# Regulating Executive Remuneration in the Post-Financial Crisis Era: A Common Law Perspective

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**Draft paper only -** Please do not cite without author's approval

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## 1. Introduction

Everyone, it seems, is currently interested in executive pay. Indeed, it has become the zeitgeist of the global financial crisis, with a wide array of potential reform proposals about executive remuneration now on the regulatory table in jurisdictions around the world.

Executive remuneration first came onto the corporate governance radar screen in the 1990s. During this period, a growing international interest in the improvement of corporate governance standards and practices emerged, which paralleled a movement from legislative regulation to self-regulation in the corporate sphere.[1] There was also

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1 A number of reports and statements of best practice in relation to corporate governance and director and executive remuneration emerged during this period. See, for example, OECD, *Principles of Corporate Governance* (1999); Department of Trade and Industry, *Directors' Remuneration: A Consultative Document* (July 1999); *Committee on Corporate Governance: Final Report* (the Hampel Committee Report) (1998); *Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury* (1995); *Report of the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Director Compensation: Purposes, Principles, and Best Practices* (June 1995).

a radical paradigm shift concerning executive pay at this time. Executive pay, which had previously been treated as a corporate governance problem, was re-interpreted as an issue of misalignment between managerial and shareholder interests. This transformation, which was strongly influenced by Jensen and Murphy's seminal article in this area, "CEO Incentives – It's Not How Much You Pay, But How",[2] envisaged pay for performance as a self-executing mechanism, which could effectively align the interests of management with shareholders. Executive remuneration had, in effect, evolved from corporate governance problem to solution.

This theoretical redefinition had major consequences in the commercial realm, with an increased focus on *ex ante* bonding devices, to align shareholder and management interests through the design of optimal remuneration contracts.[3] In this respect, the transformation also served to legitimise executive pay, since, by adopting a "just deserts" approach to remuneration, it offered the prospect of reward for superior performance and financial penalties for inferior performance.[4] However, some recent economic studies have suggested that Jensen and Murphy's reinterpretation of executive pay was perhaps less novel than it seemed, and that, in fact, US executives' wealth had been sensitive to corporate performance for much of the 20th century.[5]

Since the heyday of performance-based pay in the 1990s, there have been two major shocks to financial markets. The first involved the collapse of Enron, and analogous

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[2] See Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68 *Harv. Bus Rev* 138. See also Yablon, "Bonus Questions – Executive Compensation in the Era of Pay for Performance" (1999) 75 *Notre Dame L. Rev.* 271.

[3] For useful surveys on executive remuneration structures, see generally Guay, Core and Larcker, "Executive Equity Compensation and Incentives: A Survey" (2003) 9 *Econ. Pol. Rev.* 27; Bebchuk, Fried and Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 *U. Chi. L. Rev.* 751; Murphy, "Executive Compensation", in Ashenfelter and Card (eds), *Handbook of Labor Economics* (1999).

[4] Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68 *Harv. Bus Rev* 138.

[5] See Frydman and Saks, "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005" (June 2008, NBER Working Paper 14145), who state that "compensation arrangements have served to tie the wealth of managers to firm performance – and perhaps to align managerial incentives with shareholders' interests – for most of the 20th century" (with the exception of the 1940s and 1970s) (id, 2, 33). According to the authors, Jensen and Murphy's view in the early 1990s that CEOs were paid like bureaucrats may have accurately reflected executive pay in the 1970s, but was otherwise "not generally true in the past" (*id*, 2).

international corporate scandals around the turn of this decade; the second would be the global financial crisis from 2007 onwards.

Puzzling differences emerge in the international regulatory responses to these two sets of events. Professor John Coffee considered that executive remuneration was a possible cause of the Enron collapse.[6] Nonetheless, international regulatory responses to the issue of executive remuneration were relatively minor in the post-Enron reform period. Other aspects of corporate governance, such as board structure and the role of auditors, received far greater attention.[7] This contrasts sharply with the current environment, in which remuneration has become a regulatory flashpoint.

Although there has been much research on the determinants of executive pay, there has, until recently, been far less scholarship on policies to control executive remuneration. However, such regulatory policies to control executive have become increasingly important during the global financial crisis, when issues of managerial conflict of interest[8] and income inequality came to the forefront of regulatory debate.[9]

## 2. From Enron to the Global Financial Crisis: Some Regulatory Responses to Executive Remuneration in the US, UK and Australia

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6 See generally Coffee, "What Caused Enron? A Capsule Social and Economic History of the 1990s" (2004) 89 *Cornell L. Rev.* 269. On the role of executive remuneration in Enron and other corporate scandals, see also Miller, "Catastrophic Financial Failures: Enron and More" (2004) 89 *Cornell L. Rev.* 423; Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L.J.* 367. See also Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse* (2002), 54.

7 Coffee, *id*.

8 See, for example, Hill and Yablon, "Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict" (2002) 25 *University of New South Wales Law Journal* 294.

9 See, for example, Dew-Becker, "How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation" (2009) 55 *CESifo Economic Studies* 434.

Post-Enron legislation in the United States paid relatively little attention to executive pay. Only two provisions of the *Sarbanes-Oxley Act* of 2002 (*Sarbanes-Oxley Act*), ss 304 and 402, addressed the issue directly.

The most prominent of these, s 304, is a clawback provision, permitting recovery of bonuses, incentives-based or equity-based compensation received by the CEO or CFO, if the corporation is required to restate earnings due to material noncompliance with financial reporting requirements, as a result of misconduct.[10] Recent legal scholarship has stressed enforcement as a critical feature of dynamic financial market regulation,[11] and enforcement of s 304 has been problematical. There have been less than a handful of successful clawback actions under s 304,[12] although there have been several thousand financial restatements since the introduction of the *Sarbanes-Oxley Act*.[13] The provision's effectiveness has been undermined by a range of factors. These include the fact that courts have held that only the SEC has enforcement rights under the provision,[14] the limited range of targeted corporate participants (namely CEOs and CFOs), and uncertainty as to whether the requirement of "misconduct" must be attributable to the executive from whom recovery is sought.[15]

In July 2009, the Securities and Exchange Commission (SEC) filed its first suit seeking to recover US$4 in incentive-based compensation and stock trading profits

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10 See generally Simmons, "Taking the Blue Pill: the Imponderable Impact of Executive Compensation Reform" (2009) 62 *SMU L. Rev.* 299, 347-349.

11 See, for example, Coffee, "Law and the Market: The Impact of Enforcement" (2007) 156 *U Penn L Rev* 229; Jackson, "Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications" (2007) 24 *Yale Journal on Regulation* 253.

12 See Schwartz, "The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean" (2008) 64 *Bus. Law.* 1, 2, 13-15, noting that six years after the introduction of the *Sarbanes-Oxley Act*, the SEC had only obtained clawbacks on two occasions, against a former CEO of United Health Group Inc in 2007, and against the former CFO of Sycamore Networks, Inc in 2008. *Id*, 13-15.

13 *Id*, 2, 13-15.

14 The courts have definitively rejected private clawback actions by shareholders or corporations under s 304. See *ibid*; Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In" (2009) 46 *Harv. J. on Legis.* 323, 334, n 39.

