Statement of the European Corporate Governance Forum on Director Remuneration

- 1. The current financial crisis has put executive remuneration back at the heart of the discussion. Questions have arisen as to the incentives created by variable pay schemes that may have resulted into excessive risk taking by financial institutions and to ever increasing levels of remuneration.
- 2. The Forum believes that the remuneration issues related to financial institutions should be distinguished from remuneration issues as general corporate governance issues. Both in terms of the relation between financial incentives and risk taking by the institution and in terms of the relation between executive remuneration and remuneration of employees of the institution, financial institutions have specific systemic characteristics that merit special treatment.
- 3. The remuneration of executive directors clearly is an important element of the governance regime of companies. In the last two decades a fundamental shift has occurred to introduce and regularly increase the level of variable pay, both in cash and in shares and rights to acquire shares. The key justification provided for this is that such variable pay could help to align the interests of executive directors with the interests of shareholders of listed companies. Meanwhile, experience has shown that variable pay schemes have become increasingly complex and that in certain instances this has lead to excessive remuneration and manipulation. This has raised questions of appropriate disclosure of director remuneration and of the role of shareholders and non-executive directors in the process of determining director remuneration. In 2004 the Commission has issued a Recommendation to Member States dealing with remuneration disclosure and the role of shareholders and non-executive directors. The effective impact of the Recommendation has been minimal: see the Commission Working Staff Document SEC (2007) 1022 of 13 July 2007.
- 4. The Forum believes that further progress needs to be made on the subject of director remuneration. In doing so, a different regulatory treatment is warranted for (i) the disclosure of director remuneration, (ii) the process of setting director remuneration and (iii) the substance of director remuneration.
- 5. Disclosure of the remuneration policy of listed companies and of the individual remuneration of directors (executive and non-executive) and any material change to it should be mandatory for all listed companies in the EU. Disclosure of both the remuneration policy, its structure and individual director pay is necessary in order for shareholders to have an appropriate level of control over director remuneration as well as an appreciation of the risk inherent in such arrangements. The disclosure should contain sufficient detail to enable shareholders fully to understand the components of directors' remuneration as well as progress towards the achievement of previously granted awards and should include details on pension entitlements and increases thereof and perquisites and other benefits in kind. Without such disclosure shareholder control over director remuneration is illusory. The Forum believes all Member States should mandate such disclosure; currently only about 60% of Member States require disclosure of the remuneration policy and about two thirds of Member States require disclosure of individual director pay (see the Commission Working Staff Document referred to above). The Forum recommends that such disclosure requirements be included in an EU Directive.

- 6. An appropriate process for setting executive director remuneration requires that executive directors have no involvement whatsoever in setting executive director remuneration. Instead, this should be left to non-executive directors and to shareholders. Where shareholders do not determine individual director pay, such pay should be determined by non-executive directors within the framework of a remuneration policy. Non-executive directors involved in determining executive director pay should be independent of the company and its executive directors. Shareholders should be able to vote on the remuneration policy and any material change to it, whether in an advisory or binding capacity. Where shareholders do not determine individual director pay, schemes that grant shares or rights to acquire shares to directors or that remunerate directors on the basis of share price movements should be approved by shareholders. Remuneration consultants who advise on director pay should be independent of the company, its executive directors and other senior management and should only advise the non-executive directors and be designated by them. Member States should be required to include such rules of process in a code of corporate governance that listed companies are required to apply (i.e. comply or explain). The obligation of Member States to include these rules of process in national corporate governance codes or legislation should be laid down in an EU Directive.
- 7. The substance of director remuneration should not be regulated in a mandatory way at EU level. It is for companies and their shareholders to determine what pay structure and levels are appropriate for their directors in light of their particular circumstances and different practices and traditions in Member States are to be respected. Nonetheless, it is clear that, based on past and recent experiences, general best practices are evolving to ensure that the remuneration policy promotes the medium and long term interests of the company rather than the short term, that appropriate consideration should be given to the effects of incentive-based pay on the risks of the company, that excessive remuneration is excluded and that as little scope as possible is given to manipulation. The Forum believes that key elements of such best practices include the following:
 - The level of variable pay (typically with both a short term and a long term element) should be reasonable in relation to total pay level. Generally, the larger the variable pay element is, the stronger the focus on the beneficiary's personal interests becomes, to the possible detriment of the long term interests of the company and its shareholders. Companies should develop a clear policy on variable pay, within the remuneration policy subject to approval by shareholders. That policy should set maximum limits on all elements of variable pay.
 - Variable pay should be linked to factors that represent real growth of the company and real creation of wealth for the company and its shareholders. The factors to be taken into account for variable pay should be independently reviewed by non-executive directors.
 - In order to reduce the short term focus of variable pay, companies should consider deferring a substantial part of annual bonus payments to be released subject to continuing positive performance by the company over a period of, say two to four years.
 - Stock options (rights to acquire shares for a pre-determined exercise price) carry an increased risk of market manipulation and gaming as the upside potential is leveraged. These risks can be mitigated if vesting of the options is deferred and subject to performance conditions. Unperformanced stock options should be excluded from the remuneration policy.
 - Shares granted to executive directors under long term incentive plans should vest only after a period during which performance conditions are met. At least a certain number

- of those shares as determined by the non-executive directors (e.g. two times the value of total annual pay) should be held by directors until the end of their employment, with the exception of such part of those shares that need to be sold in order to be able to pay taxes due as a result of the grant of shares.
- To the extent possible under applicable employment laws and companies' legislation, the company should reserve the right, at the discretion of non-executive directors, to reclaim performance linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice ('clawback').
- Severance pay for executive directors should be restricted to two years of annual remuneration and should not be paid if the termination is for poor performance. The two years restriction should not be circumvented by long notice periods or otherwise.
- Pension entitlements should be fully disclosed and discretionary increases for departing executives should be avoided. Any benefit in kind should also be part of the remuneration package and should be fully disclosed.
- Benchmarking the remuneration of executive directors with the remuneration of directors of companies in a peer group, combined with the practice of aiming to reward directors at the median or upper quartile of such peer group, creates an autonomous upward pressure ("ratchet effect") on the remuneration of directors of all companies which has no relation to underlying performance of these companies or personal performance of directors. Non-executive directors should not only benchmark the remuneration of executive directors externally with peers but should also benchmark their remuneration internally with the remuneration of other employees within the company in order to ensure a consistent and fair remuneration policy throughout the company.
- Non-executive directors should have and exercise discretion to change the actual remuneration calculated on the basis of formulae, targets and benchmarks in order to ensure that the total pay executive directors receive is fair in relation to the company's and their personal performance and not excessive. Any adjustment to the operation of established remuneration schemes should be fully disclosed.
- 8. These practices should be included in a code of corporate governance that listed companies are required to apply (i.e. comply or explain). The Forum recommends that a Commission Recommendation to Member States supports such an evolution of best practices and that Member States organise a consultation at national level and monitor how best practices are included in their codes of corporate governance.