

Executive Remuneration in the EU: The Context for Reform

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Abstract

This paper shows how clear divergences arise across the EU in how executive remuneration is structured. Sharp differences also occur in the adoption of best practices in pay-setting and in the disclosure of executive pay. These divergences are broadly in line, as agency theory predicts, with block-holding and dispersed ownership governance profiles. While the EU has recently adopted two important 2004 Recommendations on executive pay, the paper argues that EU-led reforms should be undertaken with care. Harmonization should be limited and only address disclosure. Disclosure is central to the adoption of effective incentive contracts in that it can manage the particular agency costs of executive pay, across dispersed and blockholding systems, without intervening in governance choices and structures. Any other interventions in the pay process carry the risk of distorting competition and interfering with the dynamics of different ownership structures and economic contexts.

Keywords: executive remuneration, disclosure, ownership structure, corporate governance, stock options, board of directors, incentive contracts, agency costs.

JEL Classifications: G3, J33, K22

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I Introduction

Executive pay lies at the heart of current discussions on corporate governance reform and conflicts of interest management.¹ Increased disclosure on executive pay, monitoring by the media, and institutional investor activism, all suggest that the current high levels and structures of executive pay are often divorced from management performance and represent a particularly sharp conflict of interest between management and shareholder interests. The purpose of this paper is to consider current research on the burgeoning executive pay problem in the context of EU corporate governance and the 2004 EU reforms on the management of executive pay. The EU provides an important laboratory for the executive pay discussion for a number of reasons. First, the executive pay contract can be examined under dispersed and block-holding conditions and in relation to different agency problems and managerial incentives. Second, the EU and the Member States are currently engaging in a timely reform of executive pay: these reforms are in need of a context. Finally, the EU executive pay story sheds light on wider issues such as how corporate governance harmonization should proceed and the appropriate role for regulatory competition.

Three themes are canvassed. Section II considers current research on the currently dominant analytical model of pay as an incentive alignment device and a remedy for agency problems, in the context of the EU's corporate governance profile. Sections III and IV examine the EU's executive remuneration profile (law and practice) for listed companies (based on the limited publicly available disclosure from FTSE Eurotop 300 annual reports for 2001), and whether it tracks the predictions of agency theory. Section V examines the recent EU reforms. Section VI concludes.

Overall, the paper finds that the outstanding feature of executive pay across the EU is that it reflects the prediction that executive pay, as an incentive contract, behaves differently in dispersed and block-holding governance conditions. The picture is becoming hazier, however, as incentive-driven pay practices and more sophisticated controls on pay-setting and pay

¹ Section III of this paper is based on the answers to a questionnaire on the pre-enlargement EU Member States' laws relating to executive remuneration, the full text of which is available on <http://www.ecgi.org>. The paper also draws on Ferrarini, G, Moloney, N, and Vespro, C, *Executive Remuneration in the EU: Comparative Law and Practice*, ECGI Law Working Paper No 09/2003, available on <http://www.ecgi.org>, Ferrarini, G, Moloney, N, and Vespro, C, 'Convergence in Law and Practice Across the EU Corporate Governance Faultline', *Journal of Corporate Law Studies* 4, 243, and on previous presentations of this research at the University of Milan, Siracusa, Sicily (conference on a Modern Regulatory Framework for Company and Takeover Law in Europe (now published as Ferrarini, G and Moloney, N, 'Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives', in Ferrarini, G, Hopt, K, Winter J, and Wymeersch, E (eds), *Reforming Company and Takeover Law in Europe*, Oxford, Oxford University Press, 267)), London (annual meeting of the Federation of European Securities Exchanges), and Brussels (Centre for European Policy Studies conference on Corporate Governance Reform in the EU).

disclosure have, in the last few years, begun to extend across the EU, largely following market pressure and external monitoring. A shift across the EU to more pervasive equity ownership, and greater reliance on share-based pay, may bring the particular problems, and tighter monitoring requirements, currently associated with pay practices in dispersed ownership systems. Any EU reforms must, however, be flexible and reflect the different conflict of interest lines across dispersed and block-holding governance, and the consequent different concerns raised by the executive pay contract. In particular, harmonization, even quazi-harmonization through Recommendations, should be used sparingly and limited to promoting convergence in disclosure, which is central to effective executive pay practices and effective governance in pay-setting.

II Executive Pay and the Agency Model: Implications for the EU

II.1 Executive Pay as an Incentive Contract

While there are multiple characterizations of the executive pay question (see Loewenstein, 1996 on executive pay as a wealth transfer issue), the currently dominant model examines executive pay in terms of the principal/agent relationship and incentives. This model generates two competing views of executive pay. Under the first, executive pay remedies the agency costs generated by the misalignment of management and shareholder interests in the dispersed ownership company. Shareholders in dispersed ownership systems have only a fractional interest in firm profits, are not fully incentivized to discipline, and have limited opportunities to monitor, management (Jensen and Meckling, 1976). Management's unobserved actions, particularly where personally costly decisions by management (i.e. laying off employees) and privately beneficial activities (the taking of perquisites) are involved (Jensen and Meckling, 1976), can prejudice shareholder wealth and give rise to agency costs. Whether, and the extent to which, a manager will fully pursue the shareholders' agenda depends on how that manager is incentivized. Agency theory suggests that the performance-based pay contract, which links pay to shareholder wealth via performance indicators such as share prices or accounting-based targets, is a powerful way of attracting, retaining, and motivating managers to pursue the shareholders' agenda (Jensen and Murphy, 2004, 1990; Hall and Liebman, 1997; Conyon and Leech, 1994). This model has, in the dispersed ownership context, dominated the pay debate and pay practices since the early 1990s and enjoys considerable support as making management more sensitive to shareholders' interests (Holmstrom and Kaplan, 2002; Kraakmann, 2004).

But, as discussed in section II.2, executive pay can also be regarded as an agency cost in itself in that it provides a potentially fruitful and opaque device for self-dealing by conflicted

managers (Bebchuk and Fried, 2004; Hill and Yablon, 2003; Bebchuk et al, 2002). In practice, pay is not set by shareholders, but is set on their behalf by the board of directors which should align shareholder and managerial incentives (Jensen and Murphy, 2004). A conflicted board, however, may use the pay-setting process to influence pay and extract rents in the form of pay in excess of that which would be optimal for shareholders, given weaknesses in the design of pay contracts and in their supporting governance structures (Bebchuk and Fried, 2004; Bebchuk et al, 2002). In effect, executive pay raises two related agency problems: how can the effectiveness of the executive pay contract as a remedy for manager/shareholder agency costs be protected from agency problems in the form of conflicts between the board, as pay-setter, and shareholders (Jensen and Murphy, 2004). A third agency problem has also been identified. The equity-based incentive contract may, as post-Enron scholarship argues, deepen conflicts of interest between shareholders and management by generating perverse management incentives to manipulate financial disclosure, particularly earnings, and distort share prices which can lead to catastrophic corporate failures (Coffee, 2003; Ribstein, 2003; Gordon, 2002; Langevoort, 2002). The consequences of such a cycle of ever higher share prices, and their impact on pay, has been examined as “the agency costs of overvalued equity” (Jensen and Murphy, 2004).