15 Simmons, "Taking the Blue Pill: the Imponderable Impact of Executive Compensation Reform" (2009) 62 *SMU L. Rev.* 299, 347; Schwartz, "The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean" (2008) 64 *Bus. Law.* 1, 15*ff*.

from a CEO, who was not personally accused of wrongdoing, in *SEC v. Jenkins*.[16] The suit has been described as "emblematic" of the SEC's newly aggressive stance on executive pay.[17] In a motion to dismiss the case,[18] the defendant, Mr Jenkins, described the SEC's action as constituting an illegitimate and punitive "post-Madoff interpretation of s 304".[19] It has been argued that a strict vicarious liability interpretation of s 304 may undermine the *Sarbanes-Oxley Act's* policy goal of increasing corporate governance monitoring by the CEO and CFO.[20]

The second *Sarbanes-Oxley Act* provision relating to executive remuneration was section 402, which imposed a prohibition on personal loans to directors or executive officers. This provision tracked the contours of problems identified at a number of US companies, including Enron and WorldCom, where executives had received huge loans, sometimes totalling hundreds of millions of dollars, from their corporation.[21] This was apparently a common, and relatively uncontroversial, remuneration technique in the US prior to the Enron and WorldCom scandals.[22]

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16 No. CV 09-1510-PHX-JWS (D. Ariz. July 22, 2009) (available at http://www.wlrk.com/docs/comp21149.pdf). During Mr Jenkins' ten year tenure as CEO of CSK Auto Corporation ("CSK"), the corporation had engaged in pervasive accounting fraud, involving many senior officers. *Id*, para [2].

17 Savarese, "SEC Pursues Unprecedented Sarbanes-Oxley 'Clawback'", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 1 August 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/08/01/sec-pursues-unprecedented-sarbanes-oxley-clawback/).

18 *SEC v. Jenkins,* CV-09-01510-PHX-GMS, Notice of Motion and Motion to Dismiss (filed 15 September 2009), 1.

19 *Id*, 1, 4. Mr Jenkins' motion to dismiss condemned the s 304 action on the basis that "the SEC openly proposes for the first time to wield the statute as a means to inflict punishment on innocent executives". *Id*, 3. He argued that, properly construed, s 304 required personal wrongdoing by the defendant as a precondition to forfeiture, and that the SEC's complaint in the action was therefore "fatally defective". *Id*, 5.

20 See also s 302 *Sarbanes-Oxley Act*, which requires certification of financial information by the CEO and CFO. See Gorman, "Are Corporate Executives Playing Russian Roulette?", *SEC Actions*, 25 September 2009.

21 Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 *Yale L.J.* 1521, 1538.

22 *Ibid*.

An alternative form of regulation might have been the use of governance strategies,[23] to adjust the balance of power between shareholders and the board of directors.[24] The form of regulation was, however, notably absent from the *Sarbanes-Oxley* Act. The refusal of the Act to grant shareholders greater power in relation to matters such as the director elections process was described by two prominent Delaware judges at the time as the "forgotten element" of the US reforms.[25]

Enron, and other contemporaneous scandals, also raised concerns about the effectiveness of disclosure rules. Almost a decade earlier in 1992, SEC introduced landmark changes to its executive remuneration disclosure rules,[26] which were designed to improve the transparency, and comparability, of executive pay packages.[27] Although at the time of their enactment, the SEC disclosure rules were regarded as comprehensive,[28] the scandals exposed flaws and deficiencies in the rules. The SEC responded to these problems by announcing in 2006 the introduction of stricter disclosure rules for executive pay to close existing loopholes in relation to undisclosed executive perks.[29]

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[23] See Kraakman, Armour, Davies, Hansmann, Hertig, Hopt, Kanda and Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 37*ff* (2nd ed, Oxford University Press, 2009), distinguishing between prescriptive "regulatory strategies" and "governance strategies", which involve reallocation of power between a principal and agent via "agent constraining" and "principal empowering" strategies (n 13).

[24] The preamble to the *Sarbanes-Oxley Act* confirms a focus on protection of shareholder interests over shareholder participation in corporate governance. It is an Act, according to the preamble, "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes".

[25] Chandler and Strine, "The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State" (2003) 152 *U. Pa. L. Rev.* 953, 999.

[26] These changes have been described as "perhaps the best known changes in policy regarding executive pay, at least among economists". See Dew Becker, "How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation" (2009) 55 *CESifo Economic Studies* 434.

[27] See generally Hill, "'What Reward Have Ye?' Disclosure of Director and Executive Remuneration in Australia" (1996) 14 *Company and Securities LJ* 232.

[28] The NACD Blue Ribbon Commission on Director Compensation, for example, praised the 1992 SEC rules as making it "virtually impossible to conceal any form, or meaningful amount" of executive remuneration. SEC *Report of the NACD Blue Ribbon Commission on Director Compensation: Purposes, Principles, and Best Practices*, June 1995, 19.

[29] See SEC, Press Release, *SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters*, 17 January 2006. Key elements of the reforms included:- alteration to the details of whose remuneration must be disclosed;

The US regulatory response to Enron provided an interesting contrast to reforms in Australia and the UK, where legislative rhetoric focused on the need to strengthen shareholder participation rights in corporate governance.[30] One of the clearest manifestations of this goal was the introduction of a non-binding shareholder vote on executive pay.[31] In Australia, the relevant provision, s 250R(2) of the *Corporations Act* 2001 (Cth) (*Corporations Act*),[32] requires shareholders of an Australian listed company to pass a non-binding advisory vote at its annual general meeting, indicating whether they adopt the directors' remuneration report.[33] This provision was based on an analogous provision introduced two years earlier in the UK.[34] Unlike the US, where precatory shareholder resolutions have a long pedigree,[35] Australia and the UK had no prior tradition in this regard.[36]

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alterations to the required presentation of material to enhance clarity; required disclosure of total compensation; expanded scope of components of executive remuneration requiring disclosure; quantification of termination and change in control payments; and a reduced threshold for disclosure of perquisites. See generally Lublin and Scannell, "They Say Jump: SEC Plans Tougher Pay Rules", *Wall Street Journal*, 11 January 2006, C1; Scannell and Francis, "Executive-pay Disclosure Takes Spotlight in U.S.", *Wall Street Journal Europe*, 17 January 2006, 1.

30 See generally Hill, "Regulatory Show and Tell: Lessons from International Statutory Regimes" (2008) 33 *Del. J. Corp. L.* 819, 826. The Explanatory Memorandum to the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill of 2004, stressed the importance of improving shareholder participation and activism in corporate governance. See Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, paras. 4.271-4.280.

31 See generally Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L. J.* 367, 413-414.

32 Section 250R(2) was introduced into the *Corporations Act* 2001 (Cth) by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004 *(CLERP 9 Act*). See also s 249L(2) and s 300A *Corporations Act* 2001 (Cth).

33 See generally Chapple and Christensen, "The Non-Binding Vote on Executive Pay: A Review of the CLERP 9 Reform" (2005) 18 *Aust. J. Corp. L.* 263.

34 The Directors' Remuneration Report Regulations 2002, S.I. 2002, No. 1986 (UK). The provision is now found in s 439 of the UK *Companies Act* 2006. For a general discussion of post-Enron reform developments in the UK, see Ferran, "Company Law Reform in the UK: A Progress Report", European Corporate Governance Institute Law Working Paper No. 27/2005 (March 2005) (available at http://ssrn.com/abstract=644203), 24-28.

35 For historical background to precatory voting in the US under SEC Rule 14a-8, see Thompson and Edelman, "Corporate Voting" (2009) 62 *Vand. L. Rev.* 129, 143-144. See also Ryan, "Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy" (1988) 23 *Ga. L. Rev.* 97. Since the inception of SEC Rule 14a-8, shareholder proposals have shifted from social responsibility to a focus on changing corporate governance. Thompson and Edelman, *id*, 144.

