Corporate Boards*, 40 SAN DIEGO L. REV., 20 (2003).

120. Melvin Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1267 (1999); see also Edward Rock & Michael Wachter, *Islands of Conscious Power: Norms and the Self-governing Corporation*, 149 U. PA. L. REV. 1619, 1623 (2001).

more appropriate way for legislation to improve board accountability and the monitoring function of the board is from the composition aspect, by inviting more independent directors to join the functional committees. According to 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 the agent and the shareholders. However, Langevoort also claimed that if the law becomes too aggressive it will ruin the social dynamic of the board and result in a less effective working group.¹²¹ Having more independent directors on executive committees will not have much influence on executive pay design; this is explained as follows.

Delegation of various powers to the committees of boards does not function well. Mitchell concluded that the boards' problems have existed from the very beginning, since the time boards were created to solve agency problems.¹²² 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. However, the board has developed primarily to shield executive managers from liabilities,¹²³ since there is only a direct norm from legislation to indicate what is right and what is possible in practical activities.¹²⁴ As lawyers are usually the ones who interpret law to the companies, the directors' understanding of legislative norms is second- or even third-hand,¹²⁵ not to mention the fact that lawyers may sometimes deliver information after being influenced by executives.

However, the companies that failed during the 2007-09 financial crisis, despite being criticized for having inadequate governance, did have independent boards, separate positions of chair and CEO, and enough defense against hostile takeovers.¹²⁶ If legislation remains deficient in regulating the board practices, shareholder empowerment may constitute an appropriate remedy in a corporate governance context. Although scholars such as Bainbridge and Sharfman favor directors running corporations and minimizing shareholder intervention, Director Primacy may not be the most appropriate approach when dealing with executive remuneration issues. Bebchuk and Fried explained how executives and board members could benefit each other through remuneration practice.¹²⁷ Without intervention or regulation, the independence of boards and remuneration committees cannot be trusted while they are making remuneration policies and reports.

121. Langevoort, *supra* note 117, at 8.

122. L. E. Mitchell, *The Trouble with Boards*, GWU LEGAL Studies Research Paper No. 159, 6-7 (2005).

123. *Id.*

124. Langevoort, *supra* note 117, at 11.

125. *Id.*

126. Cheffins, *supra* note 15, at 6.

127. LUCIAN BEBCHUK & JESSIE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

From the arguments above, two main findings can be concluded: (1) Director Primacy is not an ideal method to handle executive remuneration issues. Employing more independent directors to improve board accountability is not adequate to promote a more effective excursive remuneration mechanism; and (2) there should be other ways to improve the board accountability within its monitoring and strategic functions. Shareholder empowerment through the say on pay has an indirect influence on pay practice, but it is the remuneration committee and the board who have the most direct impact on pay. Hence, how should the board and the board members 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 ensure their function in remuneration design and implementation. However, as Cullen argued, the traditional and nondescript 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 terms such as “structure,” “performance objectives,” and “disclosures.”¹²⁸ However, these are general requirements, without providing explicit requirements.

In fact, the GC100 and Investor Group guidance, published in 2013 and amended in 2014,¹²⁹ shows that guidelines from institutional shareholders are sometimes not as general as this. They are enriched by 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 shareholders 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 made a good start in improving guidelines from shareholders and suggesting ways to promote the accountability of remuneration committees.

Remuneration committees do not need to have expert knowledge about how to design pay. Instead, they need to negotiate with remuneration consultants and make decisions by using informed judgment. As Keay noted, with shareholders having more power to influence remuneration policy, the board, especially the remuneration committee, must increase their accountability as they are required to justify their decisions.¹³⁰ The IoD, whose members are directors from various business sectors and even CEOs from large organizations, provides a detailed

128. JAY CULLEN, *EXECUTIVE COMPENSATION IN IMPERFECT FINANCIAL MARKET*, 202 (Edward Elgar, 2014).

129. GC100 and Investor Group, *Directors' Remuneration Reporting Guidance 2016*, <http://uk.practicallaw.com/groups/uk-gc100-investor-group> [perma.cc/E8E9-FEZV].

130. ANDREW KEAY, *BOARD ACCOUNTABILITY IN CORPORATE GOVERNANCE*, 230 (Abingdon, Routledge, 2015).

introduction to the regular work of remuneration committees in setting pay policy.¹³¹

First, good knowledge of running the business is critical to ensure that compensation is set at an accurate level in relation to basic salary in comparison with peer companies. Second, they need to think of financial factors and markets, which will help them with setting pay for performance criteria associated with shareholder returns, including annual bonuses and incentive plans. Third, the company's culture must be taken into account, since remuneration should reflect the organization's values and culture. The remuneration committee members, especially the independent directors, need to recognize the company's values related to successful performance, and avoid cutting bonuses and risking the company's competitiveness. At this stage, questions may logically be raised about how these considerations by the board and remuneration committee may be effectively enforced in practice. Detailed solutions to this question will be discussed as follows.

i. The Power of the Advisory Vote

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 in relation to remuneration reports, 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 remuneration committees.¹³²

However, only in some circumstances the remuneration committee respond to a negative vote result. A few cases show voting alone may affect the remuneration outcome.¹³³ Nonetheless, institutional shareholders should show and have already shown interest in seeing remuneration committees increase their authority while negotiating pay, and improve their will to undertake difficult tasks to punish underperformance among executives.¹³⁴

The Burberry case in 2014 and the BG Group case in 2015 is a key example to investigate the remuneration committee accountability mechanisms' effectiveness. The Burberry remuneration committee provided their CEO with £28 million for his first year's compensation, which precipitated a revolt from the shareholders, with 52% voting against the proposal. At the time this was the highest veto percentage

131. IoD, *The Remuneration Committee Role*, <http://www.iod.com/guidance/briefings/cgbis-the-role-of-the-remuneration-committee> [perma.cc/5CJ7-NDXW].

132. NAPF et al., *supra* note 49, at 3.

133. Sheehan, *supra* note 91.

134. NAPF et al., *supra* note 49, at 3.

in UK history.¹³⁵ On the other hand, the board of BG Group voluntarily gave up their £25 million pay deal for the new CEO after shareholders showed strong disapproval before the resolution day.¹³⁶ At Burberry, the “golden hello,” worth £7.5m in shares for the new CEO, already received a veto from 18% of their shareholders’ in 2014.¹³⁷ These concerns were not unreasonable: the new CEO, Christopher Bailey, a designer who had previously held the position of Burberry’s chief creative officer, was a new, unexperienced incoming CEO. In 2015, a big fall in retail sales further caused the company’s share price to fall by 4%, slashing the board’s pay decision and Mr. Bailey’s high bonus, golden hello, and incentive stock pay.¹³⁸

After the strong veto for the 2014 CEO remuneration proposal, the board provided a new pay policy in the following year.¹³⁹ With 92.3% of shareholders voting yes, the revised pay policy in 2015 meant a reduction in Mr. Bailey’s income to £7.9m.¹⁴⁰ This high level of shareholder satisfaction 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 revolt.¹⁴¹ However, there were other problems with Burberry’s executive remuneration policy, such as several inexplicable vested equity options in Bailey’s pay structure that were set before he became CEO. The key lesson here is regulation can be used to improve the board’s accountability. Remuneration committees and boards should always show a willingness to facilitate and enhance communication with shareholders on remuneration issues.