This dual, and even triple, characterization of the relationship between agency problems and the executive pay incentive contract takes on an additional complexity in the context of continental European relationship-based corporate governance, characterized by concentrated shareholdings and long-term shareholder commitment. Here, incentives and conflicts change. A major study has reported a high concentration of control among continental European companies (Barca and Becht, 2001). Concentrations of direct voting power by shareholders are intensified into block-holdings and control groups by cross shareholdings between dominant block-holders, the exercise of control through complex pyramidal ownership structures which allow control to be exercised through cascades of companies, proxy voting by financial institutions connected to the company, and voting pacts. Bank influence remains pronounced. This concentration of control, and the close relationship between block-holding shareholders and between those shareholders and management, recasts the agency problem which executive pay, in dispersed ownership systems, is designed to resolve. The agency costs which trouble the dispersed ownership company are reduced as block-holding shareholders have enhanced incentives and resources to monitor managers more directly and effectively, and without high-powered incentive contracts. Block-holding shareholders should wield sufficient influence, power, and resources to access information and to control management. They should also be motivated to do so in that they suffer less from the collective action problem faced under dispersed ownership, which means that individual

shareholders do not reap the full benefits of costly monitoring efforts which accrue to the shareholder body as a whole (Garrido and Rojo, 2002). In terms of the executive pay/agency relationship, there is less need for an incentive contract to control the first agency problem (the conflict between management and shareholder interests which is remedied by executive pay). There is also less probability of the second agency problem (which derives from executive pay as a source of agency difficulties) arising.

But, as with dispersed ownership, the potential for costs and interest clashes arises. In block-holding or concentrated ownership conditions, different shareholder/manager profiles arise, however, which have varying implications for executive pay and conflict of interest management. Where the shareholder/owner manages the company, there is an alignment of interests, and the need for an incentive contract, in principle, recedes. Where a professional/outside manager manages for the owner-shareholder, who may also be a director, the owner monitors the manager's performance, reducing the need for an incentive contract. Where ownership is concentrated, however, and management is carried out by professional/outside managers, monitoring of the same is carried out by the blockholders, but the incentive contract can align managerial interests with those of the company as a whole. Protections may, however, be needed to prevent collusion between blockholders and management. In particular, where management and block-holders collude on pay-bargaining, a conflict arises between their interests and those of minority shareholders, triggering a potential misalignment of interests. The reduced focus on the incentive contract and allied controls in block-holding governance also feeds back into the agency problems provoked by the incentive contract in dispersed ownership. Management may have an incentive, in a competitive seat context, to incorporate in jurisdictions with opaque approaches to executive pay.

Consistent with this model of executive pay, we found that the degree of sophistication of regulatory intervention on pay, and the extent to which high-powered, equity-based incentive contracts are adopted, reflects governance systems across the EU (see section III). Legal controls on pay are at their most sophisticated, in terms of managing potential defects in pay-setting which may damage interest alignment, in those Member States where dispersed ownership dominates. In practice, these systems also see the heaviest reliance on equity-based, incentive-driven pay contracts. Monitoring by controlling shareholders seems to have limited the degree of reliance on high-powered equity-based contracts in continental Europe (see also Brunello et al, 2001 (for Italy) and Crespi and Gispert, 1999 (for Spain)). More informally, further illustrations can be taken from high profile companies. A comparison can be drawn, for example, between the higher levels of executive pay at Daimler Chrysler

(dispersed ownership) as compared to lower levels at BMW (essentially block-holding) which suggests, again, the influence of ownership structures on pay practices. Equity-based remuneration is also sensitive to the governance divide in that it is less likely to be attractive to management where a publicly traded, but closely held, company (common in continental Europe - Barca and Becht, 2001) has only a small "free float" and a greater possibility arises of the share price being influenced by noise (Cheffins, 2003). The link between governance systems, varying incentives and conflicts of interests, and pay seems robust.

II.2 Defects in the Incentive Contract and Reform Lines Across the Governance Divide

Certain Member States and the EU are now engaging in reform of executive pay as part of a wider movement towards corporate governance reform. But this movement demands a context. This section considers how executive pay, as an incentive alignment device, and across both governance systems, raises a number of problems, particularly with respect to the trilogy of design, governance, and disclosure.

Aggressive intervention in the design of pay structures can be highly sensitive: a requirement that variable pay be capped at 50% of total remuneration was originally included in the draft Dutch Corporate Governance Code but proved deeply controversial and was omitted from the final 2004 Code. The design of executive remuneration is not generally tackled directly by Member States and was expressly excluded from the 2004 EU reforms. But governance problems, which allow design failures to emerge through conflicted pay-setting, and disclosure failures, which can hide both governance and design failures, are addressed as weaknesses in the pay-setting process, to varying degrees, in most Member States, even though these problems are largely, although not exclusively, a feature of dispersed ownership systems.

II.2.1 Design Problems

Performance pay suffers from a number of inherent design defects which damage the performance link at the heart of the incentive contract's effectiveness as an interest alignment device and which provoke conflicts between management/shareholders or, potentially, between management/controlling shareholders and minority shareholders (according to the particular shareholder/management profile in block-holding companies). These defects heighten the need for an effective governance and disclosure matrix for pay-setting if the alignment process is to work. This discussion highlights two design difficulties: proxies for firm performance and share options. Other design weaknesses include service contracts of

over one year and the related phenomenon of contractually guaranteed "golden parachutes" which can amount to rewards for failure, excessive and opaque pension arrangements, and, more generally, the complexity and opacity of pay packages which make monitoring difficult.

The choice of performance standard for an optimum incentive contract is a complex one. At a minimum, the standard should be sufficiently robust such that it can withstand manipulation by management and align interests effectively. Share price is ordinarily the best available proxy for shareholder wealth and reflects overall corporate performance more effectively than business-line linked target-specific bonuses. But the danger arises of generating incentives to inflate earnings and manage disclosure to generate short-term share price increases. Equity-based compensation also risks over-compensation of executives who preside over a period of market growth and under-compensation of those caught in a down market cycle. It is, however, difficult to construct a better alternative for shareholder wealth given that it does reflect the market's perception of the company's current and future cash flows, and so its perceptions of management performance and investment opportunities (Murphy, 1995). The risk of management inflating the share price, however, demands that the governance matrix which monitors management and supports pay-setting, whether it be independent directors, institutional investors, or controlling shareholders, is robust.

Share options pose a second major design problem. They can create potentially powerful incentives by linking pay to shareholder returns expressed via the share price. They can incentivize executives to take efficient, but personally stressful decisions and promote greater efforts to increase the global value of the company and the share price (Gordon, 2002). They have, on first glance at least, an attractively asymmetrical pay structure in that they reward success but do not appear to penalize failure: executives are not likely to equate the failure to make a gain with an actual loss. Options can also act as a powerful inducement to attract talent and can incentivize executives to stay. By contrast, fixed salaries are set in advance and have limited incentive effects. Cash payments are highly visible and transparent and may generate backlash effects which reduce their effectiveness as incentive alignment devices. While pay in the form of shares may also align shareholder and management interests, difficulties exist, including entrenchment of management, increased risk aversion by non-diversified managers, and reductions in dividends (Rozeff, 1982). There also appears to be a difficulty with the strength of the link between management share ownership and performance (Morck et al, 1988; Loderer and Sheehan, 1989; McConnell and Servaes, 1990; Core and Larcker, 2002).

