



Corporate Governance

Board Practices

INCENTIVES AND GOVERNING RISKS



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Foreword

This report presents the results of the first thematic peer review based on the OECD Principles of Corporate Governance. The report is focused on board practices related to setting incentives and governing risks. It covers 29 different countries, including in-depth reviews of Brazil, Japan, Portugal, Sweden and the United Kingdom.

The report is based on a questionnaire that was sent to all participating countries in December 2009 (see annex A). All countries were invited to respond to the first question so as to provide an overall context within which the review could occur. The five countries that were subject to the in-depth review were invited to complete all three questions.

Based on country responses and discussions in the OECD Corporate Governance Committee, the report is structured as follows. Part I, examines the overall market and regulatory context for considering board practices in relation to managing incentives and associated risks. Part II focuses on each of the five countries that were subject to the in-depth review and examines how market practices in these jurisdictions correspond to the relevant outcomes advocated by the OECD Principles. A set of Conclusions for each of the countries are provided at the end of each country section. The report was prepared by Jim Colvin and Grant Kirkpatrick with input from Simon Wong, and approved for publication under the authority of the OECD Corporate Governance Committee in January 2011.

The OECD corporate governance peer review process is designed to facilitate effective implementation of the Principles and to assist market participants and policy makers to respond to emerging corporate governance risks. The reviews are also forward looking so as to help identify, at an early stage, key market practices and policy developments that may undermine the quality of corporate governance. The review process is open to OECD and non-OECD countries alike.

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Executive Summary

In many countries around the world the ability of the board to effectively oversee executive remuneration, as recommended by the *OECD Principles of Corporate Governance*, appears to be a key challenge in practice and remains one of the central elements of the corporate governance debate. The nature of that challenge goes beyond the level of executive and director remuneration, even though that is the focus of much political discourse, to encompass how remuneration and incentive arrangements are aligned with the longer term interests of the company. Of particular importance is the connection between remuneration structure and company risks that the board needs to manage.

In responding to this and other corporate governance challenges that have come into focus in the wake of the financial crisis, the OECD's Corporate Governance Committee launched a peer review process that is designed to facilitate the effective implementation of the Principles and to assist market participants and policy makers to respond to emerging corporate governance risks. This review, the first in the planned series, was open to OECD and non-OECD countries alike. The report covers developments in 29 countries, including in-depth reviews of Brazil, Japan, Portugal, Sweden and the United Kingdom.

As a general rule, legislators and regulators capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the level of executive and director remuneration. Policy makers have rightly focused more on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised as i) measures to improve internal firm governance and especially via mandating certain levels of independence by the board; ii) improved disclosure to shareholders on remuneration outcomes, and better explanation of how incentive based remuneration aligns with company performance; and iii) providing mechanisms to allow shareholders a means of expressing their views on director and executive remuneration.

Many jurisdictions have favoured soft law measures that can go further in providing guidance on the structure of remuneration systems. Codes are often a more appropriate mechanism for normative controls on remuneration and guidance on remuneration structure; they are generally more flexible to individual firm characteristics and can adapt to changing market circumstances.

Outside of the financial sector most jurisdictions regard remuneration as not problematic and where this is not so, the issues mainly involve social justice concerns and the perception of payments for failure. One reason for this is that an overwhelming majority of jurisdictions describe their executive labour markets as largely internal to the jurisdiction so that there is less contagion from one jurisdiction to another.

A common perception is that remuneration structures and levels in firms with a controlling shareholder, and in jurisdictions where controlling shareholders are more prevalent, are less aggressive than in companies and jurisdictions characterised by dispersed share ownership. This is consistent with the managerial power hypothesis. However, even in jurisdictions characterised by block holders and concentrated ownership, there is still a question about how to ensure that executive incentives are tied to the longer term interest of the company as a whole, rather than to the interests of the dominant shareholder.

Performance-based pay instruments are often put forward as a solution but there are significant problems. Share-based payments are often cited as a preferred means of aligning executive and shareholder interests but the incentives these create depend on factors such as vesting periods, selling arrangements and prices. For instance, where share-based remuneration forms a significant part of total remuneration, it could lead to overly risk-averse management. These problems highlight the need for boards to take an active role in designing remuneration structures that are matched to the specific circumstances (risk appetite and strategies) of the company rather than relying on more generic industry practices and to regularly review the incentives and risks the structures create.

The key challenge for boards is to understand how risk flows through the structure of remuneration and, as importantly, the remuneration metrics. This is not an easy process since there will be a certain degree of information asymmetry between the board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics. In terms of process, this suggests a number of steps that boards could take to improve remuneration arrangements: i) a better integration between risk management and compensation/incentive setting such as by cross membership of risk/audit committees and compensation committees; ii) adopting formal processes for mapping risk tolerance with incentive structure; and iii) extending the duration of performance targets and factor in greater *ex-post* flexibility including clawbacks. In the case of the last mentioned, legal and code developments in many jurisdictions are already moving strongly in this direction.

A key safeguard that boards can implement is to establish explicit governance processes for setting remuneration, where the roles and responsibilities of those involved are clearly defined and separated, and with remuneration outcomes decided through a transparent and robust process. The recommendation of the Principles to ensure that a sufficient number of non-executive board members capable of exercising independent judgement are assigned to tasks where there is a potential conflict of interest, such as remuneration, is applied in an increasing number of jurisdictions via codes. However, not all processes concern the board, different approaches being used to achieve equivalent outcomes (*i.e.* functional equivalence): in some jurisdictions the general meeting assumes direct control of the remuneration setting process, and the role of the board is limited to implementing the shareholders policies. This is particularly the case with concentrated ownership as in Sweden.

Policy options have focused on improving shareholder engagement and remuneration disclosure. Active shareholder engagement can provide a strong monitoring function on the role of boards in the remuneration process. The legal frameworks across countries vary greatly in the extent to which shareholders have a voice in setting/influencing director and

executive remuneration, from placing the matter entirely in the hands of the general meeting, to giving shareholders no formal role. The Principles recommend simply that shareholders should be able to make their views known.

The experience of OECD countries suggests that the effectiveness of “say on pay” provisions is fundamentally linked to having active and informed shareholders with a sufficient capacity to influence the board. Policy makers need to identify innovative mechanisms for providing institutional shareholders with better incentives and cost effective means, for exercising their shareholder rights. Policy measures adopted to date have included introducing codes of behaviour for institutional shareholders to exercise their voting rights diligently and reducing the costs of shareholder participation by more effective proxy access.

The quality and timeliness of disclosures around incentive and remuneration arrangements is also critical to informed shareholder engagement, and providing a level of assurance to minority shareholders that remuneration is structured to align executive and director incentives with the interests of the company as a whole. Accordingly, a key policy focus for many jurisdictions has been (and should continue to be) to improve the disclosure requirements to support pre-existing “say on pay” arrangements. These measures are focused on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes and their relationship to firm performance. In other jurisdictions, code makers have introduced amendments designed to encourage more description of how incentive arrangements align manager/director interests with those of the company and shareholders.

The countries reviewed by the report have widely different ownership and institutional structures but all are moving toward improved disclosure regimes with non-dominant shareholders having a greater say on remuneration. Functional equivalence is important with several (Portugal, Sweden) making less use of the board than others. Although there is in general a high level of implementation of the Principles, not all have been able to achieve the outcome advocated by the Principles: executive and board remuneration aligned with the longer term interests of the company and its shareholders. This is the case of the UK.

The review of Brazil notes that remuneration tends to be lower in firms with a controlling shareholder than in the more widely dispersed firms. Controlling shareholders provide a strong monitoring function and bargaining position that offsets the relative lack of independent directors on boards. New disclosure requirements for office holders are comprehensive and, as such, are fundamentally aligned with the recommendations of OECD Principle V.A.4 that disclosure should include material information on remuneration policy for board members and key executives. The lack of disclosure has hampered informed shareholder engagement in the past. Brazilian companies will now submit say on pay proposals to their shareholders for the first time. This could result in a certain rebalancing between the interests of the controlling shareholders and the more dispersed minority shareholders.

In Japan the review noted that the Tokyo Stock Exchange adopted in 2011 a new rule where all listed companies shall have one or more independent outside directors or independent outside statutory auditors who are unlikely to have conflicts of interest with general shareholders, for the purpose of protecting these shareholders interests. However, the lack of non-conflicted directors (*i.e.* “independent”) on boards does not appear to be a

particularly pressing problems in setting remuneration given the nature of the general corporate culture and the low observed rates of executive and director pay. Such a system might also actually reduce risk taking in favour of survivability of the company. Transparency has improved since 2010 with a new comprehensive disclosure arrangement and a number of institutional investors in Japan have published voting guidelines on executive remuneration proposals, especially the structure of remuneration.

Portugal is characterised by concentrated ownership so that boards are dominated by large shareholder representatives. However, the primary responsibility for setting remuneration rests with the general meeting which in most companies has delegated the remuneration setting function to a separate remuneration committee. This committee is not a sub-set of the board and in the majority of cases no member of the board sits on this committee. While not foreseen in the Principles, the outcomes appear to be functionally equivalent. Since 2010, the level of disclosure has been improved through the provision to the general meeting of a declaration on the remuneration policy for board members. Including how it aligns the interest of the board members with the company.

The level of executive remuneration in Sweden is low compared with the rest of Europe and other Nordic countries and long-term incentive pay is less common. Strong family control and internal labour markets for executive talent in company groups appear to be the main drivers. Swedish boards are dominated by independent non-executive directors and a maximum of one executive is allowed to sit on the board but they have little direct role in remuneration. The AGM approves remuneration guidelines for executives on an annual basis and these are binding on the board and the CEO. The outcome thus meets the goal of functional equivalence with the Principles which place more emphasis on the role of the board. There is a widespread view amongst institutional investors that remuneration practices at Swedish firms do not pose a serious concern.

In comparison with other OECD countries, the UK could be considered to have a highly competitive market for executives, both domestically and, to a lesser extent internationally. However, the average compensation package of CEOs has risen significantly over the past ten years. Since 2002 there has been a mandatory but non-binding vote on director remuneration for listed companies. Moreover, there are extensive Combined Code provisions relating to the structure of remuneration and especially to linking rewards to corporate and individual performance. While there have been some high profile examples of shareholder rejection of director remuneration proposals, it is an open question as to whether non-binding votes have made boards sufficiently responsive to shareholder concerns on director remuneration. In its review of the Combined Code in 2009, the Financial Reporting Council found that there were significant concerns about the quantity and effectiveness of engagement between institutional investors and boards of listed companies. A stewardship code was introduced in mid 2010 and potentially provides a means for improving the level of shareholder engagement, subject to establishing suitable mechanisms to foster compliance.

PART I

Overview of Board Practices for Managing Incentives and Risks

PART I
Chapter 1

Aligning Executive Interests with the Long-term Interest of the Company

The ability to effectively oversee executive remuneration is a central element of the current corporate governance debate. In responding to this and other corporate governance challenges, the OECD's Corporate Governance Committee launched a peer review process designed to facilitate the effective implementation of the OECD Principles of Corporate Governance and to assist market participants and policy makers to respond to emerging corporate governance risks. The process builds on Principle V.A.4. of the OECD Principles. This principle recommends that the board should fulfill certain key functions including "aligning key executive and board remuneration with the longer term interests of the company and its shareholders". This chapter discusses the market environment, the legal and regulatory frameworks and responses to remuneration and board practices, in particular, the use of remuneration consultants and board members' responsibility for shareholder engagement.

In its paper, *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles* (OECD, 2010), (hereinafter, the “Conclusions”) the Corporate Governance Committee noted that the ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice and remains one of the central elements of the corporate governance debate in a number of jurisdictions. The nature of that challenge goes beyond looking merely at the quantum of executive and director remuneration (which is often the focus of the public and political debate), and instead more toward how remuneration and incentive arrangements are aligned with the longer term interests of the company.

The *OECD Principles* (OECD, 2004) state that responsibility for aligning executive interests with the company lies with the board. The core principle in this area is Principle VI.D.4 which recommends that the board should fulfil certain key functions including “aligning key executive and board remuneration with the longer term interests of the company and its shareholders”. There are many facets to the Board’s role and their relationship with other organs and stakeholders of the Company, and clearly the appropriate role for the board in the governance of remuneration will depend largely on the institutional and regulatory arrangements that exist in any given jurisdiction.

For instance, in companies with dispersed share ownership, the Board will have a more active and dominant role in negotiating remuneration arrangements, than in companies with a dominant (family) shareholder, where there is likely to be a greater level of connection between owners and managers. Similarly, some countries (such as Sweden) invest the General Meeting with very strong powers to set remuneration policy and the role of the Board is necessarily subscribed. Whereas in other jurisdictions such as the United States, the Board still retains significant autonomy about whether and how to align remuneration and incentives with longer term company performance.

Nonetheless, the *Conclusions* found a number of core areas where practices could be improved and that were consistent with the core framework of the Principles. The challenge for boards is to understand how risk flows through the structure of remuneration, and as importantly the remuneration metrics. This is not an easy process, since both the choice of remuneration components and the performance hurdles that attach will not have purely linear relationships to either risk or company performance.¹ This is exacerbated by the fact that there will be a certain degree of information asymmetry between the Board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics (with a consequent likelihood of gaming). Taken together, this underlines the importance of boards to treat remuneration and risk alignment as an iterative process.

Active shareholder engagement can aid the process, and the *Conclusions* noted the importance for Boards to disclose (in a remuneration report) the specific mechanisms that link compensation to the longer run interests of the company. This builds on the general Principle V.A.4 that “disclosure should include, but not be limited to, material information

on ... remuneration policy for members of the board and key executives". Policy makers in several jurisdictions are responding to this challenge, (for instance, **Brazil, Japan** and **Portugal** amongst the reviewed countries) by recently introducing enhanced disclosure requirements related to director/executive remuneration in listed companies, focussed on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes (for example, key performance indicators such as relative share price) and their relationship to firm performance. In other jurisdictions, Code-makers have introduced amendments designed to encourage more description of how incentive arrangements align manager/director interests with those of the company and shareholders.

As a general rule, legislators and regulators capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the **level** of executive remuneration. Firm specific factors tend to mitigate against caps or salary controls, and this is more so, the more international or competitive is the market for executive talent. To the extent that skills are transferable across sectors, industry specific caps or controls will create distortions in the market, as will national controls. Regulatory arbitrage may also limit the effectiveness of any caps or controls, with firms and executives having significant incentive to adopt innovative remuneration arrangements to circumvent any hard constraints.²

Not surprisingly, then, policy makers have instead focused more on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised in terms of internal firm governance (and, in particular, fostering arms-length negotiation through mandating certain levels of independence), and providing a mechanism to allow shareholders to have a means of expressing their views on director and executive remuneration.

With respect to the former, the *Conclusions* noted the importance for companies to take steps to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved are clearly defined and separated, and with remuneration outcomes decided through a transparent and robust process. In terms of implementation, the key Principles relate to the twin general duties of directors to act in good faith and loyalty toward the company (Principle VI.A), and to exercise independent judgement (Principle VI.E), including giving consideration to assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks, such as the remuneration setting process, where there is a potential for conflict of interest. In those countries where there are dominant or controlling shareholders, the requirement of directors to treat all shareholders fairly (Principle VI.B) is also highly relevant, particularly in cases where the dominant shareholder exercises significant influence over the remuneration setting process. Finally, perhaps reflecting wider societal concerns about executive remuneration, there has been a tendency for policy makers and practitioners to also look at the impact of remuneration outcomes on other stakeholders (consistent with the recommendation of Principle VI.C), including firm level employees. (As an example of change in this area, while not specifically related to remuneration, the UK's new statutory statement of directors' duties places explicit emphasis on directors taking into account the interests of stakeholders.)

In terms of shareholder engagement, there has been an increased focus on introducing binding or non-binding votes (“say on pay”) provisions. The *Conclusions* noted that, in order to increase awareness and attention, it was good practice for remuneration policies and implementation measures to be submitted to the annual meeting and that there be mechanisms to enable shareholders to express their opinions (consistent with the recommendation of Principle II.C.3). The experiences of the reviewed countries suggest that the effectiveness of “say on pay” provisions is fundamentally linked to the quality and timeliness of disclosure around incentive and remuneration arrangements. So where countries such as **Brazil**, **Japan** and **Portugal** have had shareholder voting, the effectiveness of those votes (and, consequently, the extent of shareholder engagement) has been compromised by the lack of data available to understand the links between pay, performance and risk. As such, the key policy focus in these jurisdictions has been to bolster the disclosure requirements to support pre-existing “say on pay” arrangements. Jurisdictions have also sought to identify novel mechanisms for encouraging better shareholder engagement. In the **United Kingdom**, the Financial Reporting Council has recently released a Stewardship Code that seeks to encourage more active institutional investors. In **Brazil**, amendments to the proxy solicitation rules are designed to facilitate more active engagement by shareholders, by reducing costs and facilitating disclosure. In **Portugal**, the securities regulator, CMVM, has issued a set of recommendations that seek to promote active and transparent engagement by domestic institutional investors in the exercise of their shareholder rights.

1.1. Market environment and norms

Underlying the public and political debate on director and executive remuneration are concerns that both the quantum of remuneration has grown disproportionately to labour rates in the wider market, and that there is a disconnect between pay and performance (or more, specifically, that below par performance is not negatively rewarded). To the extent that such trends are observed, a principle explanation advanced is that imperfections in corporate governance allow successful rent-seeking by managers to occur.³ Such a view was one of the Key Findings in relation to the financial crisis: “The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm’s length. Managers and others have had too much influence over the level and conditions for performance based remuneration with boards unable or incapable of exercising objective, independent judgement”.

This is clearly the case in some jurisdictions, and in some industries. For instance, amongst the reviewed countries almost all identified that remuneration and incentive arrangements were an issue in their banking and finance industry. However, while many of the questionnaire responses acknowledged the level of public disquiet over director/executive remuneration levels, very few actually identified it as a particularly pressing issue in their listed company sector. Where it was identified as an issue, often it related to social justice concerns and notions of relative pay. An overwhelming majority of respondents described their executive labour markets as largely internal to their country, and where they did so, director/executive remuneration was universally considered to be unproblematic. Given that there has been widespread policy and legislative responses, even in jurisdictions where remuneration is not considered problematic, suggests that the social concerns (and the pressure to be part of a global response to the issue) have acted as strong forces in driving governance policy.

Amongst the reviewed countries, a common perception was that pay outcomes in family controlled firms were more moderate than those with dispersed share ownership. In three of the reviewed countries (Brazil, Portugal and Sweden), family controlled firms are quite dominant amongst listed companies, and this is seen in those jurisdictions as a moderating influence on pay outcomes. Such an outcome would be consistent with a managerial power hypothesis, since in family controlled firms the owners have a vested interest in pay outcomes and a more equal bargaining position when compared with companies with dispersed ownership.

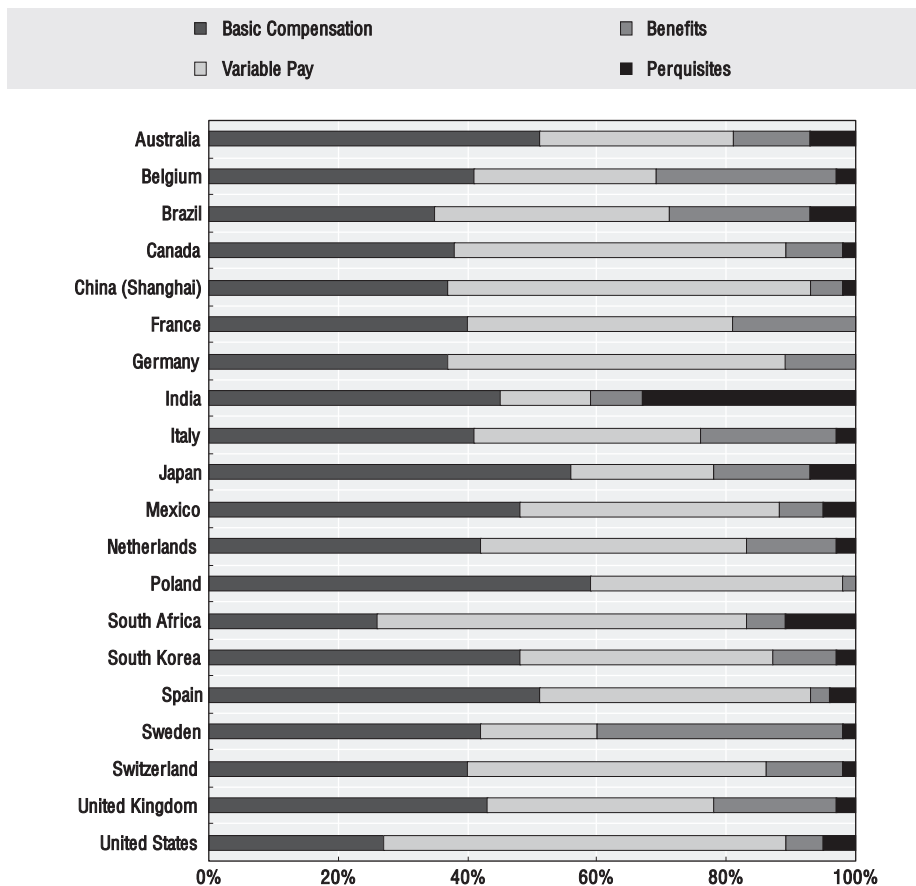
Anecdotally, market participants also felt that remuneration outcomes in companies with dominant shareholders were less complicated, and with a lesser weighting on long-term performance plans (with variable remuneration instead based more around bonus payments). This may reflect some of the inherent problems with performance based pay⁴ as a driver of long-term alignment, and the capacity of dominant shareholders to use more efficient non-monetary rewards to tie executives and directors into the company's longer-term interests. This might be especially important in company groups. For instance, in **Portugal**, market participants suggested that management pay outcomes were sometimes lower in family controlled groups because of the implicit promise that there would be later opportunities within the group at later stages of an executive's career. It may also reflect unobservable remuneration being paid by other companies. For instance, in **Brazil**, the regulators noted that in foreign controlled companies sometimes longer term performance rewards for executives were provided by the international parent, and expressed in terms of the stock price of the parent.

In both cases, this raises the risk that managers' interests will be aligned with the interests of dominant shareholders, instead of all shareholders, although these risks can be substantially moderated if the capacity for abusive related party transactions can be avoided (as is the intention with Portugal's company groups law⁵). As a starting point, it is important for minority shareholders that any arrangements with related companies or groups are clearly disclosed, and it is worth noting that in the case of both Brazil and Portugal extensive disclosure regulations have been introduced in 2010 that would require comprehensive disclosure of payments by related parties.

Despite the perceptions that remuneration structure is an issue for a limited number of countries, amongst large capitalisation companies around the world (which, on average, are more likely to have dispersed ownership) the split between variable and fixed remuneration shows significant disparity across countries, although significant amounts of variable pay are a common feature across most jurisdictions (Figure 1.1). A notable outlier is the **United States**, where remuneration at risk is substantially in excess of fixed pay. However, there is no clear split between countries which have dispersed ownership structures and those more likely to have concentrated ownership. For instance, in **Germany** the study identified a higher level of variable remuneration than in the **United Kingdom**.

The use of equity incentives is almost universally an integral part of remuneration design. A 2008 Towers Perrin study highlighted that, amongst major companies around the world, stock options remain the most popular type of long-term incentive in most countries, although use has declined in the Netherlands, Spain, Switzerland, the U.K. and the U.S. At the same time, there has also been a significant expansion in the use of restricted stock and performance shares. Restricted stock has gained ground in Canada,

Figure 1.1. **Pay components 2005 - Chief Executive Officer (as percentage of total remuneration)**



Source: Towers Watson (2006), "Managing Global Pay and Benefits", Worldwide Total Remuneration Report 2005-2006, www.towersperrin.com.

France, Mexico, Singapore and the U.S., although its use is a majority practice only at companies in the U.S. Performance shares have become more widespread in Canada, France, Mexico, the Netherlands, Switzerland, the U.K. and the U.S.

One observation that can be made based on the review is that performance pay needs to be put in the context of the wider cultural attributes and the company culture. It is clear that in **Japan**, the concept of life time employment, and affiliation to the company, is still a strong influence on executives with a resulting impact on the structure and quantum of remuneration. The use of bonuses is widespread to incentivise employees to short term performance, but longer term incentives are relatively less common, with executives personal interests strongly aligned to the company via cultural factors. The historically high proportion of salary taken in the form of retirement benefits reinforces the longer term horizons of directors and executives but may also make them risk-averse. In **Sweden**, similarly, cultural factors also play some part in dictating structures. Executives and directors are particularly attuned to income differentials with CEO salaries often measured in terms of a multiple of "industrial worker salaries".

1.2. Legal and regulatory frameworks

Legal and regulatory responses to director remuneration have tended to cover three broad areas: i) provisions relating to the structure and quantum of remuneration; ii) requirements relating to the governance of the remuneration process; and iii) disclosure requirements on both the constituents of remuneration and the policies that underlie remuneration outcomes.

Box 1.1. Director versus Executive Remuneration

In general, much of the regulation of remuneration is related to members of the Board of Directors in companies with single tier boards and to either or both the Supervisory Board and Management Board in dual tier companies. For simplicity, references in the paper to directors' remuneration refer to members of the Board of Directors/Supervisory Board and to Members of the Management Board. References to executive remuneration refers to the remuneration of senior employees whether inside or outside of these company organs.

In relation to normative requirements on structuring remuneration, as noted above, policy makers have been quite restrained, reflecting the difficulty of providing frameworks that can be applicable across a broad range of companies. Where legislation does contain provisions on the quantum and structure of remuneration, it tends to be in the form of guidance on the factors that companies should take into consideration. For instance:

- in **Estonia**, the law provides that total payments made to the management and supervisory Boards must be in reasonable proportion to their duties and economic situation; **Austria** has a similar requirement although it applies to the Supervisory Board only;
- similarly, in **Denmark**, remuneration should not exceed an amount which is considered normal given the nature of the duties, scope of work and company financial position;
- **Greece** has similar provisions, although limited to the remuneration of non-executive board members, with the requirement that they be proportional to the time they devote to their responsibilities;
- in **Brazil**, the legislation provides that board proposals for remuneration should consider the responsibilities of the officer, their dedication, competence, professional reputation and market value of their services.

Amongst OECD countries, **Germany** appears to have gone further than most in this area. In 2009, it passed a Law on the Appropriateness of Directors' Pay (refer Box 1.1) which contains a number provisions on how pay can be structured and the processes by which it is approved. In terms of structure, the German Stock Corporate Act now provides that, in the case of listed companies, the pay structure must be based on the sustainable development of the company (meaning the long-term positive trend and growth of the company). Furthermore, variable pay components, in particular bonuses, must be based on a multi-annual basis of assessment in the case of listed companies. It is important to stress that the German approach is still principles-based; there is no statutory upper limit on remuneration, and the relative proportion of fixed and variable remuneration is also not specified.

In the very rare cases where jurisdictions have imposed specific caps, this has generally related to situations where Government is involved as a shareholder, on either a temporary or permanent basis. As an example, **Slovenia**, has introduced laws to cap fixed executive remuneration in companies with state ownership to relatively low multiple of average worker salaries, with the ratio proportionate to company size (being three, four or five times average salary). Variable component of remuneration are also then capped at a maximum amount of 30% of the basic executive annual salary.

Some jurisdictions have made moves to introduce “clawback” arrangements that allow for the repayment or *ex-post* readjustment of variable remuneration, generally where the payment was based on false information. In the **Netherlands**, the government has decided to introduce a clawback regulation, whereby the level of variable remuneration can be adjusted (by the company organ that fixes the remuneration) if payment would be unreasonable: a clawback provision applies if bonuses have been paid on the basis of false information regarding the bonus criteria. In the **United States**, under new SEC rules to be issued as a requirement of the Dodd-Frank Act, listed companies’ policies on variable remuneration will be required to include mandatory recovery of that compensation following a restatement due to material non-compliance with financial reporting requirements. In **Denmark**, the revised Danish Corporate Governance Code recommends that in exceptional cases, companies should be able to reclaim in full or in part variable components of remuneration that were paid on the basis of data, which proved to be manifestly misstated.

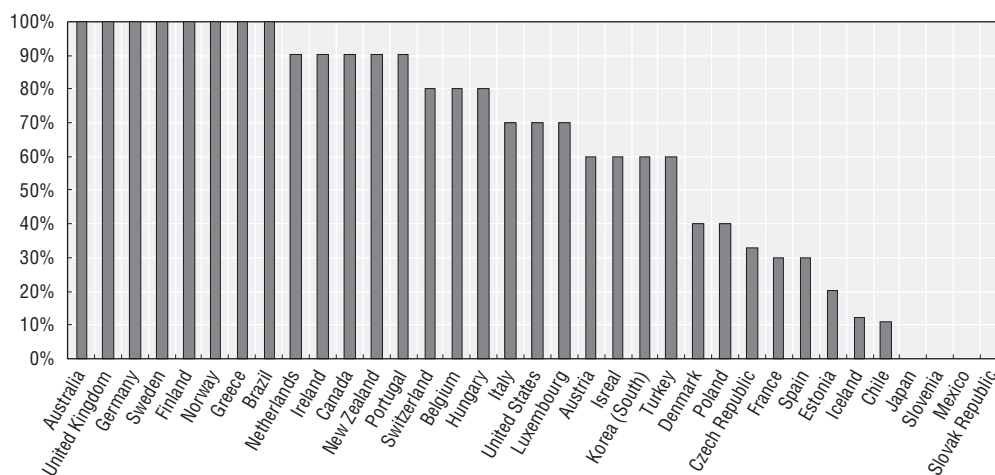
The most common approach among **OECD** countries is for the legislation to provide some degree of prescription as to how the process of remuneration setting is governed, normally in terms of assigning responsibilities amongst company organs and, less frequently, by mandating certain criteria for independence. In relation to the former, Principle II.C.3 recommends that “shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval”. Thus, the principle has two separate components: i) some form of shareholder engagement on remuneration policy for both boards and executives and ii) explicit approval of any share based schemes.

For the first of these, the basic approaches that jurisdictions have taken are to mandate either a binding or non-binding vote on board remuneration and/or remuneration policy. To be entirely consistent with the principle, this vote should encompass the remuneration policy (not necessarily levels) and should cover both directors and executives.

The OECD commissioned Manifest Information Services to conduct a top-level survey of incentives and risk management at listed companies across OECD countries and Brazil. The research focussed on the top ten listed companies in each jurisdiction by market capitalisation.⁶ To the extent that larger capitalised companies are more likely to be at the front end of corporate governance reform, the survey is more likely to highlight the trends in individual country practices, rather than current practice. With respect to “say on pay” provisions, Figure 1.2 provides a description of the number of survey respondents that had a remuneration related resolution as part of their most recent annual meeting. The data shows that there are still a sizeable number of jurisdictions where remuneration related voting is not common and where it would be difficult to conclude that practice is

consistent with the recommendations of Principle II.C.3. However, some caution should be exercised with this data since in some jurisdictions (notably Japan) shareholder voting is compulsory but is only required when there is a change in the total level of remuneration allowed. Voting often occurs less than annually, with approval sought for a total envelope greater than actual payments. It is also worth noting that there have been recent reforms in many jurisdictions regarding “say on pay” (for instance, the 2009 European Commission Recommendations – refer below) that would not be reflected in the survey data. When those reforms are implemented, it would seem reasonable to suggest that the level of adherence to the principle, while not universal, will be substantial.

Figure 1.2. **Companies with a remuneration related resolution**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

In the **UK** and **Australia**, a non-binding vote on remuneration has been in place since 2002 and 2003 respectively. The introduction of non-binding votes in both Australia and the UK were contentious reforms. In both countries, (and in other countries, such as the **United States, Canada** and **New Zealand**) there is a comparatively higher degree of autonomy afforded to the Board, and the case against voting on remuneration rests largely on the proposition that it would diminish the authority of the Board to exercise its responsibilities. This has led to a high degree of resistance to the introduction of shareholder voting in these jurisdictions. Underlying this resistance in countries other than the United States is the view that if shareholders are unhappy with the board, then they have the capacity to remove them. In practice, in neither the UK or Australia have there been widespread cases of shareholder revolt, although the few high profile cases do seem to have had the effect of making Boards more responsive to the concerns of shareholders, and more pro-active in engaging with them on remuneration issues.

In continental European countries with two tier boards, there has historically been a clear delineation between the role of the shareholders meeting and the supervisory and management boards. For example in both **Poland** and **Germany**, as a general principle, the management board is in charge of setting the remuneration of employees, the supervisory board negotiates the remuneration of the members of the management board and the remuneration of the supervisory board is determined by the shareholders meeting. Under such a structure, in many continental countries there is a high level of adherence to

Principle II.C.3 with respect to Supervisory Board members, but relatively less with respect to executives. A shareholder vote on management remuneration does not easily fit within this hierarchical structure, which may explain the relatively low adoption of shareholder votes for executives in some European jurisdictions.

This situation is quickly changing, however, in part driven by the European Commission's 2004 recommendation⁷ on director remuneration, which proposed that member states should adopt either a binding or non-binding vote on remuneration policy, as an explicit item on the agenda of the annual general meeting (**Germany**, for instance has recently adopted a non-binding vote on remuneration as part of its Law on the Appropriateness of Directors' Pay). Similarly, **Portugal** vests power for setting remuneration policy in the hands of the general meeting (although, in practice, this is often delegated to a committee established by the general meeting). The **Netherlands** also has a mandatory binding vote on the management remuneration policy and, in principle, the shareholders meeting has the responsibility to fix directors' remuneration in accordance with the policy (although in practice, this is commonly delegated to a remuneration committee composed of members of the Supervisory Board).

The Commission's 2004 recommendation also proposed that share based payments should be subject to explicit approval, consistent with the position in the Principles. **Sweden** has gone furthest in this area, with the shareholders having a General meeting having a broad mandate to decide remuneration of each individual director; all share- and share-price-related incentive schemes for the executive management, (in most cases with a quorum requirement of 90% of the votes cast); and a binding vote on the annual guidelines for the remuneration of the executive management as proposed by the board.

Among other OECD, and Enhanced Engagement countries, it seems relatively common for shareholders to have a binding vote on director remuneration.

- In **Norway**, the remuneration of board members is decided by the general meeting, and is required to prepare remuneration guidelines for executive personnel to be disclosed to the general meeting. Where these include share based payments, they also must be approved by the general meeting.
- In **Israel**, director remuneration must be approved by the audit committee, the board of directors and the general meeting (with supermajority provisions where there are controlling shareholders).
- In **Korea**, the shareholders' meeting sets the total remuneration for the Board, with individual remuneration of directors set within that global limit.
- Similarly in **Indonesia**, board remuneration is set by the general meeting (although setting of management board remuneration can be delegated to the supervisory board).
- In **Mexico**, the annual Shareholders' Meeting determines the salaries of managers and board members, when they have not been established in the by-laws of the company.
- In **Brazil**, the law requires shareholder approval of at least the global amount of director remuneration, based on a recommendation of the board of directors, and subject to specific criteria.

1.2.1. Recent reforms or proposals on the structuring and/or approval of remuneration

On 30 April 2009, the European Commission released a recommendation regarding the remuneration of directors of listed companies⁸ that sought to complement earlier

regulations in 2004 and 2005⁹. The recommendation advocates that the structure of directors' remuneration should promote the longer term sustainability of the company and ensure that remuneration is based on performance. Variable components of remuneration should therefore be linked to predetermined and measurable performance criteria, including criteria of a non-financial nature, and limits should be set on the variable components of remuneration.