The case of the BG Group is another good example of conversing with investors before a vote on pay policy to avoid public embarrassment. Transparency in executive pay is not only about putting cold statistics in front of the shareholders at the annual meeting, which may cause misunderstanding between the board and shareholders. A process of negotiating and exchange of opinions will improve the board’s accountability and enable a transparent executive remuneration process.

135. Zoe Wood, *Burberry shareholders revolt over Christopher Bailey’s pay package*, THE GUARDIAN (July 11, 2014) <https://www.theguardian.com/business/2014/jul/11/burberry-shareholders-revolt-christian-bailey-pay-package> [perma.cc/2L5N-ZFB3].

136. Sean Farrell, *BG Group shareholders rebel against Helge Lund pay deal*, THE GUARDIAN (Apr. 5, 2015) <https://www.theguardian.com/business/2015/may/05/bg-group-shareholders-rebel-against-helge-lund-pay-deal> [perma.cc/VE3M-J22F].

137. Andrew Tritman, *New Burberry CEO Christopher Bailey Handed £7.5m Golden Hello*, TELEGRAPH (May 15, 2014) <https://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/10832465/New-Burberry-CEO-Christopher-Bailey-handed-7.5m-golden-hello.html> [perma.cc/K5CK-NVVN].

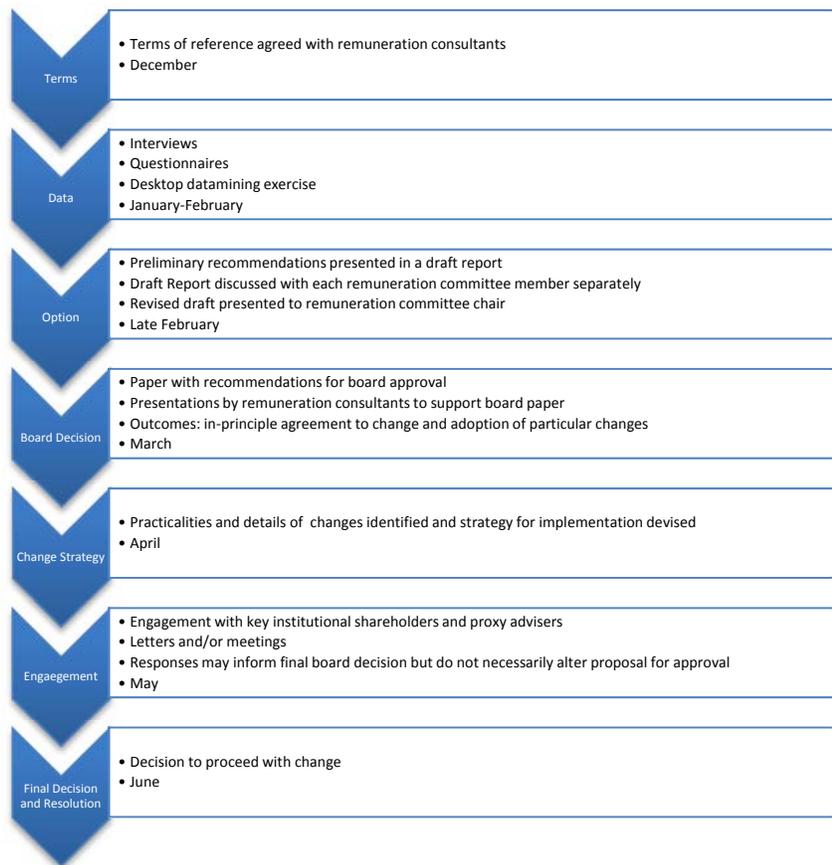
138. Andrew Roberts, *Burberry to Slash CEO Bailey’s Pay Amid Chinese Sales Slump*, BLOOMBERG BUSINESS (Oct. 15, 2015) <https://www.bloomberg.com/news/articles/2015-10-15/burberry-to-slash-ceo-bailey-s-pay-amid-chinese-sales-slump> [perma.cc/72X5-RR6S].

139. Shane Hickey, *Burberry Investors Approve Chief Executive’s Pay*, THE GUARDIAN (July 16, 2015) <https://www.theguardian.com/business/2015/jul/16/burberry-christopher-bailey-investors-approve-pay> [perma.cc/2P97-4PLQ].

140. *Id.*

141. *Id.*

The reform of executive remuneration design carried out in the UK in 2013 separates companies' pay implementation reports from their future remuneration policies. If a majority of the shareholders rejects the previous year's pay implementation report, the board and remuneration committee should present a new pay policy in the next year's annual meeting, for shareholders to vote on; this vote is binding. This regulation is valuable to corporate governance since it helps to increase the engagement of shareholders in policymaking and urges boards to enhance their communication with investors, especially institutional investors, thereby improving board accountability. The process of how a board might carry out a major review of compensation policy in practice may be illustrated in the following form¹⁴²:



Source: Sheehan "*The Regulation of Executive Compensation*" p.90

142. Sheehan, *supra* note 91, at 90.

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 the pre-voting negotiation opportunities with shareholders in case this policy also faces a revolt, because the previously 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."¹⁴³ 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 could also enhance board accountability.

How to balance the needs of shareholders and executive managers is always a central question for the 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 section.

ii. Independence and Negotiation with Executives

Regulatory measures are unlikely to have a direct influence on board independence. 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 impact on the remuneration committee's judgment, independence can still be built upon these non-executives' analysis of the executives' behavior, and the non-executives' pursuit of decisions which may benefit both the company and the executives¹⁴⁴ However, board accountability alone may not be sufficient for developing a sound executive remuneration mechanism, as "the directors on remuneration committees also need to be competent."¹⁴⁵ Under most circumstances, executive remuneration policy is primarily the outcome of negotiations between boards and their executive managers, or managers-to-be.¹⁴⁶ Before negotiating with shareholders as described above, the pay policy will already have been drawn up under the guidance of managers. Thus, how to start and maintain the dialogue with managers in order to arrive at a rational pay policy is very important for boards and remuneration committees.

143. FRC, *supra* note 6, D.2 Procedure, Supporting Principles.

144. Sheehan, *supra* note 91, at 65.

145. *Id.*

146. *Executive Pay: Neither Rigged Nor Fair*, THE ECONOMIST, June 25, 2016, at 20.