But share options also display a number of inherent inefficiencies which damage the incentive alignment mechanism and recharacterize options as a potential mechanism for deepening agency costs and allowing managers to skim profits (Bebchuk et al, 2002). These include: the relative performance problem; dilution; repricing; and the impact of options on dividend policy and risk management. Relative performance is particularly problematic. Fixed price options, where vesting is independent of performance (common in the US), can deliver very large gains for executives whenever the market is rising, even if the company is underperforming its competitors (Rappaport, 1998). This problem can be avoided by linking the option's exercise price to a market or peer group index such that executives are rewarded only when they outperform the competition, or linking exercise to the achievement of performance conditions. Share options are, however, rarely indexed to the market in the remuneration market which is generating most controversy, the US (Bertrand and Mullainathan, 2000). While the US experience shows the potential options have for assisting management wealth extraction, benchmarked options and options linked to performance targets are, however, popular in the UK. The capacity for share options to be re-priced when the share price falls on poor corporate performance (rather than on sector-wide movements) further weakens the incentive justification and damages the alignment mechanism (Brenner et al, 2000; Chance et al, 2000). This was a common practice in the US prior to changes in accounting regulations (Carter and Lynch, 2003). The hidden costs of share options also include their impact on dividend policy. If share options appropriately align shareholder and management incentives, management should be incentivized to allocate cash flow to shareholders in the form of dividends. Share options can distort this alignment as the value of options drops with dividend payment, incentivizing management to reduce dividends (Arnold and Gillenkirch, 2002; Weisbenner, 2000; Lambert et al, 1989). Share options also carry the risk of dilution, and therefore of a reduction in earnings per share and entrenchment of management voting power (Morgan and Poulsen, 2001; Chauvin and Shenoy 2001). Dilution also raises difficulties in block-holding companies where controllers may see their dominant position weakened. The proportion of pay which is fixed or cash-based does not seem to drop to reflect increases in share option pay, which optimum incentive alignment would suggest, as otherwise option pay is simply a bonus (Bebchuk and Fried, 2004). Companies also seem reluctant to restrict managers in hedging away the risks of option compensation and damaging the incentive alignment (Bebchuk et al, 2002). Finally, although share options may incentivize management to pursue projects which increase the volatility of the company's value (Rajgopal and Shevlin, 2002), executives holding very large share option grants may be perversely incentivized to engage in very risky or fraudulent activity to maintain a high share price over a short time frame.

Overall, the core difficulty with share options is that a combination of inherent design flaws and management control of the pay-setting process may give conflicted managers scope to skim wealth from shareholders and to disguise the skimming through the structure of option pay (Bebchuk et al, 2002). As a consequence, the central agency problem is exacerbated, not remedied. Option grants can, however, be structured to avoid incentive alignment weaknesses. The share option problem then becomes one of how to ensure good supporting governance in, and disclosure of, pay-setting, rather than a difficulty with the option as a tool of executive pay *per se*. Design problems are in the hands of the board, as pay-setter, and its allied monitoring structures. If the board is aligned with shareholder interests, structure problems can be mitigated. Although the connection between bad governance and suboptimal pay structures is not entirely clear, (Bertrand and Mullainathan, 2001; Carter and Lynch, 2001; Brenner et al, 2000), the link between optimal shareholder interest alignment and good governance drives the EU responses to remuneration, on both sides of the ownership fault-line, and reflects the complex interaction between pay and agency costs. Even in block-holding systems where the need for incentive pay to monitor management is reduced, governance controls are becoming increasingly important, at least as a potential protection for minority shareholders against controlling shareholders.

II.2.2 Governance Problems

The effectiveness of the incentive contract therefore depends on the management of agency problems between the board and shareholders and on adequate monitoring by, *inter alia*, independent directors and, ultimately, shareholders. This section highlights some of the potential weaknesses in governance in pay-setting which may require intervention to enhance monitoring and mitigate pay-provoked agency problems.

Governance problems in pay-setting arise in both dispersed ownership and in block-holding companies. As outlined above, in block-holding continental companies the incentive contract is, according to the particular shareholder/management profile, less important in monitoring management and the focus shifts towards the wider effectiveness of monitoring via large block-holders, financial institutions which provide debt financing, and long-standing, interlocking relationships between management, shareholders, financiers, and other stakeholders (Berglöf, 1997). Concentrated ownership should also, as long as the chief executive and senior management do not form part of the controlling group, limit the possibility for pay-setting to be transformed into a process of skimming or rent extraction (Bebchuk et al, 2002). The two-tier board structure, and specifically the supervisory board, which features in a number of continental governance systems, may, if not without controversy, also provide an important management-control mechanism (Hopt, 2002) and, in

particular, provides financial institutions with a forum for monitoring management. Labour co-determination is also likely to keep pay at politically acceptable levels, although, while co-determination has a role in managing social conflicts, recent examples, such as the Mannesmann bonus scandal, show that it is not a guarantee against board excess (Hopt and Leyens, 2004)). But while labour interests have not traditionally intervened on executive pay in Germany, this laissez-faire approach is changing and labour interests are taking the executive pay question increasingly seriously. Nonetheless, while the pay-setting process therefore provokes less acute conflicts with shareholders as compared with dispersed ownership companies where the agency conflict between shareholders and management is sharp, problems remain with respect to minority shareholder protection.

A board may become passive or captured by management, and so poorly incentivized to bargain for optimal incentive pay in shareholder interests, for a variety of well-established reasons including: conflicts of interest where directors form the senior management group; board dynamics which often result in deference and politeness towards the chief executive; social ties; and the influence of the chief executive over the appointment of directors. The addition of independent directors to the board (or board remuneration committee) may provide a solution and is a dominant theme of EU responses to remuneration, albeit adjusted, in block-holding systems, to reflect the influence of controlling shareholders, and (where relevant) two-tier board structures. Independent, well-resourced, informed, and competent directors should be able to withstand any overbearing influence of senior management and be more likely to judge performance in the shareholders' interests and with respect to the company's performance (Kraakman, 2004). There are, however, a number of difficulties. Independent directors may be reluctant to disturb the *status quo* being friends of/appointed by the chief executive, or incentivized to set pay in a manner beneficial to them where they are serving executive directors. They may lack expertise on pay or have insufficient time to become expert. Disclosure flows to independent directors on performance may be unreliable. Reputational factors, which may result in an independent director who is regarded as "tough on pay" being blacklisted from other boards may arise. The empirical evidence on the effectiveness of independent directors is equivocal (on audit committees, i.e., see Romano, 2004). It has also been suggested that independent directors have not controlled executive pay but rather presided over its explosion (Bhagat and Black, 1999). One way out of this impasse is further disclosure of the extent of the ties between independent directors and the board of directors/chief executive. Another is to readjust the process by making directors bigger shareholders, thereby readjusting their incentives, although the danger of entrenching directors and a loss of director independence arises. Yet another is to impose rigorous controls on the independence of nominally independent directors which can only be achieved to a

limited degree, in block-holding systems. Composed primarily of independent directors, and exercising pay-setting functions delegated from the board, the remuneration committee can act as an objective control on the pay-setting process. The influence of management and the chief executive may, however, damage its effectiveness. While the evidence is equivocal, some studies suggest that there is little evidence that independent remuneration committees do a better job than inside directors (Main and Johnston, 1993; Yermack, 1997). The remuneration committee may be particularly ineffectual in block-holding companies, playing, in effect, a fictional role as pay is set by the controlling shareholders directly, although it has a potentially important role in minority shareholder protection.