A range of other post-Enron reforms were introduced in Australia under the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004.[37] These included enhanced remuneration disclosure under s 300A of the *Corporations Act*, modification of provisions relating to termination pay,[38] and the introduction of a specific non-binding Remuneration Principle under the Australian Securities Exchange (ASX) Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice* (ASX *Principles of Good Corporate Governance*),[39] exhorting companies to "remunerate fairly and responsibly".[40]

## 3. Two Interesting Current Questions

### 3.1 Are Corporate Excesses a "Foreign Phenomenon"?

Jurisdictions around the world, including Australia, are again grappling to find an appropriate response to the issue of executive remuneration in the light of the global financial crisis. Two interesting background questions have emerged from the regulatory ether in this regard.

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[36] The courts had historically treated such resolutions as beyond shareholder power. See, for example, *NRMA v Parker* (1986) 6 NSWLR 517, 522.

[37] See Sheehan, "The Regulatory Framework for Executive Remuneration in Australia" (2009) 31 *Syd. L. Rev.* 273, 275-276.

[38] See generally Stapledon, "Termination Benefits for Executives of Australian Companies" (2005) 27 *Syd. L. Rev.* 683. See also Sheehan and Fenwick, "Seven: *The Corporations Act 2001* (Cth), Corporate Governance and Termination Payments to Senior Employees" (2008) 32 *Melb. U. L. Rev.* 199.

[39] Paralleling the UK "comply or expain" disclosure-based model of corporate governance, the ASX *Principles of Good Corporate Governance* operate on an "if not, why not" basis. See generally, Hill, "Evolving Rules of the Game in Corporate Governance Reform" (1998) 1 *Int. J.Corp. Gov.* 28, *.

[40] ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003), Principle 9. See also ASX Corporate Governance Council, *Revised Corporate Governance Principles and Recommendations* (2nd ed, 2007), Principle 8. See generally Ablen, "Remunerating 'Fairly and Responsibly': The 'Principles of Good Corporate Governance and Best Practice Recommendations' of the ASX Corporate Governance Council" (2003) 25 *Syd. L. Rev.* 555.

The first question is one that is important in the Australian context, and was raised explicitly by the Australian Government Productivity Commission (Productivity Commission) in its April 2009 Issues Paper.[41] This is whether corporate excess, including excessive executive remuneration, is a problem for Australia, or whether it is a "foreign phenomenon".[42] The expression "foreign phenomenon" appears to be code for an "American problem".

At first sight, there appear to have been strongly convergent international trends in the structure of executive pay in recent years.[43] The rise, and subsequent waning, of stock options as a component of executive pay reflects this general trend.[44] Nonetheless, executive remuneration is also an area where culture matters.[45] Cultural differences between various jurisdictions are reflected in levels of pay, societal tolerance for income inequality,[46] and attitudes to remuneration disclosure.[47] Social norms concerning executive pay can also change across time in a single jurisdiction. It has been suggested, for example, that changing social norms in this regard in the United States may explain the steep rises in executive compensation, wealth

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41 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009).

42 See Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009) 4.

43 For a general discussion of the theories of convergence versus path dependence theory in comparative corporate governance, see Gordon and Roe (eds), *Convergence and Persistence in Corporate Governance* (2004); Hill, "The Persistent Debate about Convergence in Comparative Corporate Governance" (2005) 27 *Syd. L. Rev.* 743.

44 See, for example, Johnston, "American-style Pay Moves Abroad: Importance of Stock Options Expands in a Global Economy", *New York Times*, 3 September 1998, C1; Ferrarini and Moloney, "Executive Remuneration in the EU: The Context for Reform" (2005) 21 *Oxf. Rev. Econ. Policy* 304. Use of stock options around the world in recent years has declined. See Mercer, *Executive Remuneration Perspective: Perfecting Long-Term Incentive Remuneration* (14 September 2008) (available at http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1320865).

45 See, for example, Levitt, "Corporate Culture and the Problem of Executive Compensation" (2005) 30 *J. Corp. L.* 749, 750 (discussing the significance of culture in relation to the structure and operation of the board of directors).

46 See, for example, Conyon and Murphy, "The Prince and the Pauper? CEO Pay in the United States and United Kingdom" (2000) 110 *Econ. J.* F640, F646-647.

47 See, for example, Ferrarini and Moloney, "Executive Remuneration in the EU: The Context for Reform" (2005) 21 *Oxf. Rev. Econ. Policy* 304.

concentration[48] and income inequality[49] in recent decades.[50] Some commentators, however, argue that rising inequality has now ceased in the United States.[51]

How do levels of executive compensation in the US and Australia compare? Executive remuneration in the US steadily increased since the mid-1970s.[52] However, it was during the 1990s, the height of the corporate governance movement, that US executive remuneration skyrocketed. Between 1993 and 2003, the average CEO compensation at S&P 500 firms rose by a dramatic 146%.[53] The increase in CEO pay levels in real terms greatly outpaced increases in the pay of average US workers – there was a 45% growth in CEO pay, compared to 2.7% for the average worker.[54] This disparity was even more striking in some countries, which came to US-style stock compensation late in life. In the Netherlands, for example, real CEO

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48 See Saez, *Striking it Richer: The Evolution of Top Incomes in the United States* (Update with 2007 estimates), noting that concentration of wealth has increased dramatically in the United States in recent decades, and by 2007 rivalled that existing in 1928 at the pre-Depression stock market peak. *Id*, 2.

49 See Dew-Becker, "How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation" (2009) 55 *CESifo Economic Studies* 434, stating that since 1980 income inequality in the US has increased "by almost any measure" (*id*, 434). According to Dew-Becker, reasons for this divergence included factors such as increased trade and immigration, reduction of the real minimum wage and a decline in unionism (*id*, 435). *Cf* however, Gordon, "Misperceptions about the Magnitude and Timing of Changes in American Income Inequality" (September 2009, NBER Working Paper 15351), arguing that "[t]he rise in American inequality has been exaggerated in magnitude and its impact is now largely in the past" (at 31).

50 See Piketty and Saez, "Income Inequality in the United States, 1913-1998" (2003) 118 *Quarterly J. Econ.* 1, 34-35, arguing, for example, that the Great Depression and World War II had a great impact on contemporaneous social norms regarding income inequality. See also Frydman and Saks, "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005" (June 2008, NBER Working Paper 14145), 33.

51 See Gordon, "Misperceptions about the Magnitude and Timing of Changes in American Income Inequality" (September 2009, NBER Working Paper 15351), 32.

52 Piketty and Saez, "Income Inequality in the United States, 1913-1998" (2003) 118 *Quarterly J. Econ.* 1; Frydman and Saks, "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005" (June 2008, NBER Working Paper 14145).