The Yahoo case from 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 approached by another Google president, Henrique de Castro.¹⁴⁷ 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.¹⁴⁸ However, the board members of Yahoo had little knowledge of the candidate because Ms. Mayer did not disclose his identity.¹⁴⁹ The new CEO provided Yahoo's remuneration committee with a pay plan for the new COO herself. In a meeting lasting half an hour one day later the committee agreed to this pay plan,¹⁵⁰ but stipulated that if any material change was made to the plan, only the committee had the authority to approve it.¹⁵¹ After this meeting, the Yahoo board suspected that Mr. de Castro was the person with whom their CEO was negotiating.¹⁵² One month later, 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.¹⁵³ After the termination of Mr. de Castro at Yahoo due to underperformance in 2014, he took his severance pay, valued at nearly \$60 million with \$40 million of this in cash.¹⁵⁴ Nonetheless, the equity options he chose to exercise before his departure were only worth \$51 million at the time he left the company.¹⁵⁵

It is no longer shocking to see underperforming executives walk away with huge amounts of money after they have resigned or been terminated. However, it is shocking that legislation emphasizes independence of boards and remuneration committees, but it remains 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 companies like Yahoo are so eager to attract directors on big salaries. One of the reasons why executives may receive unreasonably high levels of pay is due to the labor market for 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 pool of talented and skilled candidates from which the company could hire and

147. *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 761 (Del. Ch. 2016).

148. *Id.*

149. *Id.* at 762.

150. *Id.* at 762.

151. *Id.* at 762.

152. *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 762 (Del. Ch. 2016).

153. *Id.* at 763.

154. Jim Edwards, *Yahoo's COO Walks Out with \$20 Million Stock Bonus Plus \$40 Million for just 15 Month's Work*, BUSINESS INSIDER (Jan. 15, 2014), <https://www.businessinsider.com/yahoo-coo-enrique-de-castro-has-stock-bonus-pay-package-2014-1> [perma.cc/T4X3-3BQY].

155. Joseph Bachelder, *Hiring and Firing a Key Executive at Yahoo*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 22, 2016), <https://corpgov.law.harvard.edu/2016/06/22/hiring-and-firing-a-key-executive-at-yahoo/> [perma.cc/6RDD-XYKV].

choose within one industry is very small, particularly for senior management positions in public companies. Companies are under huge pressure to offer attractive pay packages to attract new talent while retaining existing employees. Thus, another issue that the board and remuneration committee need to consider is “peer group pay analysis” from remuneration consultants.

On the subject of remuneration consultants, it is their duty to provide market data from peer group companies. There is no exclusive requirement for the accuracy of their market advice. However, these consultants should provide opinions to the remuneration committee fairly and responsibly in terms of their independence and care.¹⁵⁶ The UK is 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 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 organization’s strategy, financial situation, and pay philosophy.¹⁵⁷

With general regulations in the Anglo-American system paying too much attention to conflicts of interest between consultants and companies,¹⁵⁸ other practical concerns should also be observed. These concerns may include setting standards for selecting comparative peer groups, the selection of equity incentive measures, and benchmarking for bonuses.

Further, with current regulations and rules already defined in terms of the remuneration consultant’s independent role in remuneration design,¹⁵⁹ a future regulatory framework to solve the concerns above could easily be provided based on this independence.

C. SUGGESTIONS

From the above, there are three concerns in relation to board accountability 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 are easy to understand without the risk of leaving investors in confusion. Second, the shortcomings of pay policy design are still obvious. Pay for underperformance and even for 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.

156. Sheehan, *supra* note 91, at 75.

157. *Voluntary Code of Conduct in Relation to Executive Remuneration Consulting in the UK*, (Jan. 2014), <http://www.remunerationconsultantsgroup.com> [<https://perma.cc/5FQJ-TCYE>].

158. Brian Cadman, Mary Carter & Stephen Hillegeist, *The Incentives of Compensation Consultants and CEO Pay*, 49 J. OF ACCT. & ECON. 263, 265 (2010); *see also* Kevin Murphy & Tatiana Sandino, *Executive Pay and Independent Compensation Consultants*, 49 J. OF ACCT. & ECON. 247, 249–50 (2010).

159. Sheehan *supra* note 91, at 76.

i. Reporting

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 means they have to rely heavily on advisory groups for their voting decisions. This phenomenon is not only inconvenient for the shareholders, but also allowed directors to make the presumption that shareholders are voting irresponsibly, such as in the JP Morgan case.¹⁶⁰ A sound 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.¹⁶¹ In the UK Corporate Governance Code, it is the board's responsibility to present "fair, balanced and understandable" reports to shareholders and other stakeholders.¹⁶² However, in practice the guidelines from NAPF et al. suggest although many listed companies have long-term incentive plans and deferred bonuses designed for their executives, shareholders are not able to read and understand the multiple equity options and bonus schemes.¹⁶³ There are usually several financial incentives in the remuneration policy and report, with various different performance conditions set for them.

For an example, Tesco's 2015 remuneration report had several limitations. 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 showed no data on how many shares each executive was granted.¹⁶⁴ Shareholders need to have a general view of the quantities of shares that may be held by executives, together with their salaries, bonuses, 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 the company is going to pay its departing executives in total, or any explanation of why its former CEO would be granted various payments and benefits.¹⁶⁵ Compared to the 2013-2014 remuneration report which received only a 1.38% revolt from its shareholders, this 2014-2015 implementation report led nearly 19% of the shareholders to vote negatively.¹⁶⁶ Besides shareholders' dissatisfaction about Tesco's share price drop during 2014 and 2015, part of the

160. Simon Bowers, *JP Morgan Takes Advice from Firm That Its Chief Attacked*, THE GUARDIAN (June 15, 2015), <https://www.theguardian.com/business/2015/jun/15/jp-morgan-advice-jamie-dimon-voting> [perma.cc/T77J-DJY6].

161. GC100 and Investor Group, *supra* note 129, at 5.

162. FRC, *supra* note 6, Section C, Accountability, C.1 Main Principle, "The board should present a fair, balanced and understandable assessment of the company's position and prospects."

163. NAPF et al., *supra* note 49, at 4.

164. Tesco PLC Annual Report and Financial Statements 2015, TESCO, <https://www.tesco.plc.com> [perma.cc/5XUN-R8Z5].

165. *Id.* at 55.

166. Sarah Butler, *Tesco Faces Shareholder Unrest over Executive Pay*, THE GUARDIAN (June 26, 2015), <https://www.theguardian.com/business/2015/jun/26/tesco-sales-drop-13-but-outperform-market-expectations> [perma.cc/HJ82-BMZB].

reason for this revolt was that the implementation report was not able to persuade the shareholders.¹⁶⁷ Deficiencies in remuneration reports have not only caused confusion and dissatisfaction among investors, but have also led to concerns on the part of boards about future remuneration policy making and the reputation of the company. Apart from a regulatory procedure for remuneration practice, it would be better if there were some requirements, or at least guidelines, from the government about how to draft remuneration reports.