While remuneration consultants provide expertise in the complex area of pay design, and improve disclosure flows to the remuneration committee, they are also vulnerable to capture by the board, and may exacerbate problems by acting as a camouflage mechanism to legitimize sub-optimal pay decisions (Bebchuk et al, 2002), unless selected by and accountable to the remuneration committee (Jensen and Murphy, 2004).

The effectiveness of back-stop shareholder monitoring of the incentive contract and the pay-setting process lies at the core of the pay-setting problem in the dispersed ownership context. As effective monitors, whether via direct shareholder voice mechanisms such as votes on pay or via indirect lobbying, shareholders suffer from the collective action problem and from lack of information. Collective action problems are exacerbated in the case of executive pay as shareholders are unlikely to see substantial individual gains from a reduction in the pay bill, and may suffer if management incentives are damaged. An examination of the optimality of pay decisions requires careful case-by case analysis of disclosure which, even where it is made available, can be difficult for shareholders. Institutional investors are, albeit controversially, often regarded as potentially strong corporate monitors. The extent to which institutional investors can bear on the pay process is, however, doubtful (Cheffins and Thomas, 2001). The collective action problem arises and is aggravated by the need for institutions to have diversified holdings (Hopt, 2002), which dilutes the ability of institutional investors to focus on company-specific issues. Institutions may not communicate effectively as a group and so fail to influence the board. Agency problems can also arise within an institutional investor, where, for example, an investor's corporate governance team faces pressure from other internal groups which provide services to a company's management (Romano, 2001). Institutional investors may also be prone to short-termism and ill-equipped to undertake successful long-term monitoring of executive pay strategies. There is some US evidence that large shareholders (5% and over) can act as an effective governance mechanism with respect to remuneration (Bertrand and Mullainathan, 2000). Law, and particularly

mandatory disclosure, appears to matter in this context, as the changes to UK company law in 2002, requiring a shareholder vote on the Directors' Remuneration Report, appear to be galvanizing institutional investors into action, with a number of high-profile corporate casualties arising from the 2003 and 2004 AGM seasons. It remains to be seen, however, whether the lively 2003 AGM season, in particular, represents a profound change in institutional investor behaviour (Tassell, 2003), although UK shareholder activism on governance generally appears to be on the increase with institutional shareholders increasingly and publicly intervening on board composition. But the difficulties faced by institutional investors in monitoring the incentive contract are a particular feature of dispersed ownership corporate governance. In concentrated ownership systems the existence of strong block-holders lessens the need, in principle, for monitoring by an incentive contract. Minority shareholders may, however, require mandatory disclosure support to maximize the general meeting as a forum for questioning management and exposing conflicts with the interests of management/controlling block-holders, although the effectiveness of minority shareholder voice and mandatory disclosure remains questionable (Hertig and McCahery, 2004). Consistently with this analysis, section III reveals that the use of advisory shareholder votes on remuneration is a feature of dispersed ownership systems, particularly the UK. Voting rules do apply to share option programmes on a pan-EU basis, but, here, the focus tends to be on approving option programmes as an aspect of the company's capital structure, rather than on monitoring remuneration.

The point has been well made that the optimal board structure will vary across companies according to their needs (Romano, 2001 and Hopt, 2002). The same is true of the pay-setting process which should not, as a result, be tied into a regulatory straitjacket. Flexibility is all the more important in the EU where the role of the incentive contract, the nature of conflicts of interests, governance systems, and board structures differ. Disclosure may provide the least costly way to manage the range of potential agency costs by ensuring that shareholders have sufficient information on remuneration as well as on any potential conflicts in the remuneration-setting process. Disclosure is also a more limited form of intervention in governance, which would allow flexibility and increase transparency in remuneration-setting in dispersed and block-holding ownership companies. In particular, in the block-holding context, while minority shareholders play only a limited role in governance, disclosure might, via the general meeting, whether generally or in the context of a share option programme vote, give these shareholders the opportunity to challenge remuneration, particularly where, as is the case in the continental EU, the trend seems to be towards more opaque share option grants. It would also afford investors in controlled companies the opportunity to assess the

extent to which, based on governance structures and pay practices, private benefits were, potentially, being taken.

II.2.3 The Role of Disclosure

Effective governance, in dispersed and block-holding ownership companies, therefore depends on effective disclosure. Disclosure requirements prompt the board to justify pay choices, and the pay-setting process and can also enhance the accountability and visibility of the remuneration committee. They can also sharpen shareholder monitoring, particularly by inducing institutional shareholders to play a more activist role. Disclosure of pay lowers the cost of monitoring by raising the reputation of institutional investor monitors by signaling or publicizing the results of their activism and generating greater deterrence effects. It also facilitates communication between institutional investors and with management. But as setting executive pay is a complex process, opaque disclosure will not generate effective shareholder oversight. In particular, aggregate disclosure concerning total firm executive pay which does not explain remuneration policy and the often highly complex performance conditions applicable or set out the specific components of the pay packages of particular and named senior executives will not allow shareholders to assess pay policy effectively.

While disclosure is traditionally associated with minimal regulatory intervention, there are costs involved. The benefits of potentially greater shareholder activism must be weighed against popular and political reaction to enhanced disclosure of executive pay. With enhanced disclosure, pay questions are played out in the media, influenced by labour, captured by private interests (such as those of political activists and union personnel), and politically-infused. Remuneration committees may be vulnerable to responding to political and workforce pressures and adopting suboptimal remuneration structures which are not sufficiently sensitive to performance (Romano, 2001). Disclosure which focuses on headline pay levels, invites popular hostility, and does not facilitate shareholders in assessing remuneration structures and the pay-setting process is destabilizing (Murphy, 1995). By contrast, disclosure which makes it easier to assess the pay-performance relation/incentive structure and the effectiveness of governance can remedy some of the structural and process weaknesses of executive remuneration. Other costs of disclosure include the danger that disclosure may result in an increase in pay due to a ratcheting effect.

As discussed in section III, disclosure is emerging as a key mechanism for managing pay across the EU. Disclosure is also strongly supported in the EU's reforms (section V). As a regulatory mechanism, it has considerable appeal as a non-aggressive form of intervention in bridging the difficult divide between governance systems and responses to remuneration

across the EU. Nonetheless, the widely varying degrees of disclosure required and produced by companies in practice suggest that disclosure also exposes deep cultural divides as to the primacy of personal privacy in pay.

II.3 Convergence in Governance and the Role of the Incentive Contract?