The recommendations from the Commission have elicited various responses from member states. In **Finland**, the Corporate Governance Code (which is binding on listed companies) has been updated to explicitly provide for shareholder approval of both remuneration levels and the basis of remuneration. In **Belgium** detailed legislation has been passed that requires that one quarter of any variable remuneration will have to be based on criteria with a duration of a minimum two years; another quarter will need to be based on criteria over a minimum of three years. This means that only half of the variable remuneration can be linked to performance criteria of the concerned year. These provisions do not have to be taken into account if the variable remuneration forms less than one quarter of the total remuneration or if approved explicitly by the general assembly of shareholders. In **Germany**, the existing provisions of the Joint Stock Corporation Act, which covers both supervisory board and management board members, were amended by the Law on the Appropriateness of Directors' Pay (Vorstandsvergütungsangemessenheitsgesetz). The law provides that director remuneration must be appropriate and that variable pay components must be based on a multi-annual basis of assessment in the case of listed companies (refer Box 1.2).

In July 2010, the **United States** passed the Dodd-Frank Wall Street Reform and Consumer Protection Act that amends U.S. requirements relating to executive compensation practices in a number of respects. First, the SEC is obliged to promulgate rules by mid-2011 that will require members of the compensation committee for listed companies to be independent directors (with independence to be defined according to a number of factors, including the source of compensation and lack of affiliation with an issuer). Under new "say on pay" provisions, the act requires at least once every three years, a shareholder advisory vote to approve the company's executive compensation as disclosed pursuant to SEC rules. The "say on frequency" provision requires companies to put to a shareholder advisory vote every six years, whether the "say on pay" resolution should occur every one, two or three years. In addition, in any proxy statement asking shareholders to approve an acquisition, merger, consolidation or proposed sale of all or substantially all of a company's assets, the Dodd-Frank Act generally requires disclosure about, and a shareholder advisory vote to approve certain agreements or understandings with the company's named executive officers concerning compensation that is based on or otherwise relates to the extraordinary transaction, unless the arrangements were already subject to the periodic say-on-pay vote.

In **Australia**, in March 2009, Government asked the Productivity Commission (PC) to conduct a broad ranging inquiry into the regulation of executive remuneration, including current disclosure requirements and the roles of shareholders and institutional investors. The report was publicly released on 4 January 2010, and recommended increased independence in the remuneration setting process; better disclosure through simplified remuneration statements; and recommendations to improve shareholder engagement. In April 2010, the Australian Government released its response to the PC inquiry, supporting

Box 1.2. German Laws on Director Remuneration

- In the case of listed companies the pay structure must be based on the sustainable development of the company. This means a long-term positive trend and growth of the company.
- Variable pay components, in particular bonuses, must be based on a multi-annual basis of assessment in the case of listed companies (§ 87 paragraph 1 German Stock Corporation Act). Multi-annual means at least three years. In this way, the directors are equally affected by any subsequent deterioration in a company's situation. Short-term incentives are therefore no longer possible.
- The supervisory board should agree on a way of limiting bonuses should there be extraordinary developments. "Extraordinary" means extremely high share increases, offers of a takeover, etc. All parts of the remuneration – fixed or variable – shall be in itself and together appropriate and shall not encourage over excessive risk taking (no. 4.2.3 paragraph 2 German Corporate Governance Code).
- Share options should be taken at the earliest four years after the options have been granted. Share options for the Supervisory Board are not allowed to avoid conflicts of interest.
- A supervisory board has to reduce directors' pay at a later date if a company's situation deteriorates. Such deterioration can be said to have occurred, for example, if the company has to dismiss staff and no longer pays out dividends. Pensions can also be reduced; see § 87 paragraph 2 German Stock Corporation Act.
- Contrary to the situation in Germany before the Law on the Appropriateness of Directors' Pay, decisions about directors' pay may no longer be delegated to a small group within the supervisory board but must be approved by the full board, which includes employee representatives.

nearly all of the PC's recommendations. Implementing the recommendations will involve changes to the Act, the ASX Listing Rules and the ASX Corporate Governance Principles.

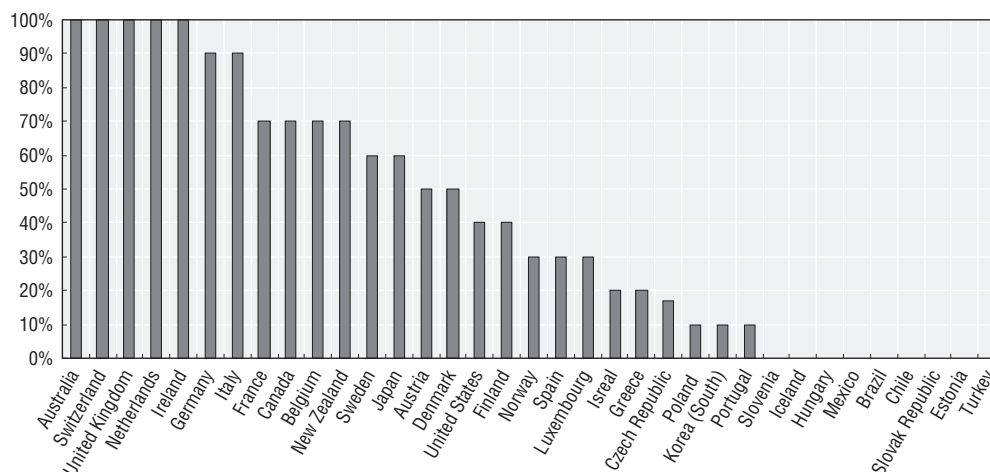
1.2.2. Requirements related to disclosure and transparency

A recognition of the need for effective disclosure of remuneration and incentive arrangements for directors and executives was a key outcome of the Committee's work on corporate governance and the financial crisis. While Principle V.A.4 provides that "disclosure should include material information on remuneration policy for members of the board and key executives" one of the Key Findings was that "transparency needs to be improved beyond disclosure. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and; how the remuneration is adjusted for related risks". The annotations to the principles also make clear that of particular interest is the link between remuneration and company performance. Companies should be expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance.

A key element of this disclosure relates to share-based remuneration. Using the Manifest survey data commissioned by the OECD, it is clear that such disclosure is by no

means widespread. Where disclosure is low, this will in part be a reflection of the fact that, in these jurisdictions, share-based remuneration is itself not widespread. Nevertheless, the data (Figure 1.3) would seem to imply that current disclosure in some jurisdictions is not strong in explaining the components of remuneration or a commentary on the relationship to risk, as suggested by the Key Findings.

Figure 1.3. **Companies disclosing share-based remuneration**



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

There is a clear trend toward countries introducing stricter disclosure requirements relating to director and executive remuneration. Among the reviewed countries, **Japan**, **Portugal** and **Brazil** have recently introduced new, more comprehensive disclosure standards.

In Europe, the Commission's 2004 recommendation proposed that listed companies should disclose a remuneration policy statement on an annual basis that included information on, inter alia, the relative importance of variable and non-variable components of director remuneration; information on performance criteria; and information on the link between pay and performance. The Commission's 2009 recommendation takes this further, emphasising the need for the remuneration statement to be clear and easily understandable (consistent with the *Conclusions*), and providing greater detail on how disclosure of performance related pay should be implemented. This includes, for instance, recommendations that remuneration statement should include an explanation how the choice of performance criteria contributes to the longer term interests of the company, and an explanation of the methods, applied in order to determine whether performance criteria have been fulfilled.

European jurisdictions are responding to the Commission's recommendations by either amending legislative/regulatory requirements on disclosure and/or making amendments to their Codes. In **Belgium**, the recent legislation noted above requires a remuneration report containing a description of the remuneration policy, including the procedure used to determine remuneration; the principles of the remuneration; the relative importance of each component; the criteria for the evaluation of the performance regarding the objectives, the periodicity of the evaluation and the description of the

method used to check if the performance criteria are fulfilled. In **Spain**, for instance, a draft Bill on Sustainable Economy (Anteproyecto de Ley de Economía Sostenible) will upgrade the transparency requirements on director remuneration consistent with the Commission recommendations and **Portugal** has already issued new regulations applying to the listed sector. **Slovakia** has addressed the 2004 recommendation via its code, and anticipates that this will be also updated to reflect the 2009 recommendation. While not a member of the EU, **Turkey** plans to implement amendments to the Capital Market Board's Corporate Governance Principles to be consistent with the Commission recommendations. In **Finland**, the Securities Market Association (which issues the Code) will issue an updated Guideline on Remuneration Statements in autumn 2010 with the emphasis on implementing the Commission's 2009 disclosure recommendations.

The use of remuneration statements is also common outside of the European Union. In **Australia**, the Corporations Act mandates a high level of disclosure to be contained in the remuneration report of the Annual Directors' statement. This includes a full description of the policy on remuneration, the link between the policy and performance, the performance conditions and the mix of fixed and variable remuneration. In **Norway**, the law requires that the board of directors establish guidelines on the remuneration of executive personnel, with these to be communicated to the annual general meeting.

In the **United States**, (prior to the amendments noted above) executive and director compensation was already one of the disclosure areas mandated by SEC rules. SEC registrants must disclose detailed information about all plan and non-plan compensation awarded to its named executive officers and directors on an individual basis. A reporting company must also provide a Compensation Discussion and Analysis (CD&A) that explains all material elements of its executive compensation programme; the objectives of the programme; what the program is designed to reward; each element of compensation; why the registrant chooses to pay each element; how the registrant determines the amount to pay for each element; and how each element fits into the overall compensation program. The SEC rules also require a registrant to disclose whether it has a compensation committee, provide disclosure regarding the committee's charter, and describe the registrant's processes for determining executive and director compensation. In addition, the Dodd-Frank Act requires the SEC to amend its executive compensation disclosure requirements to require a company to disclose in its annual meeting proxy materials the relationship between executive compensation actually paid and the company's financial performance. It is likely that the SEC's rules will require disclosure in a number of filings of the CEO's annual total compensation, the median annual total compensation of all other employees, and the ratio between these two amounts.

In December 2009, the SEC adopted amendments to its proxy statement disclosure rules to enhance the disclosure requirements concerning company compensation and other corporate governance matters. One of the amendments will require a company to discuss its compensation policies and practices as they relate to risk management for all employees, and not just for executive officers, if those policies and practices are reasonably likely to have a material adverse effect on the company. The SEC adopted this amendment based on its belief that disclosure of a company's compensation policies and practices in certain circumstances can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk taking by its employees.

Individual disclosure

Disclosure of remuneration outcomes is often a contentious issue for regulation, and in many cases this is fundamentally related to whether disclosure should be mandated on an individual basis. While the Principles note that individual disclosure is increasingly regarded as good practice, the Methodology makes clear that this is not essential for the Principle to be fully implemented, and jurisdictions have taken varied approaches to the issue. Many countries (for instance, **Denmark**¹⁰ and **Korea**) rely on aggregate disclosure; others, such as **New Zealand**, use a system of remuneration bands, with directors aggregated among the different levels. In **Australia** and **Israel**, the remuneration paid to the five highest executives (regardless of whether they are directors), must be individually disclosed.

In both **Japan** and **Brazil**, when revising their disclosure requirements in 2010 the authorities considered whether individual disclosure was desirable, with both seeking to balance the greater transparency of individual disclosure with the perceived risks of such an approach. In **Japan**, the recently released FSA regulations seek a balanced approach by requiring individual disclosure of directors'¹¹ remuneration, but limiting it to directors whose remuneration is greater than JPY 100 million on a consolidated basis for the financial year. The disclosure must include the total amount of remuneration, the director's name, and a breakdown by the type of payments. For those directors earning less than JPY 100 million, disclosure is aggregated by the different type of office-holders. In **Brazil**, regulators opted for aggregate disclosure, but with separate identification of the amounts paid to the highest and lowest paid directors. **Belgium** has also recently introduced legislation that requires company remuneration statements to provide comprehensive disclosure on an individual basis.

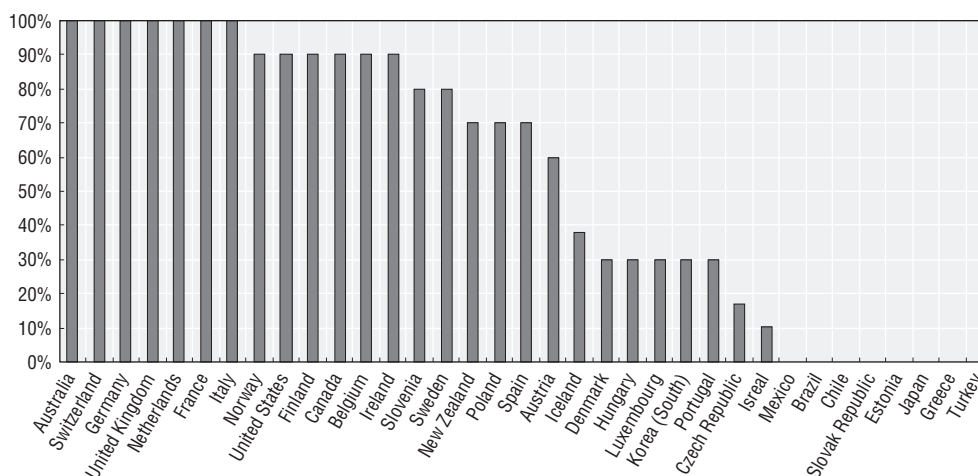
The divergence of approaches is reflected in the survey data collected by Manifest Information Services (refer Figure 1.4). Across all companies in the survey, only just over half (54%) disclosed individual remuneration. Many of those where individualised disclosure is most likely are in developed markets where, in many cases, regulatory regimes require it, such as Australia, the UK, the US and many Western European countries.

The perceived risks of increased disclosure

The arguments against greater disclosure of director and executive pay (and particularly, at the individual level) have, in OECD countries, revolved around a concern that it can lead to an upward pay spiral. This could occur, for instance, where the remuneration setters (*e.g.* Boards or Remuneration committees) routinely seek position their executives' pay outcomes in a preferred band (such as upper third quartile) with the collective outcome that director and executive pay continually ratchets up. **Sweden**, for instance, considered adopting individual disclosure, but ultimately decided against it because of such a risk. While this may be a genuine concern in some jurisdictions, the recent study by the Productivity Commission in **Australia**, found no evidence of an upward pay spiral there, where individual disclosure has been mandated since 1998.

A completely unrelated argument in some jurisdictions (for instance, **Mexico**) has been a concern that individual disclosure may create security concerns for the executives. This issue was also raised in **Brazil** during public consultation on a proposal for individual

Figure 1.4. Individual disclosure of remuneration



Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

disclosure. In the end, Brazil did not mandate individual disclosure, although for reasons not necessarily related to director security.

Given the sensitivity of the issue in many jurisdictions, the use of soft law may be a way to adequately address this issue and in this regard, the approach of **Brazil** is instructive. After the high level of opposition to individual disclosure, the new disclosure regulations introduced in 2010 did not mandate individual disclosure. At the same time, the Corporate Governance Code now provides that best practice in this area is for individual disclosure, and some companies have started to adopt this approach. Over time, it is hoped that concerns (particularly related to security) may be alleviated leading to wider adoption of more detailed disclosure.

Market trading

Even though it is not explicitly stated, the intent of the Principles (for example VI.D.6) clearly envisages the need for disclosure of market trading in the company's shares and securities by board members and key executives, including their close family members and associates. This is particularly important in allowing the Board and shareholders to assess whether share based remuneration is serving its purpose in aligning director remuneration with the companies longer term interest. An emerging issue that has arisen in some jurisdictions is the use of personal hedging to alter the risk profile of share based remuneration. In **Portugal**, in response to specific cases, the new regulations now require any personal hedging to be disclosed. Similarly, in the **United States**, under the new laws, the SEC also is required to issue rules requiring companies to disclose in their annual meeting proxy statements whether directors or employees are permitted to purchase financial instruments designed to hedge any decrease in market value of equity securities granted as part of their compensation. In **Australia**, the Productivity Commission report goes further and recommends that the Corporations Act 2001 should prohibit company executives from hedging unvested equity remuneration or vested equity subject to holding locks.

1.2.3. Soft law requirements

Code makers have necessarily had a higher degree of flexibility in their approach to remuneration, having the advantages of being more flexible to changing market circumstances and, in most cases, their non-binding nature. Because of this, in many jurisdictions Codes tend to go further in providing guidance on the structure of remuneration systems and the alignment of corporate and director/executive interests. For instance:

- In **France**, the Corporate Governance Code of Listed Corporations¹² provides detailed criteria for determining the fixed, variable and share based components of remuneration. For instance, the variable component must be understandable by shareholders; for a fixed period; must be a maximum percentage of the fixed, with the relationship between the two clear; and must be subject to pre-determined, specific quantitative and qualitative criteria.
- In the **Netherlands**, the Code provides that the variable components should be linked to predetermined, assessable and influenceable targets. The structure should be simple and transparent and promote the medium and longer term interests of the company.¹³
- In **Brazil**, the code stresses the importance of a balanced compensation policy combining short and longer term incentives, linked to performance. It also stresses using remuneration to align the interests of executives with those of the company.
- In **Switzerland**, 2007 amendments to the Code of Best Practice provide that the compensation system should reward conduct aimed at medium- and long-term corporate success with compensation elements available at a later date and should be structured in such a way as to avoid false incentives.

1.3. Board practices

The need for boards to exercise objective, independent judgement in the remuneration setting process (Principle VI.E.1) is something that needs to be established in the broader context of establishing “an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated is something commonly addressed *via* soft-law approaches” (see *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*). How this is achieved in each individual country will depend on the role of the board *vis a vis* other company organs. Where greater responsibility is placed in the hands of the General Meeting this could be considered of lesser importance, although even in these cases the Board tends to have a role in both recommending policy and implementing the policy via the contractual arrangements, both of which benefit from an independent perspective.

Reflecting the different legal frameworks, countries have adopted varying approaches to board independence in remuneration setting. The European Commission recommendation of 2005 recommends that boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors should play an effective role in key areas where there is a potential for conflict of interest, and where the board plays a role in remuneration it should establish a remuneration committee (except in cases where the board is small, in which case the function can be performed by the board as a whole). Such an approach is consistent with the observation in Principle VI.E.1 that it is considered good practice in an increasing number of countries that remuneration policy

and employment contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors.

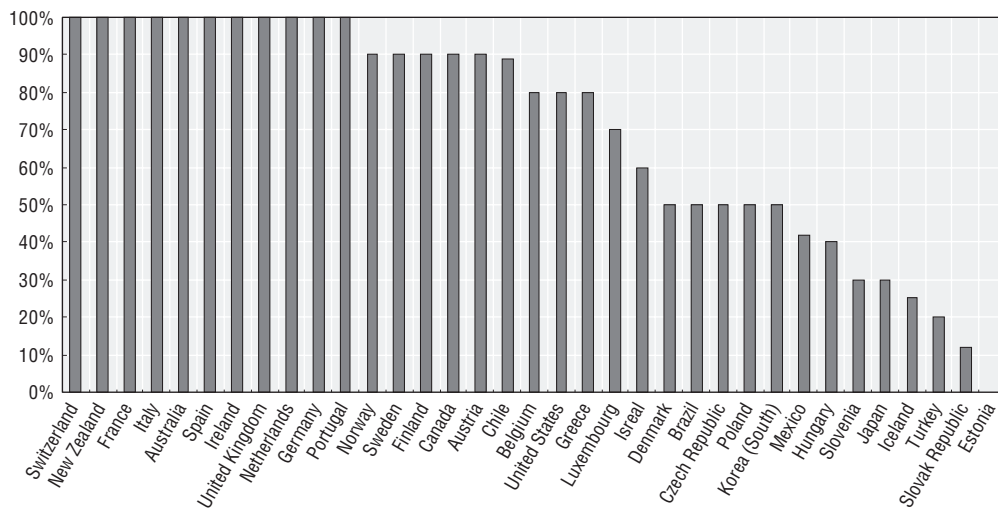
In general, member countries of the EU have implemented this recommendation, usually as part of their soft-law framework. For instance, in **France**, the Code provides that the remuneration committee should not include any executive directors, and should have a majority of independent directors. The French Code also recommends that cross-membership of remuneration committees by executives of two companies, should be avoided. A 2009 RiskMetrics study on monitoring and enforcement practices in corporate governance in member states noted that in almost all jurisdictions, a majority of companies amongst their sample had established a remuneration committee. On average 62% of the members of the remuneration committees were deemed independent.

The listing requirements in the United States generally mandate independence in the remuneration setting process. The New York Stock Exchange requires listed companies to have a compensation committee composed entirely of independent directors. The Nasdaq requires that executive officer compensation must be determined, or recommended to the board for determination, by either a compensation committee (comprised solely of independent directors) or by the majority of the board's independent directors. The Wall Street Reform and Consumer Protection Act requires the SEC to adopt rules that direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer unless, to the extent the issuer has a compensation committee, each member of the issuer's compensation committee is a member of the board of directors and independent.

Amongst other OECD countries, the regulatory and code arrangements are generally supportive of remuneration committees with high levels of independence:

- in **Brazil, Norway and Switzerland**, the respective Codes recommend boards to consider appointing a remuneration committee, which should be comprised solely of independent members;
- in **Israel**, director remuneration is approved by the audit committee, which must comprise at least two independent directors;
- in **Korea**, the Commercial law provides that the board may establish a remuneration committee. Once it is established it is subject to specific requirements as to disclosure of its operations; and
- in **New Zealand**, the NZX Best Practice Code and Listing Rules encourage the establishment of a remuneration committee (which is widely followed);
- in **Mexico**, the Code of Corporate Best Practices (mandatory for listed companies) recommends that an intermediate body, such as an ad hoc committee, shall assist the Board of Directors in the establishment of the evaluation and compensation criteria, applicable to the CEO and senior officials of the company.

In practice, the Manifest survey supports the view that remuneration committees are relatively widespread (Figure 1.5). Fewer than a quarter of the countries in the survey displayed a minority of companies with a Remuneration Committee, with the majority of countries surveyed showing 80% or more of their companies having one. The most common reason for a lack of a specific Remuneration (sub-) Committee is that remuneration matters are decided by the board as a whole. It is therefore perhaps unsurprising that some of the countries characterised by smaller average board sizes, such

Figure 1.5. **Companies with a remuneration committee**

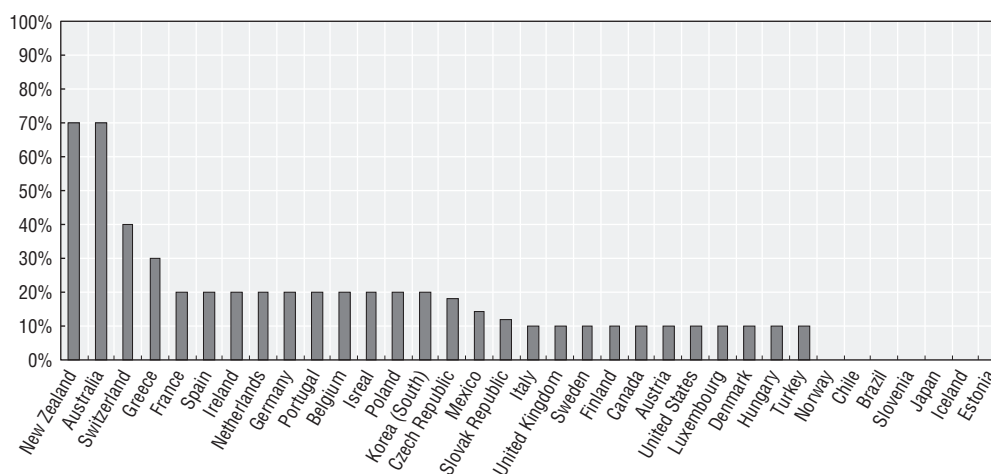
Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

as Turkey, Estonia and Iceland also have a low proportion of companies with separate Remuneration Committees.

The Key Findings report highlighted how in many cases boards had failed to adequately fulfil their duty of aligning key executive and board remuneration with the longer-term interests of the company and its shareholders (Principle VI.D.4), noting that in many cases it is striking how the link between performance and remuneration was very weak or difficult to establish. Some of the reasons cited in the report for this failing included a high degree of complexity; a lack of appropriate understanding of the linkages of remuneration policies to corporate risks; and an incomplete understanding by boards of the drivers of remuneration outcomes. In this context, a striking feature of the Manifest survey was the low incidence of specialised board committees to deal with risk (Figure 1.6). In contrast to Remuneration, the issue of Risk Management is currently much less commonly stipulated by company law or best practice code as needing or requiring a separate committee in order to address it. Consequently, few companies in the survey had a committee whose title included any reference to Risk Management. Typically, the risk management function within the board might most commonly be found within the Audit Committee, but the challenge with such arrangements is to have the committee focus on explicit separate management of corporate risks as opposed to financial control.

1.3.1. The use of compensation consultants

There has been some controversy over the use by boards of compensation consultants to assist in the remuneration setting process. On the one hand, their use is justified as providing the board with access to expertise on the structuring of appropriately incentivised remuneration arrangements. More negatively, there is the potential for their interests to be aligned with those of management (particularly if engaged on other tasks). The *Conclusions* document noted a number of good practices that would facilitate the independence of consultants: that they be engaged by the board with a key role for independent board members (e.g. the remuneration committee or equivalent); that their role, including other work for the company, should be disclosed in a remuneration report;

Figure 1.6. **Companies with a committee with explicit reference to risk**

Source: Manifest Information Services (2010), *Board Practices: Incentives and Managing Risks - United Kingdom, Sweden, Portugal, Brazil and Japan*, Report commissioned by the OECD.

and by prohibiting or limiting the contemporaneous provision of other remuneration services and by requiring them to adhere to a code of conduct.

Amongst the reviewed countries, the use of consultants was particularly identified in the **United Kingdom** as being potentially problematic. The Walker Review (into corporate governance of banks) noted that remuneration consultants were quite widely seen as having been self-interestedly responsible for some part in the escalation in remuneration with an undue focus on median or inter-quartile ranges of external comparatives rather than broader focus on the spread of underlying data and the different characteristics of companies. In response, the leading remuneration consultants operating in the UK have established a Voluntary Code of Conduct to bolster their independence and professionalism.

Sweden has also made amendments to its Code of Corporate Governance in 2010, to provide that “If the remuneration committee or the board uses the services of an external consultant, it is to ensure that there is no conflict of interest regarding other assignments this consultant may have for the company or its executive management”. This is broadly consistent with the European Commission recommendation of 2009 that proposes that “when using the services of a consultant with a view to obtaining information on market standards for remuneration systems, the remuneration committee should ensure that the consultant concerned does not at the same time advise the human resources department or executive or managing directors of the company concerned”.

In the **United States**, amendments to SEC disclosure requirements in 2009 now require disclosure that will permit investors to assess whether consultants who provide executive or director compensation consulting services may be subject to potential conflicts of interest based on receipt of significant fees for providing other services to the company¹⁴. In addition, the Dodd-Frank Act requires the SEC to identify, by rule, factors that affect the independence of compensation consultants and other compensation committee advisers and authorizes a compensation committee to retain a compensation consultant only after taking into consideration the factors identified by the SEC.

1.3.2. Board members responsibility for shareholder engagement

Beyond the formal attributes of a say on pay regime, the underlying objective of such arrangements are to provide investors with a stronger voice; to encourage a better dialogue between companies (executives and boards) and investors, based on more transparent disclosure. In jurisdictions where “say on pay” proposals have been introduced there is some evidence that the proposals have led to a greater level of dialogue on compensation plans, both in the development phase and in the lead up to the voting process.

However, there are also criticisms of the effectiveness of “say on pay” as a means of improving the interaction between shareholders and boards. Gordon (2009) argues that, based on the U.K. experience, mandatory voting creates the risk that companies choose from a narrow menu of approaches to very firm specific problems of director compensation, often exacerbated by the use of compensation consultants. According to such an argument, a narrow range, close to a “one size fits all,” is highly likely because the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs. Custom-tailored evaluation is costly; monitoring for adherence to “guidelines” or “best practices” is cheap.

In contrast, the experience across review countries was that there was a high investor demand for a greater voice in remuneration outcomes, which would not be readily apparent if remuneration structures were considered “boilerplate”. However, to the extent this is a risk, it merely reinforces the importance of boards taking an active role in ensuring that remuneration and incentive structures are appropriately matched to the risk profile and operations of the firm.

Notes

1. For instance, options are relatively more aggressive in promoting “upside” incentives compared with shares, but are asymmetric in that they provide little downside risk. Once “under water”, they provide little incentive which can then force the Board into renegotiation. Large equity holdings can promote alignment, but where there are long vesting periods (and/or they comprise a significant component of executives total wealth) may make executives risk averse.
2. This can have implications for the extent to which pay structures are optimally aligned to incentives, as well as the level of transparency of the arrangements including the resulting disclosure to shareholders. The cap on corporate tax deductions for cash salaries of USD 1 million in the US at the beginning of the 1990s, and the resulting preferential tax deductibility of stock options is widely credited with increasing the use of options in “performance” based pay.
3. Most notably, Bebchuk and Fried (2004), in the context of the US, have referred to this as managerial power theory. The theory proposes that executives obtain remuneration outcomes more favourable than those that would arise from “arm’s length” bargaining processes, due to their influence over ‘captive’ company boards. Not only is there a principal-agent problem between company owners and managers, there is also an agency problem between shareholders and the boards they elect to represent them.
4. Namely, that risk averse managers will require over-compensation for performance based pay because they will discount the rewards, and the measurement difficulties (causing managers to focus on the measured aspects and to the extent that these differ from the long term interests of the company, then there will be a divergence from shareholder interests).
5. The law contains a system of protection for subsidiary companies, their outside shareholders and creditors, by imposing on the parent a duty of covering the annual losses of the subsidiary and a direct joint liability for the settlement of subsidiary debts.
6. In some cases, smaller companies were chosen by reasoning of better disclosure, either in terms of data or language. In some countries, it was not possible to obtain sufficient data for ten companies,

as follows: Chile (nine companies), Czech Republic (six companies); Iceland (eight companies); Mexico (seven companies); Slovak Republic (eight companies).

7. European Commission Recommendation of 14 December 2004 Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies (2004/913/EC).
8. Recommendation 2009/385/EC.
9. Recommendations 2004/913/EC and 2005/162/EC.
10. While this is the position under the Danish Financial Statements Act, it should be noted that the 2010 revised Danish Corporate Governance Code recommends individual disclosure.
11. Including statutory auditors.
12. Prepared jointly by the Association Française des Entreprises Privées (AFEP) and the Mouvement des Entreprises de France (MEDEF).
13. This wording is reflective of the wording of the European Commission's 2009 recommendation that "Award of variable components of remuneration should be subject to predetermined and measurable performance criteria. Performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long term value creation, such as compliance with applicable rules and procedures". Many European countries have utilised their Codes as a means of implementing the Commission's recommendation.
14. The Dodd-Frank Act requires the SEC to make rules that are similar to, though worded differently, to these current disclosure requirements relating to compensation consultants.

PART I
Chapter 2

Best Board Practices for Overseeing Executive and Director Remuneration

Often, legislators' and regulators' capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the level of executive and director remuneration. The OECD Principles of Corporate Governance provide a strong framework for guiding policy actions that improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised as i) measures to improve internal firm governance (and, in particular, fostering arms-length negotiation through mandating certain levels of board independence); ii) improved disclosure to shareholders on remuneration outcomes, and better explanation of how incentive based remuneration aligns with company performance; and iii) providing mechanisms to allow shareholders to have a means of expressing their views on director and executive remuneration. Remuneration structures, board practices to be implemented and policy options to provide informed shareholder engagement are also discussed in this chapter.

2.1. Introduction

The financial crisis highlighted that the ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice and remains one of the central elements of the corporate governance debate in a number of jurisdictions (OECD, 2010). The nature of that challenge goes beyond looking merely at the quantum of executive and director remuneration (which is often the focus of the public and political debate), and instead focussing on how remuneration and incentive arrangements are aligned with the longer term interests of the company.

The OECD Principles recommend that responsibility for aligning executive interests with the company lies with the board. The core principle in this area is Principle VI.D.4 which recommends that the board should fulfil certain key functions including “aligning key executive and board remuneration with the longer term interests of the company and its shareholders”. A number of other principles are also highly relevant (VI.E.1, V.A.4, and II.C.3), covering board processes, transparency and shareholder input respectively.

2.2 Legal and regulatory frameworks

As a general rule, legislators and regulators capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the **level** of executive or director remuneration. Firm specific factors tend to mitigate against caps or salary controls, and this is more so, the more international or competitive is the market for executive talent. To the extent that skills are transferable across sectors, industry specific caps or controls will create distortions in the market, as will national controls. Regulatory arbitrage may also limit the effectiveness of any caps or controls, with firms and executives having significant incentive to adopt innovative remuneration arrangements to circumvent any hard constraints.

Policy makers have rightly focused more on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised as i) measures to improve internal firm governance (and, in particular, fostering arms-length negotiation through mandating certain levels of independence); ii) improved disclosure to shareholders on remuneration outcomes, and better explanation of how incentive based remuneration aligns with company performance; and iii) providing mechanisms to allow shareholders to have a means of expressing their views on director and executive remuneration. The Principles provide a strong framework for guiding policy actions across all these areas.

Soft law measures, either voluntary or operating on a comply or explain basis, tend to go further in providing guidance on the structure of remuneration systems and the alignment of corporate and director/executive interests. Codes are often a more appropriate mechanism for more normative controls on remuneration and guidance on remuneration structure; they are generally more flexible to individual firm characteristics and can adapt to changing market circumstances.

2.3. Remuneration structures and the alignment to longer term company interests

Across jurisdictions, a common view is that the misalignment between director and executive incentive structures on the one hand, and longer term shareholder interests on the other has been most acute in the financial sector, and is less problematic in the general listed sector. Where it is identified as an issue, it is often related to social justice concerns (in particular, notions of relative pay) and perceptions of payment for failure. An overwhelming majority of countries describe their executive labour markets as largely internal to their country, and where they do so, executive and director remuneration is often considered to be less problematic (outside of the financial sector).

A common perception is that remuneration structures and levels in firms with a controlling shareholder, and in jurisdictions where controlling shareholders are more prevalent, are less aggressive than in companies and jurisdictions characterised by dispersed share ownership. This is consistent with a managerial power hypothesis, since in controlled firms the owners have strong vested interests in pay outcomes, a stronger bargaining position *vis a vis* executives when compared with companies with dispersed ownership, and potentially more equal understanding of the drivers of company performance. For jurisdictions characterised by blockholder ownership structures, the problems do not revolve around excessive remuneration but in having effective mechanisms and structures in place to ensure that executive incentives are tied to the longer term interests of the company as a whole. Dominant shareholders have the capacity to use non-monetary rewards to tie executives and directors into the company's longer-term interests, but this can have the effect of aligning the executives' interests to those of the majority shareholder. For controlled companies, boards are often dominated by members aligned to controlling shareholders and lack that capacity to exercise independent oversight of the remuneration setting process. Similarly, shareholder approval of remuneration can be a formality in the presence of controlling shareholders.

There are inherent problems with many performance-based pay instruments as a means of aligning managers with the longer-term interests of shareholders. Instruments such as options have an asymmetrical risk profile and can lead to excessive risk taking. While share-based payments are often cited as a preferred means of aligning executive and shareholder interests, the incentives these create vary significantly depending on factors such as the vesting periods and prices. For instance, where share based remuneration forms a significant part of total remuneration, it could lead to overly risk-averse management. These problems highlight the need for boards to take an active role in designing remuneration structures that are matched to the specific circumstances (risk appetite and strategies) of the company rather than relying on more generic industry practices, and to regularly review the incentives and risks the structures create. Measurement difficulties can cause managers to focus on the measured aspects and to the extent that these differ from the longer term interests of the company, there will be a divergence from shareholder interests. More complicated remuneration schemes will tend to introduce greater measurement risks.

