

ENSURING FAIR LEVELS OF EXECUTIVE DIRECTORS' REMUNERATION: REGULATION AND USE OF PRINCIPLES AGAINST THE USE OF DETAILED LEGAL RULES IN DETERMINING THE MOST EFFECTIVE APPROACH FOR SETTING EXECUTIVE PAY LEVELS. A DISCUSSION

*Ewgeni Hersonski**

Abstract

The purpose of this paper is to present arguments concerning the fair levels of executive directors' remuneration. It is argued that principles are a better way to achieve this goal. However, we also find arguments in support of detailed legal rules when dealing with this matter. Since both methods have their pros and cons the paper delivers a balanced discussion and also outlines how the executive pay is currently regulated in the UK, the United States as well as on the global scale.

Keywords: Directors' Remuneration, Use of Principles, Use of Detailed Legal Rules, Pay Levels

* *London School of Economics, Houghton Street, London WC2A 2AE, United Kingdom*
Tel.: +44 (0) 755-2073997
E-mail: E.Hersonski@lse.ac.uk

The executive directors' remuneration is a contentious topic, especially nowadays when companies' profits and particularly global markets are facing a decline phase. The related discussion whether the fair levels of directors' remuneration shall be ensured by using principles instead of detailed guided legal rules is questionable as both ways of rewarding executives have benefits as well as limitations. Moreover, it is crucial that executive remuneration is well-structured, co-mingled with strategic objectives of a firm and has the aim of rewarding executive directors who contribute to the long-term success of the company by promoting business stability and growth within industries (BIS, 2012).

The outrage with executive pay that we have observed internationally was largely due to excessive and scandalous amounts of remuneration granted to many CEOs of large institutions during the financial crisis and shortly thereafter. The public was justifiably outraged since most of these companies continued to perform poorly and no value creation was recorded. However, since it is one of the goals of shareholders to see 'their' companies increasing value over time, remuneration practices must be used to attract, incentivise and accordingly reward executives so that these goals are likely to be achieved (BIS, 2011). Furthermore, in the past decade we have observed something dysfunctional about the market in executive pay since the level of pay increased

disproportionately as compared to the company performance and some people credited phenomenon to the impractical corporate governance arrangements as the executive pay levels has increased abnormally. The overall idea of rewarding generous pay levels for a strong long-term company performance is therefore a mere theory. The problems to link pay to company performance are likely to prevail in the short and medium-term since the growth rate of remuneration is much higher than the return to investors. In support of this notion (Kershaw, 2009) explained the reason for the higher remuneration is due to executives expecting a higher pay in reward for higher risk. It is conceivable that the risk factors nowadays are much more diverse and difficult to control and therefore a higher pay is justified. The theory is that a bonus element included in the remuneration is supposed to align the interests of shareholders and managers in order to reduce agency costs (Kershaw, 2009). According to (Bebchuk & Fried, 2005) and (Kershaw, 2009) the explanation is based on managerial power exercised over the board. Additionally, since the structure of pay is getting more and more complex, the transparency of executive pay suffers.

Current problems in executive pay

The main problem we are currently facing is amongst others the structure of remuneration, which does not necessarily incentivise directors to act in the long-

term interests of a company. However, the main goal of setting executive pay structures must be the linkage of pay to performance. The following is therefore an issue at the core of the whole problem: a dysfunctional corporate governance system on executive remuneration. Moreover, once a high level of remuneration is reached, it is nearly impossible to decrease the level in the short-term or even in general. Therefore, as a result, management boards have attempted to find new justifications for excessive remuneration and more notably they have come up with new ways of 'presenting the numbers', which is nowadays predominantly done via variable pay. Furthermore, since highly complex and sophisticated variable pay structures are in place, it appears safe to assume that their main tasks is to mislead analysts and readers of financial statements due to the much longer period of time needed to understand the pay structure, which might restrain busy and rationally apathetic shareholders and public at large to analyse companies' executive pay structures.