The UK Corporate Governance Code is a good example. In section D Remuneration, a subsection (D.3 Conciseness) would be useful, offering guidance on how the board and remuneration committee should explain the pay policy. This subsection would help shareholders to make more informed decisions when they vote.

i. Flexibility

In the cases of Morrisons and Tesco, in which now-departed CEOs were highly paid for underperformance, the remuneration 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.¹⁶⁸ Although shareholders have an advisory vote on the compensation implementation report, this power does not enable them to stop pay for failure. In 2016, cases from BP, JPMorgan, Citibank and Volkswagen again emphasized the importance of the implementation of remuneration design in practice. For example, BP's CEO Bob Dudley had his pay increased by 20% in 2016 for his performance in 2015, despite the fact that BP experienced the worst loss in the oil industry in 2015.¹⁶⁹ Even though BP made a loss of \$5.2 billion in 2015, the main rise in his remuneration was from his pension savings, which increased due to a change in retirement benefits, as well as his annual bonus which increased by 40% according to the bonus target set by his remuneration policy.¹⁷⁰

To prevent 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 the shareholder say on pay into separate aspects of the remuneration policy and the remuneration implementation report. However, the implementation of the policy for executives departing because of poor performance and losses to the company may require additional attention.

The French government also plans to propose a similarly flexible method of

167. *Id.*

168. GC100 and Investor Group, *supra* note 129, at 5.

169. Kiran Stacey, Ed Crooks & Stephen Foley, *BP Revives Investor Fury on Executive Pay*, FIN. TIMES (Apr. 14, 2016), <https://www.ft.com/content/be44d458-024a-11e6-99cb-83242733f755> [perma.cc/AY9Y-97BR].

170. *Id.*

shareholder voting, where recent public outrage towards the motor giant Renault's ignorance of their shareholders' revolt over the compensation of the company's CEO Carlos Ghosn reached the French government. On June 10, 2016, the French National Assembly passed the Minister's measure providing a stricter and more binding shareholders' say on pay for the remuneration of chief executives in public companies.¹⁷¹ The reason why the French government reacted so quickly and decisively to the Renault situation was partly because the French state owns a considerable shareholding (20%) in this company, and the state voted no to the CEO's pay.¹⁷² It may seem overly restrictive for the French government to propose new legislation against public companies' ignorance of shareholder power over such a short term. However, this reflects a significant corporate governance issue. The intrinsic reason here was the lack of accountability of the board, disregarding 54% of the shareholders who exercised their veto over the pay deal.¹⁷³ The French government proposed to move further on shareholders' say on pay than the UK reform, requiring that shareholders have the power to vote on remuneration implementation reports every year, on a binding basis.¹⁷⁴ Surprisingly, this reform was supported by French institutions and proxy groups, who rejected the claim that the legislation provides excessive power to the shareholders.¹⁷⁵ It seems that the current excessive pay for failure has caused serious concerns.

The importance of a remuneration policy rests on its influence on the remuneration set in the future, and the issue of how to align pay with performance. On one hand, this is probably the reason why shareholders are given voting powers on this issue, giving them the feeling that they are empowered to make decisions for the company. On the other hand, however, implementation reports must not be underestimated. From a practical point of view, the implementation report decides the final scale of the remuneration of executives. 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, especially for departing executives who been involved in a loss to the company. Although it is difficult 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, suggesting a way to stop pay for underperformance.

The revised section 430 (2B) of the UK Companies Act 2006, introduced in the 2016 reform, provides:

171. Anne-Sylvaine Chassany, *French Shareholders Win Say on Executive Pay, Legislation follows dispute pitting Renault against shareholders*, FIN. TIMES, June 10, 2016.

172. Lucy P Marcus, *Why the Revolt Against Executive Pay Is Not Going Away*, THE GUARDIAN, May 22, 2016; see also Peter Campbell & Michael Stothard, *French Government Leads Shareholder Revolt against Renault*, FIN. TIMES, Apr. 29, 2016.

173. *Id.*

174. French Assemblée Nationale, *Amendment No. 14 to the French Commercial Code*, <http://www.assemblee-nationale.fr/14/amendements/3757/AN/14.asp> [perma.cc/8REF-35VQ].

175. Campbell & Stothard, *supra* note 172.

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.

According to this provision, public companies should post an online statement about any director leaving office, including how to calculate this director's remuneration according to her pre-agreed pay policy before the loss of office. 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.

iii. Negotiation and Responsibility

From the shareholders' perspective, as summarized 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 did have some impact on 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 companies to monitor directors and their pay.

The design of the UK advisory vote on remuneration implementation reports escalates communication between shareholders and enhances board accountability towards 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 direction may be more effective than a clean-cut requirement in the corporate governance code that lacks enforcement measures, such as “the chairman of the board should ensure that the committee chairman maintains contact as required with its principal

shareholder about remuneration.”¹⁷⁶ 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 policies were not due to be revised in the following fiscal year. This is also another reason for introducing a binding say on pay for departing managers as mentioned above, in order to stop pay for failure.

Learning from the Yahoo case and from other empirical evidence about board independence from CEOs and other executive managers, improvements could be made to the negotiations between boards and executive directors. Negotiations between boards and managers may be less complicated compared with those between boards and shareholders. However, it is not an easy job for boards and their remuneration committees to maintain absolute independence during these negotiations. According to the managerial power approach, Bebchuk et al. 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 smoothly, non-executive directors usually choose to cooperate with management teams within their social networks.¹⁷⁷ Even though corporate government codes in many jurisdictions require non-executive directors on the remuneration committee, it is almost impossible for remuneration committees to obtain independence from executive directors. 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 will remain at a reasonable level.¹⁷⁸

We think it is necessary and significant to emphasize the responsibility of the leaders, including the chairman of the board and the head of the remuneration committee. Legislation could provide for appraisal schemes for every director of a remuneration committee in order to evaluate their performance.

iv. Principles

Suggestions for legislation regulating remuneration committees and boards may be summarized as follows:

1. To provide guidelines for corporate governance, encouraging companies to provide concise remuneration reports to increase the efficiency of shareholder voting and the boards' work;
2. To make the shareholders' vote on the remuneration report for departing executive managers binding, in order to prevent pay for failure;

176. FRC, *supra* note 6, Section D.2: Procedure.

177. Lucian Bebchuk, Jessie Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 768 (2002).

178. Ian Gregory-Smith, *Chief Executive Pay and Remuneration Committee Independence*, 74 OXFORD BULLETIN OF ECON. & STAT. 510, 522 (2012).

3. To pursue the responsibility of the board and its 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

“A variety of legal persons are targeted by the regulation: listed companies, boards of directors, remuneration committees, individual executives/directors, institutional investors and shareholders.”¹⁷⁹ The law only gives guidelines for progress which executive managers and the board can easily hide behind. Thus, we should pay special attention to remuneration policy design.

The International Corporate Governance Network 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 article. The accountability of the board and remuneration committee to shareholders in terms of the practice of executive compensation, which should be improved, was analyzed in the second section. However, these factors are both intended to achieve the third goal, which is pay for performance.

Pay for performance is the ultimate goal of executive remuneration practices under various theories that have been proposed to explain remuneration. The following section will present a brief analysis of how to link pay with performance in practice, and summarize the difficulties of regulating pay for performance from a legislative perspective.