53 See Bebchuk and Grinstein, "The Growth of Executive Pay" (2005) 21 *Oxf. Rev. Econ. Policy* 283. Average CEO compensation at S&P 500 firms rose from US$3.7 million to US$9.1 million between 1993 and 2003. The average compensation of the top five executives increased 125% from US$9.5 million to US$21.4 million during this period. *Id.*

54 See Ebert, Torres, Papadakis, International Institute for Labour Studies Discussion Paper DP/190/2008, *Executive Compensation: Trends and Policy Issues* (2008) (available at http://www.ilo.org/public/english/bureau/inst/publications/discussion/dp19008.pdf).

pay grew by 192% compared to 2.4% for the average worker.[55] US CEOs have nonetheless tended to receive vastly higher levels of remuneration than their counterparts in other jurisdictions.[56]

In Australia, the disparity in growth of CEO pay compared to average worker pay was less pronounced. Executive salaries in Australia have risen approximately three times the amount of ordinary full-time employee wages.[57] From 2001-2007, both the median fixed remuneration (ie non performance-based elements of Australian CEO pay) and the median total remuneration had increased by around 96% in total.[58] This compared to a 32% increase in average Australian adult weekly earnings during the same period.[59] Nonetheless, there has still been a significant escalation in CEO pay packages in Australia. A 2008 ACSI report on executive remuneration practices in the top 100 listed Australian companies found that average CEO pay had increased from A$3.77 million in 2005 to A$5.53 million in 2007.[60] A common explanation for this steep rise in executive pay is the fact that increasingly Australian companies need to compete internationally, and now appoint executives from a "mobile worldwide executive talent pool".[61] Another potentially relevant factor is firm size. Recent US empirical research suggests that, since the mid-1970s,[62] American CEO pay has been

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55 *Ibid.*

56 See Thomas, "Explaining the International CEO Pay Gap: Board Capture or Market Driven?" (2004) 57 *Vand. L. Rev.* 1171, 1173-1175. Various explanations have been given for the extreme escalation of pay in the US. See, for example, Bebchuk and Grinstein, "The Growth of Executive Pay" (2005) 21 *Oxf. Rev. Econ. Policy* 283, 298-302, discussing competing explanations offered by (i) the arm's length bargaining model and (ii) the managerial power model.

57 See Shields, "Setting the Double Standard: Chief Executive Pay the BCA Way" (2005) 56 *J. Aust. Pol. Econ.* 299, 303.

58 ACSI, Media Release, *Top 100 CEO Pay Research Released*, 27 October 2008.

59 *Ibid.* See also Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 9.

60 See ACSI, Media Release, *Top 100 CEO Pay Research Released*, 27 October 2008.

61 Tarrant, "Payday Paralysis" (2009) 79 *INTHEBLACK* 28 (CPA Australia).

62 Frydman and Saks, "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005" (June 2008, NBER Working Paper 14145), 1, 3, 17.

strongly correlated with increases in market capitalisation.[63] There has been a dramatic increase in the market capitalisation of a number of Australian companies in the last decades. The current market capitalisation of BHP Billiton, for example, is $200 billion, compared to $16 billion in 1989.[64]

Plato believed that no-one in a community should earn more than five times the pay of the lowest paid worker,[65] but this ideal has clearly taken root neither in the US, nor Australia. The 2008 annual reports of Australia's top fifteen companies reveal that, excluding share-based compensation, the CEOs earned approximately 135 times more than the average Australian employee.[66] In the US, the average executive manager in the largest fifteen US firms earned around 500 times more than an average employee in 2007.[67]

### 3.2 Did Executive Pay Cause or Contribute to the Global Financial Crisis?

The second interesting current question about executive remuneration is the extent to which it actually caused, or contributed to, either the Enron scandal or the global financial crisis. Differences of opinion emerge about the role of executive compensation in these events.[68]

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63 See, for example, Gabaix and Landier, "Why Has CEO Pay Increased So Much?" (2008) 123 *Quarterly J of Econ* 49. According to the authors, six-fold increases in CEO pay in the United States from 1980-2003 can be correlated with identical increase in market capitalisation of large US corporations during this period.

64 Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, XVIII.

65 Cited in Crystal, *In Search of Excess: The Overcompensation of American Executives* (1991), 23-24.

66 Tarrant, "Payday Paralysis" (2009) 79 *INTHEBLACK* 28 (CPA Australia).

67 The disparity is considerably higher than in 2003, when the average executive manager in the largest 15 US firms earned approximately 300 times more than an average US employee. International Labour Organization and International Institute for Labour Studies, *World of Work Report 2008: Income Inequalities in the Age of Financial Globalization* (2008), Executive Summary, 3.

68 See, for example, Tuna and Lublin, "Risk vs. Executive Reward – Obama Seeks Better Controls, but Experts Split over the Impact", *Wall Street Journal*, 15 June 2009, B6.

Professor Coffee considered that remuneration practices were one of three possible causes of the collapse of Enron (the others were gatekeeper problems and market "herding").[69] However, the US regulatory response to Enron suggests that audit failure was widely accepted as the real culprit.[70]

If there was scant recognition of the potential connection between executive compensation practices and corporate scandals like Enron, the same cannot be said in relation to the global financial crisis. Many commentators have argued that remuneration practices directly contributed to the crisis by rewarding short-term profit that encouraged excessive risk-taking, particularly in the banking sphere,[71] and to date there have been relatively few dissenting voices.[72]

The Australian and US governments have also suggested that a close nexus exists between executive compensation and the global financial crisis. In 2008, the Australian Prime Minister, Kevin Rudd described the financial crisis as a consequence of "extreme capitalism",[73] characterized by "[o]bscene failures in corporate governance which rewarded greed without any regard to the integrity of the financial

69 See generally, Coffee, "What Caused Enron?: A Capsule Social and Economic History of the 1990s" (2004) 89 *Cornell L. Rev.* 269.

70 See Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms" (2004) 84 *B.U. L. Rev.* 301, 321*ff*; Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (2002) 69 *U. Chi. L. Rev.* 1233, 1237*ff*.

71 See, for example, Crotty, "Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'" (2009) 33 *Cambridge J of Econ* 563, 565 (stating that "profits and bonuses are maximised in the boom by maximising leverage, which in turn maximises risk"). See also Avgouleas, "The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy" (2009) 9 *J. Comp. L. Stud.* 23, 42-45; Ciro and Longo, "The Global Financial Crisis: Causes and Implications for Future Regulation: Part 2" (2010) 25 *J. Int. Banking L. and Reg.* 9, 16, 17; Bebchuk and Spamann, "Regulating Bankers' Pay" (2010) 98 *Geo. L. J.* 247, 255-268.

72 See, however, Core and Guay, *Is There a Case for Regulating Executive Pay in the Financial Services Industry?*, 12-13, Working Paper, Jan. 25, 2010 (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544104), arguing that specious, backward-looking arguments have been used to find flawed compensation practices responsible for the global financial crisis. *See also* Fahlenbrach and Stulz, *Bank CEO Incentives and the Credit Crisis*, Charles A Dice Center Working Paper No. 2009-13 (July 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859) *Cf* Bebchuk and Spamann, *id*, 267-269.

73 See Bartlett, "Global crisis 'failure of extreme capitalism': Australian PM", *Agence France Presse*, 15 Oct. 2008, 16:43.

system".[74] The following year, the U.S, Secretary of State, Timothy Geithner expressed the view that perverse incentives for short-term gain in compensation contracts had "overwhelmed the checks and balances" designed to address the risk of excessive leverage.[75]

## 4. Snapshot of Key Regulatory Developments around the World Regarding Executive Pay in the Global Financial Crisis Era

The global financial crisis has generated an unprecedented response to the issue of executive pay at an international level. In November 2008, for example, the Group of 20 (G-20)[76] stressed the need for greater global co-ordination in monitoring systemic risk[77] and implementing financial market reforms, including in the area of executive compensation.[78] The Financial Stability Forum, later re-named the Financial Stability Board (FSB),[79] undertook this task, adding its voice to the chorus linking compensation practices at large financial institutions with the onset the global financial crisis.[80] Standardisation of remuneration disclosures and supervision at an international level potentially promises to minimise the risk of regulatory arbitrage.[81]

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74 Bartlett, *ibid*.

75 Braithwaite, "US will Appoint 'Pay Tsar' to Vet Executive Packages", *Fin. Times*, 11 June 2009, 06.

76 The G-20 was created in the aftermath of the Asian financial crisis in the late 1990s. The G-20 comprises finance ministers and central bank governors from nineteen countries, including the United States and Australia. For the mandate and origins of the G-20, *see* Group of Twenty, *What is the G-20?* (available at http://www.g20.org/about_what_is_g20.aspx).