A call for principles

To analyse various solutions for this issue, it is necessary to first take a closer look at the differences in principles-based and rules-based regulation of fair levels of remuneration. First of all, it is questionable what the actual fair levels of executive directors' remuneration are. Is it correct to rely on benchmarks and even more, can we observe an objective way to remunerate top executives? In order to come up with a more or less fair salary or remuneration structure, a company needs information from its sector. Furthermore, due to a highly competitive environment we are currently facing, more and more companies are targeting their pay levels in relation to what their competitors are paying. Companies do benchmark against each other and keep higher pays in order to be competitive and that practice drives the median eventually up to an abnormal level (the so-called 'ratcheting' effect). Out of this develops a best practise for remunerating executive directors. Nevertheless, it calls into question which method is more effective in order to pay a fair level of executive compensation. For example, with a principle-based remuneration, regulators are granting more flexibility and agility (Bratton, 2003). Principles allow for a more generalising approach and are expected to drive regulatory particulars from law-to-fact applications in the course of time (Bratton, 2003). There is also theoretical evidence that regulations, which are constructed in this way, are able to create close relations to regulatory objectives even though there is a large amount of conceivable variations of cases (Bratton, 2003). But in times of loads of fraud examples like Enron or WorldCom it is hard to talk about principles for executive remuneration. The reasons for this can be explained as follows: large

corporations and banks are placing the wrong incentives for managers and provoke them to gamble and run a risk of diminishing margins in their related businesses. Moreover, in bad economic times there is a lack of confidence of shareholders, society and regulators towards the right incentives for the management level and board of directors. A principles-based remuneration system therefore does not comply with the rationality of honest, in best interest and good faith acting top management employees. Many people argue, that principles can always be manipulated in favour of senior directors and a principle itself does not import incentive compatibility (Bratton, 2003). Remuneration for senior executives, and more specifically the CEOs, has climbed to amounts that have nothing to do with principles. In 2010, CEOs of a Standards & Poor's 500 Index Company received, on average, \$11,4 million in total compensation (American Federation of Labor - Congress of Industrial Organizations, 2011).¹

Say-on-pay

There have been endeavours in the past to regulate the executive pay by providing a legal framework for such issues including the newly implemented Dodd-Frank Wall Street Reform and Consumer Protection Act. In accordance with this Act the shareholders have been granted a so-called "say-on-pay" vote on executive compensation and each publicly listed company is obliged to bring the ratio of CEO-to-worker pay to light. In UK, the "say-on-pay" is mandated by Section 439 of the Companies Act 2006. This tool is to limit seemingly uncontrollable CEO remuneration. Companies must also provide their shareholders with an advisory vote that sets the desired frequency of say-on-pay votes (U.S. Securities & Exchange Commission, 2011). However, the "say-on-pay" is a non-binding vote and some people advocate a mandatory binding vote for particularly large remuneration amounts or remuneration in generally. This is reasonable since a binding vote would support the aspirations of shareholders who 'are' the company. As such, the regulation in Australia could act as a role model. In Australia a very sophisticated process is in place that automatically triggers a re-election of a Board where a 25% "no" vote by shareholders to the company's remuneration report has been recorded in two consecutive annual general meetings. It is also crucial to notice that the say-on-pay is only effective if coupled with efficient and proper disclosure. In the UK, the Company Law requires all listed companies to produce a directors' remuneration report and to put it to a shareholder vote. Disclosure plays also a crucial part due to the ability to reduce costs for shareholders of collecting relevant information about executive pay. Furthermore, the 'say-on-pay'

¹ <http://aflcio.org/corporatewatch/paywatch/>

provides a ground-breaking mechanism for institutional investors and also supports the endeavours of proxy voting advisors. Proxy voting advisors, who have become very powerful in the recent years not only advise institutional investors on how to vote, but also advise companies on how to behave. Proxy voting advisors together with institutional investors do play a valuable role nowadays in bringing shareholders' attention to remuneration proposals. But we have to admit, even the 'say-on-pay' is not free of critique: although the shareholders' advisory role on directors' remuneration was designed to empower and encourage them to be more engaged in corporate governance many of them are overseas and might not be adequately monitoring the situation. Furthermore, short-term investors are not generally interested in issues like executive pay level setting since they simply pursue their short-term strategies.

Since the 'say-on-pay' is a very popular mechanism it brings also difficulties in terms of proper implementation across different countries. An insufficient harmonisation regime of executive pay regulation was observed due to differences in local company laws and consequently different governance regimes. Looking into the European Union, shareholders' rights to monitor remuneration policy or to become active in designing that policy continue to differ.