2.4. Board practices and the challenge for firms

The key challenge for boards is to understand how risk flows through the structure of remuneration and, as importantly, the remuneration metrics. This is not an easy process, since both the choice of remuneration components and the performance hurdles that

attach will not have purely linear relationships to either risk or company performance. This is exacerbated by the fact that there will be a certain degree of information asymmetry between the Board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics. Taken together, this underlines the importance of boards treating remuneration and risk alignment as an iterative process.

In terms of process, this suggests a number of steps that boards could take to improve remuneration arrangements:

- A key requirement (and, based on the country reviews, one which seems far from well implemented) is for a better integration between risk management and compensation/incentive setting. It is important for boards to first set the strategic goals of the company and its associated risk appetite. One positive step that could be taken in this regard is greater use of risk committees together with cross membership of risk/audit committees and remuneration committees.
- Boards could adopt formal processes for mapping risk tolerance with the incentive structures. In particular, boards and compensation committees could make better use of scenario testing or modelling to check the compensation outcomes do relate to risk outcomes. This will particularly assist with choosing between various incentive instruments and their terms. Remuneration cannot just be set as a function of the risk policy; incentive arrangements create dynamic risks and it is important to ensure that control systems are in place to adequately monitor these risks.
- Boards could seek to extend the duration of performance targets and factor in greater *ex-post* flexibility (including clawback arrangements) to provide better longer-term focus in the remuneration setting process. Legal and code developments in many jurisdictions are already moving strongly in this direction.

A key safeguard that boards can implement is to establish explicit governance processes for setting remuneration, where the roles and responsibilities of those involved are clearly defined and separated, and with remuneration outcomes decided through a transparent and robust process. In terms of implementation, the key Principles relate to the twin general duties of directors to act in good faith and loyalty toward the company (Principle VI.A), and to exercise independent judgement (Principle VI.E), including giving consideration to assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks, such as the remuneration setting process, where there is a potential for conflict of interest. In those countries where there are dominant or controlling shareholders, the requirement of directors to treat all shareholders fairly (Principle VI.B) is also highly relevant, particularly in cases where the dominant shareholder exercises significant influence over the remuneration setting process. Finally, perhaps reflecting wider societal concerns about executive and director remuneration, there has been a tendency for practitioners (and policy makers) to also look at the impact of remuneration outcomes on other stakeholders (consistent with Principle VI.C), including firm level employees.

There are many facets to the Board's role and their relationship with other organs and stakeholders of the Company, and clearly the appropriate role for the board in the governance of remuneration will depend largely on the institutional and regulatory arrangements that exist in any given jurisdiction. For instance, in some jurisdictions, the General Meeting assumes direct control of the remuneration setting process, and the role of the Board is limited to implementing the shareholders' policies. While such an approach

limits the capacity to fulfil the function anticipated by Principles VI.D.4, in substance it could provide a mechanism to produce substantively similar outcomes (namely, alignment of executives/directors and shareholder interests). Nevertheless, in practice, shareholder approval suffers from some real constraints. In companies with controlling shareholders, shareholder approval entrenches the role of dominant shareholders in the remuneration setting process and so does not provide a safeguard against the key risk – namely that remuneration will be aligned with the interests of the block-holder rather than the company as a whole. In companies with dispersed ownership, low levels of shareholder engagement limit the effectiveness of a shareholder approval process as a check on the extent to which boards are adequately fulfilling their functions.

2.5. Policy options in remuneration – Improved shareholder engagement and remuneration disclosure

Active shareholder engagement can provide a strong monitoring function on the role of boards in the remuneration process. The legal frameworks across countries vary greatly in the extent to which shareholders have a voice in setting/influencing director and executive remuneration, from placing the matter entirely in the hands of the general meeting, to giving shareholders no formal role. The Principles recommend that shareholders should be able to make their views known on remuneration policy (Principle II.C.3) and increasingly good practice is for remuneration policies and implementation measures to be subject to binding or non-binding shareholder votes. Mandatory voting arrangements are more prevalent in countries with controlling shareholders, with non-binding votes (or no voting) the norm in countries with dispersed shareholding patterns.

The experiences of OECD countries suggest that the effectiveness of “say on pay” provisions is fundamentally linked to having active and informed shareholders with a sufficient capacity to influence management. Policy makers need to identify innovative mechanisms for providing institutional shareholders with better incentives, and cost effective means, for exercising their shareholder rights. Policy measures adopted to date have included introducing codes of behaviour for institutional shareholders to exercise their voting rights with diligence and reducing the costs of shareholder participation by more effective proxy access.

The quality and timeliness of disclosure around incentive and remuneration arrangements is also critical to informed shareholder engagement, and providing a level of assurance to minority shareholders that remuneration is structured to align executive and director incentives with the interests of the company as a whole. Accordingly, a key policy focus for many jurisdictions has been (and should continue to be) to improve the disclosure requirements to support pre-existing “say on pay” arrangements. These measures are focused on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes and their relationship to firm performance. In other jurisdictions, Code-makers have introduced amendments designed to encourage more description of how incentive arrangements align manager/director interests with those of the company and shareholders.

The arguments against greater disclosure of executive and/or director pay (and particularly, at the individual level) have, in OECD countries, revolve around concerns that it can lead to an upward pay spiral. While there is little hard evidence to support such concerns, given the sensitivity of the issue in many jurisdictions, the use of soft law may provide an avenue for encouraging higher levels of disclosure.

PART II

In-depth Country Reviews of Board Practices: Managing Incentives and Risks in Five OECD Countries

The following chapters provide detailed analysis of each of the five focus countries in the peer review: Brazil; Japan; Portugal; Sweden and the United Kingdom. The reviews are based on detailed questionnaire responses provided by the reviewed countries, together with independent research by the Secretariat including missions to selected reviewed countries.

For each country review, the document first describes the overall corporate governance framework, the legal and regulatory basis and the market context for the review before considering the operation of boards and the role of shareholders. Within these areas, the discussion is based on the individual principles relevant to the review. The chapters are intended to be descriptive and not normative in character. The second section for each country review is devoted to conclusions and includes comments about the reviewed country.

PART II
Chapter 3

Brazil: Review of Board Practices for Managing Incentives and Risks

This chapter on Brazil is based on detailed responses to a questionnaire provided by Brazil, together with independent research by the Secretariat including missions to Brazil. The chapter describes:

- *the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives;*
- *the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders; and*
- *how boards influence incentives and what role is played by transparency and by shareholders.*

Within these areas, the discussion is based on the individual principles relevant to the review. The chapter is intended to be descriptive and not normative in character. The second part of the chapter is devoted to conclusions about Brazil.

3.1. Detailed analysis

3.1.1. Corporate governance landscape

The development of Brazil's listed company sector began in the 1970s and 1980s when the Government offered tax and other incentives to companies to publicly list and to investors who subscribed to shares in listed companies. By the end of the 1980s there were almost 600 listed firms. However, for the majority of these firms, listing was not sought as a means of accessing private capital markets, but as a means of harvesting the government incentives to list. According to one recent study (Black *et al*, 2009) this had two negative consequences: i) there were a large number of companies that really had no need or intention to be listed; and ii) listed firms issued large amounts of non-voting preferred stock as a means of retaining concentrated levels of control¹.

While the listing incentives ceased in the 1980s, ownership concentration has persisted in all but a small number of firms. The majority of firms that listed throughout the 1990s were privatisations that did very little to change the capital market's structural features just described. The main priority of the privatisation process was to maximize government revenues, and this was accomplished by selling the government's ownership blocks to large, private controlling groups, rather than promoting dispersed ownership (da Silveira and Saito, 2009). As noted in Brazil's questionnaire response "until recently, almost all Brazilian public companies were controlled by one shareholder, or by group of shareholders, who held the majority of the company voting shares. Many companies were controlled by the members of the families who had founded them. In this context, a few shareholders had a strong influence over the management of the company and usually occupied the most important positions at the company's boards".

This situation began to change in the early half of the 2000s, in part precipitated by changes in the structure of the stock market, the BM&F BOVESPA². In 2001, BM&F BOVESPA launched three new listing segments, Level 1, Level 2 and Novo Mercado, with progressively stronger governance requirements. The Novo Mercado's main requirement was that companies only issued voting shares. This was difficult for existing listed firms with large preference shareholdings, and so the Level 1 and 2 categories were created with the intention of serving as "stepping stones" to facilitate gradual adaptation by companies when direct migration to the top level was not considered feasible³. With increased investor confidence, since the early 2000s, there has been an increase in the number of companies listing on the market⁴. Since firms newly listed on the Novo Mercado can only issue voting shares, this has also caused an increase in the number firms without a dominant shareholder. However, because the market has been structured to facilitate gradual reform, it is still true that a large majority of listed firms are controlled by a single shareholder, foreign firms or via pyramidal structures involving corporate groups. In a study completed by KPMG in 2009 cited by the CVM questionnaire response, a survey of 201 listed firms (comprising 85% of the Brazilian market capitalisation), found over 70% of the

firms had either family or shared ownership control. Less than 10% of firms had dispersed ownership, with the remainder either foreign or state-controlled.

3.1.2. Legal and regulatory frameworks

The *Corporations Law* dates to the mid-1970s but substantial amendments were enacted in 2001, at a similar time to the revisions to the BM&F BOVESPA market classifications, and with similar intentions of improving protection for minority shareholders. In particular, the legislation prescribed amendments to takeover and change of control provisions; greater minority voice in the election and removal of directors; a reduced capacity of companies to use preferred, non-voting shares and the capacity for companies to include alternative dispute resolution procedures in their by-laws to resolve conflicts between controlling and minority shareholders, avoiding the need for official judicial processes⁵.

In terms of setting remuneration and incentives systems the *Corporations Law* provides a general framework for shareholder approval of remuneration: Under the law, the general meeting prescribes either aggregate or individual remuneration (Article 152), upon a proposal by the Board of Directors⁶. Apart from mandating shareholder approval, the law also sets out some normative parameters with which remuneration proposals need to conform. In particular, proposals should be based on the responsibilities of the officer; his/her dedication, competence, professional reputation; and the market value of his/her services. However, the proposal submitted to shareholders can, at the discretion of the board, present either the total envelope of expenditure on director remuneration, including benefits and representation fees, or a detailed remuneration plan of each director. Where shareholders approve the global level of remuneration, it is the responsibility of the Board to then ensure that individual contracts conform to the normative requirements of the legislation.

The approval process relates to both the board of directors and the executive board (refer below) the composition of which is established by the Articles of Association. Beyond these bodies, there are no rules specified in Brazilian laws and regulations regarding the remuneration of the companies' other employees. In terms of the law, one could say that the requirements facilitate shareholders being "able to make their views known on the remuneration policy for board members and key executives" as proposed by Principle II.C.3). However, until this year, there was little in the way of disclosure required (although note the new regulations below) or offered by companies on director and executive remuneration. Coupled with the practice of offering shareholders a vote only on the global compensation envelope, this has meant that in practice, (non-controlling) shareholders have until this year had little practical involvement in the remuneration setting process through the general meeting.

3.1.2.1. Directors duties

The *Corporations Law* provides a comprehensive framework setting out directors' and officers' duties to act in the best interests of the company. These duties correspond to those enunciated in Principle VI.B, and includes exercising both a duty of care and a duty of loyalty in favour of the company, to a standard that a reasonable person in a like position would exercise. As part of their duty of care, directors should be professionally qualified for the position; inquire of any information that may be relevant to support a decision; monitor the activities of the company; and manage the company with the same prudence

and skill that a reasonable person in a like position would exercise under similar circumstances. Their duty of loyalty prevents them from using privileged information about the company to their own benefit, insider trading, disclosing sensitive information, or intervening in transactions if they have a conflict of interest. Enforcement of directors' duties by the CVM relies on a "business judgement rule". This rule specifies that CVM will not review the business decisions of directors who acted i) on an informed basis, ii) in good faith, iii) with no self-interest, and iv) in a manner the directors reasonably believe to be in the best interests of the corporation. In effect, this rule creates a presumption in favour of directors, freeing them from possible liability unless it is proved that they have violated their duty of care.

Enforcement of directors' duties can be undertaken by CVM as an administrative action, by the corporation or by any shareholder via derivative action (both actions are subject to prior approval at the shareholders' general meeting). If the lawsuit is not approved at the general meeting, shareholders in their own name can sue the company's directors (subject to a 5% threshold). Actions are backed by strong powers of discovery. Uniquely to Brazil, controlling shareholders also owe fiduciary duties similar to the duties owed by directors. Because of this, when actions are taken by shareholders, it is more common that they target the controlling shareholders directly for the breach of their duties, rather than targeting the directors (appointed by the controlling shareholders).

While directors' duties are well specified, the operation of shareholder agreements may in some cases act to mitigate their effectiveness in practice. As noted above there are a large number of listed companies which have a controlling shareholder, and a significant subset of these are subjected to "shared control" among several shareholders. This shared control can in certain cases be facilitated via formal shareholder agreements which mediate the relationship among the shared controllers, including ensuring cohesive voting for directors. A shareholder agreement, if filed with the company, must be made publicly available and is binding on the company. Votes at a shareholder meeting by members of the control group, which violate the agreement, will not be counted. Agreements which are not registered with the company are treated as private agreements at law, and so enforceable between the parties to the agreement, but not against the corporation or its directors.

Nevertheless, directors who are elected under a filed agreement are capable of voting against the terms of the agreement in cases where they consider the agreement in conflict with directors' judgment on what is best for the firm or best for non-controlling shareholders. CVM advises that in cases where this kind of conflict has arisen, their administrative action has been very clear: the vote of directors should be driven by the duty of care and the duty of loyalty to the company and to all shareholders. This would suggest that, even in the presence of shareholder agreements, the legal framework supports the operation of director's duties consistent with Principle VI.B, which advocates that "where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly"⁷.)

3.1.2.2. Disclosure requirements

The CVM has recently issued a new instruction (Instruction 480), which establishes detailed disclosure requirements for the remuneration of office holders (principally, directors and executive officers) of listed companies. This new regulation became effective on January 1st, 2010⁸, but existing public companies have had until 30 June 2010 to comply,

so as yet there has been little time to assess disclosure by listed corporations under the regulation. However, anecdotal evidence from the CVM suggests that it will take listed companies some time to come to terms with their new obligations.

In summary, the Instruction requires a full description of the remuneration policy for the board of directors, executive board, fiscal council (refer further below) and main internal committees of listed companies, including the objectives, composition and rationale of the policy. This rationale must include a description of “how the compensation policy or practice aligns with the company’s short, medium, and long-term interests”. For each type of remuneration, the new rules require disclosures to be broken down into their fixed and variable portions, including detailed information on bonus arrangements, stock options plans and other share-based plans.

Most controversially, the rules require disclosure of the total compensation of the highest and lowest paid members of the executive board, board of directors and fiscal council, plus the average pay for each body. Some market participants suggested that the rationale for the disclosure of averages and upper and lower bounds was the perception that directors may have been paid differential amounts based on their affiliation to controlling shareholders. In particular, some suggested that controlling shareholders may have provided higher levels of remuneration to associates placed on the board than to more independent directors. The CVM had initially proposed that the individual remuneration of each director and executive board member be disclosed, but this was strongly opposed by many listed companies (principally on the basis that it potentially jeopardised the security of office holders). In any case, the final requirement for disclosure of the upper and lower extremes, and the average, has still been opposed by some listed firms. To the extent that it is successfully implemented, the current rules should be sufficient to identify examples of differential payment.

Another important requirement of the regulations is the obligation to disclose payments or remuneration plans made by related corporations or shareholders. This was also included as a requirement in Portugal’s recent amendments to its disclosure requirements and reflects a concern to ensure that any payments made by controlling shareholders, in particular, are adequately disclosed. The authorities did not consider that this was a particular concern at this stage in Brazil although it did note that a common practice of foreign controlled firms may be for executives to be party to stock option plans in overseas parent entities.

The new disclosure arrangements are comprehensive and, as such, are fundamentally aligned with the recommendations of Principle V.A.4 that disclosure should include material information on remuneration policy for board members and key executives. Prior to the new instruction, there was criticism that the pre-existing disclosure rules did not facilitate informed debate and voting from shareholders on remuneration and incentive issues. As noted in the CVM questionnaire response, there was little information available on compensation policies adopted by Brazilian listed companies. Until the end of last year, these companies were required to disclose and submit to shareholders approval only the total value of expenditure on remuneration of all directors and executive managers, their profit sharing and some information on stock options in the financial statements. It is reasonable to assume that such scant information compromised the correct evaluation of the remuneration system and may have prevented the identification of issues concerning the compensation policy.

The increased disclosure arrangements have not been matched by any changes to the shareholder approval arrangements. That is, it would still be open to companies to offer a

single total value of compensation for approval at the shareholder meetings. However, even where companies follow such a path, the new disclosure arrangements will allow a vote on such a global figure to be made on an informed basis. (Prior to the general meeting the company will be required to disclose to shareholders the remuneration policy, the amount of remuneration and the amount of remuneration paid for the last three years, at the same level of detail required in the Instruction). This should over time mean a more meaningful implementation of Principle II.C.3. For its part, CVM expects that disclosure of such data will provide better conditions to evaluate the compensation system used in the Brazilian market.

3.1.2.3. Codes and listing rules

As noted above, the BM&F BOVESPA has segmented the market into different categories, with progressively higher governance requirements. These are regular listings, Level 1, Level 2 and Novo Mercado. At the highest level, the Novo Mercado rules required that: share capital must be comprised solely of ordinary voting stock; there must be a minimum free float of 25%; imposed more demanding accounting disclosure requirements (IFRS or US GAAP)⁹; mandated a number of rules to balance rights among controlling and minority stockholders; and provided some more stringent rules on the composition of the board of directors. There are currently approximately 100 companies listed on the Novo Mercado. Level 2 listing has similar requirements, apart from the fact that it allows the issue of preference shares. Level 1 listings have some more demanding disclosure requirements than regular listings.

In addition, to the listing rules, the Brazilian Institute of Corporate Governance has issued a *Code of Best Practice of Corporate Governance*. The Code was first published in 1999, and its fourth edition was released in 2009. The Code serves as a primary reference for corporate governance practices but it is voluntary in nature, and listed firms are not required to disclose their degree of compliance. The Brazilian CVM states that “nevertheless, many companies have decided to adhere to its recommendations – or some of them”.

The Code has specific provisions relating to the compensation of both directors and management (specifically, executive officers according to the text of the Code). For directors it emphasizes that compensation should be established by a formal and transparent procedure, which should be proposed by the Board and submitted to the general meeting for approval. It goes further than the law in recommending that both the amount of, and the policy for, remuneration setting should be approved by the General Meeting. In terms of structure, the Code recommends that the incentive pay structures for the board should be different to the executive management, given the distinctive nature of the two bodies of the organization. For the board, short term results based compensation should be avoided. For management, the Code provides a greater level of detail as to the structure and value of remuneration and the governance procedures that attach to the system. With respect to the former, there is an emphasis on aligning the incentives with the interests of the company *and* the owners, and to promote the longer term creation of value. Total compensation should be linked to results with short and longer term goals. For both the board and management, the Code recommends individual disclosure, and where this is not adopted such a decision should be justified in a comprehensive and transparent manner. Procedures for setting remuneration and incentives should be transparent, with oversight and control of decision making separated.

Box 3.1. Core Remuneration Guidelines - Brazilian Code of Best Practice of Corporate Governance

2.24 Compensation (Directors)

Directors should be adequately compensated, considering market rates, skills, value to the organization and activity risks. The Board's incentive structures should be different from those people hired for management, given the distinctive nature of these two bodies. Short term results-based compensation should be avoided.

Organisations should have a formal and transparent procedure to approve their Directors' compensation and benefit policies, including any long-term incentives paid in shares or share-based. Director access to compensation in shares should be allowed only subsequently to the term set for managers. Compensation amounts and policy should be proposed by the Board and submitted to the General Meeting for approval. The incentive structure should include a system of checks and balances to indicate the action limits of those involved, to prevent the same person controlling the decision-making process and its respective supervision.

Director compensation should be disclosed individually, or at least as a separate group from management. If there is not individual disclosure, the organization must justify its choice in a broad, comprehensive and transparent manner. The targets and metrics of variable compensation should be measurable, and can be audited and published.

3.9 Compensation (Management)

Management compensation should be structured in a way that links it to results, with short and long term goals, clearly and objectively associated to the creation of economic value for the organisation. The goal is for compensation to be an effective tool to align the interests of the officers with those of the organization.

Organizations should have a formal and transparent procedure in place to approve the compensation and benefit policy, including share and share based policies. Consideration should be given to the costs and risks involved in these programmes and a potential dilution of the shareholders' holdings in the company. Executive compensation payments and policy should be submitted to the general meeting for approval. The incentive structure should include a system of checks and balances to indicate the action limits of those involved, to prevent the same person controlling the decision-making process and its respective supervision.

Disclosure should be at the individual level and, if not, should be justified in an extensive, complete and transparent manner. The targets and metrics of variable compensation should be measurable, and can be audited and published.

3.1.3. Market environment and norms

The characteristics of the market for directors and executives in Brazil must be considered within the context of the extent to which controlling shareholders dominate. Amongst those firms, the perception of market participants was that executive remuneration tended to be lower than in the more widely dispersed firms. Controlling shareholders provide a strong monitoring function, and the relative bargaining position between owners and managers is less in favour of managers than is perhaps the case in firms with dispersed ownership. Conversely, for the listed companies that have highly dispersed share ownership, and with professional managers who are not linked to controlling investors, there is an increasing importance placed on director and executive

remuneration systems, and the governance structures surrounding them, as a means of aligning management and board interests with those of shareholders.

At the board level, the use of incentives (either short or long term) is not a common practice. Typical Board members' compensation is composed of fixed cash compensation only, in the form of monthly retainers (or base pay). Board meeting fees and committee retainers are also not common, neither benefits nor perquisites. According to a local market survey with 25 leading companies conducted by Towers Watson (a human resources consulting company) in 2009: only three companies paid meeting fees; three companies paid committee cash retainers; two companies provided stock/share compensation, and one company provided short term incentives (bonus).

Apart from being focused on fixed fees, the value of board member compensation is relatively moderate. Data obtained from the same (Towers Watson) survey is provided in Table 3.1 (below) showing annual remuneration for each of the different categories of Board members.

Table 3.1. Board - market median remuneration levels

Board Roles	Base Pay	Total Remuneration
Chairman (all cases)	BRL 270 000	BRL 270 000
Chairman (also substantial shareholder)	BRL 576 000	BRL 654 000
Chairman (independent)	BRL 240 000	BRL 240 000
Director (all cases)	BRL 144 000	BRL 156 000
Director (also substantial shareholder)	BRL 102 000	BRL 102 000
Director (appointed by controlling shareholder)	BRL 135.600	BRL 156 000
Director (independent)	BRL 156 000	BRL 180 000

Shown in Brazilian Reais: 1 Reais equals USD 0.56 in PPP terms

Source : Towers Watson 2009 survey.

Executive compensation practices tend to be driven more by market practices. In family controlled firms it is often the case that the controlling shareholder retains the role of Chairman (and nominates a number of associates or family members to the Board) but retains professionals for the CEO and senior management roles. The typical total executive remuneration package at listed companies is composed of base pay, and short and long term incentives. Most listed companies also adopt stock options schemes. A 2008 study by Risk Metrics found that equity-based compensation plans are becoming increasingly popular, and most Brazilian firms now have them. Few Brazilian companies, however, adopt performance criteria for the vesting of options, and most offer options at a discount relative to the stock price on the day of issuance, diminishing the incentive value of such plans.

In setting remuneration levels, companies generally seek to align to the market median, although a few firms (in particular, financial firms) adopt leveraged strategies, in which fixed pay is below market, compensated by more aggressive incentives. Table 3.2 shows that median market remuneration levels for Chief Executive Officers (CEO), is split rather evenly between cash, bonuses and longer term incentives. As company size increases (as expressed in revenue), the relative importance of variable remuneration increases.¹⁰ Middle management compensation strategies are in general similar to executive compensation, with the exception to long term incentive plans. Although large companies may extend these plans to management, normally they are restricted to a part of the population, according to individual performance and potential. At mid sized and small companies, they are not a prevalent practice.

Table 3.2. **Chief Executive Officer (CEO) - market median remuneration levels**

CEO/Comp Size	Base Salary	Bonus	Total Cash	LTI	Total Direct Pay
Up to BRL 4 billion	BRL 1 171 105	BRL 821 314	BRL 1 827 020	BRL 644 449	BRL 2 444 351
BRL 4.1 bi to BRL 15 bi	BRL 1 343 004	BRL 1 198 607	BRL 2 571 459	BRL 1 125 157	BRL 3 558 484
Above BRL 15 billion	BRL 1 455 350	BRL 1 200 953	BRL 2 656 303	BRL 1 306 279	BRL 3 856 281

Shown in Brazilian Reais: 1 Reais equals USD 0.56 in PPP terms

Source: Towers Watson 2009 survey

3.1.4. The role and structure of boards

As noted above, most listed companies in Brazil have a controlling shareholder or group of shareholders with a majority ownership of the business. Where these shareholders are a group, their relationship is usually formalized through a shareholders' agreement which provides for, among other matters, the internal rules regarding the composition of the board. In these companies the Board is mostly composed of inside directors representing the controlling group (or their representatives) and a small number of executives. While there is a general trend toward more dispersed ownership with greater listings on the Novo Mercado, a recent report from RiskMetrics noted that "the shift from a governance paradigm based on highly controlled companies to companies with a dispersed shareholding base has been slow and will likely continue to progress at a slow rate. The adoption of majority independent boards is unlikely anytime soon".

Brazilian listed companies are essentially established under a unitary board structure, but under Brazilian law, there are three defined corporate bodies. Two of them are mandatory: the board of directors and the executive board... The executive board is responsible for conducting the company's daily activities and it is usually composed of senior officers such as the CEO, CFO, COO, Human Resources Officer, Investor Relations Officer etc. The executive board is not a board of directors' committee. There is not any requirement for these executives to also be directors; on the contrary there is a limit that only one third of the board can be composed of executives.

The third body, the Fiscal Council, is optional, unless the company is state owned or its establishment is requested by shareholders who own 10% of voting shares or 5% of non-voting shares. Apart from state owned companies, some Brazilian companies have set up the fiscal council, mainly the companies that have ADRs listed on the NYSE (as a way to substitute the audit committee required by the SEC's rules). The term of the fiscal council's members is one year. The core functions of the fiscal council are established in the *Corporations Law* and include supervising management's compliance with their legal and statutory duties; to give an opinion to the shareholders meeting on the annual report of the management. As such their functions are quite narrowly focussed and do not appear to extent to providing any input or advice on the remuneration of the board or senior management, or the links between remuneration, incentives and performance. In practice, the majority of public companies have neither audit committee nor fiscal council, and in general the use of board committees is not widespread. According to Brazil's questionnaire response, less than 40% of listed companies (in a sample covering 85% of listed companies by market capitalisation) had any board committees (refer Table 3.3). The percentage was highest in companies where the state was a controlling shareholder (60%), and relatively higher in companies with dispersed ownership (47%).

According to data provided by CVM, the average board size is less than eight members (refer Table 3.3) with on average only two independent directors. Outside directors (including the independents) dominate, with market participants stating that it is common for the CEO to be the only executive on the board. In part this is because Brazilian corporate law specifies that a maximum of one-third of board members may be company officers. According to separate data from Manifest, average tenure across board members is a relatively low 5.38 years. In general, Executive Directors last longer than Non-Executives, and Non-Independents last longer than Independents.¹¹

Brazil has no legal requirements for board independence but the Novo Mercado and Level 2 listing rules require the establishment of a two-year unified mandate for the entire Board of Directors, which must have five members at least, of which at least 20% must be independent members. Brazilian boards are still characterized by the lack of independent directors and by the absence of clearly defined roles within the board. Even though “Novo Mercado” and “Nível 2” listed companies must have a board that is at least 20% independent, few companies exceed that minimum requirement by a large margin. Moreover, few firms outside of the BM&F BOVESPA’s differentiated corporate governance listing segments have independent directors on their boards. Board terms typically vary in length between two and three years. As a whole, board structure has evolved only slowly.

The Code notes that the number of independent members depends on the stage of a firm’s development, but nonetheless recommends that a majority of the members be independent¹². It is clear from Table 3.3 that the listing rules have a stronger bearing on board structure than the Code, with the proportion of board members who are independent being much closer to the minimum 20% mandated by the listing rules than the majority suggested by the Code. Interestingly, neither the size of the board nor the number of independent or outside directors is influenced by the ownership structure of firms. The Table also shows that the separation of the role of Chair and CEO is reasonable common practice amongst listed companies. However, as highlighted above, often this is because controlling shareholders install themselves as Chairman and then engage a professional manager as CEO.

**Table 3.3. Board composition
(sample: 201 companies)**

Control ⁽¹⁾	Board members (average)			Companies CEO ≠ Chairman		Companies with board committees	
	Total	Outside	Indep	Quant	%	Quant	%
Family	7,59	6,34	1,97	56	82,35	26	38,24
Foreign	7,71	6,38	2,00	16	69,57	6	26,09
State	7,82	6,51	2,01	15	100,00	9	60,00
Shared	7,67	6,34	1,98	65	85,53	28	36,84
Dispersed	7,72	6,39	2,04	17	89,47	9	47,37

(1) Family: 68 companies; Foreign: 23; State owned: 15; Shared: 76; Dispersed: 19
Source: Towers Watson 2009 survey.

3.1.5. Board practices

The governance model of boards is still evolving, as well as board members responsibilities in the remuneration setting process. This process of evolution will likely continue with the new disclosure requirements (and code recommendations) putting greater pressure on boards to formalize the remuneration and risk alignment process for both directors and executives. Based on current practice, it would be difficult to conclude

that, on the whole, boards are adequately fulfilling their key function of “aligning key executive and board remuneration with the longer term interests of the company and its shareholders” (Principle VI.D.4). A 2006 study (Gorga, 2006) concluded that the considerable overlap between ownership and executive leadership shows that there are few formal structures in the business decision process. As a result, independent/outside directors have more of a consulting and advice role than decision making. “Controllers act as if they own the enterprise, and they expect directors to follow their recommendations....Usually, even when directors seem to be independent, they tend to have personal relationships with the majority shareholder and/or CEO”.

The dominance of major shareholders in decision making processes suggests that the boards are marginal to the process of aligning incentive structures. This does not necessarily mean that shareholder and executive interests are not aligned, and it may be that boards (and Independent directors, in particular) are relying on dominant shareholders to perform the function of aligning company and executive interests. At one level this may be leading to reasonable outcomes; the structure of remuneration and the relatively wide spread use of both bonus payments and long term incentives and share schemes suggest that there is a process by which executive management’s interests are being aligned with [major] shareholders. For instance, according to data from Towers Watson, typical bonus plan design is based on pre-set bonus targets (based on market surveys) that are aligned to a combination of financial and strategic metrics and goals. Performance measures are cascaded in company, unit and individual levels, through a weighted scorecard. Common corporate financial measures include revenues, operating profits (Ebit, Ebitda, etc.) or economic profits. Although not a common practice, a few companies adopt profit sharing schemes, in which the payouts are based on a fixed formula (for example, as a percentage of Ebitda).

However, the risk for minority shareholders is that executive interests are being aligned with the interests of major shareholders exclusively, rather than the company (and shareholders) as a whole. To the extent that the monitoring role is provided by controlling shareholders, it is unclear whether this is making executives unduly captive to these controlling shareholders. While in certain areas controlling shareholders do create governance risks (for instance, with respect to related party transactions), remuneration setting, at least in Brazil, may be one area where the risks are offset by their strong personal motivations to align management interests with their own interests, and their incentives to invest effort into that process. Nonetheless, for non-controlling shareholders it would be preferable if there were mechanisms available to verify that the negotiated outcomes will not give rise to the potential for shareholder interests to diverge and compensation arrangements then being used to reinforce that divergence. Because of this, the strong focus placed on disclosure in the new regulations is a welcome development, since it will help minorities assess such risks.

In turn, this may put greater pressure on boards (and independent board members) to more actively exercise their functions in the compensation and risk alignment process (as envisaged by Principle VI.E.1), which would also help alleviate such risks. In this case, the relative absence of compensation committees and the low level of independent board members makes it difficult to conclude that Brazilian companies have adequately implemented this Principle. While the Code recommends that companies establish a compensation committee composed of a majority of independent directors, in practice, this recommendation is rarely followed. According to data from CVM (Table 3.4) in less

than one quarter of the companies was a compensation committee established. Of those that established a committee, the average size was just under four members and there was on average only one member who was considered to be independent. While committees were more common in companies with dispersed ownership, even there the level of independence was not much greater (1.33 members on average out of an average committee size of 3.56) than for the other company types. This may be partly explained by the fact that representatives of relevant shareholders, such as fund managers, are not considered to be independent.

Table 3.4. **Use of compensation committees**

Control	Companies with compensation committee		Compensation committee members (average)	
	Number	%	Total	Indep
Family	9	13,24	3,71	0,71
Foreign	3	13,04	3,33	1,00
State	3	20,00	4,50	1,00
Shared	20	26,32	3,50	0,94
Dispersed	9	47,37	3,56	1,33
Total	44	21.89	3.81	1.09

Source: Brazil response to OECD peer review questionnaire (2010)

3.1.6. Shareholder engagement

A recent study by RiskMetrics observed that as companies that were previously tightly controlled continue to disperse their ownership structure, Brazilian institutional investors have begun participating more actively in shareholder meetings. As an example, PREVI, Brazil's largest pension fund, adopted a proxy-voting policy (2002) which among other matters outlines the disclosure requirements it considers appropriate to make an informed decision on board and executive remuneration. Other public pension funds have followed suit, and in 2007 the Brazilian Association of Investment Banks (ANBID) required that investment funds to develop a voting policy for annual meetings. As a consequence, shareholder proposals, which were previously rare, are becoming more popular, as evidenced by recent EGMs at Cremer SA and Sadia SA.

The CVM has sought to facilitate increased shareholder participation by simultaneously seeking to reduce the costs of proxy solicitation and encouraging electronic voting platforms. Under regulations introduced in 2010, shareholders representing a minimum of 0.5% of the voting capital can be reimbursed by the company for the (defined) costs of proxy collection. If such a resolution is successful, the costs are reimbursed 100%. To avoid frivolous shareholder proposals, unsuccessful recommendations are only reimbursed at 50%. However, companies can avoid this procedure entirely by establishing an electronic voting platform that enables shareholders to nominate proposals for voting and facilitates online voting for these proposals. This has attracted considerable support in the marketplace and a number of service providers have established platforms available to companies at very little cost.

The electronic voting platforms could also help to address the low level of disclosure of meeting outcomes. Whilst the minutes of meetings must be registered with the Commercial Registry and published, companies are under no obligation to publish the voting results of resolutions at a general meeting. In practice, the disclosure of meeting

results is not high. Similarly, because voting procedures tend to follow a combination of collected proxies and a show of hands, the voting outcomes are rarely if ever collected or published.

Proxy advisory consultants do not have a long history of operation in Brazil, but are becoming increasingly prevalent. In 2009, RiskMetrics covered 230 companies; Glass Lewis, which has had operations in Brazil since 2005, covered 175 companies, but for only approximately 30 clients. The low demand for proxy services was attributed by RiskMetrics to a lack of motivation by professional investors (particularly foreign investors) to participate in shareholder meetings. This was considered to be a function both of the controlled shareholding structures and the lack of sufficient disclosure to inform voting practices.

In relation to remuneration and incentive structures, the lack of disclosure was considered to be particularly problematic to informed shareholder engagement. In 2009, Glass Lewis released voting recommendations on only 3% of management compensation proposals to general meetings, citing the lack of information available to make informed decisions. Similarly, in 2009 RiskMetrics recommended a no vote against the proposals of nine companies among the 13 companies that submitted stock option plans for a vote. The proposals did not inform how many shares were included in the plans, whether they represented excessive ownership dilution, or if they were tied to performance criteria.