The different agency costs raised by executive pay may be a particular cost of dispersed ownership, although implications also arise for block-holding systems. A number of factors may, however, provoke greater convergence in European corporate governance and, where dispersed ownership asserts itself, in remuneration practices along Anglo-American lines and in a need for tighter monitoring. These include: the growing equity culture and focus on shareholder value encouraged by the securities market reforms contained in the EU's Financial Services Action Plan; activism by Anglo-American institutional investors and by a new generation of EU institutional investors in the form of collective investment schemes; international competition in the market for executives; cross-border merger and acquisition activity; and the evidence of some movement towards more widely held companies and a (limited) loosening of control by family block-holders in continental companies as they seek equity market financing (Hertig and McCahery, 2004; Van der Elst, 2003; Winter, 2003; Commission, 2000; Hertig 2000). Nonetheless, the different roles played by the pay contract in managing conflicts of interest in dispersed ownership and block-holding conditions calls for flexibility, and particular care in the adoption of pan-EU reforms based on the Anglo-American experience.

III Member State Intervention on Pay: the Incentive Contract in Practice

Section III considers the governance and disclosure strategies adopted by (pre-enlargement) Member States across the EU in light of executive pay as a potentially flawed incentive contract and across the governance divide.

III.1 Annual Disclosure - Annual Reports

Effective shareholder monitoring as back-stop control over the agency costs of potentially conflicted, and inherently defective, incentive contracts demands, for both block-holding and dispersed ownership conflicts, that disclosure is individualized and reflects the fixed, variable, and equity-based components of pay, and their respective performance links, in order to avoid knee-jerk responses to the disclosure of headline pay levels. Our research found that a sharp distinction emerges between two groups of Member States with respect to annual disclosure of executive pay, which reflects governance profiles.

In Group 1 (UK, Ireland, France, Italy, the Netherlands, and Sweden), the six Member States all accept the principle of maximum transparency, albeit implemented with varying intensity. The UK, reflecting the monitoring role played by the pay incentive contract in dispersed ownership, stands at the apex of this group and requires detailed disclosure on executive pay packages and their performance links. Since 2002, by law, a discrete Directors' Remuneration Report must form part of the annual reporting cycle. Detailed disclosure is required on an individualized basis and as to the fixed, variable, and share-based components of executive pay. An extensive discussion of company pay policy is also required. A particular innovation, not found in any other Member State, is the requirement that the Report include a performance line-graph which illustrates the total shareholder return on the company's equity capital. In Ireland, a broadly similar, although not as extensive, regime, based on individualized disclosure is imposed: it applies on a "comply or explain basis" via the listing system. In France, by law, individualized disclosure of executive pay is required in the annual report. French best practice (as set out in the Consolidated Corporate Governance Code 2003 - it applies on a recommended "comply or explain" basis) recommends additionally that the annual report include a section on pay which sets out company pay policy and individualized disclosure of executive pay, broken down into the particular pay components. In Italy, a broadly similar approach obtains. Under Consob (the Italian Securities Commission) rules, individualized executive pay awards, specifying particular pay components, must be disclosed in the annual report. The Exchange also recommends that the Corporate Governance Report (annexed to the AGM documents) include a Remuneration Report, which considers company executive pay policy and performance links. In the Netherlands, by law (since 2002), individualized disclosure, specifying the particular components of pay, and explaining performance links, along with a report on pay policy, is required in the annual report. In Sweden, similar binding rules apply as to annual individualized disclosure, but via listing agreements. While this group includes the dispersed ownership systems of the UK and Ireland, it also contains a number of Member States where dispersed ownership is stronger than elsewhere in continental Europe (Sweden and the Netherlands).

The position in Group 2 (which contains the remaining and majority of Member States - Germany, Austria, Spain, Belgium, Luxembourg, Denmark, Finland, Greece, and Portugal) is strikingly different. This group includes the classic block-holding systems of Germany, Austria, and Belgium. Disclosure is generally minimal with aggregate disclosure of total board pay the norm. The rather reluctant approach to disclosure may reflect privacy and cultural issues with respect to pay, as well as the weaker role of the incentive contract, and the independence of controlling shareholders from mandatory disclosure protections. Corporate governance codes are, however, moving companies in the direction of fuller, individualized

disclosure. Looking to a sample of the Member States in Group 2, in Germany only aggregate disclosure of total board pay (albeit for the supervisory and management board separately) is required by law. Under the 2002 Cromme Code on Corporate Governance, however, which applies, by law, on a "comply or explain" basis, individualized disclosure, which specifies the components of pay, is recommended. It is clear from our review of the annual reports of the FTSE Eurotop 300 companies that companies are not following this recommendation: only one company disclosed on an individual basis in 2001, although this had increased to 5 in 2002. In Denmark, Finland, Greece, Luxembourg, Portugal, and Spain, broadly speaking, aggregate disclosure only is required. Belgium has recently adopted a new Corporate Governance Code (2005) which recommends, on a "comply or explain" basis, individualized disclosure of CEO pay, split out as to fixed and variable components, but only aggregate disclosure of other executive management pay, again split out as to fixed and variable components. Of particular note is the movement in Spain which, like Belgium, exposes a general reluctance to disclose remuneration on an individual basis. While the 1998 Olivencia Report recommends individualized disclosure which specifies pay components, the 2002 Aldama Report reported that companies do not, for the most part, comply with this recommendation. The Transparency Act 2003, however, now requires that listed companies publish an annual corporate governance report which includes the remuneration of individual board members.

A distinction between Group 1 and Group 2 also emerges with respect to annual share option disclosure. In Group 1, companies generally disclose, on an annual basis, individualized information on rights granted, rights exercised, and rights which remain unexercised. This is typically imposed by law and the disclosure required is extensive. The French regime is noteworthy: a special report is required on share options as part of the annual reporting cycle. In Group 2 disclosure is, again, rather patchy. In only two Member States, Austria and Germany, is disclosure made of share option grant and exercise and then only in aggregate. The German Corporate Governance Code does, however, recommend disclosure on an individualized basis.

III.2 Governance (1) - Remuneration Committees

The remuneration committee is on the rise sharply across the Member States, and across the one tier/two tier board divide, as the body responsible for proposing pay policy and packages to the board. Its use, and particularly its membership, is generally tailored to take into account the factors peculiar to continental governance including the impact of block-holding ownership structures, two-tier boards, and labour co-determination.

Sophisticated rules apply to the operation and membership of the remuneration committee in the UK and Ireland. They apply via the Combined Code, which applies to listed companies on a "comply or explain basis" through the Listing Rules. The committee should be composed exclusively of independent non-executive directors. The Code's independence requirements have been tightened following the 2003 review of the independent director by the Higgs Review. Independence is now characterized in terms of the board determining whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. Independent directors are also given additional support such as being empowered to obtain independent advice in making decisions.

In France, a remuneration committee is recommended by the 2003 Consolidated Corporate Governance Code. The Code recommends that the committee be composed exclusively of non-executive directors, but only in the majority independent. Independence is defined in terms of the director having no relationship of any kind with the company, its group, or the management of either that is such as to colour the director's judgement. A remuneration committee is also recommended in Italy, on a "comply or explain" basis, by the Corporate Governance Code. The committee's recommended membership is somewhat weaker in terms of independence than in the UK/Ireland and France, as only a majority of the members are required to be non-executive directors. In Spain, the Olivencia Report and the Aldama Report recommend, on a "comply or explain" basis, that a remuneration committee be formed. It should be composed exclusively of non-executive directors. Reflecting the features of block-holding, however, the proportion of non-executive directors representing block-holders to independent non-executives directors must reflect the same proportion as exists on the board.