Remuneration committees

Another crucial tool in regulating executive pay has been the establishment of a separate remuneration committee as first recommended by the Cadbury Code in order to have a more transparent process for appointing directors. Thus in accordance with the Code the remuneration committee shall normally consist of three independent non-executive directors (NEDs) together with external pay consultants (Kershaw, 2009). A remuneration committee is present in around 30% of large UK companies (BIS, 2011). Nevertheless, it is very likely that directors will still influence pay levels due to the dynamics of the pay setting process results in a bias towards higher executive pay. Another major problem is the self-serving dissonance described by Bebchuk and Fried (2005), who contend that remuneration committees are mainly comprised of CEOs of other industries and businesses. Consequently, those CEOs justify their own high salary by voting in favor of substantial remuneration packages of the evaluated respective CEOs. Effectively, outside CEOs (who actually do not have to be necessarily a CEO of another company) inflate their own pay level, setting the market rate higher. CEOs who are sitting on the remuneration committee and do not approve remuneration packages are risking a negative reputation that eventually might decrease their chances to become a CEO themselves (in case they

are not a CEO at that time) and not being elected to sit on the remuneration committee or board of directors. A proposal to resolve this problem and additionally to make the committee more diverse was the idea of inviting employee representatives to sit on remuneration committees. The thought is that employee representatives would bring in a different perspective and pursue a greater degree of scrutiny. However, it is argued that having employee representatives on remuneration boards (or even on the board of directors) could slow the process of decision-making. Finally, other options left for regulating executive pay represent a bonus-malus system where executives carry downside risk in addition to up-side rewards. A common practice method as a more general strategy is the progressive taxation that is well known worldwide. Furthermore, in the United States shareholders approve all equity compensation plans and consequently shareholders can simply vote against the issuance of any equity plans and thereby eliminate huge windfall gains caused for instance by bullish stock markets. The approval of equity compensation is a strong regulation technique that finds sympathy across many different countries.

In order to establish a reliable executive pay regulation, a solution must be found in particular on termination pay disclosures. Termination payments should not exceed a predetermined fixed amount. The so-called 'Golden Parachutes' that executives often receive upon termination of their contracts represent most of the times a substantial compensation package, completely unrelated to degree of losses occurred to directors. Therefore, 'Golden Parachutes' must be more regulated. Huge outrage was for instance caused by the 'Golden Parachute' of Alan Fishman who was the last CEO of Washington Mutual. Fishman received \$19 million for 17 days work in 2008 when the bank went bankrupt.

Rules in favour of executive remuneration regulation

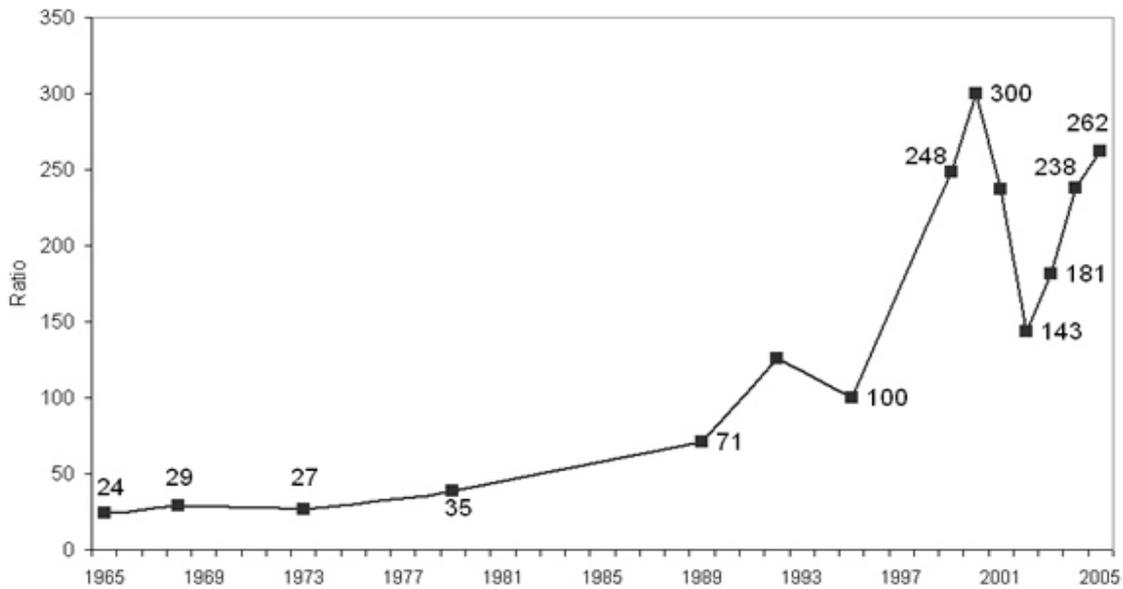
Coming back to the rules vs. principles discussion, rule-makers tend to find it difficult to create accurately defined and targeted rules (Baldwin & Cave, 1999). This can also apply to a compensation system that could be well defined, but often lacks sufficient covering of any conceivable details in terms of taxation, stock options and shares which managers and directors tend to bypass in a very sophisticated manner. A proper argument against detailed guided rules is the fact that enforcement of such rules is very expensive and effects of enforcement are also uncertain (Baldwin & Cave, 1999). However, detailed legal rules for remuneration seem to guarantee precision. According to Beck (1992) we are living in a 'risk society', meaning that human activity and advanced technology produces certain degrees of risk that is in need of special knowledge and expertise and