The new rules on proxy solicitation have also mandated increases in the timeliness and contents of disclosure. Proxy statements will have to include supporting information for each of the proposals on the agenda. In any case, market practice was already moving in that direction. In large part due to the lobbying by PREVI, which had pushed for publishing proxy statements, many companies had already started offering detailed agenda proposals well in advance of the meeting date.

While there have been tentative steps toward greater shareholder participation, in relation to remuneration this process has not worked well to date. However, the real test for shareholder engagement will commence in 2010; the new transparency rules will effectively mean that Brazilian companies will now submit say-on-pay proposals to their shareholders for the first time.

3.2. Conclusions and comments

The *Corporations' Law* in Brazil provides a general framework for shareholder approval of remuneration, prescribing approval of either aggregate or individual remuneration. The approval process relates to both the board of directors and the executive board. The law also sets out some broad normative parameters: proposals should be based on the responsibilities of the officer; his/her dedication, competence, professional reputation; and the market value of his/her services. In addition, the *Code of Best Practice of Corporate Governance* (a voluntary code developed by the Brazilian Institute of Corporate Governance) has specific provisions relating to the compensation of both directors and management. It goes further than the law in recommending that both the amount of, and the policy for, remuneration setting should be approved by the General Meeting. It also provides guidance on how remuneration should be structured to align management and director incentives with those of the company.

3.2.1. Board structure and duties

The Corporations Law provides a comprehensive framework setting out directors' duties to act in the best interests of the company. These duties correspond to those enunciated in Principle VI.B. Enforcement of directors' duties can be undertaken by the securities market regulator, CVM, as an administrative action, by the corporation or by any shareholder via derivative action. Actions are backed by strong powers of discovery.

Most listed companies in Brazil have a controlling shareholder or group of shareholders with a majority ownership of the business. Brazilian boards are still characterized by the lack of independent directors and by the absence of clearly defined roles within the board. Brazil has no legal requirements for board independence, but the listing rules for the highest market segments require at least 20% independent members. Few firms outside of these listing segments have independent directors on their boards. As a whole, board composition is evolving slowly and it is an open question whether boards are structured to facilitate objective independent judgment on matters such as remuneration (as envisaged by Principle VI.E.1).

3.2.2. Board practices

Executive remuneration tends to be lower in firms with a controlling shareholder than in the more widely dispersed firms. Controlling shareholders provide a strong monitoring function, and the relative bargaining position between owners and managers appears to be more balanced. Conversely, for listed companies with highly dispersed share ownership, there is an increasing importance placed on director and executive remuneration systems, and the governance structures surrounding them, as a means of aligning management and board interests with those of shareholders.

At the board level, the use of incentives (either short or long term) is not a common practice. For executive management, there is a relatively widespread use of both bonus payments and longer term incentives and share schemes. Based on current practice, it would be difficult to conclude that, on the whole, boards are adequately fulfilling their key function of "aligning key executive and board remuneration with the longer term interests of the company and its shareholders" (Principle VI.D.4). Boards (and independent directors, in particular) tend to rely on dominant shareholders to perform the function of aligning company and executive interests. This may be leading to reasonable outcomes, however, the risk for minority shareholders is that executive interests are being aligned with the interests of major shareholders exclusively, rather than the company (and shareholders) as a whole.

3.2.3. Disclosure

The CVM has recently issued two new instructions (Instruction 480 and 481), which establish detailed disclosure requirements for the remuneration of office holders (principally, directors and executive officers) of listed companies. These new regulations apply from July 2010, so as yet there has been little disclosure by listed corporations under the regulation. The Instructions require a full description of the remuneration policy for the board of directors, executive board, fiscal council and main internal committees of listed companies, including the objectives, composition and rationale of the policy. The new disclosure arrangements are comprehensive and, as such, are fundamentally aligned with the recommendations of Principle V.A.4 that disclosure should include material

information on remuneration policy for board members and key executives. It will take listed companies some time to come to terms with their new obligations, and the regulatory authorities are encouraged to monitor compliance closely with a view to ensuring better quality disclosures than exist to date.

3.2.4. Shareholder engagement

The shareholder approval process, together with the new disclosure requirements will mean that shareholders now have a mandatory framework for approving director and executive pay, consistent with the recommendations of Principle II.C.3. The CVM has also sought to facilitate increased shareholder participation by simultaneously seeking to reduce the costs of proxy solicitation and encouraging electronic voting platforms. These measures provide a sound basis for improving the capacity of shareholders to make their views known on remuneration policies.

In relation to remuneration and incentive structures, the lack of disclosure has in the past hampered informed shareholder engagement. While there have been tentative steps toward greater shareholder participation, in relation to remuneration this process has not worked well to date. However, the real test for shareholder engagement will commence with the new transparency rules which effectively mean that Brazilian companies will now submit say-on-pay proposals to their shareholders for the first time. This could result in a certain rebalancing between the interests of the controlling shareholders and the more dispersed minority shareholders.

Notes

1. The Brazilian law allowed companies to issue up to 2/3 of total issued capital as non-voting preferred shares (now reduced to 50%), meaning that controlling shareholders could have majority voting rights with as little as 17% of the economic interest in the company. With a pyramid structure, control could be secured with significantly less ownership of the economic interests.
2. The changes to the market structure were in turn motivated by research that related the absence of IPOs and the decline in turnover on the BM&F BOVESPA to low levels of investor protection (Black *et al*, 2009).
3. Some large companies with a commanding presence in Brazil's concentrated securities market saw very little upside in the Novo Mercado. Executives and owners of such companies seemed to fear that investors would pressure them to migrate to Novo Mercado, or else punish them for not doing so (Santana *et al*, 2006).
4. By the end of March 2009, BM&F BOVESPA had 432 listed firms, of which 99 were listed at the Novo Mercado (da Silveira and Saito, 2009).
5. If the alternative dispute resolution procedures are included within the by-laws, they are enforceable against controlling shareholders.
6. While approval of individual remuneration is possible in theory, in practice the shareholder approval is almost always in relation to the aggregate amount.
7. The annotations go on to note that this principle is particularly important to establish in the presence of controlling shareholders that de facto may be able to select all board members.
8. The Instruction 480 has created two categories of issuers, which are defined by the type of securities being issued. In Category A, issuers are authorized to publicly issue any form of securities, whereas those in Category B may not publicly distribute shares, Brazilian Depository Receipts (BDRs) nor securities that are convertible into, or grant the right to acquire, shares or depository receipts. Most new disclosure requirements only apply to the issuers in Category A.
9. Now all companies incorporated under the corporations law must use IFRS for individual and consolidated reporting from 2010.

10. The relation between firm size and variable remuneration may also be a proxy for shareholder diversification, since larger firms tend to be more likely to have a dispersed share structure.
11. One possible explanation for this is that the rapid growth in new listings, with the attendant requirements for independent directors, may bias downwards the average tenure for these independent directors.
12. Both the code and the listing rules provide definitions of independence. While the code's definition is principle-based and the listing rules are legally drafted, in substance they provide for the same outcome, and include a level of independence from the controlling shareholder and management.

PART II
Chapter 4

Japan: Review of Board Practices for Managing Incentives and Risks

This chapter on Japan is based on detailed responses to a questionnaire provided by Japan, together with independent research by the Secretariat including missions to Japan. The chapter describes:

- *the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives;*
- *the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders; and*
- *how boards influence incentives and what role is played by transparency and by shareholders.*

Within these areas, the discussion is based on the individual principles relevant to the review. The chapter is intended to be descriptive and not normative in character. The second part of the chapter is devoted to conclusions about Japan.

4.1. Detailed analysis

4.1.1. Corporate governance landscape

It is often claimed that corporate governance arrangements and practices in Japan are closely related to the needs of industrial organisation and strategy (Aoki, 1987). An emphasis on company specific human capital has underpinned “life time employment” including for executives who seldom change companies. Shishido (2009) notes that Japan is not unique in having the providers of human capital organising a team maintaining their autonomy from providers of monetary capital; what makes the “J-model” unique is that the providers of human capital create a long-lived community. In this stakeholder model, the role for shareholders as external monitors has historically been relatively low, with company boards mainly staffed by company executives.

Up until the early 1990s, an element of external oversight was provided via the “main bank” system, whereby the key institutional provider of funds exercised a residual monitoring function. The main bank did not seek to overtly interfere in company management, but they expected to be able to exercise significant control rights when operational or financial performance fell below accepted levels (Shishido, 2009). The main bank relationship, and the dominance of the internal management, was reinforced by a series of cross-shareholdings amongst the banks and non-financial companies resulting in large corporate groups (“keiretsu”) that allowed stable and incumbent friendly shareholder relationships to dominate.

The corporate governance landscape underwent incremental, though significant change during the 1990s in part due to the banking crisis. As asset prices collapsed following a bubble in the 1980s, a large number of firms faced financial difficulty. As a result, the main banks themselves started to experience difficulties, both via the accumulation of a large volume of non-performing loans and also through their direct and indirect shareholdings in their customers. While the banks’ initial approach was to avoid dealing with the problem loans, the failure of some financial institutions in the late 1990s (when most still believed the Government would not allow such an event: the convoy system) forced the banks’ hand. As a result, the banks significantly reduced their shareholdings (at its peak, the holdings of tradeable stocks by financial institutions rose to almost 50% of outstanding shares, compared to holdings of around 20% by 2007 (Aoki, 2007) and their important role in corporations’ internal governance began to gradually diminish. At the same time, holdings by foreign institutional investors increased significantly. Not surprisingly, this period also saw the beginning of changes to both the legal/regulatory corporate governance framework and voluntary reforms initiated within companies, often in response to increased investor pressure and desire to achieve a new relationship with investors. As an example of the former, in 1997 the Diet introduced legislative reforms to allow companies to grant stock options. As an example of the latter, several companies introduced an “Executive Officer” system, also from around 1997, which had the effect of decreasing the number of board members (which had traditionally been quite large),

changing the board's role to more of a monitoring function, and simultaneously establishing a *de facto* management board of executive officers.

Since that time, the corporate governance legislative framework has undergone a series of changes. In many respects, the new laws have sought to facilitate changes to governance structures, rather than to mandate them (Dore, 2008). However, they have also facilitated an evolution of company practices with a greater role for shareholders in the "stakeholder model" while not rejecting the fundamental concept: the capacity for external monitoring has increased; the allocation of stock options has been allowed; and derivative shareholder actions have been facilitated.

4.1.2. Legal and regulatory frameworks

Amendments to the Japanese Commercial Law in 2002 (which came into effect in 2003) allowed listed companies to adopt one of two legal forms. The traditional structure, and that adopted by the overwhelming majority (97%) of listed enterprises is known as the "Company with Statutory Auditors" model, which is essentially a unitary board structure. Functional power rests with a single board of directors, who execute and manage the business of the company as well as exercising a supervising/monitoring function with respect themselves and other executives/employees. Where this model is adopted, there is a separate organ of the company known as the "statutory auditors", or *Kansayaku*, whose members are elected by shareholders and owe fiduciary duties like directors. The role of the *Kansayaku* is similar to the role of Fiscal Councils in Portugal and Brazil, in terms of ensuring the legal validity of the actions of the Board of Directors. *Kansayaku*, however, sit with the Board of Directors and can express their opinions, (although they have no vote). They are required to report annually to shareholders; in the absence of any unresolved concerns such reports would normally attest that in their opinion that the board has acted within its authority. Where they consider that the Board has acted or will act outside of their legal authority or the action taken by the Board is illegal they can, if required, take action on behalf of the company.

Separate legislation enacted in 2005 introduced a new requirement for large companies, where a minimum of three *Kansayaku* are required, to have a majority from "outside" the company. For this purpose, "outside" is defined to mean that they cannot be a current or former employee of the company or an employee or executive officer of a subsidiary. *Kansayaku* can be officers/employees of parent or sister companies (i.e. *keiretsu* companies). However, in the case of listed companies, the majority of outside *Kansayaku* are independent from the interested parties and related companies, statistically.

The second corporate form allowed under the 2002 legislation is a newly established form called "Company with Committees". Where this form is adopted, the company must establish three committees (remuneration, audit and nominating committees), with each committee composed of three or more committee members appointed from among the directors. The majority of committee members of each committee are required to be outside directors. The introduction of this model was designed to provide companies with the option of adopting what is perceived as a "US style" of corporate governance, but there has been limited acceptance within the market place of this structure.

The legislative requirements with respect to setting director remuneration differ depending upon the legal form adopted. For a company established with statutory

auditors, the act specifies that the shareholders' meeting has the power to determine the director's remuneration. The shareholders meeting must approve i) the amount of remuneration for a fixed remuneration, ii) the specific method of remuneration for those amounts not fixed, such as incentive based payments, and iii) the specific content or description of non-monetary remuneration. Judicial interpretations of these requirements have confirmed that the shareholders' meeting can be simply asked to decide the total amount of remuneration for all directors, with the board delegated the right to decide the remuneration for individual directors and therefore executives. Once the shareholders meeting has approved the upper limit on fixed pay, the company need only submit a resolution on remuneration as to the fixed payment in subsequent years if the upper limit is going to be increased. As an indication, in 2008 approximately 210 TSE first section companies with a 31 March year end (out of approximately 1,400 companies) submitted a revision proposal relating to directors' remuneration (J-IRIS Research). For a company established with committees, the compensation committee is responsible for determining both the amount of remuneration for each of the individual directors and for establishing the collective and individual remuneration policy for the directors¹.

In general, the *legislative arrangements* could be considered as consistent with the approach advocated by Principle II.C.3 that "shareholders should be able to make their views known on the remuneration policy for the board and key executives". Similarly, because shareholders must approve the mechanisms for share-based payments, the Japanese law is consistent with the recommendation in that Principle that "the equity component of compensation schemes should be subject to shareholder approval.

Apart from the legislative framework, the Tokyo Stock Exchange (TSE) has developed a set of Principles of Corporate Governance for Listed Companies (released in 2004) that is structured around the chapter headings of the 1999 version of the OECD Principles. Listed companies are expected to observe the code, but there is no requirement on listed companies to document their compliance with the code or to explain non-compliance. The TSE Principles do not address the issues regarding remuneration and incentive structures in detail. One Principle does state, however, that a function of the board is to provide "motivation for the management to maximize corporate value through positive convergence of management and company interests by appropriate means"².

4.1.2.1. Disclosure

Principle V.A.4 states that disclosure should include "material information on ... remuneration policy for members of the board and key executives". The annotations make clear that since there is a particular interest in the link between remuneration and company performance, companies should generally disclose sufficient information to assess the costs and benefits of remuneration plans. The *Conclusions* report emphasised the importance of transparency beyond disclosure, noting that firms should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and; how the remuneration is adjusted for related risks.

The level of disclosure, and the rules relating to disclosure, is an evolving issue in Japan. The principal mandatory requirements relating to disclosure are set out in regulations issued under the Companies Act, and provide guidance on the content of business reports issued by the company board and required to be presented to annual shareholders meetings. Under the current law, there are the following basic options for

disclosure of executive remuneration via the business report: a company may disclose i) the total remuneration amounts for a) directors, b) statutory auditors, and c) outside directors and outside statutory auditors, respectively, without disclosing the remuneration of each director and statutory auditor; ii) the remuneration for each director and statutory auditor separately, or iii) combination of i) and ii).

Apart from the Companies Act requirements, regulations under the Financial Instruments and Exchange Act require that matters concerning corporate governance of a listed company must be described in the annual report. The TSE listing rules require the disclosure of information describing stock option plans and introduced performance-linked remuneration systems.

The FSA has, in March 2010, introduced comprehensive disclosure arrangements for director and statutory auditors (Refer Box 4.1). These amendments to Cabinet Office Ordinance on Disclosure of Corporate Affairs now require disclosure of the total amounts of remuneration paid respectively to inside directors, inside statutory auditors, and outside directors/outside statutory auditors, and a breakdown by the type of payments for each

Box 4.1. Recent FSA amendments to remuneration disclosure for directors and statutory auditors

It is considered that the information concerning the remuneration for directors and statutory auditors is important for shareholders and investors as it would allow them to examine whether incentive structures for the management of the company are formed appropriately, remuneration amounts are appropriate in terms of performance, and governance situations are proper and well-balanced. From this viewpoint, we will require listed companies to disclose detailed information regarding the remuneration for directors and statutory auditors in securities reports as follows:

- i) For each of those directors/statutory auditors whose remuneration for the relevant fiscal year is JPY 100 million or more, the total amount of remuneration and his/her name, and a breakdown by the type of payments (e.g., salary, bonus, stock option, and retirement payment);
- ii) (Note) If a director/statutory auditor of a company is also a director/statutory auditor of any of the subsidiaries of the company, the remuneration amount he/she has received from such subsidiaries should be counted in the amount of the remuneration he/she has received from the company.
- iii) The total amounts of remuneration paid respectively to inside directors, inside statutory auditors, and outside directors/outside statutory auditors, and a breakdown by the type of payments for each class; and
- iv) (Note) The total amounts of remuneration paid to directors and that for statutory auditors should be disclosed under the Japanese Company Law.
- v) The explanation of the company's remuneration policies for its directors/statutory auditors, and the way they are decided, if such policies are put in place as of the date of filing the relevant securities report.

(Note) Listed companies should disclose these new items in their securities reports for fiscal years ending on or after March 31, 2010.

Source: Financial Services Agency

class. In addition, companies will have to disclose the remuneration policies and the ways they are determined if such policies are put in place. Finally, companies also have to disclose individual remuneration for directors/statutory auditors earning JPY 100 million or more on a consolidated basis. Taken together, these new regulations will ensure that the regulatory framework provides for a full implementation of Principle V.A.4.

4.1.2.2 Directors duties

The legal framework for establishing directors' duties in Japan is aligned with Principle VI.A that "board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders". Directors owe a duty of due care (as a prudent manager) as their general duty to the company, and consequently to shareholders. The courts have also interpreted that directors owe, as one of their duties, the duty to establish internal control systems which promote the company's corporate governance (on a case-by-case basis according to the size and business area of the company). Under the Companies Act, directors also have a codified duty of loyalty (to the company), to act in compliance with laws and regulations, the articles of incorporation, and resolutions of shareholders meetings³.

There is a strong history of enforcement of director liability for breach of duties, via shareholder derivative actions. These were first allowed in 1950 and amended in 1993, and proved very "successful" to the extent that they gave rise to some very large damages awards against directors. By 2001, some curbs were placed on the liability of directors in response to business sector lobbying. In particular, *ex-ante* limitation of outside director liability (at two times annual salary) could be established by a company amending their by-laws. *Ex-post* limitation of inside director liability (at six times annual salary) could be established subject to a special company resolution. The reform in relation to outside directors has been beneficial to establishing a framework to facilitate independent directors.

While not a part of their strict duties, the corporate model in Japan in practice means that directors take into account the interests of stakeholders, as advocated by Principle VI.C. In particular, there is a strong focus on the interests of employees, with a key objective of the board often being to provide additional employment, and promotions and benefits to their existing employees, subject to earning "reasonable" returns⁴. This system, which is fundamentally related to the model of lifetime employment (refer further below) is a defining characteristic of many Japanese firms and provides a framework for understanding the remuneration and incentive setting processes in listed companies.

4.1.2.3 Recent reforms or proposals

Reflecting the importance of the corporate governance debate in Japan, during 2008 and 2009, there were a number of government-led and private study groups that examined potential corporate governance reform proposals. Those groups to canvas reforms included the Ministry of Economy, Trade, and Industry (METI), the Financial System Council (FSC), the Tokyo Stock Exchange, Nippon Keidanren (a business association), and the Asian Corporate Governance Association. These reports have focused principally on board independence and shareholder issues, such as the use of selective rights issues. It is a common view amongst market participants in Japan that, since the absolute level of remuneration is low and there are few CEOs who receive large amounts of remuneration

compared to high profile examples in other OECD jurisdiction,, executive compensation is not generally considered a hot-button issue requiring considerable policy effort.

The only exception to this is the Financial System Council’s Study Group on the Internationalization of Japanese Financial and Capital Markets”, published in June 2009, which did consider enhancing the disclosure of executive compensation. The report recommended that “listed companies should disclose their existing executive remuneration policies, and also improve disclosures of pay, with a breakdown according to the type of incentives provided to executives, including stock options”. In response to this report, the FSA issued the revised disclosure arrangements discussed above.

4.1.3. Market environment and norms

As noted above, the dominant feature of the market for executives in Japan is the enduring importance of life time employment, with highly developed labour markets within firms and a consequently lower development of external labour markets. As a corollary, there has historically been a high level of job security. A recent study (Jackson, 2007) looking at rates of employment reduction across five countries (France, Germany, Japan, UK and USA) between 1991 and 2005, showed that Japan had consistently the lowest level of redundancies; on average it was less than half of Germany, which also is oriented toward an inclusive stakeholder approach to governance⁵.

This largely internal market for executives has historically used seniority based pay (that is linking pay to age and/or rank) as a means of ordering the market. At the pinnacle of this, directorships have been a means of rewarding and motivating employees, with the consequence that boards became very large in size. Executive remuneration must be looked at through this light; the prospect for lifetime income smoothing means that examining remuneration levels at a particular point in an employee’s career can give a misleading sense of the relative level of remuneration over that career. In Japan’s case, salaries for new permanent employees are low relative to productivity but this is accepted on the condition that by staying with the firm one has a right to higher income later and a large deferral of benefits until retirement. Taken together, this structure could bias risk taking downwards with an emphasis on longer term survival of the company.

Absolute levels of remuneration for executives are quite low in Japan (Table 4.1). The average executive director earns approximately JPY50m (~USD 550 000) with even the highest salary earners only earning JPY300m (~USD 3 300 000). Apart from being a reflection of the life time employment framework, the low levels of executive remuneration also means that executive remuneration has not been a high priority issue for shareholders in Japan.

Table 4.1. **Executive remuneration of 186 firms that revised it in 2008**

		Executive remuneration (JPY)	Remuneration per person (JPY)
Directors	Average	479 167 769	50 736 273
	Low	30 000 000	3 750 000
	High	3 400 000 000	299 000 000

Source: Targets TSE1-listed companies with fiscal years ending in March that revised remuneration at June 2008 general meetings of shareholders (1,368 companies). Prepared by J-IRIS Research. Ueda, R (2009).

In terms of structure of remuneration, the most common form of variable compensation is an annual bonus, although in comparison to fixed remuneration, the

average level of bonus is quite small. According to J-IRIS Research, recent bonuses per director were less than 20% of the total remuneration of directors, although the variation in bonuses paid was quite large (Table 4.2). However, it is important to note that bonuses are payable across the whole labour force and are very flexible to current conditions. To the extent that the most recent data reflect current business conditions, the level of executive bonuses reported in Table 4.2 may significantly understate the level of variable salary paid to executives over the course of the business cycle.

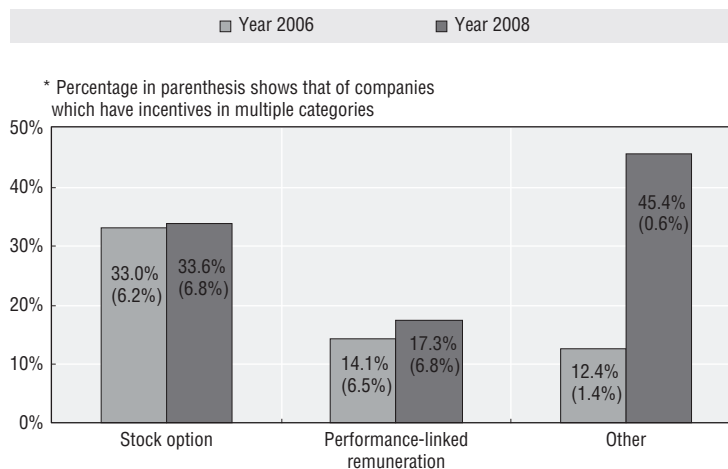
Table 4.2. **Executive bonuses**

	Total executive bonuses (JPY)	Bonuses per director (JPY)
Average	81 539 249	7 801 546
Low	3 000 000	300 000
High	1 077 000 000	58 333 333

Source: Prepared by J-IRIS Research from AMSUS data. Ueda, R (2009).

The use of other forms of remuneration is not particularly significant, and it does not appear that the structure is changing to any great extent. Data from the Tokyo Stock Exchange showed that stock options were used in approximately 33% of companies in 2008 and performance linked remuneration was used in 17% of companies. These figures were little changed from 2006 (Figure 4.1). There was a large change in the reported use of “Other Incentives” by the TSE but this is a statistical anomaly; prior to the most recent revisions to the Commercial Code bonuses weren’t systematically considered to be remuneration, but were rather considered a distribution of profits. Since they are now explicitly stated to be remuneration this has caused a spike in the reported level of benefits.

Figure 4.1. **Implementation of initiatives to offer incentives**



Source: Tokyo Stock Exchange (2009), White Paper on Corporate Governance.

Taxation appears to have some impact on the structuring of executive pay, but generally tax preference is afforded to remuneration methods that would be more likely to incentivise executives/directors to work toward the longer term interests of the company and shareholders. In particular, stock options are only taxed at the point they are

exercised, rather than at the time they are awarded. In addition, retirement bonuses are only taxed on retirement and at a concessional tax rate, which may partially explain the past practice of heavily weighting director remuneration to retirement benefits. However, in the main, it does not appear that the tax system acts to a great degree to distort the preferences of directors/remuneration setters in structuring performance related pay or in deciding the relative split between fixed and variable remuneration components.

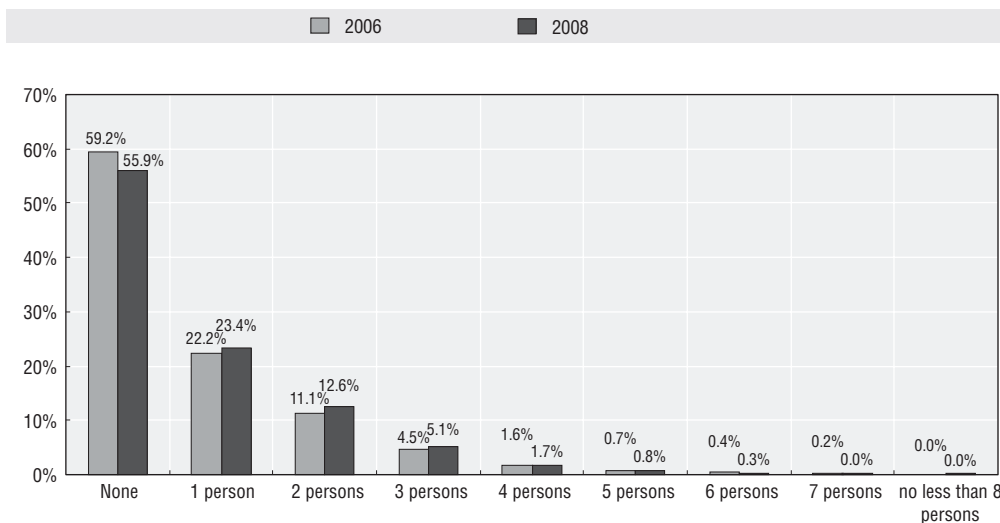
Discussions with market participants drew a distinction between those listed firms that were domestically focussed, where internal markets still dominated, and export oriented or new technology firms that were more likely to operate market based compensation structures. Reinforcing this perception a recent study (Jackson, 2007) using data from the Ministry of Economy, Trade and Industry, concluded that firms with foreign ownership and younger firms were less likely to use seniority based pay. Equally, younger firms were more likely to use pay based on performance. In addition, to the extent that Japanese companies themselves undertake takeovers, there will obviously be some tensions in their capacity to integrate the differing performance and incentive cultures.

4.1.4 Board composition and structure

Japanese Boards have historically (and to a large extent remain) dominated by inside executives. In 80% of listed companies (Tokyo Stock Exchange, 2009), the CEO/President is also Chairman of the Board. In the majority of other cases (19% of listed companies), the role of Chair and CEO/President are split, but with the Chair being another internal, executive director of the company, (in order to satisfy external demands that these roles be separated, while still concentrating executive power in the President). In less than 1% of listed companies is the Chairman independent or outside of the internal management. The common conception of the role of the board is as an executive management body, and inside technical knowledge of the business is considered the key attribute. At present, listed companies have on average less than one independent director and some large companies still have no outside directors (Figure 4.2)⁶. Part of the rationale for this is that companies consider that the statutory auditors including outside statutory auditors, provide sufficient focus on supervising directors. The FSA has recently introduced new requirements for listed companies to describe in their securities report, the functions and roles of any outside directors and outside statutory auditors in the governance of the company. In addition, TSE has recently introduced the new rule where all listed companies shall have one or more independent outside director or independent outside statutory auditor who is unlikely to have conflicts of interest with general shareholders, for the purpose of protecting these shareholders' interest.

Companies in Japan have made considerable efforts to restructure their boards by significantly reducing their size. The average board size for a listed company is now under ten (Tokyo Stock Exchange, 2009) (compared to more than 20 several years ago) and, as noted above, there has been a minor increase in outside directors. In some cases, this has been a function of the implementation of an "executive officer" system, where previous executive board member positions are transferred to a new informal "executive officer" position and a *de facto* new management body is created "under" the board, comprising these executive officers and the remaining executive directors of the board.

Figure 4.2. **Number of outside directors (companies with statutory auditors)**



Source : Tokyo Stock Exchange (2009), White Paper on Corporate Governance.

4.1.5 Board practices

The structure and conception of Boards in Japan as management dominated means that the recommended practice in Principle VI.E.1, (namely that *Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities [include] board remuneration*) is difficult to achieve in practice. With respect to remuneration setting, companies with *Kansayaku* take a different approach to resolve the issue of conflict of interest; i.e., the primary responsibility for setting board remuneration rests with a shareholders' approval, which is legally binding. Therefore, the company can not pay executive compensations without an advance authorization from the shareholders' meeting. It is closer to observed practice under the Company with Committees structure, since the law requires a compensation committee to be dominated by outside directors, although even here the definition of outside director does not guarantee the level of "independent judgement" envisaged by the Principle.

For Companies with Statutory Auditors, the guidance is less likely to be followed; however, these companies take the different approach for the remuneration setting under the Company Act as mentioned above. The responsibility of *Kansayaku* does not extend to considering the incentive effects of remuneration via its structuring, or even the impact on shareholders (for example, excessive dilution via overly generous stock option awards), although they would have a role in monitoring malfeasance with respect to remuneration practices. There have been examples of listed companies in Japan that have adopted progressive approaches in terms of their governance systems by appointing one or more highly independent outside directors and having them cooperate closely with the board of auditors and officers in charge of internal audits and internal control. In their 2009 Study Report, the Financial System Council felt that these evolutionary developments represented a "preferred realistic model that maintains consistency with Japan's legal system". They stated that "this type of governance system can compensate for the authoritative and systemic deficiencies relating to auditors while effectively utilizing the

functions of auditors, and it enables the supervisory function over management to be strengthened". There is also some evidence of companies adopting informal committee structures to provide advisory services to the board.

It is relevant to ask the extent to which a perceived lack of independent oversight represents a significant issue in the Japanese context. The thrust of the Principle is to ensure that there are mechanisms to moderate potential conflicts of interest. For instance, the *Methodology* notes that independent board members "play an important role in areas where the interests of management, the company and its shareholders diverge such as executive remuneration". The lack of non-conflicted directors (i.e. "independent") on boards does not appear to be a particularly pressing problem in setting remuneration in Japan given the nature of the general corporate culture and the low observed rates of executive and director pay. Such a system might also actually reduce risk taking in favour of survivability of the company.

It is also true that in export oriented sectors, Japan has leading-edge manufacturing companies that exhibit very high levels of innovation with high productivity. However, there is also a large group of domestically focused listed companies with lower levels of productivity (OECD, 2002). For these companies, with growth slowing in their main markets, "innovation" has involved excessive company diversification so as to ensure "life time" employment (Porter et al, 2000). For companies in this category, the more dynamic aspect of incentivising managers to pursue the longer term shareholder interests remains an issue and could potentially be aided by more independent director involvement. External directors nominating performance related incentive structures may provide a means of better aligning managers and shareholders. In this regard, Shiseido provides an interesting case example. In 2001, the company (which is organized as a company with statutory auditors) established a remuneration advisory committee, chaired by an independent (cf outside) director. This committee has systematically increased the performance linked compensation of inside directors such that it now comprises 60% of total remuneration and includes bonuses, mid-term and long term (10 year) performance rewards.

4.1.6 Shareholder engagement

The Japanese legislative requirements with respect to shareholder approval of director remuneration are consistent with Principle II.C.3 that advocates that *shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes...should be subject to shareholder approval.* While the rules apply only to directors, the dominance of executives on Japanese boards means that the shareholder votes effectively apply to most senior executives. In addition, the TSE's voluntary Principles of Corporate Governance emphasise the importance of companies developing "an environment in which shareholders exercise voting rights appropriately" and "an environment in which shareholders are inclined to participate in general meetings of shareholders". In practice, the effectiveness of the legislation and the code in achieving meaningful shareholder engagement has, in the past, been partially frustrated by low levels of disclosure by companies as to the composition of remuneration, and the practice of companies obtaining global approval for the total amount of director compensation.

In addition, some practical aspects of the organisation of meetings have frustrated effective shareholder engagement. For instance, it is common practice in Japan that

shareholder meetings are concentrated on just several days. According to J-IRIS Research, in 2009, 50.3% of companies held their AGM on the most concentrated day. However, it should be noted that there is a gradual trend away from this practice; in 2006 over 56% of companies held their meeting on the most concentrated day. Nevertheless, almost 90% of listed companies hold their AGM within the same week. In addition, the average notice period provided by companies for the AGM is just over 18 days (compared to a legal minimum of 14 days). Together, the clustering of meeting dates and the short notice provided by companies of meeting resolutions provides a check on the capacity for shareholders and external (proxy) advisors to adequately monitor AGM resolutions with respect to remuneration, and to vote meaningfully.

In this context, the legislative framework has sought to facilitate greater investor engagement by permitting (since 2001) voting by electronic means, and the Tokyo Stock Exchange has established an electronic voting platform for institutional investors. At this stage, just over 20% of listed forms have established the infrastructure for electronic voting (Tokyo Stock Exchange, 2009). In the past, the disclosure of voting results subsequent to shareholder meetings seems relatively poor (see *Conclusions*). In this respect, recent amendments by the FSA require listed companies to disclose the number of votes cast for, against and withheld for resolutions at the shareholder's meeting for all shareholder meetings held after March 31, 2010.

Apart from the formal voting procedures, Japanese companies appear to have a relatively good record at providing briefings for domestic investors. Table 4.3 details the prevalence with which listed companies provide briefings. These data include individual briefings for particular investors. While the focus of investor briefings seems to be overwhelmingly on reporting of financial results, the TSE noted that there is an increasing prevalence of companies seeking to establish a dialogue with investors. This is not particularly in relation to remuneration and, while this remains a relatively uncontroversial area for institutional investors, it seems unlikely that there will be a great demand for greater dialogue on remuneration and incentive arrangements.

Table 4.3. **Regular seminars for investors
(market section)**

	For individual investors		For foreign investors		For analysts and institutional investors	
		Change from 2006		Change from 2006		Change from 2006
TSE First Section	26.6%	4.3%	76.3%	-0.5%	20.9%	1.2%
TSE Second Section	19.5%	4.8%	43.3%	-2.7%	2.4%	-0.7%
TSE Mothers	47.2%	5.2%	89.7%	-2.2%	9.2%	-2.8%

Source: Tokyo Stock Exchange, (2009), White Paper on Corporate Governance 2009.