77 G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), xi-xii. This report also noted the need to avoid regulatory arbitrage, by ensuring that greater cross-border regulatory consistency. *Id*, vi.

78 *Id*, 32-35.

79 For background on the creation of the Financial Stability Forum and its role in the global financial crisis, see Carrasco, "The Global Financial Crisis and the Financial Stability Forum: The Awakening and Transformation of an International Body" (2010) 19 *Transnat. L. & Contemp. Probs*. 101.

80 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009). See also G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), 33. *Cf* The U.K. Turner Review,

In April 2009, the Financial Stability Forum released a set of guiding principles for remuneration in financial institutions (FSB Principles),[82] which will be translated into national prudential standards.[83] International committees of financial regulators, such as the FSB,[84] have been described as exemplars of "'governance', and regulation beyond the state".[85]

The FSB has stated that:-

> "Action in all major major financial centers must be speedy, determined and coherent. Urgency is particularly important to prevent a return to the compensation practices that contributed to the crisis".[86]

There has also been a wide array of regulatory responses to perceived problems in executive remuneration at a national level, including in common law jurisdictions, such as the US, UK and Australia. The following provides a snapshot of some of the

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which considered that remuneration was a far less important theme in the global financial crisis than other factors, such as inadequate regulation of capital, accounting and liquidity. Financial Services Authority (FSA), *The Turner Review: A Regulatory Response to the Global Banking Crisis*, 80 (March 2009). In the Australian context, see also Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 13.

[81] See Joint Forum, Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors, *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations* (2010), 4.

[82] Financial Stability Forum, *id*. The FSB Principles were endorsed by the G-20. See G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), 32-33.

[83] *See generally* FSB, *Principles for Sound Compensation Practices: Implementation Standards*, 25 September 2009; FSB, *Thematic Review on Compensation*, 22 December 2009.

[84] Other relevant international bodies include, for example, the International Organisation of Securities Commissions (IOSCO) and the Bank of International Settlements (BIS).

[85] Black, "Empirical Legal Studies in Financial Markets: What Have We Learned?" (2010, Law Society Economics Working Papers 4/2010, London School of Economics, 28.

[86] FSB, *Principles for Sound Compensation Practices: Implementation Standards*, *id*, 1.

current responses to executive pay and the perceived problem of "extreme capitalism" in these jurisdictions.[87]

## 4.1 The Australian Response

Australia's response to the issue of executive compensation during the global financial has been broad and multifaceted,[88] in spite of the fact that the impact of the crisis on the Australian economy has been far less serious than in many other Western jurisdictions.[89]

The first significant regulatory response was designed to implement the FSB Principles. It involves an extension by the Australian Prudential Regulatory Authority (APRA)[90] of its existing prudential standards for financial institutions to impose additional requirements on boards of financial institutions concerning executive compensation (APRA guidelines).[91]

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87 See Bartlett, "Global Crisis 'Failure of Extreme Capitalism': Australian PM", *Agence France Presse*, 15 October 2008, 16:43, citing Kevin Rudd.

88 *See generally* Hill, *New Trends in the Regulation of Executive Remuneration*, in DIRECTORS IN TROUBLED TIMES 100, 104-105 (Austin & Bilski, eds., 2009).

89 See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 34.

90 APRA is the prudential supervisor of four key industries in Australia, namely deposit-taking, life insurance, general insurance and superannuation, under Australia's "twin peak" regulatory structure. See Laker (Chairman, APRA), "APRA: The Year Ahead", Speech to the Australian British Chamber of Commerce, Sydney (26 February 2009), 2-3. In 2008, the U.S. Department of Treasury proposed sweeping changes to America's financial regulation framework, in which it recommended an objectives-based regulatory approach directly modelled on Australia's twin peaks structure. *See* The Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, 13-14, 143-46 (2008) (available at http://www.treas.gov/press/releases/reports/Blueprint.pdf).

91 See APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009); APRA, *Prudential Practice Guide: PPG 511 – Remuneration* (November 2009); APRA, Prudential Standard APS 510 - Governance (November 2009). For background to APRA's involvement in prudential supervision of executive remuneration in financial institutions, *see* APRA, Media Release No 08-32, *APRA Outlines Approach on Executive Remuneration*, 9 December 2008.

The APRA guidelines[92] are interesting for a several reasons. First, they constitute a form of principles-based regulation, which is often portrayed as a superior regulatory tool, in terms of flexibility and adaptability, to a rule-based approach.[93] The APRA guidelines constitute a more intense form of government monitoring of executive pay than has applied in Australia, where there has been, to date, a clear preference for market-based regulation.[94] The policy justification for the guidelines is the need to ensure prudential management of systemic risk to promote financial safety.[95] This justification deviates significantly from the traditional goal of aligning executive pay with shareholder interests under an agency paradigm.[96] Yet, it has been suggested that the link between executive compensation and excessive risk-taking in the finance industry was far less pervasive in Australia than in a number of other countries.[97]

As recent legal scholarship shows, enforcement intensity is an important factor in comparing different jurisdictions for the purposes of the "law matters" and convergence hypotheses.[98] It is yet to be seen whether the approach of national prudential regulators, such as APRA, in translating and enforcing the FSB Principles

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92 The APRA guidelines will commence operation in April 2010.

93 For discussion of the benefits of principles-based regulation over rule-based regulation, see Financial Services Authority, *Principles-based Regulation: Focussing on the Outcomes that Matter* (2007), 6-7. See also Ferran, "Principles-based, Risk-based Regulation and Effective Enforcement", in M. Tison (ed), *Perspectives in Financial Regulation*, 427, 427-31 (2009); Black, "Forms and Paradoxes of Principles-based Regulation", 3 *Cap. Mkts. L. J.* 425 (2008). *Cf* Cunningham, "A Prescription to Retire the Rhetoric of 'Principles-Based Systems' in Corporate Law, Securities Regulation and Accounting" (2007) 60 *Vand. L. Rev.* 1411.

94 *See* Sheehan, *The Regulatory Framework for Executive Remuneration in Australia*, 31 SYD. L. REV. 273 (2009). For a snapshot of Australia's current regulatory framework for regulation of executive compensation, see Sheehan, *ibid*; Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 125-38.

95 See Financial System Inquiry (Wallis Committee), *Final Report*, Chapter 8, "Financial Safety" (1997).

96 *See, e.g.,* Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68 *Harv. Bus. Rev.* 138.

97 See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, xxv.

98 See Coffee, "Law and the Market: The Impact of Enforcement" (2007) 156 *U Penn L Rev* 229; Jackson, "Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications" (2007) 24 *Yale Journal on Regulation* 253.

will result in a harmonised approach to regulation of executive pay in financial institutions, or create a new sphere of regulatory divergence.[99]

The APRA guidelines introduce industry specific regulation of executive pay. In a related initiative in 2009, the Australian Productivity Commission undertook a more general review of the remuneration framework for directors and executives[100] under the *Corporations Act* 2001 (Austl.) (Corporations Act).[101] The Productivity Commission's final report, *Executive Remuneration in Australia*, was released in December 2009.[102] The Productivity Commission made seventeen recommendations in total, the majority of which relate to ensuring procedural integrity of the pay-setting process[103] and to shareholder approval, increased disclosure and reporting requirements.

One interesting issue addressed by the Productivity Commission was the non-binding shareholder vote under §250R(2) of the *Corporations Act*. Although this provision

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99 For an overview of the convergence-divergence debate in comparative corporate governance, see Hill, "The Persistent Debate about Convergence in Comparative Corporate Governance" (2005) 27 *Syd. L. Rev.* 743.