Recent reforms have taken a similar approach in Belgium and the Netherlands. In Belgium, a remuneration committee is recommended by the 2005 Corporate Governance Code: a majority of its members should be non-executive directors. The 2004 Dutch Corporate Governance Code recommends that where the supervisory board consists of more than four members, it appoint a remuneration committee from among its members. The new Code will apply on a "comply or explain" basis by law and early indications suggest that it is being observed. Like the UK's Combined Code, the Code also contains recommendations on the amount and composition of remuneration, as set by the remuneration committee, including that variable remuneration be linked to previously determined, measurable, short and long-term targets.

In Austria and Germany the position of the remuneration committee is weaker. In Austria, the human resources committee of the supervisory board, where one exists, is responsible for pay.

Labour co-determination impacts here: the Corporate Governance Code provides that employee representation rights apply to all supervisory board committees. The committee which is designated as responsible for the employment contracts of management board members may, however, be established without employee representation. In Germany, the Cromme Code simply states that the establishment of a remuneration committee is good practice: it does not require that a remuneration committee be created. It is increasingly the practice among large companies, however, for a remuneration committee to be established from the supervisory board (Hopt and Leyens, 2004).

There is, therefore, some transplantation of the classically Anglo-American remuneration committee device, but it not yet prevalent across the EU and considerable differences emerge with respect to committee membership. There is evidence, however, of a movement towards the remuneration committee among those companies still lacking one, often following media and market pressure (Hewitt, 2003).

III.3 Governance (2) - Shareholder Voice

Direct shareholder voice as a means of managing conflicts in the pay-setting process does not feature strongly across the EU. The UK gives the most direct role to shareholders by imposing, by law, a requirement for a non-binding shareholder vote on the annual Remuneration Report. This voting requirement was used for the first time, and to dramatic effect, during the 2003 and 2004 AGM seasons as concerted action by major institutional shareholders led to large (albeit minority) dissenting votes at a number of AGMs and, in the case of the 2003 GSK AGM, the rejection of the Remuneration Report. The UK (and Ireland) also imposes shareholder approval requirements on the adoption of certain option and long-term incentive plans via the Listing Rules. Detailed rules apply to the disclosure which must be made to shareholders in advance of the shareholder vote.

While most of the other Member States also require shareholder approval of option plans, approval is usually linked to approval of a capital increase, and is not a form of shareholder control over executive pay. Only in France can shareholder approval be seen as a mechanism for shareholder approval of pay policy, as a vote is required regardless of whether the option plan involves a capital increase.

In conclusion, it appears that across the EU public regulation is relatively important for disclosure of executive pay, although best practice codes are, increasingly, exerting an influence on the way in which executive remuneration is set and disclosed. The sharp divergences in regulatory approaches observed seem to reflect differing ownership structures

given that the remuneration problem is more acute in dispersed ownership systems. There is, however, some evidence of convergence in continental Europe towards the Anglo-American model, but it is not consistent: many companies refuse to implement the principle of full disclosure, even in Member States where it is recommended as best practice. Governance institutions such as the remuneration committee are not easily transplanted to systems characterized by concentrated ownership or two-tier governance structures. The role of the shareholder meeting in the remuneration-setting process is also still debatable, particularly with respect to concentrated ownership systems.

IV Empirical Evidence of Pay Practices in the FTSE Eurotop 300

The second element of our examination of executive pay in the EU concerned the empirical evidence available on pay practices in EU companies, based on the public disclosure made available by companies in the FTSE Eurotop 300 and, in particular, the 2001 annual report. One striking feature of EU disclosure, as compared to US data, is that it is very limited and, particularly where only provided in aggregate, opaque. The predominance of aggregate disclosure, in particular, combined with a lack of consistency in disclosure practices, makes accurate direct comparison of pay practices across the EU via the annual report very difficult and conclusions on pay trends, based on annual report disclosure, tentative. A move towards some degree of harmonized pan-EU disclosure, particularly with respect to individualized disclosure, the performance/pay link, and the components of pay, seems essential if effective cross-border monitoring is to emerge.

IV.1 Chief Executive Officer Pay

Individualized disclosure of CEO pay is made available in the annual report in seven Member States (UK, Ireland, France, Italy, Netherlands, and Sweden – Group 1) and Finland. A number of trends emerge from this disclosure. Headline cash and bonus-based pay (excluding share-based pay) range from a high of Euro1.9 million in France to a low of Euro 0.9 million in Finland. A considerable proportion of pay is in the form of variable cash bonuses. The range is from 47% of pay in France to 27% in Finland. These figures are, however, somewhat deceptive in that they do not include share-based/long-term incentive pay. With these elements factored in, the UK moves ahead by some distance with respect to the proportion of variable pay. Total variable pay, including share options and long-term incentive plan awards, represents 78% of total pay in the UK, as compared to 60% in France.

IV.2 Share Options

The annual reports of the FTSE Eurotop 300 reveal that share options are, increasingly, forming part of the executive pay contract across the EU. This is the case across the dispersed

ownership/block-holding ownership divide, notwithstanding the association of share options with dispersed ownership. The pan-EU emergence of share options as a core element of pay is, however, a recent development. In the UK, for example, all 68 companies in the Eurotop 300 have share options programmes which are generally long established. The UK trend, however, is away from share options and towards more long-term, share-based incentives (see IV.3). In France, while 40 of 42 companies examined have share options programmes, these date from 1997. In Italy the position is similar, if the incidence slightly lower, with 25 of the 44 companies in the Eurotop 300 operating option plans. As in France, adoption is generally relatively recent (1999-2000). In the Netherlands, 17 of the 18 companies considered have share options programmes. Patterns of share option adoption are similar in Sweden with 16 of 19 Swedish companies in the Eurotop 300 operating share option plans. In Germany, however, share option use is more limited. Seventeen of the 30 German Eurotop 300 companies operate share option plans. In addition to reflecting the impact of block-holding governance on incentive structures, the limited use of share options can also be explained by the only recent removal of a prohibition on share options by the Kontroll-und Transparenzgesetz in 1998. Recent stock market weaknesses have also reduced their popularity in Germany. Share option incidence is also low in Spain, where only 5 of the 18 Spanish companies in the Eurotop 300 have adopted share option plans. It is difficult to draw any conclusions on the problematic connection between performance conditions and share option awards across the EU. Disclosure as to performance conditions is very variable (although extensive in the UK, where concerns remain as to the alignment effect of performance conditions (Patten 2004)), making it impossible to draw meaningful comparisons based on publicly-available disclosure

IV.3 High powered share-based incentives

The sharpest distinction emerges with respect to long-term share-based incentives. Clear evidence emerges from the Eurotop 300 annual reports of their use in the UK, where the popularity of share options is waning. The schemes in operation include performance share schemes, deferred equity transfers, and conditional awards of shares, reflecting the replacement of share options by long-term incentive plans as equity-based pay for executives in the UK (Jensen and Murphy, 2004). Scheme awards are typically linked to total shareholder return-based performance indicators. Elsewhere in the EU there is strikingly little evidence of reliance on long-term share-based incentives: their use is sporadic at best. The limited examples include Denmark, where Danske Bank in 2001 introduced an incentive programme which included conditional shares, and Portugal, where Banco Espirito Santo introduced a share-based incentive scheme in 2002 based on blocks of shares with deferred

settlement. This trend has been confirmed by a 2003 survey of EU companies which showed that only 28% provided equity based pay (Hewitt, 2003).