A number of institutional investors in Japan have published voting guidelines on executive remuneration proposals, and in general these seem to cover three themes: i) trying to tie remuneration with longer term company performance; ii) paying particular attention to the structure of retirement benefits; and iii) preventing excessive dilution through stock option grants. The Pension Fund Association principles focus on linking remuneration to shareholder returns over a three and five year period. Rather than looking at limits, the voting guidelines for the Pension Fund Association for Local Government Officials focuses specifically on the issue of whether there is sufficient incentive for executives to give due concern to profitability.

According to J-IRIS Research, institutional investors in Japan are subjecting executive remuneration proposals to greater scrutiny and adverse voting. In particular, they cite research showing that there has been an increase in scrutiny of the eligibility of stock option grants and exercise prices that has led to an increase in the level of opposition to remuneration proposals. Not surprisingly, the likelihood of meaningful engagement seems to increase when there are substantial outside owners. J-IRIS found that where remuneration proposals have been either rejected or withdrawn, there was either a foreign shareholder ratio of greater than 30% or there was an extremely high ratio of individual shareholders.

4.2. Conclusions and comments

The corporate governance landscape in Japan has undergone incremental, though significant change, since the early 1990s, with changes in both company practice and significant legislative and regulatory reform. Japan relies predominantly on hard laws to regulate firm governance. The Tokyo Stock Exchange has nevertheless developed a set of broad Principles of Corporate Governance for Listed Companies, with which listed companies are expected to comply. Under Japanese Law listed companies can adopt one of two legal forms. The traditional structure, and that adopted by the overwhelming majority (97%) of listed enterprises is known as the “Company with Statutory Auditors” model, which is essentially a unitary board structure, with a separate group of officers, or “statutory auditors”. The statutory auditors sit with the board and supervise the legal validity of the actions by management, but do not vote. The second form, known as a “Company with Committees”, has a unitary board and three compulsory board committees (remuneration, audit and nominating committees).

The legislative requirements with respect to setting director remuneration differ depending upon the legal form adopted. For a company established with statutory auditors, the act specifies that the shareholders’ meeting has the power to determine the director’s remuneration. For a company established with committees, the compensation committee is responsible for determining both the amount of remuneration for each of the individual directors and for establishing the collective and individual remuneration policy for the directors.

4.2.1. Board structure and duties

Japanese Boards have historically (and to a large extent remain) dominated by inside executives. At present, listed companies have on average less than one independent director and some large companies still have no outside directors. Part of the rationale for this is that companies consider that the statutory auditors, including outside statutory auditors, provide sufficient focus on supervising directors, even though their formal powers relate only to ensuring that actions by the company are legal. Over the last twenty years, companies in Japan have made considerable efforts to restructure their boards by significantly reducing their size and establishing an executive officer system. The average board size for a listed company is now under 10.

The dominance of management executives on boards limits their capacity to assign a sufficient number of non-executive board members to tasks where there is a potential for conflict of interest, such as remuneration (Principle VI.E.1). With respect to remuneration setting, companies with statutory auditors take a different approach to resolve the issue of conflict of interest; i.e., the primary responsibility for setting board remuneration rests with

a shareholder's approval, which is legally binding. Therefore, the company cannot pay executive compensations without advance authorization from its shareholder's meeting. Under the Company with Committees structure, the law requires a compensation committee to be dominated by outside directors, which is fully consistent with the intent of the Principles.

There have been examples of listed companies in Japan that have adopted progressive approaches in terms of their governance systems by appointing one or more highly independent outside directors and having them cooperate closely with the board of auditors and officers in charge of internal audits and internal control. The more dynamic aspect of better incentivising managers to pursue not just the interests of insiders but also those of other constituencies (especially shareholders) could be aided by more independent director oversight.

The legal framework for establishing directors' duties in Japan is aligned with Principle VI.A that "board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. Directors owe a duty of due care (as a prudent manager) as their general duty to the company, and consequently to shareholders. There is a strong history of enforcement of director liability for breach of duties, via shareholder derivative actions.

4.2.2. Board practices

The dominant feature of the market for executives in Japan is the enduring importance of life time employment, with highly developed labour markets within firms (and their company groups) and a consequently lower development of external labour markets. Absolute levels of remuneration for executives and directors are moderate and remuneration structures are not widely considered to be a high priority issue for shareholders in Japan. In terms of structure of remuneration, the most common form of variable compensation is an annual bonus. Bonuses are payable across the whole labour force and are very flexible to current conditions. The use of other forms of remuneration is not particularly significant, and it does not appear that the structure is changing to any great extent.

The structure and level of remuneration would suggest that boards have not relied heavily on remuneration as a means of aligning executive and board members' interests with the longer term interests of the company and its shareholders (as recommended by Principle VI.D.4). Instead boards can rely on synthetic elements of corporate structures such as long term employee allegiance to substitute for these more formal elements.

4.2.3. Disclosure

The FSA has, in March 2010, introduced comprehensive disclosure arrangements for director and statutory auditors. These amendments to the Cabinet Office Ordinance on Disclosure of Corporate Affairs now require disclosure of the total amounts of remuneration paid respectively to inside directors, inside statutory auditors, and outside directors/outside statutory auditors, and a breakdown by the type of payments for each class. In addition, companies will have to disclose the remuneration policies and the ways they are decided if such policies are put in place. Companies also have to disclose individual remuneration for directors/statutory auditors earning JPY 100 million or more on a consolidated basis. Taken together, these new regulations will ensure that the regulatory framework provides for a full implementation of Principle V.A.4.

4.2.4. Shareholder engagement

The legislative requirements for shareholder approval of remuneration are consistent with the recommendation of Principle II.C.3 that “shareholders should be able to make their views known on the remuneration policy for the board and key executives”. Similarly, because shareholders must approve the mechanisms for share-based payments, the Japanese law is consistent with the recommendation in that Principle that “the equity component of compensation schemes should be subject to shareholder approval. The legislative framework has also sought to facilitate greater investor engagement by permitting (since 2001) voting by electronic means, although take up by companies remains low.

In practice, the revised disclosure arrangements adopted by the FSA should aid more meaningful shareholder engagement on remuneration issues, and are a welcome development. The common practice in Japan that shareholder meetings are concentrated on just several days constrains the capacity for meaningful shareholder engagement. While there is a gradual trend away from this practice, almost 90% of listed companies hold their AGM within the same week. Apart from the formal voting procedures, there is an increasing prevalence of companies seeking to establish a dialogue with investors.

Notes

1. Article 404(3), Companies Act.
2. Principle 5(2) of the TSE Principles of Corporate Governance For Listed companies (2004).
3. It should be noted that the Supreme Court has interpreted that the codified duty of loyalty under the law is the same as the duty of due care.
4. See further Aoki (2007).
5. One reason for lower changes to employment levels is the high degree of nominal wage flexibility through downward adjustment to annual bonuses. The only other OECD country with such nominal flexibility is Austria that also has an important age based wage profile.
6. The Tokyo Stock Exchange and the Osaka Stock Exchange have recently introduced a new listing rule requiring listed companies to have one or more independent directors or statutory auditors.

PART II
Chapter 5

Portugal: Review of Board Practices for Managing Incentives and Risks

This chapter on Portugal is based on detailed responses to a questionnaire provided by Portugal, together with independent research by the Secretariat including missions to Portugal. The chapter describes:

- *the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives;*
- *the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders; and*
- *how boards influence incentives and what role is played by transparency and by shareholders.*

Within these areas, the discussion is based on the individual principles relevant to the review. The chapter is intended to be descriptive and not normative in character. The second part of the chapter is devoted to conclusions about Portugal.

5.1. Detailed analysis

5.1.1. Corporate governance landscape

The evolution of the listed company sector in Portugal has a relatively short history. Prior to the 1970s there was only a very narrow utilisation of listed markets for capital funding. In the mid-1970s the then government nationalized almost all large companies across the banking, insurance, energy and manufacturing sectors. It was not until the 1980s, led by a process of extensive privatisation of formerly nationalised enterprises, that the listed capital markets started to develop. In parallel with the privatisations, there was a process of consolidation of listed companies and de-listing of merged enterprises. Many of today's listed companies have evolved from those concurrent processes.

The listed company sector in Portugal is still relatively small, with only 50 companies with their primary listing on the Euronext Lisbon Stock Exchange¹. Similar to many other continental European countries, a key feature of the listed sector is the dominance of controlling (often family) shareholders. In 27 of the listed companies (55%) a single shareholder owns a majority stake, and in 41 of the companies (81%) the largest shareholder owns at least a 25% stake. In total the average stake of the biggest shareholder across all companies was approximately 47%. Government has equity stakes in nine listed companies and still has a relevant ownership position in the three largest listed companies².

Despite its relatively small size, Portugal has a highly developed legal and regulatory structure. The current Companies Law was substantially revised in 2006 and provides a comprehensive and modern legal architecture for regulating the listed sector. The principle regulator of the securities market, CMVM, has a highly active role in enforcement and, unusually for OECD countries but in accordance with the requirements of the Directive 2006/46/CE, is also responsible for developing and monitoring compliance with the Corporate Governance Code, which operates on a comply or explain basis.

5.1.2. Legal and regulatory frameworks

The principle legal framework for Portuguese listed companies is the Companies Law for corporate governance matters and the Securities Law for transparency matters. With respect to governance, the most substantial revisions of the Companies Law involved the establishment of a wider range of allowable corporate structures for listed companies; a more comprehensive description of directors duties and their liability for failing those duties; and enlarged scope of powers and responsibilities for the company organ responsible for audit functions (the exact nature of that body is dependent upon which management model is adopted – see below).

Under the Companies Law, listed companies have a choice between three different corporate oversight structures. These comprise:

- The “Monist” or “Latin” model. Under this framework, there is a Board of Directors, and a separate Audit Board which comprises members who are not drawn from the Board of

Directors and does not sit with the Board during board meetings, except when considering matters related to the Audit Board's functions³. In effect, this is a single tier structure, where the board responsibilities for auditing are separated to a different organ of the company. The members of the Audit Board cannot be executives of the company, and the majority must be independent.

- The “Anglo-Saxon” model, which comprises a conventional single tier Board of Directors, but which also makes mandatory the existence of an Audit Committee constituted within the Board of Directors. Under this structure, the members of the Audit Committee must all be non-executive directors and a majority must be independent.
- The “Dualist” model: This is a conventional two tier structure comprising an Executive Board of Directors, and a Supervisory Board comprised solely of non-executive directors, the majority of whom must also be independent. The Supervisory Board must also appoint a Financial Matters Committee that is responsible for carrying out similar audit supervisory functions, as the Audit Board/Audit Committee under the other models.

The first two structures dominate among listed companies with only two companies having adopted the Dualist model. Under either of these first two arrangements, the Board of Directors is solely responsible for managing the affairs of the company, however, they can delegate management powers to an Executive Committee. The key roles of the audit body under both models (either the Audit Board, Audit Committee) are to monitor the financial reporting process; monitor the effectiveness of internal company controls, internal audits where applicable, and risk management systems; monitor the statutory auditing of annual and consolidated accounts; and (d) review and monitor the independence of the Statutory Auditor or Audit Firm⁴.

With respect to the governance of the remuneration setting process, the Companies Law requirements again depend upon the company structure adopted. For the two structures involving a single Board, the law provides that the general meeting of shareholders (or a remuneration committee nominated by the general meeting) has the power to determine the remuneration of both executive and non-executive board members. Where this is delegated to a remuneration committee, it is important to note that the members of this remuneration committee need not be drawn from the Board of Directors but can, and where they exist usually do, include external persons nominated by the shareholders meeting. Under the two tier structure, the legal framework provides that the general meeting of shareholders has the power to determine the remuneration of the Supervisory Board. It is then up to the company articles of association to specify the method of setting the remuneration structures for the executive board: variously, this could entail the remuneration being set by the shareholders meeting; a remuneration committee of the shareholders meeting; the Supervisory Board; or even a remuneration committee of the Supervisory Board.

Based on these provisions, across the different company forms, the legal framework provides shareholders with a very strong capacity to voice their views on board (and executive) remuneration, that are highly consistent with the recommendation of Principle II.C.3 that “shareholders should be able to make their views known on the remuneration policy for board members and key executives. Further, the mandatory “say on pay” provisions for the single tier boards and the Supervisory board of the dual structured companies, effectively mean that the equity component of compensation schemes for board members and employees is subject to shareholder approval, as also recommended by the Principle.

In terms of the structure of remuneration, the Companies Law provides a limited mandatory framework. In general, the Companies Law establishes that directors' remuneration may be fixed or may consist partially of a percentage of the profits for the financial year. In the latter case, the Companies Law requires that the maximum value of that percentage shall be authorised in the articles of association. For single tier companies it specifies that members of the audit body (either the Audit Board or Audit Committee) can only be paid fixed fees. For dual tier companies, it similarly provides that the remuneration of the Supervisory Board must be fixed. The structure of remuneration is also extensively covered by CMVM Corporate Governance Code, as set out in Box 5.1 infra.

5.1.3.1. Directors' duties

Directors have statutory duties of care and loyalty under Article 64.º/1 of the Portuguese Company Law. The directors' duty provisions were significantly enhanced as part of the 2006 revisions to the law. Notably, a statutory duty of loyalty was introduced⁵, such that it is now expressly clear that company officers must comply with duties of both care and loyalty.

The definition of, and enforcement regimes applicable to, these duties are consistent with the recommendation of Principle VI.A that "Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders". The Act defines the duty of care as being demonstrated by availability, technical skills and knowledge of the company's activity (as well as, in this context, acting diligently as would a judicious and reasonable person). Compliance with the duty of care is demonstrated where the Board member shows that i) under his acts of management, other avenues have been considered; and ii) it has taken the most adequate measures under business rationality criteria. As part of the 2006 amendments, the enhanced duties were also matched by the incorporation of a 'business judgement rule' into the Companies Act, which allows directors to avoid liability by proving that they acted i) in an informed manner, ii) free of any personal interest and iii) using the criteria of corporate rationality.

The duty of loyalty is exercised by taking into consideration the interests of the company, as well as the *long term interests* of shareholders and any other interests which might be relevant to the company, such as those of employees, clients and creditors (Barrocas, 2009). This latter requirement to consider the interests of stakeholders more generally was introduced in 2006, and so quite explicitly implements the recommendations of Principle VI.C that boards "should take into account the interests of stakeholders". In their questionnaire response, Portugal explains that "this evolution is a compromise between the Anglo-Saxon model of company interest and the German model, where workers interests is stronger and therefore the duty of care is given a primary role vis-à-vis the duty of loyalty"⁶.

There are various mechanisms for enforcement of directors' duties. Principally, directors have joint and several civil liability to external parties for any damages resulting from non-compliance of fiduciary duties. This liability is not limited to the company and/or shareholders, but also extends to other stakeholders who suffer loss. Shareholders are capable of taking derivative actions on the part of the company (subject to a 5% voting threshold) or can take actions in their own name.

As a specific enforcement mechanism, the law includes the possibility of directors' removal as a result of a derivative suit from the shareholders/the corporation against the directors. When the company is a financial institution or a listed company, the directors' removal for breach of fiduciary duties or specific management duties can also be decided and imposed by the Portuguese Central Bank or the Portuguese Securities Commission (CMVM) as a consequence of *ex-ante* and/or *ex-post* supervision actions and powers concerning "fit and proper" regulatory requirements and controls. The breach of fiduciary duties may, in a limited number of circumstances, be considered as a criminal act.

Finally, the CMVM Corporate Governance Code, with which listed companies have to either "comply or explain" (see below), includes a number of recommendations concerning directors' fiduciary duties. While there is no strict and mandatory rule to comply, an annual disclosure on the compliance with the Code is mandatory and, as such, makes public the level of compliance with respect to the specific duties. According to the Portuguese questionnaire response "the pressure of the market over the non-compliant companies, as well as the capitalization effects driven by the "naming and shaming" mechanism are informal but somehow effective means of enforcement of the directors' duties to act according to the interests of the company."

5.1.3.2. Corporate governance code

Unlike most other OECD countries (Spain and Turkey being the other exceptions), the Securities Market Regulator in Portugal, CMVM, has been responsible for developing the only existing Corporate Governance Code applicable to listed companies. The code, which was first released in 2007 as a Code, but existed already as CMVM Recommendations since 1999 (having been since then revised every two years), applies on a "comply or explain" basis and CMVM has also taken on the responsibility for enforcing this compliance/disclosure regime.

There have been efforts on the part of private sector interests to develop a self-regulatory code. The Portuguese Corporate Governance Institute released a White Book on Corporate Governance in 2006 that was seen as a precursor to the establishment of a formal Code, and more recently the Institute has prepared a draft Code for consideration by its members, but as yet no privately sponsored code has eventuated. For its part, CMVM has encouraged the development of a private sector response, and in 2010 introduced regulatory amendments to facilitate companies adopting an alternative code to their own. However, until such an initiative eventuates, the CMVM Code will continue to apply to all listed companies in Portugal.

With respect to remuneration, the Code provides relatively greater guidance on the structure of remuneration than contained in the hard law provisions, while it is relatively less developed in relation to both the governance of remuneration and incentive structures and the transparency/disclosure aspects, which are both more fully covered in the legislative and regulatory frameworks⁷. The key elements of the Code with respect to the structure of remuneration, which have been significantly amended in 2010, are set out in Box 7.1. The recommendations emphasise structuring remuneration to tie in with the longer term interests of the company, with variable components to be subject to: pre-defined performance criteria; maximum limits; deferral periods of at least 3 years for a significant component (including all stock options); and a requirement to hold all allotted shares (up to a limit) until the end of their terms.

Box 5.1. Portuguese code of corporate governance recommendations

The remuneration of members of the Board of Directors should be structured so that their interests are capable of being aligned with the long-term interests of the company. Furthermore, the remuneration should be based on performance assessment and discourage extreme risk taking. Thus, remuneration should be structured as follows:

- a) the remuneration of Board Members carrying out executive duties should include a variable part determined by a performance assessment carried out by the company's competent bodies according to pre-established quantifiable criteria. These criteria should take into consideration the company's real growth and the actual growth generated for shareholders, its sustainability in the long term and the risks taken, as well as compliance with the rules applicable to the company's activity;
- b) the variable part of the remuneration should be reasonable in general terms when compared with the fixed share of the remuneration and maximum limits should be set for all parts of the remuneration;
- c) a significant part of the variable remuneration should be deferred for a period not less than 3 years and its payment should depend of the company's steady positive performance during said period;
- d) Board Members should not enter into contracts with the company or third parties that will have the effect of mitigating the risk associated to the variability of the remuneration determined by the company;
- e) until the end of their term, Executive Directors should hold, up to twice the value of the total annual remuneration, the company shares that were allotted by virtue of the variable remuneration schemes, with the exception of those shares that are required to be sold for the payment of taxes imposed on the gains of said shares;
- f) when the variable remuneration includes stock options, the period for exercising these should be deferred for a period of not less than 3 years;
- g) the appropriate legal instruments should be established so that in the event of a Director's dismissal without due cause, the envisaged compensation should not be paid out if the dismissal or termination by agreement is due to the Director's performance; and
- h) the remuneration of Non-Executive Board Members should not include a part depending on the performance or the value of the company.

Source: CMVM

An interesting element of the framework is the recommendation that managers should not enter into contracts with the company or third parties that will have the effect of mitigating the risk associated to the variability of the remuneration determined by the company. This addresses a concern that executives could (and in at least one past case, did⁸) use derivatives such as put options to change the risk profile of their share based payments.

5.1.3.3. Transparency and disclosure of remuneration

Over the last year, Portugal has significantly increased the level of disclosure required of listed companies in relation to their remuneration and incentive structures. This has been achieved via significant changes to the legislation in 2009, complemented by new regulations issued by CMVM in 2010 and amendments to the Corporate Governance Code, also in 2010.

With respect to the legislative amendments, the new laws passed in July 2009 require the board (or the remuneration committee, if it exists) to submit annually to the approval of the General Meeting a declaration on the remuneration policy of the board members. The law does not only apply to listed companies, but to a wider group of “public interest companies” that includes state owned enterprises, investment funds, insurance companies and all financial intermediaries. The remuneration declaration must inform the General Meeting, at least, of the following:

- how the remuneration policy aligns the interest of the company and board members;
- how the variable part of the remuneration will be determined;
- whether board members benefit from share allotment plans or share option plans;
- the extent to which the variable remuneration can be reduced, if the results show a deterioration in the performance of the company during the last financial year or are likely to deteriorate during the current financial year.

In addition, the law provides that public interest companies (including listed companies) must disclose, either in their annual report or in their annual report on corporate governance, the remuneration policy on remunerations applicable to board members and to the audit or supervisory body members. Via regulations passed in 2010, CMVM has enumerated an extensive list of disclosures that listed companies must release as part of their annual report on corporate governance. This report must include, amongst others: an explanation on the relative weight of the fixed and variable part of the remuneration; details of deferred payment arrangements for variable remuneration; details of performance criteria for long term and variable components; termination payments; payments by other companies in the group; and an estimate of the value of the non-pecuniary benefits considered remuneration.

Under the Regulation on Corporate Governance issued in 2010, CMVM has reinforced the new disclosure regime applicable to listed companies. Moreover, according to the abovementioned new Regulation, Portuguese listed companies must additionally disclose to shareholders the following elements:

- a) the annual remuneration, both on an aggregate and individual basis, of the board members and of the members of the audit or supervisory board;
- b) the fixed and each type of variable component of remuneration, differentiating between those parts already paid and those parts subject to deferred payment;
- c) the remuneration received from other companies of the same group, both in an aggregate and individual basis;
- d) the pension rights acquired during the relevant financial year.

In addition, listed companies must inform the CMVM regarding any share based remuneration plans approved for employees. The information must include, in particular, the reasons for the adoption of the plan; the category and number of employees subject to the plan; the conditions for allocating shares, including price, vesting periods and any incentive arrangements; and the powers of the Board to alter the plans.

5.1.3. Market environment and norms

As noted above, share ownership in Portugal is highly concentrated, and in a large number of listed firms there is at least one dominant shareholder. In most cases this is a family shareholder, but can also be a foreign parent/partner or in a limited number of cases

the Government is a qualified shareholder. In some cases there is more than one dominant shareholder, with for instance both the state and a private shareholder, or two family groups, having substantial influence of the one company⁹. Nevertheless, cross-shareholdings amongst listed companies do not appear to be a common phenomenon, and share ownership by creditors, competitors, customers and suppliers are all at average levels of less than 5%¹⁰.

According to discussions with market participants, the anecdotal evidence would suggest that the presence of controlling shareholders has had a moderating influence on the level of remuneration to executive directors (and executives generally). One study by Silva (2009) also found that the per capita remuneration is lower in companies where qualified shareholders¹¹ were present in the remuneration committee. Interestingly, however, the presence of qualified shareholders did not have an influence on the structure of remuneration in terms of the weighting between fixed and variable components.

Part of the explanation for this may also lie in the source of director remuneration. Based on data from CMVM, on average only approximately 70% of the global direct remuneration received by the Board of Directors came from within the company; the remaining 30% from other companies of the same economic group. This seems to be a bigger issue for the outside directors (particularly those appointed to represent controlling shareholders) as opposed to executive directors. For executive directors, the weight of the remuneration that comes directly from the company is slightly over 80%¹². It is arguable that relying on payments from other group companies to remunerate directors compromises the capacity of directors to appropriately discharge their duty of loyalty to the company. It also has the potential to align their interests with the controlling shareholder, rather than the company per se.

CMVM has sought to address this concern by requiring complete disclosure of payments to directors from outside entities as part of the new disclosure regulations introduced in 2010. Since shareholders must approve the remuneration policy, this effectively gives shareholders a binding vote on any such external payments. To the extent that the payments come from controlling shareholders who themselves exert considerable control over the general meeting, then it is questionable whether this approval process will alter the practice of external payments. However, these arrangements need to be considered in the context of the extensive provisions in the Portuguese corporate protecting in place for minority shareholders in controlled company groups. In particular, the Portuguese Companies Act acknowledges the *de facto* presence of company groups as a dominant structure and provide for an express legitimation of the exercise of the power of control of a parent company over the management of its subsidiary and the primacy of the group global interest over the interests of the various individual subsidiaries. To balance this, the law provides corresponding protective mechanisms for the subsidiary companies, their minority associates and creditors. For instance, in certain circumstances, controlling companies have a duty of covering the annual losses of the subsidiary and a direct joint liability for the settlement of subsidiary debts (Antunes, 2008).

5.1.3.1. Quantum and structure of remuneration

Remuneration levels in Portugal appear to be reasonably moderate in average. For executive directors, the average per capita remuneration in 2008 was slightly less than EUR600 000 per annum. The split between fixed and variable remuneration was on average 55% for fixed pay, with the remainder comprising variable remuneration. However, this

data masks a considerable variation amongst the listed companies. Only 15 companies paid the members of their Executive Committees (that is, executive directors) any kind of variable remuneration. In other words, the reported data effectively shows that a small group of companies (dominated by financial firms) are paying highly variable remuneration, balanced by another group of companies paying largely fixed salaries. In fact, data from CMVM concluded that 2/3 of the remuneration of the Executive members in the financial sector companies is variable in nature.

Reflecting this, performance bonuses paid to Executive Committees was only reported in ten companies in 2009, when the recently issued mandatory regulation on remuneration was not yet in force and only five companies report other components of remuneration. Portugal's questionnaire response suggests that "one of the possible reasons for this practice could be the momentum of the economic cycle, more favourable to salary and bonuses moderation." However, outside of the financial sector it does seem that the payment of variable salary components is not a prevalent practice.

Table 5.1. Components of director remuneration

Table VI- total, Fixed and Variable Remuneration during 2008					
	Total Remuneration	Fixed Remuneration	Variable Remuneration and Performance Bonus	Other Factors	Per Capita
Total Board of Directors (single tier)	2,597,277.40	56.3%	42.4%	1.3%	EUR 275,005.80
Management Board members (two tier)	5,475,941.00	70.4%	29.6%	0.0%	EUR 782,213.00
All Executive Directors (single and two tier)	2,835,712.60	55.1%	43.7%	1.1%	EUR 595,149.60

Source: Comissão do Mercado de Valores Mobiliários (CMVM). Data provided as part of Portugal's response to OECD peer review questionnaire.

During 2009, there were only four companies that had stock option plans in place for directors, and in each of these cases, the plans were also available to the remainder of the company workforce. At 31 December 2008, all of the schemes had exercise prices well in excess of market prices¹³ and had an average remaining duration of over 450 days. A further six companies had remuneration schemes for directors based directly in shares (as opposed to options) and again these were also available to the wider workforce. The characteristics of all the plans were properly approved by the General Assembly in all the cases, suggesting that in practice Portuguese listed companies comply with the recommendation of Principle II.C.3 that "the equity component of compensation schemes for board members and employees should be subject to shareholder approval".

5.1.3.2. The market for executives and the impact on incentive structures

The Portuguese questionnaire response offered a view that, based on the available evidence when boards are considered as a whole (executives and non executives), "a market for managerial talent appears to exist." There is empirical evidence that the rotation of executive managers is sensitive to the company performance. In fact, as demonstrated by Farinha and Bessa (2007), that studied a universe of 47 Portuguese companies listed in Eurolist by Euronext Lisbon in the period of 2003-2007, there is a negative and statistically significant relationship between executive managers' rotation and the past performance of companies. This would suggest that there is a market discipline mechanism that penalizes bad managers by promoting their substitution or dismissal whenever they don't meet the expectations of controlling shareholders. More informally, market participants suggested that the threat of dismissal (particularly in

family controlled groups) was real and that this acted as an effective (if blunt) substitute for more formalised performance related remuneration.

Nonetheless, executive members of Portuguese companies' boards tend to stay for longer periods in the same company than non-executive members. According to data from CMVM, in 2008, executive members of Portuguese companies' boards had an average tenure of 7.2 years, compared to six years for non-executives¹⁴. These relatively modest average tenures (even for executives) are also associated with relatively high turnover in Board membership. Between 2007 and 2008, 25% of all board members in listed companies were newcomers¹⁵. Anecdotally, market participants suggested that part of the reason for this high turnover was that family groups tended to manage the succession process of executives quite actively, and were able to effect renewal by providing opportunities to retiring/replaced executives either in other parts of the group or via new business initiatives. As with the threat of dismissal, this succession planning effectively provided an internal market for executives that limited the need for more formal long term incentive structures.

5.1.4. Board structure and composition

In 2008, the average size of the Board of Directors of the 45 companies that opted for a single tier structure was 9.4 members. Around these averages, the number of board members varied quite markedly, from a high of 26 (for a company adopting the Anglo-Saxon model) and a low of 3 (Latin model). The average size of the Board of Directors is also higher amongst the larger capitalised companies that comprise the PSI 20 stock index (13.4) and those that belong to the financial sector (16.8)¹⁶. While not legally required, quite a few companies have established a separate Executive Committee, which is a subset of the board of directors comprised solely of the executive directors.

Across all listed companies, boards tend to be roughly split between executive and non executives, with the average number of non-executive directors is slightly less than five (4.8). Non-executive directors are more prevalent in larger companies and also in companies that have adopted the Anglo-Saxon model¹⁷. Nonetheless, boards are still dominated by large shareholders, with over 40% of all directors being either reference shareholders or the relatives of reference shareholders. In large companies (those included in the PSI20 Index), where the free float is higher, there is still significant presence of shareholders in the boards: on average, 36.4% of the directors are or are related to qualified shareholders. Anecdotally, market participants advised that where there was one dominant shareholder, it was common for that shareholder to take the position of Chairman, and then to install a professional CEO and managers. Other non-executive directors are often then dominated by associates or relatives of the controlling shareholder.

Given this structure, it is an open question whether Portuguese boards are "able to exercise objective independent judgement on corporate affairs" as envisaged by Principle VI.E. The Corporate Governance Code recommends that "non-executive members must include an adequate number of independent members. The size of the company and its shareholder structure must be taken into account when devising this number and may never be less than a fourth of the total number of Directors". Despite this recommendation, the proportion of independent directors in the boards as a whole is not high and does not on average meet the Code recommendations, with just over 20% of board's members are independent. Larger capitalised companies (that is the PSI 20 being the 20 largest) have just under 40% of the board as independent members, which roughly correlates with the average free float.

5.1.5. Board practices

With respect to the remuneration of directors, the Principles emphasise the important role of independence in the remuneration setting process: Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest (Principle VI.E.1), with board remuneration being one of the specific items mentioned in the Principle. In Portugal, the situation is complicated by the fact that the primary responsibility for setting board remuneration in a legal sense rests with the general meeting, since there is a mandatory approval process required. As noted above, the general assembly can either execute the function of setting remuneration directly or defer this to a separate committee. In almost all cases (44 of the 47 listed companies), the general meeting has established a separate remuneration committee which is usually composed of three members. This committee is not a subset of the Board, and in just over half of the cases (28 companies) no member of the board sits on the remuneration committee, and in 31 companies all members of the committee were considered to be independent¹⁸. To the extent that these remuneration committees are independent, then the outcome envisaged by Principle VI.E.1 would appear to be satisfied, albeit that the function is not performed by the Board.

However, there are some caveats that could be placed on such an assessment. In practice, the remuneration committees do not meet frequently (on average, less than twice a year) and in many cases it seems that their main role is to act as a conduit between the Board and shareholders in mediating an acceptable pay outcome. Despite the fact that the formal process is external to the board, there are two principal means by which boards (and individual board members) play an active role in setting director's remuneration. Firstly, members of the board of directors are not prevented from being nominated to the remuneration committee by shareholders, and in a significant number of companies (16) this approach is adopted. While often there is an independent director representative on the committee, in some of the family controlled companies it is common practice for the controlling shareholder (e.g. as company Chairman) or their representative to be elected. In fact, in at least 45% of companies, major shareholders are present on the Compensation Committee (Silva, 2009)¹⁹.

Secondly, in some Portuguese companies, the board of directors nominates an informal remuneration committee of its own, which acts as an advisor to the remuneration committee nominated by the General Meeting and in general has responsibilities regarding evaluation of the board of directors and their members in accordance with the recommendation of the CMVM Corporate Governance Code. The creation of a remuneration committee within the board of directors is seen as a tool to enable the board to participate in the process of remuneration setting. The added value of the board's participation in the process is its performance evaluation of executive directors. On balance, one could argue that Portuguese companies have established a system which seeks to balance an appropriate role for the board in the remuneration setting process, while retaining a reasonable degree of independence via the remuneration committee established by the general meeting.

However, it is not clear that this process has resulted in the board being able to fully execute its function of aligning "key executive and board remuneration with the longer term interests of the company and its shareholders", as envisaged by Principle VI.D.4, and there could be scope to more fully formalise the role of the board in setting remuneration policy when the General Meeting establishes its own remuneration committee. This is

particularly so, given that the CMVM Corporate Governance Code now contains extensive guidance on how executive remuneration should be structured, and the board (and in particular, independent non-executive members) would be well placed to provide a lead role in determining a suitable structure.

In terms of the outcomes of the remuneration setting process, the relationship between the economic performance of the companies and the structure of remuneration has been examined in several academic studies (Fernandes (2005), Nascimento (2007) and Silva (2009)). The conclusions of these studies indicate a very strong relationship between the size of the company and the remuneration paid to its management team (Fernandes (2005) and Nascimento (2007)), but the relationship between remuneration and performance is less clear cut especially as the variable remuneration is probably short term performance. According to Fernandes (2005) there was no clear statistical association between performance and compensation of executive management. Similarly, Nascimento (2007) did not find evidence to support the view that total remuneration of the Board of Directors is correlated to the company economic performance. However, Silva (2009) reported a strong connection between the company's financial results and the compensation of the executive members of boards, and this was stronger in companies with independent Compensation Committees (where variable remuneration was also on average higher as a percentage of total compensation). This latter point may suggest that independent committee membership is a critical feature of the remuneration setting process. It may also reflect the fact that strongly controlled companies utilise non-financial mechanisms (such as threat of dismissal and extra-corporate opportunities) to manage the shareholder alignment process.

5.1.6. Shareholder engagement

A general observation amongst market participants was that there was not a high level of engagement by shareholders in the remuneration setting process. While the mandatory approval process provides shareholders with a legal mechanism to engage on appropriate incentive arrangements, in practice this has not been prevalent. In large part, this can be explained by the existence of controlling shareholders who dominate not only the remuneration structuring process at board level but also the approval process at the general meeting. However, the lack of shareholder engagement can also partly be attributed to the poor level of disclosure by Portuguese listed companies prior to the new legal and regulatory requirements introduced since mid-2009. According to data from the proxy advisory firm Manifest, prior to the new legal regime around 50% of Portuguese large-cap companies had a separate vote on a Remuneration Report submitted by the board for shareholder approval. However, the shareholders' ability to actually hold directors to account for what they earn was severely restricted by the aggregate nature of the disclosures.

With the introduction of the 2009 Law, a remuneration policy statement must now be included in the Annual Report on Corporate Governance. The detailed regulations by CMVM ensure that this disclosure will facilitate understanding the structure, the drivers and the outcomes of the remuneration setting process, at an aggregate and individual level. Since this statement must be approved by the general meeting, it provides shareholders a more robust means for expressing an opinion on remuneration policy consistent with the recommendations of Principle II.C.3.

In terms of institutional shareholders, it seems that foreign domiciled investor's funds have been more active in their engagement than locally domiciled funds, particularly as it

relates to participation in general meetings. Based on survey data for 19 AGMs collected by CMVM, in 2008, at least one foreign fund was present in 14 out of the 19 meetings, and at least one foreign bank in 13 of the 19 meetings. This may be in part related to home country (or institutional requirements) to actively exercise their voting rights, but also or mainly due to the institutional banking model, which allows the banking institutions and/or financial groups to manage investment funds and diminishes consequently the shareholder activism of fund managers for the reasons explained below.