A. SETTING FOR PERFORMANCE

Normally, most executive pay policies are set on an *ex ante* basis, where the level and structure of directors' compensation packages are influenced by business conditions and the size of companies. Executive remuneration levels and company performance may be conditional on the companies' investment opportunities.¹⁸⁰ Because directors' 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, because the ability to observe executives' actions is decreasing, incentive compensation, which indicates

179. Sheehan, *supra* note 45, at 33.

180. Clifford Smith & Ross Watts, *The Investment Opportunity Set and Corporate Financing, Dividend and Compensation Policies*, 32 J. OF FIN. ECON. 263, 280–81 (1992).

market performance, is increasing.¹⁸¹ Developing from these empirical investigations, Baber et al. found that shareholders' investments are associated with the company's market-based performance, rather than its accounting-based performance, while the executive directors' stock incentive compensation is a crucial consideration in the investors' judgments.¹⁸² 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. inferred from their research that the influence of market-based performance factors on shareholders' investment will encourage cynical executive action to attract shareholder interest.¹⁸³

Interference from legislation and government, as mentioned above, may provide several methods to solve or at least mitigate such situations. If there is little legislative intervention endowing shareholders with voting rights and regulating an independent remuneration committee, there may be 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 relationship between country-level shareholder rights and national judicial efficiency. The researchers found that companies in countries with weak legal systems normally have lower governance rankings in the international data, and under those weak legislative situations a company's good performance is more positively correlated with better market-based and accounting performance.¹⁸⁴ 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 against the company's stock market return, while accounting-based performance concerns the accounting return on the company'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. Pay performance sensitivities represent the executives' share of the value that they have created. When shareholders' wealth increases by \$1, the value of executives' restricted and unrestricted stockholdings will increase in line with executives' ownership of their

181. Jennifer Gaver & Kenneth Gaver, *Additional Evidence on the Association Between the Investment Opportunity Set and Corporate Financing, Dividend and Compensation Policies*, 16 J. OF ACCT. & ECON. 125, 155 (1993).

182. William Baber, Surya Janakiraman & Sok-Hyon Kang, *Investment Opportunities and the Structure of Executive Compensation*, 21 J. OF ACCT. & ECON. 297, 315 (1996).

183. *Id.*

184. Leora Klapper & Inessa Love, *Corporate Governance, Investor Protection and Performance in Emerging Markets*, 10 J. OF CORP. FIN. 703, 723 (2004).

company's shares¹⁸⁵ Additionally, these two performance standards each have an impact on the other. Executive income is indirectly tied to stock-price performance through accounting-based bonuses, which reflects the correlation between accounting returns and stock-price performance, and also through annual adjustments of salary levels and target bonuses.¹⁸⁶

Earlier studies have confirmed theoretical assumptions that there is a linear relationship between executive compensation and performance from market and accounting perspectives.¹⁸⁷ 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.¹⁸⁸ They also suggest that companies that are developing quickly tend to place more emphasis on executives' market-based performance than on their accounting-based performance.¹⁸⁹

Apart from executive directors' management behavior, other uncontrollable factors could also decrease the relative weight that these two performance factors have on executive compensation levels.¹⁹⁰ These factors are 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;¹⁹¹ and (2) financial incentives in pay are created depending on various factors, including the executive's portfolio and the company's future risk preference.¹⁹² Argarwal and Samwick suggest that the level of corporate 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.¹⁹³ According to these financial studies, failure to allocate company risk to compensation incentives will underestimate the real pay for performance relation.¹⁹⁴

Even with regulations providing shareholders with voting rights and requiring the independence of boards and remuneration committees, previous factors such as

185. KEVIN MURPHY, *Executive Compensation: Where we are and how we got there*, in HANDBOOK OF ECON. & FIN., G. 25 (Constantinides ed., 2013).

186. *Id.*

187. Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 89–90 (1979); Rajiv Banker & Srikant Datar, *Sensitivity, Precision, and Linear Aggregation of Accounting Signals*, 27 J. ACCT. RES. 21, 34–35 (1989).

188. Richard Lambert & David Larcker, *An Analysis of the Accounting and Market Measures of Performance in Executive Compensation Contracts*, 25 J. ACCT. RES., Studies on Stewardship Uses of Accounting Information 85, 113 (1987).

189. *Id.* at 114–15.

190. *Id.*

191. Murphy, *supra* note 185, at 37.

192. *Id.*

193. Rajesh Aggarwal & Andrew Samwick, *Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence*, 54 THE J. FIN. 1999, 2032 (1999).

194. Paul Gregg, Sarah Jewell & Ian Tonks, *Executive Pay and Performance in the UK*, 9 AXA Working Paper No. 5, Discussion Paper No. 657, 2010.

excessive pay for failures and wrongful incentive design to encourage executives to take unreasonable risks 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 utilize will be discussed.

B. PAY STRUCTURE

i. Long-term Equity Option Vesting Period

The most serious problem in relation to the realization of executive directors' equity options, especially with long-term incentive plans (LTIPs), is that there are no requirements on the length of the post-exercise period in the current legislation.¹⁹⁵ Several issues in relation to long-term equity options need special attention from remuneration committees. These issues include 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 currently is no limitation on the holding period, under most circumstances executives will use their power to push share prices to a high level and sell their shares immediately after the exercise point. This type of managerial behavior, focusing on short-term profits, will certainly jeopardize companies' long-term success and shareholders' long-term interests.

Equity markets and product markets may sometimes help with pay for underperformance. Under good industrial performance or if the company has performed badly on previous occasions, 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.¹⁹⁶ Peer group review is a method that remuneration committee can use to avoid paying executives for under-performance. This type of review includes an evaluation of the level and structure of executive pay given by comparative companies in the same industry. This analysis may be carried out by the remuneration committee, by remuneration consultants, and sometimes even by the managers.¹⁹⁷ The reason why the companies and remuneration consultants should pay attention to this comparison is that shareholders, especially institutional shareholders, already recognize peer group reviews as a general performance measure for long-term incentive plans.¹⁹⁸

195. McClendon, *supra* note 107.

196. Diago DiMartino, *Are CEOs Hiding Behind Long-term Awards? Trend Towards Incentives Opens Another Chapter in Compensation Debate*, DALLAS MORNING NEWS, June 1, 2003.

197. Sheehan, *supra* note 91, at 124–25.

198. ABI, *Association of British Insurers, 2008, Executive contracts and Severance Guidelines from ABI and NAPF*, <https://www.abi.org.uk/News/News-releases/2008/02/Executive-contracts-and-severance-Guidelines-from-ABI-and-NAPF> [perma.cc/ASY5-5GKC].

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 be exercisable at least three to five years after the vesting period. This will be particularly relevant 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, the companies would normally reward and compensate them with other bonuses, short-term incentives, and benefits. If executives are dismissed or resign because of underperformance, companies will probably cancel their long-term incentive plans.

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.¹⁹⁹

According to Deloitte's study on the executive remuneration reports of FTSE 250 companies, 80% of the long term incentive plans of investigated companies now incorporate a post-vesting holding period.²⁰⁰ It may be observed that Schedule A has provided a good example in encouraging public companies to adopt a longer holding period in long-term incentive plans. This improvement has also shown that, under good direction from regulation, it is possible to develop and adjust the structure of executive remuneration policy and regulate it through soft law.