hence must be controlled. Due to these reasons, the potential impact of complex and uncontrolled actions could be very serious. According to this and the volatility of risk, not only in the global markets, but also in political issues where it is difficult to find consistency, the conduct of activeness provide a “booklet” for the right behaviour. In relation to remuneration of executive directors’, it is crucial to have a common ground for high-paid executives in order to have a fair remuneration system. Too many executives are facing and persuading the wrong incentives that is constructed and packed by the board of directors. Incentive-based remuneration increases the chances of getting involved in risk taking activities, particularly in the banking sector. The incentive problem has to be solved first before implementing a principle-based remuneration into practise, which might occur eventually in the future (Bratton, 2003). Generally speaking, detailed guided

rules provide a solid foundation towards fair levels of executive directors’ compensation due to the objectivity of the regulatory system and its reliability to create guidance that satisfies not only shareholders, but also taxpayers, workers and different industries.

If a company were permitted to rely on principles, most would make use of judgement to determine the salary or bonus package. In contrast, a rules-based compensation well established. The figure on the next page clearly outlines that there is no fair level of executive directors’ remuneration. By the end of 1990s, an average CEO in the United States earned 300 times more than an average worker. Furthermore, in 2005, a CEO earned more in one workday than an average worker earned in the complete man-year (Mishel, 2006). Most people would undoubtedly argue, that this is beyond a fair level of executive directors’ remuneration.

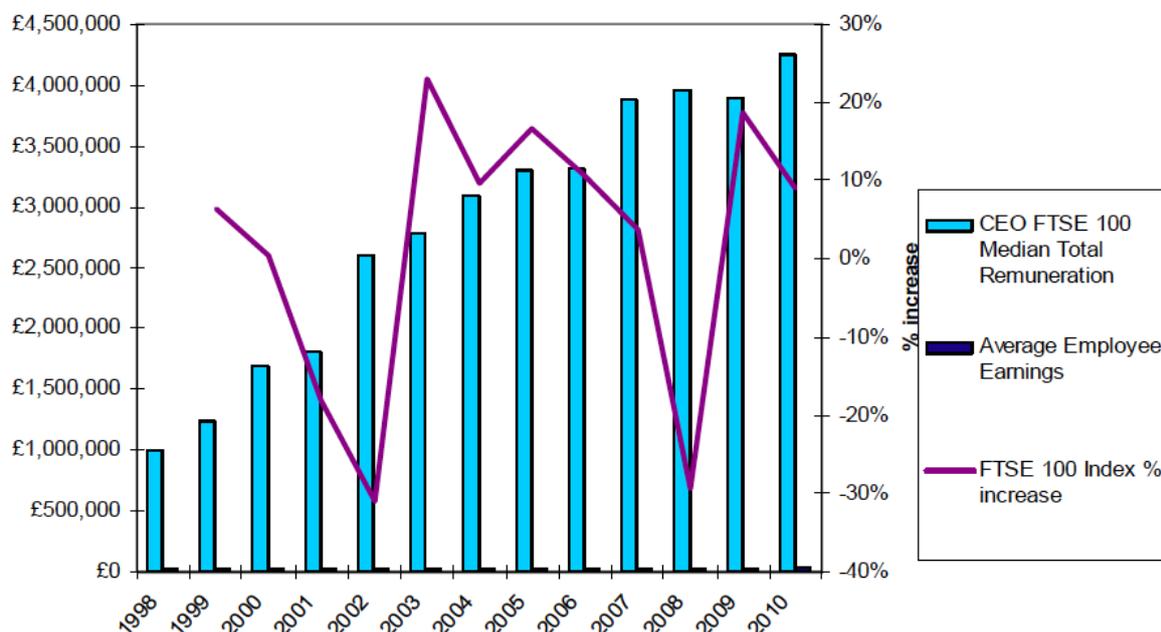
Figure 1. Ratio of CEO to average worker pay, 1965-2005 (USA)



Source: Mishel, Bernstein, and Allegretto, *The State of Working America 2006/07*, forthcoming, Figure 3Z.