In contrast, the highest participation by local institutional investors was for the pension funds, where at least one fund attended only five of the 19 meetings (refer Table 5.2). The low levels of participation by domestic institutional shareholders may reflect the fact that these shareholders are very often controlled by banks, which have potential conflicts of interest in their roles as investors and funders, and seek to avoid these conflicts via abstaining from voting or shareholder decision making. In addition, the limited relevance of institutional shareholders in the capital structure of Portuguese listed companies – there are only 16 qualified positions held by fund managers, only two of them of more than 5%²⁰ may also explain the low level of funds activism.

CMVM, together with the Insurance Regulator (ISP), has recently issued a set of recommendations to promote more active participation in general meetings by investment funds and pension funds. The recommendations propose that these institutional investors should develop a strategy to be pursued with regard to the exercise of voting rights, including the factors taken into account in deciding whether to actively participate. This strategy should be defined in each of the fund's instrument of incorporation. The recommendation also contains a set of prescriptive guidelines that investors should use in guiding their decisions on whether to actively participate. Under this strategy, institutional investors are also required to develop a set of general guidelines which sets out the criteria used to determine voting outcomes.

Table 5.2. Institutional investors – sample data concerning general assemblies held during 2007 and 2008

	N° of general assemblies	Foreign funds	Foreign banks	Portuguese banks	Portuguese insurers	Portuguese brokers	Portuguese pension funds	Portuguese investment funds
2008	19	14	13	3	4	2	5	2
	%	73.7%	68.4%	15.8%	21.1%	10.5%	26.3%	10.5%
2007	17	12	10	8	4	4	7	8
	%	70.6%	58.8%	47.1%	23.5%	23.5%	41.2%	47.1%

Note: the total number does not add more than one institutional investor per category present in each single general assembly

Source: Comissão do Mercado de Valores Mobiliários (CMVM). Data provided as part of Portugal's response to OECD peer review questionnaire.

Not all companies provided a full public disclosure of the voting outcomes and the disclosure on actual voting breakdown is very poor. The vast majority of voting results is available only from the minutes of the meetings which provide extensive description of the meeting developments in Portuguese language only. The introduction of the EU Shareholder Rights Directive should have a positive impact on the disclosure. The companies will be obliged to publish their voting results a maximum 15 days after the meeting, however, the directive allows companies to provide that, 'if no shareholder requests a full account of the voting, it shall be sufficient to establish the voting results

only to the extent needed to ensure that the required majority is reached for each resolution”.

5.2. Conclusions and comments

The listed company sector in Portugal is small, with only 50 companies having their primary listing on the Euronext Lisbon Stock Exchange. Similar to many other continental European countries, a feature of the listed sector is the dominance of controlling shareholders. Despite its relatively small size, Portugal has a highly developed legal and regulatory structure. The current Companies Law was substantially revised in 2006 and provides a comprehensive and modern legal architecture for regulating the listed sector. A wide range of legal forms are allowed, including both single and dual board structures, and a “Latin” model with both a board of directors and a separate audit board. The principal regulator of the securities market, CMVM, has a highly active role in enforcement and is also responsible for developing and monitoring compliance with the Code, which operates on a “comply or explain” basis.

With respect to the governance of the remuneration setting process, the Companies Law requirements depend upon the company structure adopted. For the two structures involving a single Board, the law provides that the general meeting of shareholders has the power to determine the remuneration of both executive and non-executive board members. Under the two tier structure, the legal framework provides that the general meeting of shareholders has the power to determine the remuneration of the Supervisory Board, who in turn has the power to determine Management Board remuneration. The Code is more expansive on the structure of remuneration and emphasises the need to tie directors and executives incentives in with the longer term interests of the company.

5.2.1. Board structure and duties

Across all listed companies, boards tend to be roughly split between executive and non executives. The Code recommends that non-executive members must include an adequate number of independent members and should comprise at least a quarter of the total number of Directors. Despite this, the proportion of independent directors in the boards as a whole is not high and does not on average meet the Code recommendations. Boards are instead dominated by large shareholder representatives. The composition of Portuguese boards limits their capacity “to exercise objective independent judgment on corporate affairs” as envisaged by Principle VI.E, particularly in areas where the interests of controlling shareholders and minorities might conflict. With respect to remuneration setting, this may prove less problematic, since the primary responsibility for setting board remuneration in a legal sense rests with the general meeting, the role for the board in aligning executive incentives with company objectives is constrained. In almost all companies, shareholders have delegated the remuneration setting function to a separate remuneration committee. This committee is not a subset of the Board, and in just over half of the cases (28 companies) no member of the board sits on the remuneration committee, and in 31 companies all members of the committee were considered to be independent.

Directors have statutory duties of both care and loyalty under Portuguese Company Law, provisions were significantly enhanced as part of the 2006 revisions to the law. The definition of, and enforcement regimes applicable to, these duties are consistent with the recommendations of Principle VI.A.

5.2.2. Board practices

Remuneration levels in Portugal appear to be reasonably moderate on average and the presence of controlling shareholders appears to have had a moderating influence on the level of remuneration to executive directors (and executives generally). The split between fixed and variable remuneration was on average 55% for fixed pay, with the remainder comprising variable remuneration. However, this data masks a considerable variation amongst the listed companies with a small group of companies (dominated by financial firms) paying highly variable remuneration, balanced by another group of companies paying largely fixed salaries.

The limited role for boards in the remuneration setting process makes it difficult to conclude that they can exercise the role of aligning executive and board remuneration with longer term interests of the company (Principle VI.D.4). However, the strong role for the General Meeting suggests that institutional arrangements are sufficient to facilitate equivalent outcomes. In some Portuguese companies, the board of directors nominates an informal remuneration committee of its own, which acts as an advisor to the remuneration committee nominated by the General Meeting. The creation of a remuneration committee within the board of directors is seen as a tool to enable the board to participate in the process of remuneration setting.

5.2.3. Disclosure

Over the last year, Portugal has significantly increased the level of disclosure required of listed companies in relation to their remuneration and incentive structures, via 2009 legislation amendments; new regulations issued by CMVM in 2010; and amendments to the Corporate Governance Code, also in 2010. The legislative amendments require General Meeting approval of a declaration on the remuneration policy of the board members. In particular, the remuneration declaration must detail how the remuneration policy aligns the interest of the company and board members; how the variable part of the remuneration will be determined. The new regulations enumerate an extensive list of disclosures that listed companies must release as part of their annual report on corporate governance, including detailed descriptions of the fixed and variable components and deferral and performance arrangements. In addition, Portuguese listed companies must disclose the annual remuneration components, both on an aggregate and individual basis, of all board members. These requirements are fully consistent with the recommendations of Principle V.A.4. This is a welcome development, given the dominant role of shareholders in the remuneration setting process, and their need for accurate and timely disclosure to adequately exercise this function.

5.2.4. Shareholder engagement

Across the different company forms, the legal framework provides shareholders with a very strong capacity to voice their views on board (and executive) remuneration that are highly consistent with the recommendation of Principle II.C.3. While the mandatory approval process provides shareholders with a legal mechanism to engage on appropriate incentive arrangements, in practice this has not been prevalent. In large part, this can be explained by the existence of controlling shareholders who dominate not only the remuneration structuring process at board level but also the approval process at the general meeting. In terms of institutional shareholders, it seems that foreign domiciled investor's funds are more active in their engagement than locally domiciled funds,

particularly as it relates to participation in general meetings. The CMVM and the insurance regulator have recently released a set of recommendations applying to insurance and investment fund managers that propose a set of good practices regarding the diligent execution of their shareholder rights, including voting at annual meetings. These recommendations are a welcome development to increase the level of institutional shareholder engagement.

However, the lack of shareholder engagement can also partly be attributed to the poor level of disclosure by Portuguese listed companies prior to the new legal and regulatory requirements introduced since mid-2009. These new laws and regulations should also facilitate better shareholder understanding of the structure, the drivers and the outcomes of the remuneration setting process, at an aggregate and individual level. Since this statement must be approved by the general meeting, it provides shareholders a more robust means for expressing an opinion on remuneration policy consistent with the recommendations of Principle II.C.3.

Notes

1. Including non-resident companies, the total number of listed companies in the Euronext Lisbon Stock Exchange Eurolist is 56. In the data they collect on corporate governance, CMVM focuses on the 50 primary listed companies. This includes three football clubs that are listed that are excluded from some analyses, meaning that core information is collected on 47 companies.
2. Government has a dominant position in only one of the 3 largest listed companies; it has a golden share in another, and in the third there is a shareholders' agreement between 3 shareholders, one of them Caixa Geral de Depósitos – a public bank owned by the State.
3. In addition, the legislation provides that there must be a Statutory Auditor (or Statutory Audit Firm), that cannot be a member of the Audit Board.
4. This is consistent with the requirements of the EU's Eighth Company Law Directive (Article 41), otherwise known as the Statutory Audit Directive.
5. While this was a new duty for the statutory law provisions, a fundamental duty of loyalty had nevertheless already been recognised via relevant doctrine and jurisprudence as being owed by directors towards the company.
6. Although it must be noted that, given the recent legislative amendments to the statutory duties in the UK, the Anglo-Saxon model, although still a 'shareholder oriented' one in the whole, has undergone some significant changes regarding the relative weight of the interests of shareholders vis-a-vis other stakeholders.
7. Given that CMVM is responsible for both the regulatory regime and the Code, it is reasonable to expect that the Code would be used to augment the mandatory aspect of the regulatory regime. In jurisdictions where Codes are established outside of the regulatory framework, it is more common to see a greater degree of overlap between the regulatory framework and the Code provisions.
8. The case involved an executive using a "zero cost collar" to lock in the price of their existing shares at a point when the company was the subject of the takeover offer. At the same time, management were advocating to shareholders that the takeover offer should be rejected. When the takeover offer ultimately failed and the share price fell, the executive was protected against loss by the existence of the collar.
9. In a survey by CMVM, listed companies were asked to identify the number of shareholders exercising "significant influence over the company's affairs". According to the company responses, on average 2.8 shareholders exercised significant control. In 20 of the companies, only one shareholder was considered to exercise significant control.
10. As per data provided by CMVM.
11. Note that a qualified shareholder is not necessarily a controlling shareholder, (merely one that exceeds the disclosure threshold) although it is likely that most qualifying shareholders who choose to sit on a remuneration committee would be those capable of exerting substantial influence on the company.

12. As per data provided by CMVM.
13. With respect to stock option plans for executive members of the Board, outstanding options were equivalent to, on average, 1.1% of the company's equity and the ratio between the average exercise price and the market price, as of 31st December 2008, was 147.9%. It is important to note that the ratio of exercise price to market price is not at the time of award of the options; the high ratio may be a function of falling market prices, post award of the options.
14. Part of the explanation for the shorter tenure for non-executives may be due to an observed increase in board size and a greater proportion of independent non-executives being appointed in recent years.
15. The discrepancy between the turnover figures and the tenure figures can be explained by an increase in board size, and directors of newly listed firms being classified as new board members.
16. Based on data from CMVM.
17. In part, this is one and the same thing, since larger companies are more likely, on average to have adopted the Anglo-Saxon model.
18. That is, there are a number of cases where a member of the board sits on the remuneration committee, but this is an independent board member. As CMVM's Corporate Governance Code recommends that members of the remuneration committee or alike should include at least one member with knowledge and experience in matters of remuneration policies it is not unreasonable for a non-executive member of the board to be nominated member of the remuneration committee.
19. Actual percentages could be higher since the data were compiled on the basis that the presence was certain, and was not an exhaustive and direct survey of the companies (Silva, 2009).
20. As at 31 December 2009.

PART II
Chapter 6

Sweden: Review of Board Practices for Managing Incentives and Risks

This chapter on Sweden is based on detailed responses to a questionnaire provided by Sweden, together with independent research by the Secretariat including missions to Sweden. The chapter describes:

- *the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives;*
- *the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders; and*
- *how boards influence incentives and what role is played by transparency and by shareholders.*

Within these areas, the discussion is based on the individual principles relevant to the review. The chapter is intended to be descriptive and not normative in character. The second part of the chapter is devoted to conclusions about Sweden.

6.1. Detailed analysis

6.1.1. Corporate governance landscape

Sweden's listed company sector is one traditionally characterised as being dominated by controlling shareholders. This is certainly true in comparison to countries such as the UK and US, which have comparatively widely held share ownership structures. But the level of control is quite consistent with other continental European markets. Recent data showed that approximately 64% of Swedish listed companies had one shareholder with at least a 25% shareholding (by comparison, in Italy it was 65% and Germany 82%). Further, in 26% of listed companies the blockholder had a majority holding of at least 50% (Italy 56%; Germany 64%) (Gilson, 2005). State ownership is also quite significant in Sweden, both directly through significant shareholdings in some listed companies and indirectly through state pension funds.

While the level of formal ownership control is consistent with, or lower than, other European countries, there is a strong history in Sweden of using structural devices such as differential voting to leverage voting rights. The acceptance of such arrangements is perhaps reflective of the positive view in the Swedish business community as well as in society at large, of strong owners taking an active and long-term responsibility for their companies. The same study above cites the fact that 66% of listed Swedish companies had dual class voting stock (compared to 47% in Italy and 17% in Germany). Just less than half of all listed companies are controlled by family groups (Gilson, 2005), and a small number of families have attained controlling positions in a large number of listed companies.

The family controlled groups often act as conglomerates with holdings in many industry sectors. The voting structures have allowed for the establishment of a central controlling firm, often without overly large direct holdings in a number of the controlled firms. The ability of the central firm to monitor its subsidiaries and related companies is facilitated not only by their equity holdings, but because they often serve as major credit advisors to the firms in their portfolio (Lubatkin *et al*, 2005). In this respect, there are some similarities with the relationship between main banks and *keiretsu* groups in Japan, although the Japanese groupings involve more cross-shareholdings, as opposed to a pyramidal structure that is evident in Sweden.

Corporate governance systems in Sweden have historically been well functioning, ordered by industry practice rather than formalised rule, and assisted by the dominance of the family groups who have provided a strong monitoring function. However, much as in the UK, the reliance on informal practice has changed over the last decade with a greater emphasis on codification of good practice and the increasing use of regulations and codes to structure company relationships and disclosure.

6.1.2. Legal and regulatory frameworks

As a result, corporate governance in the listed company sector in Sweden is now governed by a combination of hard and soft laws and generally accepted practices. The

main instruments for corporate governance regulation in Sweden are the Companies Act (2005), the Code of Corporate Governance (recently amended in 2010), and the stock exchange listing rules. These laws and rules are also supplemented with statements by the Swedish Securities Council on what constitutes good practice in the Swedish securities market.

The Companies Act sets out the decision making organs that are compulsory for listed companies. From a structural point of view, Swedish corporate governance can be described as a third alternative to on one hand the so-called unitary board system, predominantly used in the US and UK and other countries with an Anglo-Saxon judicial tradition and, on the other hand, the dual board system, used in many European continental countries. Compared with those, the Swedish Companies Act provides for a unitary board system but with entirely or predominantly non-executive boards and the executive duties delegated to a separate, one-person, CEO function. The main governance decision bodies, the Shareholders' Meeting, the Board and the CEO, make up a strictly hierarchical chain-of-command, where the Shareholders' Meeting is sovereign to decide on virtually any matter within the limits of the Law and the company's Articles of Association, and each of the other bodies are fully subordinate to the next higher body.

In practice, the board of directors' main responsibilities are to: elect one managing director, or CEO; to supervise the CEO's day to day running of the company; and to take company strategic decisions when necessary. As such, it has potentially greater powers than a traditional Supervisory Board, but not necessarily the extent of executive power usually exercised by a unitary board. In addition, the only executive member of the board, if any, is the CEO (and slightly less than half of the listed companies have the CEO on its Board¹) meaning that external and independent members dominate.

The CEO then has the responsibility for choosing the remainder of the executive management, who are at a level below the CEO. They report to the CEO and the CEO only. Hence, their position is quite different from the members of the management boards in operation in continental Europe.

The Code complements the Act by placing higher demands on companies on certain issues, while simultaneously allowing them to deviate from rules in individual cases if it is deemed that this will lead to better corporate governance (that is, it follows a "comply or explain" model). There is a very strong emphasis placed on providing substantive justification for non-compliance rather than enforcing compliance as far as possible. Since 1 July 2008, the Nasdaq OMX Stockholm and the NGM stock exchanges have stated that the Code is applicable for all companies whose shares are traded on the respective exchange. Nevertheless, the Code is not formally a part of the exchanges' rules. The Code is indirectly a part of the rules since it is seen as an expression of good stock market practice regarding corporate governance, and the exchanges' rules state that a listed company shall conduct its business in line with common accepted market practice (Eckbo, Paone, Urheim, 2010).

The determination of directors' and executive remuneration is addressed both in the Code and in the law, but the Code rules have been significantly expanded with new rules that apply from July 2010. All Board remuneration, to be decided upon for each board member individually, is determined by shareholders according to the Companies Act. The Act also requires the shareholders to annually approve remuneration guidelines for executives. These guidelines are binding upon the Board, who can only deviate if special reasons apply, provided that the possibility to made deviations in such situations was included in the guidelines.

In terms of coverage, it is important to note that the remuneration provisions of the Code relate not only to directors, but also the remuneration setting for executive management. This is important in Sweden, since the Board is much more akin to a Supervisory Board, with the CEO, normally, being the only executive member, if any (refer above). The current version of the Code has essentially two process-driven requirements for the remuneration setting process: i) proposals on remuneration should be prepared by either the whole board or a specialised independent committee; and ii) shareholders should decide on all share based payments for executives.² The revised code provisions (reproduced in Box 6.1) are much more extensive, providing extensive guidance on the process/governance aspects; the structure of remuneration and alignment with company interests; and the disclosure and approval processes. In summary, the code establishes: the role of the remuneration committee (particularly in terms of monitoring outcomes); the structure of remuneration and the design of incentive based payments (aimed at the longer-term), including capacity for clawback; the disclosure of information to shareholders to promote informed voting on share based payments; and restrictions on severance payments. The code also sets out that the non-executive board members should not participate in share and share price-related incentive schemes designed for executive management. These amendments to the Code have, in part responded to the European Commission's 2009 recommendation (2009/3177/EC) on director remuneration in listed companies.

The voting requirements on share-based remuneration contained in the code reinforce specific legal requirements contained in the Companies Act. Under the Act, all long-term incentive plans are subject to shareholder approval and indeed, depending on their structure, may require several separate resolutions, with different majority requirements. If the long term incentive scheme involves a share issue, a sale of own shares or transfer of shares in a subsidiary, a nine-tenths majority of votes cast and shares present at the general meeting is required, otherwise a simple majority is sufficient³. The voting requirements on long term incentives is consistent with Principle II.C.3 which advocates that shareholders should be able to make their views known on board and executive remuneration and that "the equity component of compensation schemes for board members and employees should be subject to shareholder approval".

6.1.2.1. Disclosure and transparency

Consistent with Principle V.A.4 that company "disclosure should include, but not be limited to, material information on ... remuneration policy for members of the board and key executives", Swedish boards are required under the Companies Act to present a remuneration policy for approval by shareholders at the AGM and to publish the policy on the company's website no later than two weeks prior to the shareholders meeting⁴. Some Swedish commentators, however, complain that the remuneration policies voted upon at AGMs are often vaguely worded and do not therefore constrain boards and management sufficiently. 2008 revisions to the Code specifically address this concern, requiring that, in relation to incentive based payments, "the material is to be clear and simple enough to allow shareholders to form an opinion on the reasons for the scheme, the principle conditions of the scheme and any dilution of the share capital that may result from it, as well as the total cost to the company of different conceivable outcomes".

Swedish law also requires companies to disclose the individual remuneration of all board members and the CEO. The Code or, in the case of NGM Equity the listing

Box 6.1. Swedish code of corporate governance – remuneration provisions

Companies are to have formal and clearly stated processes for deciding on remuneration of members of the board and the executive management. Remuneration and employment terms are to be designed with the aim of ensuring that the company has access to the competence required at a cost appropriate to the company, and that they have the intended effects for the company's operations.

9.1 The board is to establish a remuneration committee, whose main tasks are to:

- prepare the board's decisions on issues concerning principles for remuneration, remuneration and other terms of employment for the executive management,
- monitor and evaluate programmes for variable remuneration, both ongoing and those that have ended during the year, for the executive management, and
- monitor and evaluate the application of the guidelines for remuneration that the annual general meeting is legally obliged to establish, as well as the current remuneration structures and levels in the company.

9.2 The chair of the board may chair the remuneration committee. The other members of the committee appointed by the shareholders' meeting are to be independent. Appropriate knowledge and experience of executive remuneration issues is to exist among the members of the committee. If the board considers it is more appropriate, the entire board may perform the remuneration committee's tasks, with the exception of executives who are members of the board.

9.3 If the remuneration committee or the board uses external consultants, it is to ensure that there is no conflict of interest regarding other assignments this consultant may have for the company or its executive management.

9.4 Variable remuneration is to be linked to predetermined and measurable performance criteria aimed at promoting the company's long term value creation.

9.5 Variable remuneration paid in cash is to be subject to predetermined limits regarding the total outcome.

9.6 When designing systems for variable remuneration of the executive management that is to be paid in cash, the board is to consider imposing restrictions

- which make payment of a certain proportion of the remuneration conditional on whether the performance on which compensation is based proves to be sustainable over time, and
- which allow the company to reclaim components of remuneration that have been paid on the basis of information which later proves to be manifestly misstated rather than a misjudgement.

9.7 The shareholders' meeting is to decide on all share-based incentive schemes for the executive management. The decision of the shareholders' meeting is to include all the principle conditions of the scheme. Background material pertaining to the proposed scheme is to be made available to shareholders in good time before the meeting.

9.8 Share and share-price related incentive programmes are to be designed with the aim of achieving increased alignment between the interests of the participating individual and the company's shareholders. Programmes that involve acquisition of shares are to be designed so that a personal holding of shares in the company is promoted. The vesting period is to be no less than three years. Non-executive members of the board are not to participate in programmes designed for the executive management or other employees. Remuneration of non-executive board members is not to include share options.

9.9 Severance pay should not exceed an amount equivalent to the individual's fixed salary for two years.

requirements, permit a maximum of one member of management to sit on the board. Slightly more than half of listed companies do not have any executives on the board. For other senior executives – namely other members of the management– remuneration is disclosed on an aggregate basis. Several years ago, the Swedish government proposed broadening individual disclosure of compensation to a larger set of executives. However, this proposal was subsequently withdrawn out of fear that such disclosure would contribute to an upward ratchet of pay.

6.1.3. The role and structure of boards

The majority of companies determine their board size at their respective AGMs, and the size (minimum and maximum) is stipulated in the company Articles of Association. The law does not permit public companies to have boards smaller than three members (Chapter 8, Section 46). The Code (on NGM, the listing requirements), stipulates that the board may not contain more than one executive director (Section 4.3) and, according to the Companies Act, it is not possible for the CEO to also be the Chair. The majority of directors must according to the Code (in relation to Nasdaq OMX Stockholm – on NGM, this requirement is part of the listing requirements, which do not include a comply or explain possibility) be independent of the company and management and at least two of the independent directors must also be independent of major shareholders (*i.e.* those holding over 10%). . In addition to the Board members elected by the shareholders meeting, the board will include two or three employee representatives with deputies. Except for special conflict of interest situations, these Board members have the same rights and duties as the other members of the Board.

Swedish boards are elected by “plurality vote”, as mandated by the Companies Act (Chapter 7, Section 41). In this voting system the single winner is the candidate with the most votes; there is no requirement that the winner gain an absolute majority of votes. Nomination committees are regulated by the Code. The nomination committee is appointed by the shareholders meeting and must have no less than three members. The Nomination Committee submits a proposal to the AGM for the size of the board and nominates a corresponding number of candidates for election for a one-year term. Any shareholder may (at or ahead of the meeting) submit additional candidates for consideration or suggest an alternative board size, but this is rare in practice. Where the board size and the number of candidates are identical, a single vote in favour is sufficient to elect a candidate to the board. Technically each director is therefore elected individually, although it may appear to some as if the proposal is a bundled resolution. The procedure followed at AGMs may give the impression that shareholders must vote for or against all candidates as a bundle, however any shareholder may ask the chair of the AGM to instruct shareholders to vote for each candidate individually.

The Swedish nomination process is one of Europe’s most shareholder friendly systems, and could be considered an outcome consistent with the spirit and intent of Principle II.C.3 (“effective shareholder participation in key corporate decisions, such as nomination and election of board members should be facilitated”) and Principle VI.D.5 (“Ensuring a formal and transparent board nomination and election process”) . Under the Code, the AGM should appoint the members of the nomination committee or specify the manner of their appointment. Data from proxy advisors Manifest suggested that the implementation of this requirement is almost uniform, with listed companies routinely including such a resolution on their AGM agenda. The Code recommends that the

nomination committee should represent the shareholders and a majority of the committee must not be directors. Typically the nomination committee presents a proposal whereby the committee will comprise the chairman of the board of directors and the representatives of the four largest shareholders.

The number of directors on a typical Swedish board has remained relatively constant in the past three reported years, at around ten or eleven members, with independent non-executive directors dominating (refer Table 6.1), consistent with the code requirements for a majority of directors to be independent. The high proportion of independent directors (and the additional requirement for a proportion of directors to be independent of the blockholders) would suggest that, in practice, board composition in Sweden would facilitate the exercise of “objective independent judgement on corporate affairs” as proposed by Principle VI.E. The range of actual board sizes is generally between six and 14, with the larger board sizes being at the larger capitalised companies, consistent with the Swedish Code recommendations on board size, which state that “the board is to have a composition appropriate to the company’s operations, phase of development and other relevant circumstances” (4.1). It is also important to recognise that the figures in Table 6.1 include a number of employee appointed directors, with directors appointed by the AGM being significantly smaller. Market data (SIS Ågarservice AB, 2010) for 2009/10 suggested that the average number of AGM appointed directors was significantly lower at 6.3 directors across companies listed on the NASDAQ OMX and NGM exchanges.

Table 6.1. Board composition in Sweden

	Average board size	Proportion of execs	Proportion of NEDs	Proportion of independent NEDs
2007	10.1	11%	95%	70%
2008	10.7	10%	92%	59%
2009	11.3	10%	92%	64%

Source: Manifest Information Services (2010)

Directors’ duties are not listed exhaustively in the Companies Act, but the legal provisions and practices relating to their duties are in line with the recommendations of the OECD Principles. In the performance of their functions, directors have a duty to exercise due care and act in the best interests of the company (consistent with the twin duties of care and loyalty identified in Principle VI.A). In addition, there are specific provisions in the Companies Act ensuring equitable treatment of minority and controlling shareholders with respect to decisions by the company’s board and CEO (consistent with the requirements of Principle VI.B). The Swedish Companies Act states that a member of a board of directors or a managing director who, in the performance of his or her duties, intentionally or negligently causes damage to the company must compensate such damage. This applies not only to a director actively ignoring the best interests of the company but also a director who is passive or does not take sufficient action (Jackson and Wilson, 2008).

Where duties are breached, claims for damages to the company may be brought by the board of directors or shareholders. Shareholders representing at least 10% of the shareholding can bring derivative actions. The Companies Act provides that the general meeting of shareholders must annually consider a resolution discharging members of the board of directors and the CEO from liability, and the auditor’s report must contain a

statement concerning whether the members of the board and the CEO should be granted discharge. The principal effect of a decision to grant discharge from liability is to bar any action (with some exceptions) by the company against the board members and the managing director in relation to the financial year covered by the discharge. However, it only covers actions by the company; the discharge does not prevent actions being brought by shareholders.

6.1.4. Market environment and norms

Executive level pay in Sweden is low compared to the rest of Europe and other Nordic countries. A 2008 survey by the Swedish consulting firm Hallvarsson and Halvarsson, and based on annual report data, showed that Swedish CEOs “earn about 43% as much as their colleagues in Europe”. CEOs of 23 largest listed companies, excluding investment firms, earned on average 13.5 million kronor (or less than USD 2 million) in salary each year, not counting pension contributions. In addition, the survey found that the variable component of salary was not as great as for other European countries. About one third of Swedish CEOs’ compensation consists of variable compensation, compared to about half for other Nordic countries, while variable compensation accounts for about 73% of annual earnings by CEOs in other European countries (Hallvarsson and Halvarsson, 2009).

According to another recent study (Thomas, 2008) total average CEO pay package in 2005 at comparable Swedish firms was USD 948,990, or about 44% of the American CEO. Consistent with the above research, the study found that the pay structure at Swedish corporations is still heavily skewed toward salary, bonus and company contributions to government social programs or voluntary company sponsored plans. Long term incentive pay, including stock options, stock grants and other long term pay, comprises only 8.4% of total pay. Total variable pay, covering bonuses and long term incentive pay, is only 18% of CEO pay. For instance, annual bonuses at many Swedish companies do not exceed more than 2-3 months’ salary. Furthermore, the use of stock options has declined in listed companies.

The relative low levels of pay and the weighting toward fixed remuneration may in part be explained by the dominance of family controlled firms, and the relatively small and internal market for managerial talent. Family company control of a large number of enterprises means that there is comparatively little competition for executives, and employees have a naturally longer term focus on progressing within corporate groups. It seems likely that these company groups actively control career paths of the managers who work at each of their holdings with the capacity to transfer executives from one firm to another, even though the two are technically independent entities (Lubatkin *et al*, 2005).

As noted in the Swedish questionnaire response, “in very general terms it may be said that whereas monetary incentives certainly play a strong role – probably increasing over the last few decades - factors affecting the individual’s personal standing and career opportunities are also of considerable importance. Especially in a relatively small business community like the Swedish, it is of great importance as an individual to take care about one’s “CV record” and to develop a good personal standing and reputation on the market. Basically, this is true at all levels of organisation, but not the least at the senior executive and board director echelons, where informal credentials tend to play a more decisive role in recruitment procedures than for lower-level positions”.

Nonetheless, some Swedish investors are concerned about certain executive remuneration practices. For example, some firms position the pay of their executives at the upper quartile. Furthermore, some investors worry that boards often agree excessively generous compensation packages to external CEO recruits, which impact then ripples to lower levels of management as well as peer firms.

Cultural factors also play a large part in moderating salary levels and dictating structures in Sweden. A 2008 RiskMetrics study on executive compensation noted that Scandinavians are particularly sensitive to income gaps and that CEO salaries are often measured in terms of a multiple of “industrial worker salaries”. Further the report noted that there is unease with the concept that variable salary should be necessary to motivate executives, combined with a sceptical view of executive bonus arrangements as simply a disguised form of fixed salary (i.e. that bonus hurdles are illusory). A recurring theme in the public debate has been an emphasis on the capacity to structure performance criteria such that they are within an executive’s sphere of influence, with a related concern that executives could receive bonus payouts based on factors outside of their control. As noted in the questionnaire response, “a great majority (80-90%) of the adult population in Sweden have a direct or indirect ownership interest in the stock-listed companies through ownership of share and/or share funds of various kinds. This forms the basis of a certain degree of tolerance of high executive compensations, provided that they are firmly linked to relevant performance criteria and have a reasonably long-term perspective”.

Within companies themselves, this egalitarian ethos also appears to act as a self-moderating influence on pay levels and structures. Also, Swedish boards appear highly attuned to public sentiments about executive compensation, particularly in the wake of the global financial crisis. One Swedish board chairman noted that “you cannot ignore public opinion on remuneration because you need a ‘license to operate’”. In addition, public sensitivity regarding executive pay is used by some Swedish boards to repel demands by executives for higher compensation. Finally, while difficult to attribute the extent of its influence, high marginal tax rates may act as a moderating influence on pay outcomes.

Among the large listed firms average executive director tenure is less than four years (3.9 in 2008) and, given that the sole executive director is generally the CEO, this suggests that there is an active market for CEOs at least⁵. Despite the history of low executive pay, there is also a clear trend in Sweden toward higher executive salaries. Remuneration to executives in companies listed on the Stockholm Stock Exchange increased by 70% during the period between 1997 and 2002 (equivalent to an annual average growth rate of 11%). This rate of change, rather than the absolute level of remuneration, may in part explain the level of public disquiet.

Similarly, the number of long term incentive programs for executives has increased substantially over the last 15 years. In 1994, there were around 50 programs in place among the companies listed on the Stock Exchange, whereas the corresponding number for 2004 was 700 (Lubatkin *et al*, 2005). Nearly half of the OMXS30 companies use some kind of share option or share award schemes in their remuneration structure. The majority of these (80% or more) avoid annual retesting, operate over a performance period of three years and have a single performance criterion (usually Total Shareholder Return).

Despite this, only 3 companies in the OMXS30 actually paid out on any share schemes last year. One of the companies in question was Astra Zeneca, whose remuneration report resolution attracted some dissent. The average proportion of total remuneration that

share-based remuneration represented across the three companies whose schemes actually paid out during the most recently reported financial year was around 35%, varying between 10% and 55%. The 55% measure was at Volvo, whose remuneration policy allows for up to 65% of total remuneration to be variable remuneration.

6.1.5. Board practices

While the AGM is responsible for approving remuneration guidelines for executives on an annual basis, (and these are binding for the Board and the CEO, the functional role of the Board in the remuneration setting process) the Board still plays a key role. The main responsibilities of Swedish boards (excluding the CEO where they are a member) in respect of remuneration are to: propose the remuneration guidelines to be decided by the AGM including incentive schemes for company employees; determine the compensation package for the CEO and often (through the “Grand-Pa principle”) also to approve such packages for executives directly subordinate to the CEO as proposed by the CEO; monitor and evaluate all ongoing and recently expired programmes for variable remuneration, as well as the approved remuneration guidelines; and to report the results of these evaluations on the company’s website no later than two weeks before the AGM (Code rule 10.3, last paragraph).

Because of the non-executive nature of Swedish boards they do not have the same integrity problem vis-à-vis the company management in questions of CEO and top executive remuneration as is the case for boards with significant numbers of executive directors. (It should be noted that the single executive director permitted on Swedish boards cannot in any case participate in the Board’s deliberations on his or her remuneration on grounds of lawful disqualification.) Board independence is structurally strengthened by the mandatory separation of chairman and CEO roles under the Companies Act. Within the ambit of their role, it is therefore not difficult to conclude that the remuneration setting process is consistent with the practice advocated in Principle VI.E.1, that “boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest” including remuneration.

The Swedish Code proposes the establishment of a remuneration committee, that may comprise the Chairperson, and otherwise the other shareholders’ meeting-elected members of the committee must, according to the Code, be independent of the company and its executive management. While remuneration committees are commonly utilized in Sweden, their authority is necessarily limited. According to the Code, their main tasks are to i) prepare the board’s decisions on issues concerning principles for remuneration, remunerations and other terms of employment for the executive management; ii) monitor and evaluate programmes for variable remuneration, both ongoing and those that have ended during the year, for the executive management, and iii) monitor and evaluate the application of the guidelines for remuneration that the annual general meeting is legally obliged to establish, as well as the current remuneration structures and levels in the company. The annotations to the Principles note that in some jurisdictions it is considered good practice that “remuneration policy and employment contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors.” Given the positive requirements for independence contained in the code recommendations (and the already significant independence of the Board) Swedish practice would appear consistent with this

recommendation⁶. In any case, given the primacy of the shareholders meeting, it would seem that the use of the remuneration committees are not designed to be an independence-enhancing mechanism but simply to improve the ability of the board to discharge its duties efficiently. In this respect, the revised requirements placed on boards under the new Code may see an increase in the utilisation of the remuneration committee to perform the *ex-post* monitoring and evaluation functions.

While Swedish boards have always decided the CEO's compensation, their involvement in setting overall remuneration policy has expanded in recent years. This trend is driven by the increasing use of equity-based incentive schemes, which must be presented to shareholders for approval. Active board of directors' involvement in setting remuneration is the norm at Swedish companies, regardless of firm size or industry. On a relative basis, boards of financial institutions appear to have the most extensive involvement in setting executive remuneration. With incentive schemes that are more complex and cover a larger proportion of employees, the remuneration policies of these firms are usually more comprehensive and detailed.