100 The review related to remuneration of directors and executives of "disclosing entities". Under s 111AC of the Australian *Corporations Act*, disclosing entities are listed companies and managed investment schemes, with at least 100 investors. The review considered a range of regulatory mechanisms such as shareholder voting, disclosure and reporting practices. See Treasurer, Joint Media Release with Assistant Treasurer and Minister for Competition Policy and Consumer Affairs and Minister for Superannuation and Corporate Law, *Productivity Commission and Allan Fels to Examine Executive Remuneration*, 18 March 2009, "Terms of Reference: Review into the Regulation of Director and Executive Remuneration in Australia".

101 See Treasurer, Joint Media Release with Assistant Treasurer and Minister for Competition Policy and Consumer Affairs and Minister for Superannuation and Corporate Law, *Productivity Commission and Allan Fels to Examine Executive Remuneration*, 18 March 2009, "Terms of Reference: Review into the Regulation of Director and Executive Remuneration in Australia".

102 Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009. The Productivity Commission published several interim papers prior to release of its final report. *See* Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009) and Australian Government Productivity Commission, Discussion Draft, *Review into the Regulation of Director and Executive Remuneration in Australia*, 30 September 2009.

103 *See e.g.*, Banks (Chairman, Productivity Commission), *Executive Pay: Economic Issues from the Commission's Report*, speech to the Economics Society of Australia, 14 October 2009, 13, stating that the Commission had "focused more on the integrity of the sausage-making than the sausage" in its inquiry into executive remuneration in Australia.

was controversial at the time of its introduction in 2004,[104] the Productivity Commission considered that it had been successful in the goal of fostering "more productive engagement between shareholders and boards".[105] Shareholders of listed Australian companies also have a binding vote in a range of other remuneration-related situations,[106] including the issue of securities to particular directors through an employee incentive scheme under ASX Listing Rule 10.14.[107] It appears that some shareholder protest votes have been recorded at companies that had gained ASX waivers to avoid the need for shareholder consent under this listing rule in relation to executive pay.[108]

The Productivity Commission's view on the non-binding shareholder vote diverges from the view of some scholars, who have questioned the efficacy of the non-binding shareholder vote, particularly in the UK context,[109] where, at least until 2009, protest votes were relatively rare.[110] Perhaps the most extreme protest vote during 2009

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104 Business groups strongly opposed the introduction of the non-binding shareholder vote on the remuneration report. See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 281.

105 See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 277. See also *id*, 282.

106 See generally *id*, 279.

107 ASX Listing Rule 10.14 is found in Chapter 10, "Transactions with Persons in a Position of Influence", of the ASX Listing Rules (available at http://www.asx.com.au/ListingRules/chapters/Chapter10.pdf). The Australian Shareholders Association has argued, however, that loopholes exist to the operation of ASX Listing Rule 10.14, which could be exploited by companies to avoid the need for a shareholder vote. See See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 288.

108 See Washington, Executive Rewards Wake a Sleeping Giant, Sydney Morning Herald, 12 November 2007, at 19.

109 See, for example, Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in" (2009) 46 *Harv J on Leg* 323, noting that "pay continues to increase in the UK".

110 During 2009, there were a number of significant protest votes on executive pay by shareholders at major UK companies, such as Bellway. Bellway shareholders voted against the directors' Remuneration Report after it was announced that the board of directors had agreed to award bonuses of more than £630,000 to senior executives, in spite of a 28% drop in share value and a 50% fall in sales. The bonuses constituted 55% of the executives' salaries. See Goff, "Bellway pay-outs prompt concern", *Financial Times*, 5 January 2009, 19; Cookson and O'Doherty, "Bellway investors' vote goes against bonuses", *Financial Times*, 17 January 2009, 13. The Association of British Insurers ("ABI") warned UK companies at the

occurred at the Royal Bank of Scotland, where shareholders cast an unprecedented 90.42% of votes against the remuneration report.[111] However, even prior to this time, empirical research existed suggesting that the non-binding shareholder vote had been effective as an outrage constraint on pay packages with structures deviating from best practice principles.[112] Also, a study by Ferri and Maber indicated an increased degree of sensitivity of executive compensation (particularly cash compensation) to negative operating performance from the time when the non-binding shareholder vote was introduced in the UK, which the authors view as consistent with the UK government's policy against "rewards for failure".[113]

Significant shareholder protest votes have been far more common in Australia than in the United Kingdom,[114] and there are many examples of Australian companies that have amended their remuneration practices in response to such votes.[115] One example

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time that the global financial crisis should not be seen as an excuse for retrospective waiver of performance targets. The ABI issued an unusual "red top alert" over the Bellway bonuses, See Masters and Grant, "'Boards Warned over Backlash on Executive Pay", *Financial Times*, 6 January 2009, 21.

[111] The remuneration included a £703,000 pension payment to former CEO, Sir Fred Goodwin, who was granted a controversial early retirement at age 50. The newly appointed board chair stated that he had retained two law firms plus legal counsel to scrutinize the former CEO's contract to see if it was binding on the bank. See Croft and Bolger, "Thumbs Down for RBS Pay Report Reject RBS Pay Report", *Financial Times*, 4 April 2009, 12.

[112] See Sheehan, "Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia" (March 2007, available at http://ssrn.com/abstract=974965), 3.

[113] See Ferri and Maber, "'Say on Pay' Votes and CEO Compensation: Evidence from the UK" (June 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394.

[114] See generally Hill, "Regulatory Show and Tell: Lessons from International Statutory Regimes" (2008) 33 *Del J Corp L* 819, 829-837.

[115] In its submission to the Australian Productivity Inquiry, for example, BHP Billiton stated that "is no shortage of examples of Australian companies that have responded to a substantial "Against" vote, by making changes to their remuneration practices". See Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 282. The response in 2007 by Telstra, Australia's primary telecommunications company, to a significant shareholder protest vote on its remuneration report constituted, however, a clear exception to the trend described by BHP Billiton. Telstra took a decidedly unapologetic stance, blaming the outcome on either a lack of understanding by shareholders of the complexity of the remuneration structures or on shareholders blindly following the advice of proxy advisors. See Hill, *id*, 834-837. Nonetheless, in 2008, Telstra amended its remuneration practices, and received overwhelming shareholder support for the 2008 remuneration report. Australian Government Productivity

is Macquarie Bank, colloquially known as the “Millionaires’ Factory”. In 2007, RiskMetrics (then ISS) advised shareholders to vote against Macquarie Bank’s remuneration report,[116] and a protest vote of 21.4% was recorded.[117] Macquarie Bank accordingly altered its executive pay structure so that more remuneration was in the form of shares that must be held for three years, thereby regaining the support of RiskMetrics in 2008.[118]

Nonetheless, the Productivity Commission expressed concern that some companies continue to be non-responsive to shareholder views. In 2008-2009, for example, approximately 5% of ASX 200 companies received consecutive “no” votes of 25% or more, including Qantas.[119] The Productivity Commission sought to strengthen consequences of a significant “no” vote, via a “two strikes and re-election resolution” recommendation.[120] Under this proposed reform, a 25% “no” vote on the remuneration report would trigger a formal obligation on the board to explain how shareholder concerns are being addressed.[121] Two consecutive “no” votes of 25% or

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Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 284.