Figure 2 below makes it clear how fast the median executive pay level rose between 1998 and 2010 in the UK. The discrepancy between executive pay and average employee earnings grew over time where the median total remuneration of FTSE100 CEOs has risen from an average of £1 million to £4.2

million during the period of 1998-2010. Therefore, since executive pay levels have risen faster and larger than the FTSE100 index increase, the ever increasing pay levels of CEOs, in the UK, the USA and also worldwide should be taken very serious by politicians as well as regulators to tackle this trend.

Figure 2. Comparison of FTSE100 CEO median total remuneration, average employee earnings and FTSE100 performance 1998-2010

Conclusion

To sum up, due to recessionary times in contemporary economies, it is difficult for participants in the global economic systems to have trust and confidence in management's decisions and regulators' frameworks. Therefore, crucial decisions including how to remunerate executive directors cannot be completely left to the companies' top management or even the board of directors. I firmly believe, that if laws such as the Dodd-Frank Wall Street Reform and Consumer Protection Act exist, it shows that remuneration for executive directors' must be regulated by rules that have a prescriptive status and not be entirely left to principles which are easily subject to be abused or changed from one day to another. In general, both rules and principles are applied in practice because it is hard to agree on just one procedure due to complexity and fast-paced changing business environment. However, in terms of remuneration there must be less flexibility and more detailed guided rules to constrain any conceivable gap or dichotomy in setting pay levels. Therefore, the executive directors' remuneration must be regulated by detailed guided rules, without any exceptions and moral area of freedom for negotiation. Moreover, in terms of executive pay regulation, my prediction is that remuneration structures will be much more complex in the future in order to conceal the real remuneration sums. I expect particularly complex variable pay structures since variable pay makes up the largest part of remuneration structures. Highly complex mechanisms are in place to restrain shareholders to analyse remuneration reports. It is known that potential investors, shareholders and analysts analyse financial statements and

remuneration reports of respective companies. Potentially, the goal of complex variable pay structures is to make shareholders and analysts reluctant of an in-depth analysis since complex variable pay structures involve a great degree of time and scrutiny. There must be a proper and greater degree of scrutiny by politicians and regulators. Also, a new solution must be found in order to harmonize the different legislations in order to have a harmonised and unified framework of executive pay regulation. The goal must be to implement prescriptive rules and test on regulatory arbitrage on a continuous basis. Only after that, managers and directors will be trained and used to unified standards in executive pay setting that are more or less shared by creditors, stakeholders, employees and the public in general.

References

1. American Federation of Labor - Congress of Industrial Organizations. (2011). *2011 Executive PayWatch*. Retrieved October 14, 2011 from 2011 AFL-CIO | American Federation of Labor - Congress of Industrial Organizations: http://aflcio.org/corporatewatch/paywatch/#_ftnref1
2. Baldwin, R., & Cave, M. (1999). *Understanding Regulation*. Oxford: Oxford University Press.
3. Bebchuk, L. A., & Fried, J. M. (2005). Pay Without Performance: Overview of the Issues. *Journal of Corporation Law*, 30 (4), 647-673.
4. Beck, U. (1992). *Risk society: towards a new modernity*. Sage Publications.
5. BIS. (2011, September). Executive Remuneration: Discussion paper. London.
6. BIS. (2012, February 15). Shareholder votes on executive remuneration. London.

7. Bratton, W. W. (2003). Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents. *Villanova Law Review*, 1023-56.
8. Hood, C., Rothstein, H., & Baldwin, R. (2001). *The Government of Risk*. Oxford: Oxford University Press.
9. Kershaw, D. (2009). The Market for Corporate Control. In D. Kershaw, *Company Law in Context: Text and Materials*. Oxford University Press.
10. Mishel, L. (2006, June 21). *CEO-to-worker pay imbalance grows*. Retrieved October 14, 2011 from Economic Policy Institute : http://www.epi.org/publication/webfeatures_snapshots_20060621/
11. U.S. Securities & Exchange Commission. (2011, 25 01). *SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act*. Retrieved October 14, 2011 from U.S. Securities & Exchange Commission: <http://www.sec.gov/news/press/2011/2011-25.htm>.
12. *Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act*. Retrieved October 14, 2011 from U.S. Securities & Exchange Commission: <http://www.sec.gov/news/press/2011/2011-25.htm>.