Overall, disclosure varies considerably in practice, with the degree and sophistication of disclosure diminishing sharply as the governance fault-line is crossed. In the UK, for example, detailed, individualized disclosure on the remuneration packages of all executives (including salary, bonuses, share options, and long-term incentive schemes) as well as on remuneration policy is available in the annual report, while in Greece information is available only on the aggregate total pay of the company's board of directors, including executive and non-executive members. An examination of the 2002 annual reports, however, reveals, in some Member States, a weak trend towards more extensive and individualized disclosure.

The Eurotop 300 annual report sample suggests a pan-EU increase in the performance orientation of executive pay and in the use of variable pay. While this development appears encouraging, it is not without difficulties. The shift in Anglo-American pay practices appears to be away from troublesome share option awards and towards a more calibrated mix of long-term, performance-linked equity based /cash bonuses (Roberts, 2004). The continental trend appears to be somewhat different. While reliance on cash-based bonuses is well-established, share options, which emerged, in Anglo-American governance, as potential mechanisms for delivering massive gains to underperforming executives, are increasingly being used to deliver long- and medium-term incentives..

V EU Reforms

V.1 The Approach to Reform

As discussed in section II, structural weaknesses in the incentive contract, and the potential for pay-setting to trigger conflicts of interests, suggest that governance and disclosure mechanisms are required to correct failures in the bargaining process and ensure effective interest alignment in the pay process. The range of incentives and agency problems across the EU's block-holding and dispersed ownership companies calls for care, however, in addressing executive pay, particularly where quasi-harmonization through Recommendations is concerned. This is all the more so as governance systems do not split cleanly across the Member States: in the Netherlands, for example, dispersed ownership and block-holding ownership co-exist. In 2002 the High Level Group on Company Law (HLGCL) presented proposals for effective pan-EU corporate governance, which included recommendations on executive pay. The Commission's 2003 Company Law Action Plan, which set the parameters for the two key 2004 Recommendations on Executive Pay and on Non-Executive Directors (discussed below), broadly reflected the HLGCL Report's key recommendations: disclosure

of remuneration policy and individualized disclosure; and the establishment of remuneration committees on a pan-EU basis.

The EU's approach is based on the assumption that, while design is for individual company policy, the executive pay contract should provide proper incentive alignment, monitored by shareholders and market forces, and that EU intervention, to promote convergence in best practices, is necessary to achieve this. The reforms are calibrated, albeit bluntly, to reflect the different contexts of dispersed and block-holding ownership: the 2004 Executive Pay Recommendation, for example, expressly aims to respect the diversity of governance systems. Under both Recommendations (Executive Pay and Non-Executive Directors), Member States retain the freedom to proceed through regulatory measures or "comply or explain" codes which should allow for company divergence as well as market monitoring: market pressure (with public opinion) has been identified as the single most important factor pushing EU companies to improve the pay/performance link (Hewitt, 2003). The Recommendations, which are non-binding and so allow for some sensitivity to Member State governance systems and culture, may promote the convergence in good governance currently underway, among certain Member States at least. Standards are recommended at a principles- rather than rules-level: the individualized disclosure required under the Executive Pay Recommendation is considerably less formidable than that required in a number of EU Member States, while the independence recommendation acknowledges that what constitutes independence is fundamentally for the board to determine. .

Nonetheless, it is clear that a degree of quazi-harmonization is envisaged by the Recommendations, raising questions about the effectiveness of the EU reforms, and more, generally, the appropriateness of harmonization in this field, given that the legitimacy of harmonization in the corporate governance sphere generally is doubtful. It remains possible for Member States to ignore the Recommendations: a floor is not put in place and variable pressure for best practice across the market could allow Member States to adopt opaque systems for pay, notwithstanding the deep conflicts provoked by executive pay across dispersed and block-holding systems. While this may exacerbate conflicts of interests and perverse director incentives on, for example, company incorporation, the trend across the Member States seems to be in favour of greater disclosure and stronger governance, supported by "comply or explain", often embedded in a statutory reporting obligation (most recently, see the Spanish (2003) and Dutch (2004) examples). With the exception of the shareholder vote reforms, the reforms seem designed to encourage this convergence rather than impose new, "one size fits all" standards. To the extent, therefore, that they encourage policy choices already underway in Member States, reflect market pressure, and, critically,

accommodate competition, the Recommendations may speed the adoption of best practice (Enriques, 2003). Their adoption has also allowed for centralized pan-EU consultation and discussion on executive pay. Member States may, however, move to standardize executive pay governance in line with the Recommendations, damaging competition, particularly as the threat of full, binding harmonization remains: the Commission has reserved the right to monitor progress on their adoption. But governance structures, and particularly board structures and practices, should not be harmonized, even through quazi-harmonization in the form of Recommendations, as they reflect different ownership structures, legal traditions, and economic systems. Corporate governance structures should remain a function of competition between company laws across the EU. Disclosure, however, remains an appropriate sphere for harmonization given the clear reluctance across the Member States to converge toward full disclosure on executive pay, its importance in assessing company choices as to corporate governance structures, and, ultimately, its impact on share price and monitoring. While the determinants of investor confidence remain elusive, disclosure of pay, pay policy, and the pay-setting process may feed into investor confidence and the EU's capital market integration project: this aspiration is expressed in the Executive Pay Recommendation which links the executive pay reform to the wider reform of disclosure in EU securities markets.

V.2 Reform (1): Disclosure

The Commission's disclosure reforms are set out in the October 2004 Executive Remuneration Recommendation. The Recommendation follows Anglo-American best practice, requiring companies to disclose, in the annual report, or in a self standing report, general information on forward-looking remuneration policy, allowing evaluation of incentive effects, in order to "enable shareholders to assess remuneration." The information required implicitly promotes incentive-based pay, emphasizing disclosure on: the relative importance of variable and non-variable remuneration; performance criteria; the linkage between pay and performance; and the parameters and rationale for bonus schemes. Reflecting the link between design flaws and governance, disclosure is required on the pay-setting process and, tracking the strong shareholder governance theme, the role of the general meeting in setting pay. Individualized disclosure of executive director remuneration is isolated, unsurprisingly, but controversially, as an important mechanism for assisting shareholders to understand the pay/performance link. Total remuneration must be "disclosed in detail" and cover at least salary and other fixed elements of remuneration including bonuses and profit-sharing schemes (including the reasons for grant), termination payments, and other non-cash benefits. Detailed information is required on share options granted, exercised, unexercised, and any changes in option terms and conditions and on grants under share schemes. These disclosure requirements broadly reflect the convergence currently underway in some Member States.