Also, if governments feel that this legislation has intervened too heavily in the governance issues of public companies, institutional shareholders can strongly recommend in their remuneration guidelines that their investee companies should provide longer vesting periods in their equity incentives.

As the next step to promote a longer holding period for exercisable shares, this paper proposes regulations to push remuneration committees to provide reasons in remuneration policies together with using the expertise of consultants from peer group analysis.

199. FRC, *supra* note 6, at 24.

200. Deloitte, *Your Guide: Directors' remuneration in FTSE 250 companies*, (Oct. 2018), <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/tax/deloitte-uk-tax-your-guide-directors-remuneration-in-ftse-250-companies.pdf> [perma.cc/FS9V-XHLE].

ii. Short-term incentive options

The HSBC case is worth discussing as it raises several interesting points concerning pay policy design. The HSBC remuneration committee proposed a policy to benefit the long-term profits of the company in 2011. Top executives would only be able to sell their equity options after their retirement.²⁰¹ From the remuneration structure discussion above, it is positive that these top executives in the banking sectors must 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, in order to promote the company's future success.

This policy has influenced the level of pay of HSBC's CEO, Stuart Gulliver; his pay was £12.5 million in 2011, but his remuneration was £7.4 million, £8 million and £7.6 million from 2012 to 2014 respectively.²⁰² However, shareholders were confused by the criteria suggested by John Thornton, the chairman of the remuneration committee at that time, which suggested measuring the share awards in a way that was not based on the company's share returns.²⁰³ Also, in 2015 nearly 23.7% of the HSBC 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.²⁰⁴ The increase in the shareholder veto in 2014 was due to the newly introduced EU executive bonus cap rule, 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."²⁰⁵

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 also have an impact on 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 share prices up to 2008, which brought the attention of

201. Masa Serdarevic & Patrick Jenkins, *HSBC Proposes Pay Shake-Up*, FIN. TIMES, Mar. 22, 2011.

202. Graham Hiscott, *HSBC boss earns 500 times more than bank's lowest paid workers last year*, DAILY MIRROR, Mar. 2013; see also Vivek Ahuja, *Here's What HSBC's Best-Paid Executives Earned*, WALL ST. J., Feb. 24, 2014.

203. Jill Treanor, *Investors split over HSBC plans to shake up executive bonuses*, THE GUARDIAN, Mar. 21, 2011.

204. Martin Arnold, *Almost A third of investors refuse to back HSBC pay*, FIN. TIMES, Mar. 14, 2015.

205. Ian Johnston, *HSBC Stuart Gulliver to get 70% pay rise – taking his salary to £4.2m a year*, THE INDEPENDENT. (Feb. 25, 2014), <https://www.independent.co.uk/news/business/news/hsbc-stuart-gulliver-to-get-70-pay-rise-taking-his-salary-to-42m-a-year-9150504.html> [perma.cc/YC8P-V3ER].

the public and governments to focus on managers' compensation.²⁰⁶ In 2010 long-term incentive options made up 47.8% of the total pay of the U.S. Fortune 500 companies, compared with 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 2006.²⁰⁷ As discussed above, measures such as increasing the vesting periods for long-term equity plans, recovering deferred bonuses, and reducing golden parachutes were already implemented before the financial crisis.²⁰⁸ Their role in linking performance and pay, and how to regulate them in law, will be analyzed next.

Short-term incentives, normally annual bonuses and restricted equity options, may 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 company'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 shares after the vesting period, so it is in their own personal interest to boost the share prices before selling, or to focus excessively on short-term prices for those options while neglecting the long-term performance of the firm.²⁰⁹

In our opinion, the rules for reporting short-term incentive pay should be embedded in the corporate governance code, under the "comply or explain" principle. Under Murphy's theory, the economic cost of companies granting equity options should be emphasized and calculated as if the companies did not grant those shares to its managers. Murphy suggests that, first, remuneration committees and boards should calculate their company's income as if its executive managers were not granted short-term share plan.²¹⁰ After this calculation, remuneration committees and boards can include these figures in the company's remuneration report, or even show what the company has spent on granting shares to managers instead of selling them to outside investors. This requirement will improve the transparency of pay reporting, and promote the long-term success of the company through shareholder engagement and monitoring.

NAPF's institutional shareholders alliance principle on executive remuneration suggests that there has been too much debate between companies and

206. Phred Dvorak & Joann Lublin, *Bailout's Bid to Limit Executive Pay Will Be Tough to Realize*, WALL ST. J., Oct. 6, 2008 at B.5.

207. The Conference Board, *The US Top Executive Compensation Report*, <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2848> [perma.cc/QZ6W-49HV]; see also Income Data Services, *Directors' Pay Report*, <http://www.incomesdata.co.uk/wp-content/uploads/2014/10/IDS-FTSE-100-directors-pay-20141.pdf> [perma.cc/G72V-MV55].

208. Sonnenschein Nath & Rosenthal LLP, *Congress Passes New Limits on Executive Compensation Paid by Troubled Financial Institutions*, (Oct. 3, 2008), http://www.sonnenschein.com/pubs/e-alerts/Congress_Passes_New_.html [perma.cc/YE3H-D7L7].

209. Jessie Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosures*, 71 S. CAL. L. REV. 303, 365 (1998).

210. Murphy, *supra* note 159, at 249.

investors around short-term or medium-term compensation designs.²¹¹ They suggest that the current average three-year period of equity vesting in executive pay may not be the best way to promote long-term success, particularly for the largest and most complex companies such as those listed in the FTSE 100.²¹² Studies of executive compensation from the financial industry suggest that to stop executive managers focusing on short-term profits and gaining excessive pay by using strategies 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.²¹³

To promote the companies' long-term success, Bhagat and Romano even propose that financial incentives in executive pay should all be changed to restricted stock or long-term stock options.²¹⁴ 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 their last day in office to sell the shares they already owned at the time of their departure.²¹⁵

In terms of financial incentive development, short-term incentives may be merged gradually with long-term incentive plans, because shareholders prefer to invest in companies where executive remuneration is based more on long-term share plans.²¹⁶ However, due to the advantages of short-term options over long-term incentives, such as attracting new executive managers to join the business and paying managers for short-term performance by encouraging long-term commitment, investors seem to be more inclined to approve short-term plans.²¹⁷ Thus, removing the pay element from the executive remuneration structure may not be the best proposal.

C. FAIR PAY?

i. Fairness in Regulation

A central question surrounding government regulation of pay gaps is how far the government can intervene in fairness issues.

Fair pay issues from company law and corporate governance perspectives can be categorized according to two factors. First, how do pay gaps and inequality between executive directors and employees in a company influence the lower-level employees' performance and the company's long-term productivity? Second, do

211. NAPF et al., *supra* note 49, at 3.

212. *Id.*

213. Cullen, *supra* note 128, at 97.

214. Roberta Romano & Sanjai Bhagat, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, YALE L. & ECON. RES. Paper No. 374, at 2-4 (2009).

