GOVERNANCE

Contrasting EU Executive Pay Rules Evoke Need for Legislation

Guido Ferrarini, professor, University of Genoa, and founder of the European Corporate Governance Institute, and **Maria-Cristina Ungureanu**, resarch fellow, University of Genoa, advocate creating a single, detailed EU executive remuneration reporting regime.

The EU Commission Green Paper on corporate governance sets forth a corporate governance action plan for years to come. The Commission raised the possibility of executive-remuneration disclosure as a way to improve best practices. In its consultation, which recently closed, the Commission sought company and government guidance as to whether remuneration disclosure and a shareholder vote on remuneration should be mandatory.

So far, the EU has had a self-regulatory, market-based approach to executive remuneration, based on non-binding recommendations. Only a few member states have set requirements for its disclosure; corporate governance codes tend to recommend disclosing some information on pay without specifying details. Individualised disclosure of directors' pay, which identifies the fixed and variable elements, is central to effective remuneration disclosure. Significant improvements have occurred in this regard in the last five years or so, yet requirements around Europe vary, with the U.K. maintaining remuneration report regulations since 2002, and the absence of mandates in the rest of Europe. Most continental rules or codes provide that remuneration disclosure can be offered anywhere in the annual report, including the corporate governance report, the management report or the notes to the financial statements.

In the absence of binding rules, firms appear reluctant to provide full disclosure concerning remuneration, particularly on important aspects such as the pay-performance link. Given that disclosure can promote stronger shareholder monitoring and act as a deterrent to rent-seeking at board level, it seems there is a market failure that EU legislative intervention could address.

The risks of board-level conflicts of interest and of minority shareholder oppression, the growth in incentive pay, the persistence of poor disclosure practices and the apparent reluctance of member states to intervene suggest that an EU binding regime may carry benefits. More so, a binding requirement for a separate remuneration report, providing a clear, "one-stop" evaluation of remuneration and explaining the underpinning remuneration policy should be introduced. Standardisation of the format in which disclosure is provided would also support better monitoring and positive externalities, given that it is difficult to compare remuneration across companies.

The Green Paper also consults on the introduction of a mandatory say-on-pay in Europe. In most member states a vote on the remuneration report or on company remuneration policy has not been a separate item on the general meeting agenda. The reluctance to engage with a direct "say on pay" may reflect the influence of controlling shareholders, as well as the more limited role of the general meeting in blockholding governance. The U.K. is an exception: the Companies Act requires listed companies to put the report to an advisory shareholder vote. share-based incentive schemes policies are different. Most member states have either recommended or, more usually, imposed by law a requirement for shareholder approval of share-based incentive schemes.

Generally, evidence suggests that shareholder approval has some impact on the structure of remuneration, as it becomes more performance related, but not on its level, which increases as a multiple of 'ordinary' workers' salaries. However, the benefits of "say on pay" are still controversial, even in countries that already require a vote on either remuneration policies or remuneration reports. Any intervention should be limited to the requirement for either an advisory vote on the remuneration report or a binding vote on remuneration policy.

There are risks in taking particular topics out of codes and transferring them to legislation, and these risks apply also to legislating directors' remuneration practices. This is not to say that moving a particular topic to legislation is never an appropriate policy but rather that a very strong case must exist before this step is taken.

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