National requirements continue to differ sharply, however, particularly with respect to individualized disclosure, as the empirical evidence shows, making effective pan-EU comparisons and monitoring difficult. In this sphere, therefore, quazi-harmonization is appropriate as convergence towards the Recommendation should enhance transparency in pay and with respect to pay-setting and choice of governance structures. The extent to which this disclosure will lead to effective voice for minority shareholders remains questionable, however. Effective implementation of the reforms demands that the disclosure standards are acceptable at a pan-EU level in that they reflect capital market conditions and corporate governance structures in the Member States. While the Commission's approach is ambitious, it is not set at the highest (UK) level: it does not, for example, suggest comparator group disclosure (as called for by certain respondents to consultation) or require discussion of the company's share price performance as against a benchmark. It remains to be seen whether disclosure practices will change. Reliance on a Recommendation may not be sufficient to dislodge the entrenched distrust of individualized disclosure in some Member States, as is clear from the resistance to full disclosure in Germany notwithstanding the pressure from market forces.

V.3 Reform (2): Board Governance – Independent Directors and the Remuneration Committee

The second element of the Commission's strategy, effective board governance in pay-setting, is set out in the partner 2004 Non-Executive Director Recommendation. At the heart of the Recommendation is the Commission's position, and the essentially Anglo-American convention, that independent board oversight, effectively resourced and capable of challenging management decisions, can, particularly in key committees, protect the interests of shareholders (and other stakeholders), and reduce the agency costs of pay, across the governance divide. The non-executive director mechanism is employed to protect the interests of weak shareholders over management in dispersed ownership and to ensure that the interests of minority shareholders are considered in block-holding systems. The remuneration committee requirement, in particular, is based on the high potential for conflicts of interests in the remuneration of directors on both sides of the governance divide. The Recommendation requires that remuneration committees be set up where the board sets remuneration and be composed exclusively of non-executive directors, in the majority independent. The challenge of establishing even soft pan-EU standards on independence is not entirely shirked: a profile on independence lists the main threats to director independence which may create a conflict of interest such as to jeopardise exercise of judgment, and includes being, or representing, a controlling shareholder. The key power of initiative over remuneration passes to the committee: it is to propose remuneration policy to the board, including fixed, and (reinforcing

the Commission's support of the incentive contract) performance-related elements. Proposals with respect to performance-related pay would include evaluation criteria and, in an express commitment to the alignment function of the incentive contract, align director and long-term shareholder interests appropriately. The committee would also make proposals with respect to individual director remuneration. Disclosure flows to the committee are addressed, but only insofar as the Recommendation suggests that the committee avail itself of consultants in assessing market standards for remuneration: disclosure flows from the board/elsewhere in the company (ie human resources) are not directly addressed. Reflecting the potential for capture, the committee is to be responsible for establishing the selection criteria, selection, appointment, and setting of terms of reference for any consultants. These reforms are less interventionist and more flexible than the disclosure and shareholder voice (below) reforms, particularly given the requirement that only a majority of the non-executive directors on the remuneration committee be independent (some Member States set the number of directors), which reflects the more general requirement that boards have an "appropriate balance" of executive and non-executive directors and that a "number" of independent directors be elected "sufficient to ensure material conflicts" are dealt with. Similarly, the remuneration committee functions may be carried out by small supervisory boards in two tier systems, as long as the composition requirements are followed. Given the weakness of the general meeting and shareholder voice mechanisms in block-holding systems, oversight by independent directors may be the most effective way to proceed, but only as long as independent directors remain, in addition, engaged and competent. The Recommendation's profile of director qualifications (knowledge, judgment and experience) and commitment sets a minimum benchmark which is subject to shareholder and market monitoring (as are the independence requirements) through the annual report disclosure mechanism. Without time, expertise, and resources, the remuneration committee cannot, regardless of independence, operate as an effective monitor. But while the board reforms seem to reflect pan-EU convergence and may contribute to the extension of the remuneration committee, and related best practice, to the remaining Member States, this is not an appropriate area for harmonization, with effective governance structures being best achieved via disclosure and competition.

V.4 Reform (3): Shareholder Voice

Shareholder voice has emerged as a third core element of the reform strategy. The centrality of shareholder voice is implicit in the disclosure reforms and in the endorsement of "comply or explain" mechanisms in implementing the reforms. But it is explicit in the requirement that remuneration policy be a specific item on the agenda of the annual general meeting. Further, in a dramatic change to current practice, the Commission has recommended, "in order to

increase accountability” that the remuneration policy statement be submitted to the general meeting for an advisory vote which, in an attempt at flexibility, may be mandatory or advisory. This uncompromising commitment to traditional shareholder governance, notwithstanding the weakness of the general meeting in block-holding systems, is clear from the Commission’s rejection of the objections of a majority of participants in the prior consultation on this reform. The HLGCL had also rejected direct shareholder voice reforms given that the effects of such a vote could vary between the Member States. This reform certainly sits uneasily across the governance divide, does not appear to track market pressures for best practices, and may be overly ambitious or distract the wider corporate governance reform process from other methods of controlling the taking of private benefits, in general, by block-holders (Lannoo and Khachaturyan, 2003). A less ambitious shareholder voice reform addresses shareholder approval of share-based remuneration schemes, currently required, albeit linked to changes in company capital structures, in many continental Member States. Approval is also required for the grant and main terms of share-based schemes and long-term incentive schemes, including, giving specific protection against the re-pricing problem, the conditions for subsequent changes in option exercise prices. Information must also be provided on dilution implications. While this reform may provide a significant bulwark against some of the design problems provoked by share options, it is dependent on effective shareholder voice, although the distribution of extensive advance information to shareholders, including disclosure on the relationship between the schemes and overall remuneration policy, is required prior to the relevant general meeting. The combination of shareholder voice mechanisms and enhanced, informative disclosure may result in greater activism on pay and improved performance links, as appears to have happened in the UK. It may also harness, and enhance the transparency of, growing institutional investor concerns on pay. Pension funds activism on executive pay has, for example, been reported in the Netherlands, Norway and Sweden (Hewitt, 2003). Nonetheless, it remains to be seen how these potentially costly reforms will work in block-holding systems, where policy is approved in advance by the main shareholders. At the least, some movement towards the general meeting as a back-stop correcting mechanism, supported by independent non-executive directors, may occur. The appropriateness of harmonization in this area, closely tied as it is to ownership structures and the different dynamics of control across dispersed and block-holding systems, however, is doubtful.

VI Conclusion

Our research reveals clear divergences across the EU (broadly in line, as agency theory predicts, with governance profiles) in how incentive contracts are structured and used to remedy differing agency costs, and in the adoption of best practices in pay-setting. But any

EU-led reforms should be undertaken with care and in light of the impact of varying corporate governance regimes on pay. In particular, harmonization should be used sparingly, and only with respect to disclosure. Disclosure is, in principle, central to the adoption of effective incentive contracts in that it can manage the agency costs of executive pay, across dispersed and block-holding systems, without intervening in governance choices and structures. The evidence suggests that while EU convergence towards effective disclosure is underway, it is slow, and would benefit from harmonization. This should, in turn, promote tighter monitoring and minority shareholder protection and, as a result, more effective incentive contracts and pay-setting processes. Any other interventions, particularly on board structure and shareholder voice, carry the risk of distorting competition and interfering with the dynamics of different ownership structures, economic contexts and the need for flexibility in accommodating different governance structures.

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