215. *Id.* at 2-3.

216. James Brickley, Sanjai Bhagat & Ronald Lease, *The Impact of Long-Range Managerial Compensation Plans to Shareholder Wealth*, 7 J. ACCT. & ECON. 115, 120 (1985).

217. ROBERT KOLB, TOO MUCH IS NOT ENOUGH: INCENTIVES IN EXECUTIVE COMPENSATION, 160 (2012).

directors consider inequality when they are making pay decisions? If so, under what circumstances should regulation towards fairness occur?

Several studies show increasing dispersion in pay leads to lower productivity, less cooperation, and larger threats to turnover.²¹⁸ Hicks discussed the importance of the psychology of workers in 1963, noting “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.”²¹⁹ Additionally, research indicates companies will perform better with less dispersion in pay because the employees are less resentful towards the executives and more willing to contribute to the company.²²⁰

Therefore, a negative correlation can be postulated between higher executive and employee compensation, and employee and company performance. Then, the next essential question to arise will be how to address the problem of pay inequality.

Wade, O’Reilly, and Pollock studied 122 public companies over a five-year period and proposed, 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.²²¹

In August 2015 the U.S. 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 clarified that a public company’s pay policy needs to give a record of the ratio of the total CEO remuneration to the median total employee compensation, in effort to promote board accountability to shareholders in relation to executive compensation practices.²²² As noted by the SEC Chair Mary Jo White, this rule “provides companies with substantial

218. Matt Bloom & John Michel, *The Relationships among Organizational Context, Pay Dispersion and Managerial Turnover*, 45 ACAD. MAG. J. 33, 38 (2002); Jeffrey Pfeffer & Nancy Langton, *The Effect of Wage Dispersion on Satisfaction, Productivity and Working Collaboratively: Evidence from College and University Faculty*, 38 ADMIN. SCI. Q. 382, 40 (1993).

219. JOHN HICKS, *THE THEORY OF WAGES*, 112 (St. Martin’s Press, 1963).

220. Olubunmi Faleye, Ebru Reis & Anand Venkateswaran, *The Effect of Executive-Employee Pay Disparity on Labour Productivity* (Apr. 2010), <http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.615.3427>; Pedro Martins, *Dispersion in Wage Premiums and Firm Performance*, 8 CENTER FOR GLOBALIZATION RES., 5 (2008); see also Douglas Cowherd & David Levine, *Product Quality and Pay Equity between Lower-level Employees and Top Management: An investigation of distributive justice theory*, 37 ADMIN. SCI. Q. 302, 316–17 (1992).

221. James Wade, Charles O’Reilly, III & Timothy Pollock, *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, 17 ORG. SCI. 9. 527, 539 (2006).

222. SEC Public Statement, *The CEO Pay Ratio Rule: A Workable Solution for Both Issuers and Investors*, (Aug. 5, 2015), <http://www.sec.gov/news/statement/statement-on-open-meeting-on-pay-ratio-aguilar.html> [perma.cc/ZW4J-9DU3].

flexibility in determining the pay ratio, while remaining true to the statutory requirements.”²²³

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. 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 about narrowing the pay gap between CEOs and employees. Although think tanks in the U.S. and the UK have both suggested that pay ratios should be used to decrease pay gaps and inequality in the work place,²²⁴ the new section in the Dodd-Frank Act 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 company’s total share return and the share return of comparative peer group companies over the preceding five years, chosen by the compensation committee.²²⁵ This proposed amendment will help shareholders by providing detailed remuneration reports with additional information to enable them to vote on remuneration issues.

The U.S. shareholder say on pay amendment stays at the advisory level. Requiring a pay ratio to be reported in the proxy statements may provide shareholders with a more general view of CEO pay levels. However, it rarely provides ways to decrease pay gaps. Governments in the UK and the U.S. are still focused on attracting investment for their public companies by providing shareholders with more detailed information and the power to decide on pay policies and reports. A possible solution may relate to redistribution, tax regulation, or it may draw from another corporate governance model, for example the German model. Providing shareholders with the power to veto proposals may not be the best way to stop inequities in pay.

223. SEC Press Release, *SEC Adopts Rule for Pay Ratio Disclosure*, (Aug. 5, 2015), <http://www.sec.gov/news/pressrelease/2015-160.html> [perma.cc/S67B-28DN].

224. See Institute for Policy Studies (IPS), *2016 Executive Pay Reform Scorecard: Institute for Policy Studies*, Aug. 27, 2016, <https://inequality.org/research/2014-executive-pay-reform-scorecard/> [perma.cc/5U8T-EYQF]; see also High Pay Centre, *Reform Agenda: How to Make Top Pay Fairer*, (July 14, 2014), <http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer> [perma.cc/4K3H-TJD2].

225. Pay Versus Performance, SEC proposed rule, Exchange Act Release No. 34-74835, File No. S7-07-15 (proposed Apr. 29, 2015).

ii. Having Employees on the Board?

The German corporate governance model certainly does not suit every jurisdiction. Nonetheless, it does provide some useful lessons. The Volkswagen case shows that to reassess executive pay for underperformance, it is not enough to have employees on the board. After the German auto giant's emissions scandal in 2016, the management board members' bonuses were cut by 30%.²²⁶ However, this reduction in executive pay did not assuage Volkswagen shareholder dissatisfaction.²²⁷ 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.²²⁸ In the letter, this TCI suggested that the reason why managers in Volkswagen could be paid for underperformance was due to their efforts to save unnecessary job losses and increase employees' wages.²²⁹ Because the company has employees representing the German Labor Union on its supervisory board, and because these employee representatives have the power to decide how to pay management teams, it becomes crucial and logical for executives to devote extra attention to employees' interests to maintain their compensation level. After an evaluation of Volkswagen's recent cash-flow and payouts, TCI also pointed out that shareholders should have the power to monitor executive pay practice by annual voting on the remuneration report and via intervention from investors, another potential route for more effective executive pay practice.²³⁰

Besides this letter, governance experts have also expressed 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 are likely to lack professional management knowledge. This lack of expertise may undermine board accountability to shareholders. Since 2002, the chairman of Volkswagen has discussed business issues with the workers' council and agreed a position first, then brought it to the shareholders—unlike the situation in the UK, where the chairman arrives at a common position with the shareholders first and then talks with the board.²³¹ A former Volkswagen executive once said

226. Jan Schwartz, *VW Management Accepts Bonus Cuts of at least 30 percent*: source, REUTERS (Apr. 13, 2016), <http://www.reuters.com/article/us-volkswagen-uaw-idUSKCN0XA1WU> [perma.cc/6C5Z-D3RR].

227. John Rosevear, *Volkswagen Shareholders Are Fuming Over Executive Pay*, The Motley Fool (May 7, 2016), <http://www.fool.com/investing/general/2016/05/07/will-volkswagen-face-a-shareholder-revolt.aspx> [perma.cc/S4RZ-H6EG].