116 RiskMetrics complained that bonuses paid to Macquarie Bank executives were not commensurate with shareholder returns. During 2006-07, Macquarie Bank awarded bonuses totalling A$180.3 million to its 13 most senior managers, while total profit returned to shareholders was only A$ 633 million. See Marsh and Tucker, “Executive pay revolt brewing at Macquarie”, *Financial Times*, 4 July 2007, 15. RiskMetrics also criticised Macquarie Bank’s remuneration structure for the dominance of annual bonuses, which it claimed failed to provide adequate long-term alignment with shareholder interests. For example, more than 85% of the total A$25.6 million remuneration in 2006-2007 represented annual bonuses. *Ibid*.

117 See Linebaugh, “Macquarie Pay Plan Passes, But 'No' Vote Gets Louder”, *Wall Street Journal*, 20 July 2007, C3.

118 See Maiden, ‘‘Rudd's Executive Idea is to Force a Fine-tuning of the Payment to the Piper”, *The Age*, 16 October, 2008, 12. Macquarie Bank’s executive remuneration structure provides a good example of the potential for extreme downside elasticity in the global financial crisis. In the 2008-2009 financial year, it was reported that the CEO’s annual remuneration fell from A$27 million to under A$300,000 and the remuneration of the twelve most senior executives fell from A$125 million to A$11.4 million. Macquarie Bank reported its first fall in earnings in seventeen years See Smith, “Macquarie Chief Suffers Steep Cut in Performance-Related Pay”, *Financial Times*, 2 May 2009, 10.

119 Qantas received “no” votes of 41% and 43% for 2008 and 2009 respectively. Australian Government Productivity Commission, Productivity Commission Inquiry Report No. 49, *Executive Remuneration in Australia*, 19 December 2009, 283.

120 See Recommendation 15, *id*, XL, 294*ff*.

121 *Id*, 295.

more would activate a separate "re-election" resolution, which, if successful, would require all elected directors who signed the remuneration report to submit to re-election at an extraordinary general meeting to be held within 90 days.[122]

Other Productivity Commission recommendations sought to enhance the legitimacy of the non-binding vote by prohibiting key management personnel from voting *qua* shareholder on the remuneration report,[123] and from voting undirected proxies on remuneration issues.[124] The Productivity Commission also proposed that executives should be prohibited from hedging unvested equity remuneration or vested equity subject to holding locks, on the policy basis that such hedging undermines the nexus between pay and performance.[125]

In April 2010, the Australian Government responded to the Productivity Commission, supporting virtually all its recommendations, including the controversial "two strikes and re-election resolution" proposal.[126] The government recommended further strengthening of the proposals relating to the legitimacy of the non-binding remuneration vote,[127] and also announced that it would consider the introduction of an additional clawback provision.[128]

The approach of the Productivity Commission and the Australian Government to addressing perceived problems with executive pay provides a sharp regulatory contrast to that of the Institute of Company Directors (AICD Guidelines) in guidelines on executive pay released in early 2009.[129] These guidelines reflected a strong

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[122] *Id*, XXXII.

[123] Recommendation 5, *id*, XXXIV.

[124] Recommendation 6, *ibid*. Recommendation 7 would also require proxy holders to cast all directed proxies on remuneration reports. *Ibid*.

[125] Recommendation 4, *ibid*.

[126] See Minister for Financial Services, Superannuation & Corporate Law & Minister for Human Services, Joint Media Release, *Government Responds to the Productivity Commission Report on Executive Remuneration*, 16 April 2010.

[127] The Australian Government recommended further strengthening of the following Productivity Commission proposals: Recommendation 4, 5 and 7. *Ibid*.

[128] *Ibid*.

[129] AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009).

preference by the business sector for self-regulation,[130] and were clearly an attempt to forestall more intense government regulation.[131] The AICD guidelines focused predominantly on the process for determining executive remuneration,[132] and on the terms and structure of compensation packages.[133] The Australian Shareholders' Association (ASA) also released a policy statement on executive remuneration[134] around this time, which recognised the increased likelihood of government intervention in the event of failure by the corporate sector to respond to public concerns over executive pay.[135] It seems that that this prediction has now come to pass, in the light of the government's recent response to the Productivity Commission's final report.

Finally, Australia already introduced specific legislative reforms[136] in 2009 to deal with "golden handshakes".[137] There had been strong criticism of the previous law

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[130] According to the guidelines, the AICD is "firmly of the view that executive remuneration should remain a matter for boards, and that further regulation in this area is unnecessary and often counterproductive to the outcomes sought". *Id*, 5.

[131] *Cf* the approach of the Financial Stability Forum, which described voluntary action as desirable but of limited value as a regulatory constraint, due to competitive pressures. Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009), 1 (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf).

[132] AICD, *Executive Remuneration: Guidelines for Listed Company Boards*, 9-15 (2009). The guidelines included, for example, the following recommendations:- that executive remuneration should be determined by a remuneration committee comprised solely of non-executive directors (*id*, 6); that the board should obtain expert advice, independent of management, in entering into executive employment contracts (*id*, 6,13-14); that executives should have no involvement in setting their own pay, given the inherent conflict of interest (*id*, 12); and that the board should provide an executive candidate with the draft contract, rather than vice versa (*Id*, 13).

[133] *Id*, 16-25. In addition, the guidelines discuss "Reviewing arrangements" (*id*, 26-28) and "Other matters" (*id*, 29-32), such as the need to gauge public sentiment concerning executive remuneration (*id*, 30) and consider whether remuneration packages are publicly defendable and affect corporate reputation (*id*, 29, 31).

[134] See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009.

[135] *Ibid*.

[136] The Corporations Amendment (Improving Accountability on Termination Payments) Act 2009, which received Royal Assent on November 23, 2009.

[137] See Bills Digest No 6 2009-10, *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* (available at http://www.aph.gov.au/library/pubs/BD/2009-10/10bd006.htm), "Purpose". For an overview of key policy issues relating to termination

concerning termination pay,[138] on the basis that it was overly generous to executive officers[139] and potentially delivered "rewards for failure".[140] A key aspect of the 2009 Act is that it caps a director's termination pay at one year's average base salary – a significant reduction from the previous seven year threshold - unless shareholder approval is obtained.[141]

### 4.2 The US Response

The US reform environment in relation to executive pay is fluid and evolving. Although the US response was originally rapid and highly targeted towards financial institutions receiving federal bail-out funding, it has now become far more wide-ranging, with application to the corporate sector generally. The reform proposals have also become increasingly complex and demonstrate significant overlap.

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pay, see Stapledon, *Termination Benefits for Executives of Australian Companies*, 27 SYD. L. REV. 683 (2005).

138 See, for example, Sheehan and Fenwick, "Seven: The *Corporations Act 2001* (CTH), Corporate Governance and Termination Payments to Senior Employees", 32 MELB. U. L. REV. 199 (2008); RiskMetrics Group, Press Release, *Shareholders Pay the High Cost of Failure: Average CEO Gets $3.4 Million to Walk*, Nov. 26, 2008.

139 Under Part 2D.2 of the Corporations Act (former § 200F), shareholder consent was only required if termination benefits exceeding seven times a director's annual remuneration package. See, for example, Paatsch and Lawrence, *Money for Nothing*, BUS. SPECTATOR, Jul. 17, 2008, describing Part 2D.2 of the Corporations Act "in reality a dead letter".

140 "Rewards for failure" became topical following the U.K. government's release in 2003 of two reports on this issue in 2003 – (i) Department of Trade and Industry (DTI), *"Rewards for Failure": Directors' Remuneration – Contracts, Performance & Severance* (June 2003); (ii) UK Parliament, House of Commons, Trade and Industry Committee, *Rewards for Failure* (September 2003). See generally Stapledon, *Termination Benefits for Executives of Australian Companies* 27 SYD. L. REV. 683, 691-693 (2005). The UK government subsequently announced that it did not intend to legislate to control termination payments. *Cf* Harrison, *Dismay as DTI Baulks at Limits on Fat Cat Pay*, THE INDEPENDENT, February 26, 2004, 42; Tucker and Wright, *Excessive Pay-offs Decision Welcomed – Executive Rewards*, FIN. TIMES, Feb. 23, 2004, 2.