Although the time commitment varies among companies, remuneration committees at the largest firms will meet up 4-6 times a year to discuss compensation issues that require addressing, gather and analyze market data, and prepare papers for discussion at board meetings while the full board will usually discuss remuneration on at least several occasions. At one large listed company, the remuneration committee met six times in 2009 while the full board addressed compensation at four of its twelve meetings the same year. At smaller firms, the remuneration committee will meet 2-3 times a year while the full board may discuss executive compensation issues only once a year. At all firms, the board and the remuneration committee will devote more time to remuneration when the overall policy is to be significantly altered or when new incentive schemes are proposed.

In terms of day-to-day involvement, the company's human resources department provides extensive support to the remuneration committee, assisting with such activities as gathering data, conducting analysis, and developing detailed proposals for consideration by the full board. In setting compensation structure and level, large company boards will usually conduct benchmarking exercises against industry competitors as well as similarly sized firms. Given the nature of the economy, the relevant market for benchmarking executive talent is the national market and, for a small minority, the regional market (*i.e.*, Nordic area). However, many of the largest listed companies and those in the financial sector believe they must set compensation at internationally competitive levels in order to attract the appropriate calibre of talent and prevent defections of their employees to foreign firms. At one financial institution, the board benchmarks compensation to domestic and international peers in its industry and to domestic firms with similar market capitalization.

While there is active debate in Sweden regarding the extent to which financial incentives motivate employees, as noted above, their prevalence – in the form of performance-based bonus and long-term incentive programs – has increased over the past decade, particularly among larger companies. Many listed companies retain compensation consultants to help design share schemes and provide comparative data to help boards decide salary and other compensation conditions for the CEO. In the past the process to appoint remuneration consultants was not always transparent and, at many companies,

they appear to be appointed by management, including the CEO and the human resources department.

The Code is silent on the issue of disclosure of Remuneration Advisors used⁷, and this does not seem to be an area where companies excel. In 2009, data from Manifest noted only four OMX30 companies disclosed the names of remuneration advisors used during the year. A related issue is the extent to which external consultants are conflicted via other standing engagements with the firm or through their means of appointment. The *Conclusions* paper noted that “where remuneration consultants are hired to advise on remuneration contracts and conditions, it is good practice for them to be engaged by the board with a key role for independent board members”. The recent changes to the Code have sought to address this point by providing that “if the remuneration committee or the board uses the services of an external consultant, it is to ensure that there is no conflict of interest regarding other assignments this consultant may have for the company or its executive management”. (Code 9.3)

At most listed companies, the CEO’s performance and remuneration is first assessed by the remuneration committee and then by the full board. Item 8.2 of the Code stipulates that “the board is to continuously evaluate the work of the chief executive officer. The board is to examine this issue formally at least once a year, and no member of the executive management is to be present during this formal evaluation process”. Performance is evaluated using a variety of financial and non-financial metrics. The process is normally led by the board chairman, who also serves as the remuneration committee chair at many companies (as allowed under the Code – 9.2). At one large listed company, the board evaluates the CEO on the achievement of financial objectives (e.g., return of equity and profit growth), personal qualities (e.g., leadership and decision-making) and other metrics integral to the long-term sustainability of the group (e.g., customer satisfaction). The factors employed have different weights and will evolve to reflect changing business priorities.

Consistent with the *Key Findings* that “evidence pointed to remuneration being set by a process where executives held a strong bargaining position”, Swedish chief executives are influential in the setting of executive remuneration. Apart from having in the past played a role in the appointment of compensation advisers, the CEO’s involvement in this area includes evaluating the performance of his subordinates and determining their compensation levels. In addition, the CEO provides input to the board on the overall structure of the remuneration policy and key elements of equity-based incentive schemes. Lastly, the CEO will usually solicit and convey to the board the views of the top management team regarding desirable changes, such as the introduction of an equity-based incentive scheme. However, the active involvement of major shareholders in nominating directors and serving as board members, acts as a constraint on CEO power and accordingly, the finding in the *Conclusions* that “the ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice” may apply less to Sweden than other markets.

Principle VI.D.4 states that one of principal responsibilities of the board is “aligning key executive and board remuneration with the longer term interests of the company and its shareholders”. In Sweden, boards are increasingly seeking to accomplish this objective through the use of short-term and long-term incentive arrangements, which typically employ performance targets to determine payout levels and require top management to

buy company shares with their own funds in order to be eligible to receive additional, “matching” shares. The requirements of the 2010 Code amendments will reinforce this process. This includes an overall requirement that variable remuneration “be linked to predetermined and measurable performance criteria aimed at promoting the company’s long term value creation”; and a further requirement that “share and share-price related incentive programmes are to be designed with the aim of achieving increased alignment between the interests of the participating individual and the company’s shareholders”. The Company Law requirement for 90% of voting shareholders (shares and votes) to agree to any scheme that involves the issue or transfer of shares is designed to avoid overly short-term and aggressive schemes, and schemes that are generally not considered to align the interests of shareholders, however, the difficulty of achieving a 90% threshold may mitigate against share based schemes being widely adopted.

Within the current variable remuneration, boards consistently use performance metrics – such as growth in share price and return on capital measures – to link executive remuneration to the achievement of the company’s strategic objectives. The challenge facing Swedish boards is devising performance metrics that, according to a local corporate governance expert, “will incentivise people in the right direction” and are relevant to individual executives. For example, although share price is a widely used performance metric at many Swedish companies, it may not be the most meaningful one for most managers since only the CEO is responsible for the overall performance of the company. Furthermore, given the dynamism of a competitive marketplace and difficulties in making accurate projections of performance beyond 2-3 years, there are limits to using any particular metric and performance target to achieve long-term strategic objectives. These concerns tie in with the overall debate in Sweden about the capacity to devise individual performance metrics for managers that are within their sphere of influence.

6.1.6. Shareholder engagement

As noted above, the legal and Code framework provide a good basis for allowing shareholders to make their views known on the remuneration policy for board members and key executives (Principle II.C.3). Ten years ago, executive remuneration was largely the province of the board chairman and the CEO, with little or no involvement of retail or institutional investors (controlling investors being the exception as they are able to provide input on executive remuneration through their membership on the nomination committee and the board). Since 2006, Swedish companies have been required to include a binding resolution on the remuneration policy on the AGM agenda. In addition, all equity issuances that would dilute existing shareholders – such as share schemes for executives and other employees – must be presented to the AGM and garner the support of 90% of the share capital and votes present to be approved. Today, owing to these approval provisions, and the increasing use of share-based incentive schemes (particularly at large listed companies), it is common for Swedish firms consult their shareholders on executive remuneration matters in advance of the annual general meeting.

In terms of format, some firms organize one-to-one and collective meetings with investors 2-3 months before the AGM to discuss remuneration proposals to be voted upon at that meeting and obtain feedback on such matters as the suitability of performance metrics proposed and vesting conditions for share awards. Collective meetings usually involve the ten largest shareholders and, in some cases, the retail-focused Swedish Shareholders Association. Equally prevalent are one-to-one meetings between the company and its shareholders, driven in part by the concern of some institutional

investors (particularly foreign investors) over related party issues. Until a few years ago, the chief executive would normally lead the discussion with investors on executive remuneration. In the face of investor opposition to this practice, today the board chairman or remuneration committee chairman spearheads dialogue with shareholders. As remuneration issues have become more complex, meetings with investors have increasingly included remuneration consultants and human resources personnel.

While institutional investors have welcomed the requirement for boards to present the overall remuneration policy for shareholder approval at AGMs, many investors – including institutional and controlling shareholders – do not wish to be involved in setting the compensation of individual executives. This responsibility, they maintain, rightly belongs to the board and the CEO.

As a result of its holdings in such companies as TeliaSonera and Nordea and role as a regulator, the Swedish government is also involved in setting executive remuneration. In the wake of the financial crisis, the government has sought to reduce the quantum of pay and eliminate or reduce the proportion of variable pay, especially in the financial sector. In 2008, the government announced a set of remuneration principles for CEO of state-owned companies. For listed companies these principles were negotiable after discussions with other shareholders (similar guidelines were issued in 2003 but had not been fully implemented). Apart from excluding CEOs from bonus arrangements, the new guidelines seek to cap other managers' bonuses at a maximum of four months' salary. Performance criteria should be well-defined, measurable, and within the control of the concerned employee. No severance pay should be due in case of resignation (and change in control).

Companies have also responded to recent rejections by shareholders – particularly foreign investors – of a share scheme at Ericsson and a share issuance proposal at Electrolux, so that Swedish companies with substantial foreign share ownership have stepped up their engagement with these investors on remuneration. As foreign investors are often unable to travel to Sweden for meetings to discuss executive compensation, some firms such as Ericsson and TeliaSonera organize teleconference calls for foreign investors. In addition, as foreign investors tend to rely heavily on proxy voting advisory firms in making voting decisions, some Swedish firms also consult these advisers on their remuneration proposals.

Nevertheless, despite owning approximately 35-40% of the Swedish stock market, foreign investors are not actively involved in the broader debate on executive remuneration and do not generally provide input on remuneration matters at individual companies, except when they sit on a company's nomination committee. According to one Swedish institutional investor, the lack of involvement by foreign investors in this area is attributed to their view that remuneration practices at Swedish firms do not pose a serious concern.

Voting procedures may also provide some explanation of a lack of engagement. Shareholders wishing to vote in absentia are required to designate a representative to act on their behalf at the meeting. Generally, while the outcome of voting proposals is disclosed (*i.e.* whether the required majority was achieved), more detailed data is not. Among the leading companies, turnout was disclosed in respect of seven AGMs, with four of these companies being incorporated outside of Sweden. Voting data is fully disclosed by some companies, partially by others (*i.e.* against votes and abstentions only, but not for votes) but not at all by the majority. In most cases, it is stated that the data is included in the appendices to the minutes, which are generally not included on the company website

although may be sent to shareholders upon written request. However should shareholders specifically request votes to be counted, then the law provides for this to be carried out.

Unlike other markets such as the UK where boards struggle to reconcile divergent investor views on remuneration, Swedish institutional investors appear to maintain broadly similar positions on executive compensation. According to one Swedish institutional investor, “Sweden is a consensus society and consensus has been found among institutional investors on most areas of executive remuneration, such as the desirability of including performance conditions in incentive schemes and requiring executives to acquire a certain amount of shares in the company using their own money”.

6.2. Conclusions and comments

Sweden’s listed company sector is one traditionally characterised as being dominated by controlling shareholders, consistent with other continental European countries. Corporate governance systems in Sweden have historically been well functioning, ordered by industry practice rather than formalised rule, and assisted by the dominance of the family groups who have provided a strong monitoring function. However, the reliance on informal practice has changed over the last decade with a greater emphasis on codification of good practice and the increasing use of regulations and codes to structure company relationships and disclosure. Corporate governance in the listed company sector in Sweden is now governed by a combination of hard and soft laws and generally accepted practices.

The determination of directors’ and executive remuneration is addressed both in the Code and in the law. All Board remuneration, to be decided upon for each board member individually, is determined by shareholders according to the Companies Act. The Act also requires the shareholders to annually approve remuneration guidelines for executives. These guidelines are binding upon the Board. The Code provisions have been significantly expanded with new rules that will apply from July 2010. The Code establishes: the role of the remuneration committee (particularly in terms of monitoring outcomes); the structure of remuneration and the design of incentive based payments (aimed at the longer term), including the potential for clawback; the disclosure of information to shareholders to promote informed voting on share based payments; and restrictions on severance payments.

6.2.1. Board structure and duties

Swedish boards are dominated by independent non-executive directors, consistent with the code requirements for a majority of directors to be independent, and a maximum of one executive is allowed to sit on the board. The high proportion of independent directors (and the requirement for a proportion of directors to be independent of the block-holders) suggests that, in both law and practice, board composition in Sweden facilitates the exercise of “objective independent judgment on corporate affairs” as proposed by Principle VI.E. Within the ambit of their role, it is not difficult to conclude that the remuneration setting process is consistent with the practice advocated in Principle VI.E.1, that “boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest”.

Directors’ duties are not listed exhaustively in the Companies Act, but the legal provisions and practices relating to their duties are in line with the recommendations of

the OECD Principles. In the performance of their functions, directors have a duty to exercise due care and act in the best interests of the company (consistent with the twin duties of care and loyalty identified in Principle VI.A). In addition, there are specific provisions in the Companies Act ensuring equitable treatment of minority and controlling shareholders with respect to decisions by the company's board and CEO (Principle VI.B).

6.2.2. Board practices

Executive level pay in Sweden is low compared to the rest of Europe and other Nordic countries. The pay structure at Swedish corporations is still heavily skewed toward salary, bonus and social security contributions. Long term incentive pay, including stock options, stock grants and other long term pay, are less common. The relatively low levels of pay and the weighting toward fixed remuneration may in part be explained by the dominance of family controlled firms, and the relatively small and internal market for managerial talent. Family company control of a large number of enterprises means that there is comparatively little competition for executives between company groups, and employees have a natural longer term focus on progressing within corporate groups.

Given that the Companies Act provides that the AGM approves remuneration guidelines for executives on an annual basis, and these are binding for the Board and the CEO, the functional role of the Board in the remuneration setting process is constrained. The main responsibilities of Swedish boards (excluding the CEO where they are a member) in respect of remuneration are to typically implement the company's overall remuneration policy decided upon by the shareholders meeting, oversee the development of share-based incentive schemes, and determine the compensation package for the chief executive. In addition many – but far from all – boards apply the so-called “Grandpa Principle” through which the Board reserves the right to have a final say on the remuneration of senior executives directly subordinate to the CEO.

Because of the limited scope of their role in the remuneration process, it is difficult to conclude that boards are exercising the role of “aligning key executive and board remuneration with the longer term interests of the company and its shareholders” (Principle VI.D.4). Nevertheless, the strong role of the General Meeting in setting remuneration would suggest that the institutional arrangements are sufficient to facilitate equivalent outcomes. The requirements of the 2010 Code amendments will reinforce this process. This includes an overall requirement that variable remuneration “be linked to predetermined and measurable performance criteria aimed at promoting the company's longer term value creation”. While designed to protect against dilution, the strict Company Law requirement for 90% of voting shareholders to agree to any scheme that involves the issue or transfer of shares may mitigate against share based schemes being adopted as a means of aligning shareholder and executive interests.

6.2.3. Disclosure

Consistent with Principle V.A.4, Swedish boards are required under the Companies Act to disclose the individual remuneration of all board members and the CEO and to present a remuneration policy for approval by shareholders at the AGM and to publish the policy on the company's website no later than two weeks prior to the shareholders meeting. There has been some discussion that the remuneration policies voted upon at AGMs are often vaguely worded and do not therefore constrain boards and management sufficiently. 2008 revisions to the Code have sought to address this concern, requiring that, in relation to

incentive based payments, “the material is to be clear and simple enough to allow shareholders to form an opinion on the reasons for the scheme, the principle conditions of the scheme and any dilution of the share capital that may result from it, as well as the total cost to the company of different conceivable outcomes”.

6.2.4. Shareholder engagement

The legal and Code framework provide a strong basis for allowing shareholders to make their views known on the remuneration policy for board members and key executives (Principle II.C.3). While institutional investors have welcomed the requirement for boards to present the overall remuneration policy for shareholder approval at AGMs, many investors – including institutional and controlling shareholders – do not wish to be involved in setting the compensation of individual executives. This responsibility, they maintain, rightly belongs to the board and the CEO and, in any case, there is a widespread view amongst institutions that remuneration practices at Swedish firms do not pose a serious concern.

Notes

1. According to the Code, only one member from the company’s management, if any, may sit on the Board.
2. Rules on share based payments are also laid down, in more detail regarding the decision making process and information requirements, in statements from the Securities Council.
3. The requirement for a 90% majority of both votes cast and shares present at the shareholders meeting has proved problematic for the approval of share schemes in the past. At their 2007 AGM, Telefon AB LM Ericsson proposed a number of resolutions to implement long term incentive plans for executive and staff. The proposals were not approved because of the inability to pass the 90% threshold for the issue of shares.
4. With the implementation of the shareholders’ rights directive in 2011, this will be changed to three weeks prior to the AGM.
5. Outliers in executive tenure were Volvo, Scania and Investor AB, all of whom were above 12 years.
6. Furthermore, the independence of non-executive directors is maintained – or at least not compromised – by a prohibition on their participation in incentive schemes.
7. In addition, the European Commission Recommendation on fostering an appropriate regime for the remuneration of directors of listed companies in 2004 setting out that the Remuneration Statement “should include information, if applicable, about [...] the names of external consultants whose services have been used in determination of the remuneration policy” (although it should be noted that the Commission’s own review of implementation of the Recommendation did not mention this aspect of it at all).

PART II
Chapter 7

United Kingdom: Review of Board Practices for Managing Incentives and Risks

This chapter on the United Kingdom is based on detailed responses to a questionnaire provided by the United Kingdom, together with independent research by the Secretariat including missions to the United Kingdom. The chapter describes:

- *the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives;*
- *the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders; and*
- *how boards influence incentives and what role is played by transparency and by shareholders.*

Within these areas, the discussion is based on the individual principles relevant to the review. The chapter is intended to be descriptive and not normative in character. The second part of the chapter is devoted to conclusions about the United Kingdom.

7.1. Detailed analysis

7.1.1. Background

The UK has a highly liquid listed company sector with dispersed ownership and a system of corporate governance that has developed significantly over the last two decades. Prior to the release of the Cadbury report in 1992, corporate governance of UK companies is best described as being regulated by custom and practice. The Companies Law, together with some stock exchange requirements, laid down only basic rules concerning boards of directors, financial reporting and audit (Abdullah and Page, 2009). The Cadbury review, which was established in response to a series of financial scandals, began the process of greater codification of corporate governance norms and was the first set of external recommendations on the arrangement of company boards and accounting systems in the UK. Since that time, the UK has progressively developed a system of both hard and soft law frameworks to strengthen its corporate governance framework. This has included systematic revisions to the Combined Code (now called the UK Corporate Governance Code, under its 2010 iteration) as well as a major rewriting of the Companies Act.

Together with the US, the ownership structure of UK listed firms is one of the most dispersed amongst OECD countries. For example, in about 90% of companies listed on the London Stock Exchange, there is no major shareholder owning 25% or more of the voting rights in companies (Goergen, and Renneboog, 2001).

By comparison, as noted in the section on Sweden, approximately 64% of Swedish listed companies had one shareholder with at least a 25% shareholding, and in Germany it is the case in 82% of companies. Share ownership is instead dispersed widely in the hands of financial institutions both local and foreign. In 2008, foreign shareholders accounted for over 40% of all shareholdings on the London Stock Exchange (and evidence suggests that it is increasing still). This was not true 20 years ago when domestic investors predominated. In 1989, foreign shareholders accounted for approximately 12% of all shareholders). Domestic pension, insurance and other financial institutions accounted for over 35% of shareholdings (down from approximately 50% in 1989). Individuals, on the other hand, accounted for just over 10% of direct shareholdings (as opposed to over 20% in 1989) (UK Office for National Statistics, 2008).

7.1.2. Legal and regulatory frameworks

The principle legislative framework governing corporations in the UK is the Companies Act (2006). The Act was substantially rewritten in 2006, following an extensive review process designed to bring the company law framework in to line with modern business needs. One of the expressed objectives of the reform process was “to enhance shareholder engagement and a long term investment culture”¹; via measures such as improved shareholder dialogue, and greater transparency and disclosure.

UK company boards have a unitary structure, usually comprising both independent, non-executive directors and executive directors who are responsible for the day to day operations of the company. For listed companies it is usual that the Chairman is an independent appointment, separate from executive management². The Chief Executive has responsibility for the day to day management of the company and putting into effect the decisions and policies of the board. Executive directors, other than the CEO often include divisional or geographical heads and/or the finance director (FD). A Company Secretary usually attends the board meetings but is not normally a director.

With respect to remuneration, the UK introduced new reforms in 2002 that afforded shareholders a mandatory but non-binding vote on director remuneration, for companies listed on the London Stock Exchange. These “say on pay” reforms have been retained with the introduction of the new Companies Act in 2006. The provisions fulfil the recommendations of Principle II.C.3 that “shareholders should be able to make their views known on the remuneration policy for board members and key executives”. While the “say on pay” provisions do not require a mandatory vote on the equity component of compensation plans for board members and key executives (the final limb of Principle II.C.3) this is an explicit requirement under the Combined Code (refer further below). In addition, the Listing Rules require shareholder approval of all new share option schemes and Long Term Incentive Plans as well as approval for significant changes to existing schemes.

To the extent that there are key executives who are not on the board, then the “say on pay” provisions would not have the full coverage anticipated by the Principles. In this regard, it has been the case in the past that most key executives would also be executive directors on the board. However, there has been some suggestion that one impact of the provisions has been to reduce the propensity for executives to actually sit on boards, in part to avoid the disclosure and approval regimes that their membership would invoke. While this is hard to judge in practice, data from manifest does show a gradual reduction in the proportion of executive directors sitting on company boards (refer Table 7.1). However, it should be noted that this trend – which has also been attributed to the 50% non executive directors requirement in the 2003 Code – pre-dates both the 2002 Regulations and 2003 Code, although it has continued since. Research by the London School of Economics into the composition of FTSE 350 boards found that the average number of executive directors fell from 5.2 in 1995 to 4.8 in 2000 and 3.9 in 2005.

Table 7.1. **Board composition in the UK**

	Average board size	Proportion of execs	Proportion of NEDs	Proportion of Independent NEDs
2007	11.2	34%	66%	61%
2008	11.2	33%	67%	62%
2009	10.9	30%	70%	64%

Source: Manifest Information Services (2010)

7.1.2.1. The duties of directors

Directors duties are expressed in favour of the company, rather than shareholders, and in the UK have traditionally been the preserve of the common law. However, as part of the 2006 reforms, the government introduced a statutory statement of directors’ duties such that they are now expressed as seven discrete general duties within the Companies Act³.

While these are largely a restatement of the pre-existing common law fiduciary and other duties, one manifestation of the new focus on a longer term investment culture was to describe the duties under a framework of “enlightened shareholder value”. In particular, the codified “duty to promote the success of the company” is an extension of the common law fiduciary duty to act in good faith in the company’s best interest. As casting this responsibility as one “to promote the success of the company” the act embraces a wide definition of the matters to which a director must give attention. Of importance for the remuneration setting process, the duty requires directors to consider “the likely consequences of any decision in the long term”. The codified duties encompass the twin duties of care and loyalty envisaged by Principle VI.A.

While the common law duty of directors was expressed in favour of the company, the legislation goes further to require directors to more explicitly consider the interests of shareholders and stakeholders: while the directors must “promote the success of the company for the benefit of its members as a whole”, the legislation is more expansive in requiring directors to **consider** matters such as: i) the relationships with suppliers and customers; ii) the interests of employees iii) the impact of the decision on community and environment; iv) the desirability of maintaining a reputation for high standards of business conduct; and v) the need to act fairly as between members of the company. In this respect, the legislation provides an expansive implementation of Principle VI.B (“where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly”) and Principle VI.C (“The board should ... take into account the interests of stakeholders”). This move toward more explicit consideration of stakeholder interests is a potentially significant evolution in the conception of the role of the board in the UK. However, there has yet to be relevant case law to provide clarity on the extent to which directors need to take account of these objectives, including with respect to the setting of remuneration and incentive structures, and how directors may act when the relevant interests are in potential competition with the overriding objective to the company, or among themselves.

7.1.2.2. The role of the combined code

The Companies Law is supplemented by the Combined Code of Corporate Governance, which provides guidance to companies on four discrete areas: the role of the board; the remuneration of directors; auditing and disclosure; and relationships with shareholders. The code also provides guidance for institutional shareholders on their interaction with listed companies. The Code forms a part of the Listing Rules at the London Stock Exchange, so that all UK incorporated companies⁴ whose primary listing is in London are also subject to the Code. The Code operates on a ‘comply or explain’ basis, giving companies the flexibility to choose to comply with the provisions of the code or, alternatively, offer reasonable explanation which is for the market to judge as to why they are not compliant with any particular provision.

The extensive provisions relating to the setting of director remuneration are ordered under two main principles. The first relates to the structure and quantum of director remuneration. It provides that levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance. The second main principle relates to the governance of the

remuneration process. There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Beneath these two overarching requirements the Code provides a number of supporting principles and code provisions that seek to expand on both the structuring of remuneration and the governance of the process. In relation to the former, the Code provides that the performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. A schedule to the Code sets out a number of specific provisions on the design of performance related remuneration (Refer Box 7.1). Taken together, these provisions are a highly consistent, and extremely detailed, expression of the requirements of Principle VI.D.4 that the board should align “key executive and board remuneration with the longer term interests of the company and its shareholders”.

While the first overarching principle (on remuneration structure) relates only to directors, for the remuneration setting process, the coverage of the code is wider than directors and includes senior executives who are not directors. The second overarching principle makes this clear when it states that the board is responsible for establishing a “formal and transparent procedure for developing policy on executive remuneration”. The sub-principles go on to note that the remuneration committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of ‘senior management’ for this purpose should be determined by the board but should normally include the first layer of management below board level. In addition, in relation to long term incentive schemes, the Code provides that “shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules” and this does not seem to be limited to director plans only since the Listing Rules refer to employee schemes. As such it would seem that key executives, who are not members of the Board, are subject to the Code provisions, and the remuneration setting process would cover the full range of personnel envisaged by Principle VI.D.4.

In terms of the governance processes, the Code recommends that the board should establish a remuneration committee of at least three or, in the case of smaller companies, two independent non-executive directors. In addition, the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. These provisions are consistent with the approach advocated in Principle VI.E.1 (that boards should consider assigning a sufficient number of non-executive members capable of exercising independent judgement to tasks such as board remuneration setting) and in Principle VI.E.2 that the “mandate, composition and working procedures [of board committees] should be well defined and disclosed by the board”.

In March 2009 the Financial Reporting Council (FRC) announced a review of the Combined Code, as a result of which it proposes to make a number of revisions to the Code. Consultation on these proposals ended on 5 March 2010. In December 2009, the Financial Reporting Council released its review of the Combined Code that included a review of the

Box 7.1. Combined Code Provisions on the Design of Performance Related Remuneration

- The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, ambitious and designed to enhance shareholder value. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.
- The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.
- Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
- Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
- Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
- In general, only basic salary should be pensionable.
- The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

remuneration related elements of the Code. An important finding of the review was the conclusion that the Code should not become more prescriptive, recognising that best practice in the area is evolving and prescription could lead to any recommendations becoming out of date. Instead, the Code review sought to better enunciate some high level principles. In particular, the review proposed a new supporting principle to be added emphasising that performance-related remuneration should be aligned to the longer term success of the company. The Code would not specify how this should be achieved, with this left for each company to explain in the context of their own circumstances. The code will also be amended to make an explicit reference to link between remuneration and risk policy, and to the clawback of variable compensation in certain circumstances.

7.1.2.3. Institutional guidance

Apart from the provisions of the code, there are strong traditions in the UK of encouraging appropriate corporate governance practices through notions of generally accepted business practice. In many cases these practices (or, in some cases, aspirations) have been given expression through best practice documents issued by various market participants. Such guidelines have strong moral suasion and companies generally seek to

abide by this institutional guidance. Among institutional investors, guidelines issued by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) are considered the most influential. Their importance is reflective of their membership: ABI members own or control approximately 20% of the listed capital on the London Stock Exchange; the members of the NAPF control assets approximately half that size.

With respect to remuneration, in December 2009 the ABI released a set of Guidelines on Policies and Practices in Executive Remuneration. These extensive guidelines cover the overall role of the board and the remuneration committee in the remuneration setting process (namely, “adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term”; guidance on how to structure remuneration arrangements; and specific guidance on share based schemes. Importantly, the guidelines stress the importance of remuneration Committees paying particular attention to arrangements for senior executives who are not board members but have a significant influence over the company’s ability to meet its strategic objectives including its risk appetite. This reflects the concern noted above that the Code’s focus on director remuneration may not adequately address the importance of the remuneration of non-director executives to a company’s risk profile and longer term performance.

7.1.2.4. Other recent reforms or proposals

In February 2009, the UK Government established a review committee to examine corporate governance practices in the financial sector (the Walker review), in response to failings revealed during the financial crisis. The review’s final recommendations were released in December 2009. While the findings are specific to the financial sector, they have provided some insight into the role of boards in the remuneration setting process and the particular the issue of aligning incentive structures with the longer term objectives of the company. To this extent, the Walker Review has provided valuable input into the Financial Reporting Council’s review of the Combined Code. The terms of reference for the review required it to specifically examine “the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively”.

One area where it noted a need for better governance, and which may be applicable more widely than the financial sector, was in the interaction between risk committees (or equivalent) and remuneration committees. While the need for incorporating risk alignment considerations into the remuneration process is reflected in the Code provisions requiring alignment of remuneration with longer term value creation, the difficulty for boards is how to operationalise such arrangements. The Walker review noted that “while it is for the remuneration committee to determine, the performance objectives for the remuneration packages it decides will be appropriate, the board risk committee, advised by the CRO, should be accorded an effectively independent authority in respect of risk adjustment of these objectives”. This proposal makes clear that the remuneration committee should retain overall responsibility for making recommendations but that they should seek the input of the risk setting body (e.g. the risk committee) on appropriate risk adjustments to remuneration. This is consistent with the finding in the *Conclusions* that “it is important that the risk management and reporting functions system should consider any risks that may be related to the company’s remuneration and incentive systems”.

7.1.2.5. Disclosure and transparency

The Companies Act provides that the advisory “say on pay” vote of shareholders must be based on a detailed Directors’ Remuneration Report to be approved by the Board. The contents of the report are consistent with the guidance provided in Principle V.A.4 that company “disclosure should include, but not be limited to, material information on ... remuneration policy for members of the board and key executives.” Under their remuneration report, UK boards are required to prepare a comprehensive remuneration report covering, *inter alia*:

- Composition of the remuneration committee
- Details of salary, bonus, and other features of employment contracts of individual directors, including loss of office provisions
- Details of pension arrangements of individual directors
- Description of short-term and long-term incentive programs and details of incentive awards granted to individual directors
- Statement discussing consideration of pay conditions elsewhere in the company
- Graph comparing the company’s total shareholder return to the performance of a relevant broad market and/or industry index

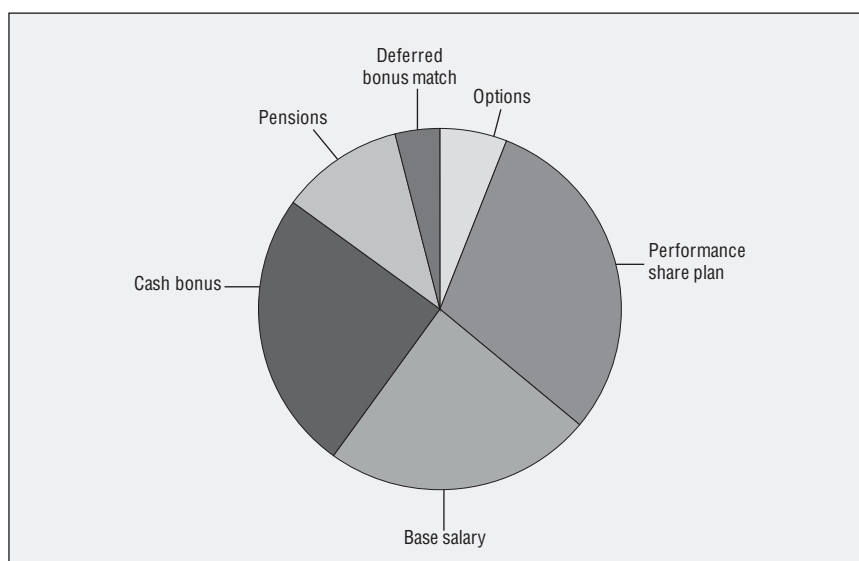
In addition, certain disclosures in the remuneration report – such as salary, bonus, and share awards for executive directors – are subject to audit since they are part of the financial statements.

7.1.3. Market environment and norms

In comparison with other OECD countries, the UK could be considered to have a highly competitive market for executives, both domestically and, to a lesser, extent internationally. In terms of outcomes, executive pay has increased considerably in recent years. At FTSE 100 companies, the average compensation package of the CEO rose from GBP1 million in 1998 to approximately GBP3.5 million in 2008 (equivalent to an annual average growth rate of over 13%). Over this period, the ratio of CEO compensation to average employee pay increased from 47 to 128⁵. Many commentators, including remuneration committee chairmen, have expressed the view that while designing a good structure is relatively straight forward, dealing with level of compensation has been extremely difficult due to the competitive environment for talent, disclosure requirements, public scrutiny, and the highly personal and adversarial nature of negotiations with executives on this topic. In this regard, the position of the *Conclusions* paper that “the ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice” applies to the UK.

Total remuneration levels in the FTSE 100 for CEOs for the most recently reported results vary between approximately GBP1.1m at the lower end and GBP58m. On average, this figure settles at around GBP3.5m across the whole group, inclusive of projections of reasonable achievement of long term incentive awards. The composition of CEO remuneration is shown in the following graph.

According to data from Manifest, the average distribution of Bonus and Long Term Incentives as a percentage of total remuneration in the FTSE 100 varies with market capitalisation. Those with the lowest market capitalisation average around 48% for CEO’s, and 45% for other Executives, rising to 66% and 68% respectively for the largest. The

Figure 7.1. **Average package mix 2009 for FTSE 100 CEO**

Source : PriceWaterhouseCoopers (2010), *Is Pay for Performance a Force for Good? Executive Compensation Review of the Year 2009*.

acceleration towards this higher figure is much more marked amongst CEO's some of whom take a very large proportion of total compensation. This increase in proportion is entirely fuelled by the increased likelihood of Long-term Incentive payouts. Cash bonuses have actually increased substantially in relation to base pay but have stayed relatively constant as a proportion of total remuneration (because long term incentives have increased so markedly).

For non-CEO executives, the general mix of the constituent parts of total remuneration for a typical executive in the FTSE 100 is currently 30-35% salary, 10% pension, 10-15% cash bonus, with the remaining 35-45% made up with Long Term Incentives. The balance of the different constituent parts is variable according to market cap as well as sector practice. The same data shows that the percentage of bonuses paid out in the most recent year was on average approximately 50% of the maximum allowed across the FTSE 100. This suggests that the performance hurdles for bonuses are genuine. Larger capitalisation companies have lower payout levels (41% on average) than smaller companies (55%).

The use of share options – which provides executives with significant upside but limited downside potential – has declined among listed UK companies. At the same time, the common practice of calculating the value of shares to be granted as a percentage of an executive's salary (e.g., BP's CEO is eligible to receive annual share awards of up to 550% of base salary) does not appear to create alignment with shareholders – particularly in a severe bear market – as executives stand to receive a greater number of shares if the company's share price declines.

The Combined Code Provisions on the design of performance related remuneration suggest minimum three year vesting periods for long term incentives. This recommendation is generally followed by listed companies and is systematically enforced by institutional investors when consulted about potential schemes. According to data from Manifest, across the FTSE 100 there are a very few schemes (only four) that do not meet this length of performance period. Further the average overall length of performance period for

share option schemes is just less than three years, suggesting that taking into account the fact that four schemes have shorter periods, virtually all of the remainder have adopted the standard three year period.

The vesting of share awards at most UK companies is based upon a graduated schedule rather than an “all-or-nothing” structure. To illustrate, UK share awards employing share price as a performance metric typically vest in the following manner:

- 25% of shares awarded will vest for median share price performance (versus a relevant comparator group of companies).
- 100% of shares awarded will vest for upper quartile or upper quintile share price performance.
- The percentage of vesting will rise proportionately (i.e. in a straight line) for share price performance between these two points.