228. Miles Johnson & Patrick McGee, *TCI Launches Campaign Against Executive Pay at Volkswagen*, FIN. TIMES, May 6, 2016.

229. *Id.*

230. *Id.*

231. Richard Milne, *Volkswagen: System failure*, FIN. TIMES (Nov. 4, 2015), <https://www.ft.com/content/47f233f0-816b-11e5-a01c-8650859a4767> [perma.cc/X7EH-ZG3L].

that “the board was really a show.”²³² Although there are employee representatives on the board, these representatives do not seem to be active in performing their monitoring and supervising job as expected. Current and former employee representatives of Volkswagen supervisory board have stated that they knew nothing of the company’s emissions cheating and had never discussed engine issues with any other director.²³³

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 emphasis on gaining employees’ favour and support, neglecting payback for shareholders and the whole company’s interests. Tilley 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.”²³⁴ Companies’ long-term interests should be set as the main goal of remuneration design and practice, rather than the balance among the interests of shareholders, managers and employees. The employee monitoring function aims to improve the independence of the board and the remuneration committee. However, if employee representatives start leaning towards increasing managers’ pay for underperformance, the problem will be the same with non-executive independent directors; in fact, it may be even worse, since independent directors may not have a strong relationship with the company. One lesson to be learnt from Volkswagen is that governments should consider carefully before introducing legislation that accommodates employee representatives on the board.

There have been several other suggestions, such as having more employees holding the equity of the company; “broader capital ownership would curb income and wealth inequality, expand investment and employment, and reduce the demand for redistribution through the state.”²³⁵ This may be a wise option to enable a company to benefit and retain valued employees. However, from the legislation perspective, it is not the duty of either the Companies Act or a corporate governance code to intervene that much. On the other hand, if benefitting and retaining employees are to draw the attention of regulation, as in German companies, perhaps regulations like this may not bring improvements for executive remuneration.

Reports of an increase in general income and the recovery of pay in the public sector may indicate that the UK government should refrain from introducing additional regulation to promote fairness at the moment. Perhaps this overall increase was one reason why the UK parliament turned down a law on reporting pay ratios and placing employee representatives on boards to negotiate payment

232. *Id.*

233. *Id.*

234. Charles Tilley, *For Fair Pay, See Plato*, THE GUARDIAN, June 3, 2010.

235. Robert Wade, *Get Profits Share to Support a More Equal Income Distribution*, FIN. TIMES, Aug. 21, 2015.

issues.²³⁶ The UK is still a country with the default shareholder primacy norm embedded in company law and corporate culture.²³⁷ Additionally, while workers' wages are increasing at their fastest rate for six years,²³⁸ and in the context of the UK's smooth economic recovery, which has shown a decrease in unemployment and inflation since 2011,²³⁹ 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 may not be addressed by law.

IV. CONCLUSION

Mooney suggested that executive remuneration should be simplified in structure, and reforms should push companies to reduce the complexity of their reports.²⁴⁰ However, this suggestion for simplifying pay structures probably stems from only a partial understanding of pay structures and practices. It is difficult to avoid complexity in executive pay because it derives from variation in the incentives set for managers, even though these incentives' aims can be stated simply and clearly in pay reports and policies. It is the job of remuneration committees and boards to make those aims accountable to shareholders for resolution. Since the movement in favor of "shareholder say on pay" has become a popular legislative approach but also has proved to have implementation difficulties, current regulations should build upon present foundations to improve the quality of shareholder monitoring.

Due to variation in cultures and industries, each government has a unique method of regulating remuneration practice. This article only provides suggestions for legislations that are useful under general regulatory conditions. In relation to shareholders' voting power, this article proposes to improve understanding of the complexity of remuneration reports. Shareholders should have a meeting before they vote on executive remuneration issues, to improve their understanding of the complexity of the remuneration report. In order to prevent pay for underperformance among executive directors, shareholders should have a binding vote on the implementation pay reports of executives who are going to leave the company. In relation to board accountability, suggestions have been made that

236. 26 JUN. 2012, Parl Deb HC (2012) col. 41; 04 SEPT. 2013, Parl Deb HC (2013) col. 105 (UK) (Proposals suggesting having employee representatives in remuneration committee have been declined twice in the UK.).

237. Association of Chartered Certified Accountants Report 2015, *Shareholder Primacy in UK Corporate Law: An exploration of the rationale and evidence*, 41, <http://www.accaglobal.com/us/en/technical-activities/technical-resources-search/2011/september/rationale-and-evidence.html> [perma.cc/N5CM-EANQ].

238. Edward Cadman, *Earnings Grow at Fastest Rate for Six Years*, FIN. TIMES, Sept. 17, 2015.

239. Editorial, *UK's Enviably Smooth Economic Recovery*, FIN. TIMES, Sept. 17, 2015, at Opinion.

240. Attracta Mooney, "Get Rich Quick" Executive Pay Deals under Threat, FIN. TIMES, Apr. 12, 2018.

facilitate better communication with shareholders. A concision requirement should be imposed on remuneration reporting content and structure, perhaps via the corporate governance code. In order to promote the independence of board members and their negotiation with executive directors on executive remuneration, legislation should be introduced to impose liabilities upon members who do not fulfil their duty of care. From the perspective of pay for performance, companies' long-term interests may be promoted through executive remuneration structure adjustment. Regulations should encourage companies to increase the executives' shareholding period after these shares have been exercised, and companies should disclose the economic cost of issuing restricted share options to executive directors. These proposals cannot guarantee that executive compensation levels will be reduced, but they may make remuneration practices, such as shareholder engagement in reports and remuneration committee accountability, more efficient.

Shareholders' engagement in shareholding meetings and their passivity in relation to corporate governance are still huge concerns. However, with the globalization of the shareholder say on pay as a 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.²⁴¹ Although providing shareholders with a say on pay does not necessarily lead to pay for performance and promote the company's long-term success, with more investors who are knowledgeable about and willing to engage in remuneration practice, shareholders' intervention may develop in a positive direction.

Additionally, from the point of view of executive directors' incentives, several metrics have been designed to award managers for their leadership, community skills, and teamwork, as long as these performances result in effective management. Financial performance measures are usually calculated on a quantitative basis, but these non-financial performance criteria are qualitative.²⁴² The standards for paying managers for their non-financial performance may be quite subjective compared to financial incentive schemes. Current concerns about the relationship between remuneration committees and executive managers will make it even harder for legislation to provide appropriate methods to pay directors for their efforts, ethics, and reputations.

241. PwC, *Shareholder Activism: Who, what, when and how?* (Mar. 2015), <http://www.pwc.com/us/en/governance-insights-center/publications/shareholder-activism-is-your-company-prepared.html> [perma.cc/6BEH-LPVE].

242. Thomas Albright, Christopher Burgess, Aleecia Hibbets & Michael Roberts, *Four Steps to Simplify Multimeasure Performance Evaluations Using the Balanced Scorecard*, 63 J. CORP. ACCT. & FIN., (July-Aug. 2010).