7.1.3.1. The relative importance of director remuneration versus executive remuneration

While the focus of the UK’s disclosure and approval regime is on directors’ remuneration, the main target of these arrangements would appear to be the executive directors (and, in particular, the CEO), rather than non-executive directors. A survey of FTSE 100 companies in 2009, showed that the median board fees for Chairmen GBP300 000, and for non-executive directors GBP62 000 (with additional fees for committee chairmanship; a median GBP18 000 for the audit committee chairman). Given that the structure of their remuneration is largely fixed, and their relatively senior profile, it is reasonable to assume that the focus of non-executive director engagement with the company will be essentially geared around their core attribute of independence.

The Combined Code makes clear that the remuneration of non-executive independent directors should be structured in a manner consistent with promoting their independence. The Code provides that the level of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Furthermore, holding of share options is considered relevant to the determination of a non-executive director’s independence

As noted above, the extent to which law focuses on director remuneration may exclude from the scope of disclosure and shareholder engagement, the remuneration arrangements for senior executives who nevertheless have a significant bearing on the longer term performance of the firm and, in particular, its risk profile. Such a view was expressed by the Walker review, although clearly this was limited to the financial sector where arguably sub-director level executives have a greater capacity to influence the risk profile than may be systematically the case in non-financial listed companies. The review noted that “disclosure of “high end” remuneration, going well beyond the previous exclusive focus on executive board members, is essential if major shareholders are to be able to reach informed views on the governance of their investee companies and appropriate alignment of incentives”. The report noted that while there was significant pressure (including in the media) to report individual remuneration of “high end” executives, the review preferred an aggregated approach whereby disclosure was based on remuneration bands.

7.1.4. Board structure and composition

The Combined Code goes to some length to set out provisions on board balance and size, with emphasis on balance. Whilst no specific figure is stated as a preferred maximum size, the code is careful to prescribe that boards do not become so big as to be 'unwieldy'. In relation to balance, the code is clear on the notion of independence. There should not be undue concentration of power or dominance within or between executive directors and non-executive directors (especially independent directors). In practice, this means that at least half of the directors (not including the chairman) should be deemed independent by the company.

As a part of independence considerations for non-executive directors, tenure is a consideration. Whilst any measure may be argued arbitrary (and evidence shows that shareholders are indeed sensitive to this), the measure set out in the combined code is a maximum of nine years. (The average tenure amongst the FTSE 100 is approximately half this (4.6 years), whereas the average tenure for executive directors is just over five years). The code is also careful to note the importance of directors having appropriate qualification and experience represented on the board relevant to the area of business of the company in question. Therefore the more complex a business, the larger the board may justifiably be. Amongst the FTSE 100, the average size of the board is approximately 11, with a 30/70 split between executives and non-executives. Almost all non-executives are independent. In general, the composition of boards would seem consistent with the overarching recommendation in Principle VI.E that the "board should be able to exercise objective independent judgement on corporate affairs".

The Combined Code has an entire section devoted to the issue of the roles of chairman and chief executive. Provision A.2.1 of the code states that "the roles of chairman and chief executive should not be exercised by the same individual". In practice, this requirement is almost universally followed. Only four companies the FTSE 100 had a joint Chair/CEO in the most recently reported year (2008), constituting 4% of the index. Marks and Spencer was by far the most conspicuous, attracting international press attention in light of its long running succession planning problems (however, this has now been resolved, with a separation of the Chair and CEO functions). The separation of the Chair and CEO roles is consistent with the guidance provided in the annotation to Principle VI.E that "with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of chief executive and chairman".

For listed companies, the Code provides for one of the non-executive directors to be nominated as the senior independent director. This is also consistent with the best practice mentioned in the annotations to Principle VI.E, which notes that this can "help to ensure high quality governance of the enterprise and the effective functioning of the board". In the UK, the role of the lead independent director is to provide a sounding board for the chairman, to be responsible for the evaluation of the chairman and to serve as a trusted intermediary for the non-executive directors. They also act as a conduit for shareholders who wish to raise issues through a medium other than the Chairman. The need for the senior independent director role in the UK is partially explained by the unique role of Chairmen in the governance process. The Combined Code (refer below) does not classify Chairmen as non-executive directors but equally they would rarely be considered executive directors. Rather, Chairmen could be considered as both guardians of shareholder interests but also a facilitator between the executive management and the non-executive directors.

The Code states that “the board should establish a remuneration committee of at least three [...] independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. Every FTSE 100 company has a remuneration committee. According to data from Manifest, the average committee size is just above four members (4.2), with no company having fewer than the minimum Code standard of three. During the most recently reported financial year, only one constituent of the FTSE 100 had fewer than three independent directors on their remuneration, and in this case it was due to one of the directors being just over the tenure threshold for independent directors. In one company, the Chairman was also chair of the Remuneration Committee, which is interestingly the same company (Xstrata) that showed the highest levels of total remuneration for the CEO in that year (GBP 58million).

7.1.5. Board practices

In recent years, UK boards have devoted increasing attention to setting executive remuneration. In terms of processes, the practice amongst UK companies is generally consistent with Principle VI.D.4 that boards should align “key executive and board remuneration with the longer term interests of the company and its shareholders”. In the UK, boards endeavour to accomplish this objective through the use of performance-based short-term and long-term incentive arrangements. Commonly utilized performance metrics include earnings per share, return on capital measures, and share price. Remuneration committees will normally modify performance metrics every few years to reflect changing business priorities as well as to prevent gaming by executives. In the past year, a few firms have also extended the time frame for evaluating management performance and introduced clawback provisions to enable the company to reclaim previously paid bonuses if an executive’s actions prove damaging to the firm in the longer-term.

Nevertheless, it is an open question as to whether the outcomes of the remuneration setting process, and in particular the setting of correctly specified performance metrics, is consistent with Principle VI.D.4. In this regard, a potential cause for concern is the relatively dominant role played by executives in the remuneration setting process. In line with the *Key Findings* that “evidence pointed to remuneration being set by a process where executives held a strong bargaining position”, UK chief executives are actively involved in the remuneration setting process. The CEO (and CFO) will usually propose the performance targets (*e.g.*, earnings per share growth) that the remuneration committee would use to determine the amount of bonus to award at the end of the year and the proportion of restricted shares that will vest at the end of the relevant time period. Given the potential information asymmetry that exists between executives and the board members involved in setting performance targets, there is the prospect that performance hurdles to be specified at levels which do not adequately align management incentives to shareholder and company interests. It is interesting to note that management bargaining power seems to be a greater risk in the UK (with its diverse shareholder base) than in those reviewed countries (Brazil, Sweden and Portugal) that have controlling shareholders that seem to act as a counterbalance to executive power, and may not suffer from the same information asymmetry problems.

7.1.5.1. Remuneration committees

UK practice is generally consistent with Principle VI.E.1 that “boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential conflict of interest... [such as] board remuneration” and with the annotation to Principle VI.D.4 that “remuneration policy and employment contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors”. At most British companies, the board typically decides non-executive director remuneration but delegates responsibility for setting executive compensation to a remuneration committee comprising a majority or solely independent directors. Apart from enhancing efficiency, this arrangement is seen to be necessary because UK boards comprise a significant proportion of executive directors (up to 50%), who will be conflicted if they participate in board discussion on executive pay.

The remuneration committee typically determines the company’s overall remuneration policy, sets the salaries and other compensation components of the executive directors, and develops short and long-term incentive programs for top management. In recent years, many remuneration committees have begun to examine the compensation of individuals that sit 1 - 2 levels below executive directors, which suggests that practice is extending beyond the formal requirements of the Code. The broadening scope of remuneration committee activity provides the added benefit of enabling the board to evaluate the calibre of talent below the board and ensure that suitable replacements are available in the event the CEO or other executive directors depart unexpectedly. Lastly, for prudential and risk mitigation purposes, some remuneration committees have begun to examine the compensation of lower level executives who earn as much as executive directors.

7.1.5.2. Remuneration consultants

In many large and mid-cap companies, remuneration consultants are retained to assist the remuneration committee and human resources department. Their roles include providing market and comparative data, designing incentive plans, and rendering advice to remuneration committee chairmen. Remuneration consultants are usually appointed in one of two ways: 1) The remuneration committee leads the process from the very beginning, including initiating contacts with potential consultants or 2) the human resources department is tasked with producing a short list of 2-3 candidates, who are then presented to the remuneration committee for final selection.

The criteria to select remuneration consultants include ability to deliver the required data, familiarity with the industry, geographic breadth, quality of relationship with shareholders, extent of conflicts of interest, and personal rapport with the remuneration committee chair. Remuneration consultants are usually compensated based on time spent and can be terminated at will, although their appointment is reviewed formally every 2-3 years. There have been suggestions that remuneration consultants can be conflicted when they also provide other services to the company, such as pension administration, which might lead to higher pay outcomes. The *Conclusions* paper recognised this concern when it concluded that “steps must be taken to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated”.

While this is a potential concern, it does not appear that the use of remuneration consultants in the UK market has led to systematically higher pay outcomes (as compared to companies that did not use such consultants). Recent empirical research (Conyon, 2008) comparing CEO pay at UK and US firms found little empirical support for the view that the use of remuneration consultants in the UK had led to higher pay outcomes⁶. The same research suggested that there was a positive correlation between the use of consultants and the amount of equity based pay as a fraction of total pay for CEOs. This could imply that using compensation consultants may be having a positive impact on the structuring of executive compensation to better align with the interests of shareholders. However, it should be noted that increases in variable pay, *per se*, do not mean better management-shareholder alignment; this will only be the case if the pay at risk is subject to appropriate and longer term performance measures.

The Code makes clear that the remuneration committee should be responsible for appointing any consultants in respect of executive director remuneration, which minimises the risk for conflicts of interest. In practice, this seems to be borne out. To deal with conflicts of interest arising when a remuneration consultant tasked with assisting the board on executive remuneration also provides other services to the company, some remuneration committees will appoint a separate adviser to provide a more independent view. In a small minority of companies, the chief executive will retain his own compensation consultant to undertake analysis and develop proposal for consideration by the board.

The consulting companies, themselves, have also responded to the concern about potential conflicts of interest by establishing a voluntary code of conduct. This was a development alluded to in the *Conclusions* paper as being a positive step. In the UK, the Voluntary Code of Conduct (which has been developed by the major remuneration consulting firms) seeks to provide guidance on how consultants should manage their relationship with listed UK firms to minimise the potential for conflicts to arise. The core guidelines propose that consulting firms should not accept contingent fees and should not act as both principal remuneration consultant to the company and as a firm's client relationship manager for non-related services.

Although many companies conduct benchmarking exercises annually, the scope of each exercise will usually vary. In some years, the remuneration consultant may be asked to provide data on salary changes only, while in other years, a more comprehensive review is undertaken. In terms of comparator groups, pay consultants will typically examine two sets of data: 1) peers in the same sector (most relevant for the CEO and business unit heads) and 2) companies with similar market capitalization (most relevant for functional roles such as CFO and company secretary). A perennial criticism with the current remuneration setting process is that companies often choose inappropriate peers (*e.g.* much larger companies, companies that are not genuine competitors), thereby contributing to ever rising pay levels. Some of the largest UK firms (*e.g.*, global mining companies, global banks), however, confront considerable difficulty identifying a sufficiently large group of peer companies.

While the media and shareholders complain that compensation consultants are too influential, the remuneration committee chair of a large listed UK company maintains that their influence is limited because a variety of factors are considered in formulating compensation packages, such as prior performance, availability of suitable replacements,

career prospects, and likelihood that an executive will depart. According to one remuneration adviser, pay consultants may be more influential at smaller firms because their remuneration committees rely much more on comparative data in deciding pay levels.

7.1.5.3. Aligning incentives and risks

In the wake of the global financial crisis, there is also growing recognition among UK companies of the need to incorporate risk considerations when devising executive remuneration. For instance, the remuneration committee of one financial institution now regularly invites the chief risk officer to attend its meetings. In addition, it is becoming more common for the audit committee chair to attend remuneration committee meetings or receive papers from those meetings. At some firms, linkages between risk and compensation are maintained through cross memberships between the audit and remuneration committees. A veteran UK compensation consultant noted that many remuneration committees devote considerable time to evaluating whether certain metrics (*e.g.*, incentivizing revenue growth at the expense of profit margin) and/or performance targets will likely lead to undesirable behaviour. At the same time, the wide range of potential outcomes in some incentive plans (*e.g.*, vesting of share awards could range from zero to 200%) may tempt executives at those companies to take inordinate risks to achieve maximum payouts.

Nevertheless, most UK boards would assert that strategic objectives are incorporated into compensation schemes through the use of performance metrics in short-term and long-term incentive arrangements. In turbulent periods, the necessity to link remuneration with the company's strategic objectives is often heightened. For example, some struggling UK companies structure their compensation arrangements in such a way as to pay substantially above the industry norm if a new management team is able to successfully turnaround the firm.

7.1.6. Shareholder engagement

Principle II.C.3 states that “the equity component of compensation schemes for board members and employees should be subject to shareholder approval”. In the UK, the Financial Services Authority listing rules, Combined Code on Corporate Governance and Association of British Insurers (ABI) guidance on executive remuneration provide that companies should obtain shareholder approval for all long-term incentive schemes, including material changes thereto. As noted above, the Companies Act requires companies to present a remuneration report for shareholder approval at the annual general meeting. This vote, however, is non-binding.

Despite their non-binding nature, “say on pay” votes nonetheless attract considerable attention. According to data from Manifest, in 2008-09, the top issues measured by voting dissent were again the report of the remuneration committee and long-term incentive arrangements. The table below shows the dissent on resolutions to approve new or amend existing long-term incentive arrangements and to resolutions seeking approval of the remuneration report.

Shareholders were slightly less likely to oppose new long term incentive plans (“LTIPs”) with high annual individual maximum award limits noted (greater than 300% of annual salary), as such plans were met with 6.6% dissent, while new plans with lower limits noted attracted 8.3% total dissent⁷. A number of other factors will influence shareholder opinion

Table 7.2. **Directors remuneration and long-term incentives**

Resolution issue	DISSENT		NUMBER of Resolutions	
	2008-09	2007-08	2008-09	2007-08
Long Term Incentive Arrangements	7.8%	8.4%	27	44
Share Option Plans	9.8%	3.7%	9	10
Performance Share Plans	9.8%	10.3%	11	26
Deferred Bonus Plans	7.7%	5.3%	7	11
Co-investment Plans	16.9%	5.1%	1	4
Cash LTIPs	–	5.6%	0	4
Remuneration Report	12.3%	6.9%	n/a	n/a

Source: Manifest Information Services (2010)

of new LTIPs – including plan type, design and performance conditions - so this statistic, while noteworthy, provides only a small glimpse of the overall voting picture. In 2008-09, it appears that shareholders preferred new performance share or discretionary share option plans over new deferred bonus or co-investment plans. There were 12 of the former and seven of the latter (six of which were deferred bonus plans) in the 2008-09 period, averaging dissent of 6.6% and 9.0%, respectively. Of the deferred bonus and co-investment plans, all had low (under 300% of salary) individual award limits, providing a possible explanation for the unusually higher level of dissent for LTIPs with relatively low award limits.

Voting on the remuneration report remains the most contentious of the ordinary AGM business at FTSE 100 companies, although the dissent levels recorded during the 2008-09 season were generally higher than those of previous years. The fallout from an extended economic contraction, combined with increased focus from the media and investors alike on excessive senior executive pay packages, proved to be a volatile mix as shareholders revolted against management at some of the UK's biggest firms. The average dissent for remuneration reports was 12.1% (2007-08: 6.9%); the highest average recorded since 2002-03 (the first year such resolutions were required by law).

To secure sufficient support for their remuneration policies and incentive arrangements, large and mid-cap UK companies engage extensively with shareholders on remuneration and, to a much lesser extent, on risk. Typically, larger firms will endeavour to contact their largest investors that collectively hold 50-60% of their shares. For FTSE 100 companies, this set will usually comprise the 20-30 largest investors and for FTSE 250 firms, perhaps the 8-10 largest shareholders. Board consultation with shareholders on remuneration became widespread after the introduction of the advisory vote on the remuneration report in 2003. In the initial years, however, many companies espoused the attitude that “we are consulting you because we must” and some firms provided little time for shareholders to give feedback (*e.g.*, contacting investors one day before the remuneration report is to be printed). Today, companies maintain a more positive mindset regarding engaging shareholders on remuneration and some firms genuinely value constructive feedback from their investors.

According to one remuneration adviser, boards consult shareholders on remuneration principally to communicate the structure of and rationale for the company's remuneration arrangements, obtain feedback, and ensure that they have accurately gauged shareholder sentiment. The larger UK firms employ similar processes to consult shareholders on remuneration matters. The majority of companies typically allocate several weeks to

obtain feedback from investors and some plan for 2-3 rounds of iterative exchanges. A small number of firms, however, give shareholders very limited time (sometimes less than a week) to respond.

The process usually begins with the board – normally the remuneration committee chair – sending a letter to targeted shareholders describing the principal changes and their rationale, and requesting comments by a specified date (usually 2-3 weeks after the date of the letter). The letter will also mention the possibility of one-to-one meetings with the remuneration committee chair and/or remuneration consultant. In response, institutional investors – usually the corporate governance team at large UK investment houses – would convey comments to the company in writing or by telephone. Ordinarily, questions raised by institutional shareholders relate to performance metrics employed, vesting criteria, and quantum. Thereafter, companies would respond to individual comments and/or provide an omnibus response summarizing the comments received and any amendments to the original proposal.

In parallel with consulting individual institutional shareholders, many UK companies will also engage with influential shareholder bodies, particularly the ABI and National Association of Pension Funds (NAPF). Furthermore, larger firms will likely consult proxy advisors – such as RiskMetrics and Pensions and Investment Research Consultants – as a matter of routine, particularly when controversial changes are proposed. In 2009, RiskMetrics received 140 remuneration consultations, including 40 from FTSE 100 companies. The influence of the ABI and RiskMetrics has contributed to the standardization of incentive schemes, which some boards find unhelpful as business models differ and, in their view, incentive schemes should accommodate such differences.

In some cases, particularly with respect to high-profile companies or controversial changes, collective meetings will be organized with ABI or NAPF members. While collective meetings are time efficient for both boards and investors, they may be sub-optimal in that a few institutions may dominate the discussion, the process of arriving at a consensus may result in a less coherent remuneration package, and “outlier” issues that will inform decision-making may be crowded out. Consequently, many UK firms organize both individual and collective meetings with institutional shareholders.

Among UK investors, the most active ones are the largest mainstream investment houses such as Standard Life, Aviva, and Legal and General. In addition, specialized activist investors are often quite active on remuneration. By contrast, shareholders domiciled outside of the UK are not highly active with respect to remuneration matters at UK companies and typically do not respond to consultation exercises. In terms of voting, many of them follow the recommendations of proxy voting agencies.

One issue with board-shareholder engagement in this area is that UK shareholders often hold diverse views on remuneration issues (including divergent opinions between fund managers and their corporate governance colleagues) and boards experience great difficulty reconciling them. When confronted with conflicting feedback, boards decide which comments to incorporate by considering such factors as consistency of a suggestion with overall corporate objectives and strategy, source of feedback, and level of support they wish to garner from shareholders (usually 85-90% but varies by company).

Although interaction between boards and shareholders on executive remuneration is well established, there is a greater distrust and hostility between the two camps today. Boards complain that shareholders – particularly corporate governance specialists at large

investment firms – are too dogmatic in their approach to executive remuneration and do not understand the broader company and competitive context. On their part, shareholders believe boards are too beholden to management and are not sufficiently candid with them. According to one remuneration committee chair, “Shareholders used to give us the benefit of the doubt unless we really mess up. Today, it appears that the burden of proof has shifted to us in the first instance”. Tensions in this area have resulted in UK institutional shareholders insisting on the use of objectively verifiable performance metrics (e.g., share price) and strict application of vesting criteria, even though both sides agree that a customized and flexible approach would be more appropriate.

In its review of the Combined Code in 2009, the Financial Reporting Council (while not speaking necessarily about incentive structures) found that there were significant concerns about the quantity and effectiveness of engagement between institutional investors and boards of listed companies. This echoed concerns expressed in the Walker review (of the governance of banks and other financial institutions which noted that “there is a need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies” and recommended that the FRC ratify a “Stewardship Code” based on the Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders’ Committee. The FRC has subsequently recently released a voluntary Stewardship Code and proposes to publish the names institutions that have agreed to sign up to the code. The code comprises seven principles that encourage institutional investors to disclose how they will go about enacting corporate change, how they vote, and how they scrutinise company conduct. According to the FRC, the code seeks to fulfil five policy objectives: i) set standards of stewardship to which mainstream institutional investors should aspire; ii) promote a sense of ownership of the Code amongst institutional investors in order to encourage compliance; iii) ensure that engagement is closely linked to the investment process ; iv) contribute towards improved communication between shareholders and boards; and v) ensure sufficient disclosure to enable institutional shareholders’ prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.

In general, UK boards do not engage with stakeholders directly on remuneration, with the exception of the financial sector where regulators have increasingly focused on remuneration structures in their assessment of systemic risks. However, information on remuneration is made available to stakeholders via annual reports and other channels. Whether this will change with the expanded definition of directors’ duties, and the explicit reference to the need to consider the role of stakeholders, is an open question.

7.2. Conclusions and Comments

The UK has a highly liquid listed company sector with dispersed ownership and a system of corporate governance that has developed significantly over the last two decades, included systematic revisions to the Combined Code (soon to be called the UK Corporate Governance Code, under its 2010 iteration) as well as a major rewriting of the Companies Act. Together with the US, the ownership structure of UK listed firms is one of the most dispersed amongst OECD countries, with institutional shareholders (both local and foreign) dominating.

The UK introduced reforms in 2002 that afforded shareholders a mandatory but non-binding vote on director remuneration for Listed companies. These “say on pay” reforms have been retained with the introduction of the new Companies Act in 2006. The extensive Code provisions relating to the setting of director remuneration are ordered under two main principles. The first relates to the structure and quantum of director remuneration. It provides that a significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance. The second main principle relates to the governance of the remuneration process: there should be a formal and transparent procedure for developing a policy on executive remuneration and for fixing the remuneration packages of individual directors.

7.2.1. Board structure and duties

UK company boards have a unitary structure, usually comprising both independent, non-executive directors and executive directors. For listed companies it is usual that the Chairman is an independent appointment, separate from executive management. Amongst the FTSE 100, the average size of the board is approximately 11, with a 30/70 split between executives and non-executives. Almost all non-executives are independent. In general, the composition of boards would seem consistent with the overarching recommendation in Principle VI.E that the “board should be able to exercise objective independent judgment on corporate affairs”.

Directors duties are expressed in favour of the company as a whole and in the UK have traditionally been the preserve of the common law. However, as part of the 2006 reforms, the government introduced a statutory statement of directors’ duties such that they are now expressed as seven separate duties under the Companies Act. As part of the codification process, the legislation makes clear that directors have a “duty to promote the success of the company” for the benefit of its shareholders as whole, but that they can best do this if they have regard to a wide range of other stakeholder interests. Of importance for the remuneration setting process, the duty requires directors to consider “the likely consequences of any decision in the long term.” The codified duties encompass the twin duties of care and loyalty envisaged by Principle VI.A.

7.2.2. Board practices

In comparison with other OECD countries, the UK could be considered to have a highly competitive market for executives, both domestically and, to a lesser, extent internationally. In terms of outcomes, executive pay has increased considerably in recent years. Many commentators have expressed the view that while designing a good structure is relatively straight forward, dealing with level of compensation has been extremely difficult due to the competitive environment for talent.

UK boards are devoting increasing attention to setting executive remuneration. In terms of processes, the practice amongst UK companies is generally consistent with Principle VI.D.4 that boards should align “key executive and board remuneration with the longer term interests of the company and its shareholders”. Nevertheless, it is an open question as to whether the outcomes of the remuneration setting process, and in particular the setting of correctly specified performance metrics, is consistent with this Principle. In this regard, a potential cause for concern is the relatively dominant role played by executives in the remuneration setting process. One of the *Key Findings*, namely that

“evidence pointed to remuneration being set by a process where executives held a strong bargaining position”, would seem to apply more broadly in the UK listed sector.

UK practice is consistent with Principle VI.E.1 that “boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential conflict of interest... [such as] board remuneration” and with the annotation to Principle VI.D.4 that “remuneration policy and employment contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors.” In particular, companies generally comply with the Code recommendation that boards should establish a remuneration committee of at least three or, in the case of smaller companies, two independent non-executive directors.

7.2.3. Disclosure

The Companies Act provides that the advisory “say on pay” vote of shareholders must be based on a detailed Directors’ Remuneration Report to be approved by the Board. The contents of the report are consistent with the guidance provided in Principle V.A.4 that company “disclosure should include, but not be limited to, material information on ... remuneration policy for members of the board and key executives.” Under their remuneration report, UK boards are required to prepare a comprehensive remuneration report covering, composition of the remuneration committee; details of all salary, bonus, and other remuneration; short-term and long-term incentives; pay conditions elsewhere in the company; and a graph comparing the company’s total shareholder return to the performance of a relevant broad market and/or industry index.

7.2.4. Shareholder engagement

The “say on pay” regime is consistent with the recommendations of Principle II.C.3 that “shareholders should be able to make their views known on the remuneration policy for board members and key executives”. While there have been some high profile examples of shareholder rejection of director remuneration proposals, it is an open question as to whether non-binding votes have made boards sufficiently responsive to shareholder concerns on director remuneration. The “say on pay” provisions do not require a mandatory vote on the equity component of compensation plans for board members and key executives (the final limb of Principle II.C.3), however, this is an explicit requirement under the Combined Code. Additionally, to the extent that there are key executives who are not on the board, then the “say on pay” provisions would not have the full coverage anticipated by the Principles.

In its review of the Combined Code in 2009, the Financial Reporting Council found that there were significant concerns about the quantity and effectiveness of engagement between institutional investors and boards of listed companies. This echoed concerns expressed in the Walker review (of the governance of banks and other financial institutions) which noted that “there is a need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies” and recommended that the FRC ratify a “Stewardship Code” based on the Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders’ Committee. In response the FRC has subsequently recently released a “Stewardship Code” based on the Code on the Responsibilities of Institutional Investors, (prepared by the Institutional Shareholders’ Committee). The implementation of this code

is a welcome step that potentially provides a means for improving the level of shareholder engagement, subject to establishing suitable mechanisms to foster compliance.

Notes

1. Company Law Reform White Paper, 2005.
2. This is a recommendation of the combined code but not mandatory by law. Nevertheless, in cases where the roles have been combined, there has been strong shareholder opposition, as in the case of Marks and Spencer at the AGM in 2009, where 40% of shareholders voted for an independent chairperson to be appointed.
3. The seven duties are: i) to act within power ii) to promote the success of the company iii) to exercise independent judgement iv) to exercise reasonable care, skill and diligence v) to avoid conflicts of interest vi) to not accept benefits from third parties and vii) to declare any interests in proposed transactions or arrangements of the company.
4. At present overseas incorporated companies with a primary listing do not have to apply the code. However, the introduction of the premium listing regime in mid-2010 will mean that such companies will have to “comply or explain” against the UK Code. For an overseas company that has a premium listing on 5 April 2010 this will only apply in respect of financial years beginning after 31 December 2009.
5. Under the Company Law disclosure requirements, companies are now required to provide a narrative report on how employee pay was taken into account when determining directors’ pay. This was previously a provision in the Corporate Governance Code.
6. While there was a link between the use of remuneration consultants and pay levels in the US, other studies (Armstrong *et al*, 2008) have argued that after controlling for poor firm governance, the correlation between CEO pay and use of consultants is less compelling.
7. These figures exclude dissent on resolutions for new LTIPs with no set individual award limit and resolutions to amend the terms of an existing LTIP. The figure in Table 12 is the average dissent of all resolutions pertaining to LTIPs, amendments to such plans inclusive.

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ANNEX A

Questionnaire of the OECD Corporate Governance Committee

Theme 1.1. Board practices: incentives and governing risks

The completed questionnaire should be returned to the Secretariat (James.Colvin@oecd.org cc Ruth.Fishwick@oecd.org) by the end of January 2010. Any questions of procedure or content should also be addressed to them.

About the current theme

There was a consensus in November 2009 to look at Board Practices that are extensively covered by Chapter VI of the Principles and in the *Conclusions* report. This is identified as **Theme 1**. Within this overall heading, several themes were noted: compensation of executives, boards and management, risk management, relations with shareholders and balancing competing interests of stakeholders. In line with *Corporate Governance and the Financial Crisis: Conclusions*, the Committee decided that remuneration needed to be placed in a wider context of incentives and risk. If incentives are not structured well there is a possibility that that companies will not be managed with a view to the long term including with due regard to the board's chosen business model and risk appetite. It is not a study of risk management per se that was discussed by the Group as part of its Strategic Response, but is simply one, less granular aspect of it.

The concern of the review is with board practices and therefore not only with the legal and regulatory framework. As noted in the Methodology, this means that information and responses to questions might be in the form of how widespread are thought to be certain practices. It is thus a macro structural study since it is the contours of the corporate governance landscape that are relevant.

The thematic review will be concerned with listed companies. However, it will not go into any detail for financial companies with respect to remuneration since this is subject to other reviews by *inter alia*, the FSB and the Basel Committee. For many countries a focus on larger listed companies might be sufficient. In some cases there might well be significant concentration of small caps so that respondents should note this and the difference with large caps in their response.

For each country being reviewed, there will need to be a description of the legal, regulatory and code requirements as an input to understanding the market context that is covered throughout the Principles but especially by Chapter I. However, this is not a detailed review of the legal framework. There will also need to be a description of the

market for executives in which context individual boards operate. This might include the extent to which the market is international (relevant in the UK and in Japan, but polar opposites), mobility between firms etc. Data about the composition of remuneration and levels should also be considered. This would complement the work of the FSB/BCBS. There might also be reference to whether compensation is considered a problem and, if so, why.

The relevant Principles

The principal outcome involved is given by principle VI.D.4: the board should fulfil certain key functions including...aligning key executive and board remuneration with the longer term interests of the company and its shareholders. In addition, the Conclusions note that the policy needs to be consistent with the strategic objectives of the company and its risk appetite as also set by the board. The duties of the board to the company are further developed in principles VI.B and VI.C that recognise different shareholder groups and the interests of stakeholders¹

A number of other principles are to a greater or lesser extent process or instrument oriented and as such will form a key part of the response. The questions are designed to provide information relevant to these principles. The principles are VI.E.1, V.A.4, and II.C.3, covering board processes, transparency and shareholder input respectively². In reality, other processes may be equally if not more important and documenting these will be an important objective of the review: it is of lesser importance how the outcome is achieved so long as it works in a given market context.

Who should complete the Questionnaire

The questionnaire is intended to provide relevant information to the Secretariat including academic and other studies. It is not expected that replies should be long and detailed. For example, we do not expect long translations of legal documents as required for FSAP and FATF reviews. We are only interested in the content of the law and not a review of the legal framework. For those countries only replying to Question 1, several pages should point the Secretariat to the main features of the corporate governance framework and to appropriate studies. For those countries being reviewed, it is suggested that a response to questions II and III might be around 3-5 pages each.

With the emphasis on board practices, incentive systems and the overall economic and regulatory framework, it is suggested that the stock exchange, and any code oversight body, might be an appropriate body to make a first reply with Committee members reviewing the response and adding any additional material. Alternatively, an academic, research organisation, director's institute or a corporate governance organisation might also be appropriate respondents.

The Secretariat will follow up responses with short visits to each review country to obtain additional insights from experts.

Question I. What is the corporate governance framework influencing board oversight of the remuneration and incentive systems and its compatibility with corporate objectives?

All countries are requested to reply. Please describe briefly in a page or two the duties of board members with respect to setting the remuneration of executives, board members and management as specified in codes, company law, jurisprudence and other regulation such as listing

requirements. Is there a code covering executive remuneration (apart from any special code covering the banking system) and what is its nature? Are there plans to change any of these instruments and for what reason? Is the remuneration and incentive system regarded as an issue in your country and for what reasons? Do executives and CEOs move frequently between companies so that there is a market for managerial talent or do they tend to stay for long periods in the same company so that there is instead an internal labour market?

Note: Question I will be complemented with data from, *inter alia*, IOSCO and compensation and board practice surveys by *inter alia*, GIM/Risk Metrics.

(The following two questions are to be completed by Brazil, Japan, Portugal, Sweden and UK).

Question II. What is the market and corporate context influencing whether incentive structures are in the long term interest of the company and its shareholders?

Please provide a detailed description of the nature of any general and/or specific duties of the board to the company and/or to shareholders in your jurisdiction, and the means by which these duties are defined and enforced, including information about of relevant laws and jurisprudence? This should include, in particular, any body of law and jurisprudence defining what is meant by “long term” and “the company”.

In the following questions please indicate which factors cover the whole jurisdiction and which vary across companies, indicating whether the practice is widespread, sector specific etc. Please describe the nature of market norms and incentives motivating board members, executives and lower level management (e.g. including internal promotion, guaranteed employment etc) and how these incentives impact on the structure of remuneration? What role is played by performance- related remuneration and what is the nature of such compensation (e.g. shares, options)? In what manner is the incentive system affected by taxation provisions? Is there a general feeling that incentives are short- term in nature? What form do these take? If the system is considered to provide long term incentives, what form do these take and how does it promote or affect risk taking?

Question III. How do boards influence incentives and what role is played by transparency and by shareholders?

*In the following questions please indicate which factors cover the whole jurisdiction and which vary across companies, indicating whether the practice is widespread, sector specific etc. Please provide data about board composition in general (e.g. executive members, outside directors, independent board members, and audit boards) and its variability across companies. Please describe what is known about board processes covering remuneration and incentive systems for executives and lower levels of management. How does the composition and structure of boards impact on these processes (e.g. what is the role of board committees and independent board members)? What are the requirements covering transparency of remuneration and incentives? Do companies generally exceed these requirements? What is the *de jure* and *de facto* role of shareholders in influencing remuneration and other incentive schemes?? Which types of shareholders appear to be most active? What is the role of other stakeholders?*

Notes

1. Principle VI.B: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly; and Principle VI.C: The board should apply high ethical standards. It should take into account the interests of stakeholders.
2. Principle VI.E.1: The board should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are...board remuneration; Principle V.A.4: Disclosure should include material information on... remuneration policy for members of the board and key executives; and Principle II.C.3: Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

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Corporate Governance

Board Practices

INCENTIVES AND GOVERNING RISKS

This document examines how effectively boards manage to align executive and board remuneration with the longer term interests of their companies. This is a major and ongoing issue in many companies and one of the key failures highlighted by the financial crisis. Aligning incentives seems to be far more problematic in companies and jurisdictions with a dispersed shareholding structure since, where dominant or controlling shareholders exist, they seem to act as a moderating force on remuneration outcomes.

Executive Summary

Part I Overview of Board Practices for Managing Incentives and Risks

Chapter 1. Aligning Executive Interests with the Long-term Interest of the Company

Chapter 2. Best Board Practices for Overseeing Executive and Director Remuneration

Part II In-depth Country Reviews of Board Practices: Managing Incentives and Risks in Five OECD Countries

Chapter 3. Brazil: Review of Board Practices for Managing Incentives and Risks

Chapter 4. Japan: Review of Board Practices for Managing Incentives and Risks

Chapter 5. Portugal: Review of Board Practices for Managing Incentives and Risks

Chapter 6. Sweden: Review of Board Practices for Managing Incentives and Risks

Chapter 7. United Kingdom: Review of Board Practices for Managing Incentives and Risks

Annex A. Questionnaire of the OECD Corporate Governance Committee

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