141 A number of changes were made during the passage of the Corporations Amendment (Improving Accountability on Termination Payments Bill 2009. For a summary of differences between a May 2009 Exposure Draft of the Bill and the actual Bill, which was introduced into the House of Representatives on 24 June 2009, see Freehills, *Limits on Termination Payments: Bill Introduced into Parliament*, JUN. 26, 2009 (available at http://www.freehills.com/5121.aspx); Mallesons Stephen Jaques, *Government Introduces Executive Termination Payment Laws into Parliament*, JUN. 24, 2009 (available at http://www.mallesons.com/publications/2009/Jun/9966946W.htm).

The early US reforms were closely tied to emergency federal funding assistance to prevent the failure of financial institutions and restore confidence in US financial markets. Between October 2008 and February 2009, a raft of legislation and guidelines were introduced by the US Treasury and Congress, aimed at controlling executive pay at institutions receiving federal financial assistance under an array of government bail-out programs. These included rules created under the *Emergency Economic Stabilization Act* of 2008 (EESA),[142] which authorised Treasury to access up to US$700 billion to protect and restore confidence in US financial markets.[143] The first program under the EESA, the Capital Purchase Program, introduced new rules on executive compensation for participating institutions.[144] The initial participants in the Capital Purchase Program were nine of the largest US banks, which received US$125 billion under the program.[145]

In February 2009, Treasury released guidelines (Treasury guidelines) under the EESA, restricting executive pay at companies receiving future federal financial assistance.[146] The guidelines create a two-tier assistance regime, distinguishing between institutions receiving funds under "generally available" capital programs, and those requiring "exceptional assistance",[147] for which stricter constraints apply.[148] For

142 The EESA was signed into law on 3 October 2008. See generally Davis Polk & Wardell, "Executive Compensation Rules under the Emergency Economic Stabilization Act of 2008", 23 October 2008 (available at http://www.dpw.com/1485409/10.23.08.epg.tarp.memo.pdf).

143 *Ibid*.

144 For a summary of EESA rules on executive remuneration applying to various categories of EESA participants, see *id*, 15-18.

145 *Id*, 2.

146 See US Department of the Treasury, Press Release, *Treasury Announces New Restrictions On Executive Compensation*, 4 February 2009 (available at http://www.treasury.gov/press/releases/tg15.htm); Davis Polk & Wardell, "New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf).

147 For firms receiving exceptional assistance, a range of new restrictions apply under the guidelines. These include a strict pay cap, under which senior executives are limited to US$500,000 total annual salary (excluding restricted stock); a non-binding "say on pay" shareholder vote requirement; expanded clawback and golden parachute restrictions; certification that the compensation does not encourage excessive risk taking; and disclosure of policies on luxury expenditures. See generally Farrell, "US Bank Chiefs Face $500,000 Limit", *Financial Times*, 5 February 2009, 05; Davis Polk & Wardell, *ibid*.

148 Davis Polk & Wardell, *id*, 3*ff*.

example, although both categories of funding assistance attracted a senior executive pay cap of US$500,000 on total annual compensation (excluding restricted stock), this cap could in certain circumstances be waived by shareholders of institutions receiving financial assistance under generally available capital access programs.[149]

In addition to the Treasury guidelines, the *American Recovery and Reinvestment Act* of 2009 (ARRA), commonly referred to as the "stimulus bill", was signed into law in February 2009. Provisions in this Act included additional limitations on executive compensation, demanded by Congress, for institutions participating in the Troubled Asset Relief Program (TARP).[150] One controversial aspect of the stimulus bill was the fact that it limited bonus payments to one third the value of total annual compensation.

Another US regulatory approach adopted in the bail-out context was the introduction of governmental pay oversight. In June 2009, the US government appointed Kenneth R. Feinberg as soi-disant "Pay Czar",[151] to oversee executive remuneration at institutions receiving federal financial assistance.[152] Mr Feinberg has authority in relation to the setting of salaries and bonuses of the five most senior, and twenty five most highly paid, employees of such institutions.[153] His appointment has been

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[149] *Id*, 3. For criticism of this waiver power, see Bebchuk, "Pay Caps Debate: They Don't Go Far Enough…", *Wall Street Journal*, 6 February 2009, A11.

[150] See generally Bachelder, "Executive Compensation under TARP", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 28 April 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/04/28/executive-compensation-under-tarp/#more-966); Morphy, "Economic 'Stimulus' Legislation to Impose New Executive Compensation Restrictions", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 16 February 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/02/16/economic-%e2%80%9cstimulus%e2%80%9d-legislation-to-impose-new-executive-compensation-restrictions/#more-870).

[151] Mr Feinberg formerly had responsibility for compensation claims made by families of the victims of the September 11 terrorist attacks. See Story and Labaton "Overseer of Big Pay Is Seasoned Arbitrator", *New York Times*, 11 June 2009, 1.

[152] Companies subject to Mr Feinberg's authority include AIG, Citigroup, Bank of America, GM and Chrysler. See Solomon, "US Pay Czar to Rework Contracts Deemed High", *Wall Street Journal*, 27 July 2009, A1; Labaton and Andrews, "Treasury to Set Executives' Pay at 7 Ailing Firms", *New York Times*, 11 June 2009, 1.

[153] Labaton and Andrews, *ibid*.

variously described as in the financial press as a "hard-to-believe turn" for the US "market" economy,[154] and evidence of the US federal government's "increasingly visible hand in corporate affairs".[155]

Since mid-2009, US reform proposals have become more broad-ranging and complex. These later reform proposals relate not only to executive pay, but also to the issues of shareholder power and corporate governance generally. The earlier TARP reforms have proven to be merely the tip of the regulatory iceberg, serving as a blueprint for more general reforms in the corporate sector.

The need to restore market trust has emerged in the global financial crisis as a new policy rationale for shareholder empowerment,[156] which was so conspicuously absent from the US post-Enron reforms. An example of the recent trend in US reform proposals towards granting shareholders more power over corporate governance is the Shareholder Bill of Rights, which was introduced by US Democrat Senators, Charles Schumer and Maria Cantwell, in May 2009. The Shareholder Bill of Rights sought to increase shareholder powers to counteract extreme risk-taking and excessive executive compensation.[157] Although some provisions of the Shareholder Bill of Rights related directly to executive remuneration in public companies, such as a

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[154] "The New Wage Controls", *Wall Street Journal*, 12 June 2009, A14. Republicans on the US House Financial Services Committee, for example, have accused the Obama Administration of using the financial crisis to effect further government encroachment in the private sector. Cyrus Sanati, "House Panel Clashes Over Pay Restrictions", *New York Times*, 12 June 2009, 4.

[155] Story and Labaton "Overseer of Big Pay Is Seasoned Arbitrator", *New York Times*, 11 June 2009, 1.

[156] See Bratton and Wachter, "The Case Against Shareholder Empowerment" (2010) 158 *U Pa L Rev* 653.

[157] See Senator Charles E. Schumer, Press Release, *Schumer, Cantwell Announce 'Shareholder Bill of Rights' to Impose Greater Accountability on Corporate America*, 23 May 2009 (available at http://schumer.senate.gov/new_website/record.cfm?id=313468).

mandatory annual non-binding shareholder vote on executive compensation,[158] many others were more general corporate governance provisions.[159]

Increased shareholder participation in the director nomination process (the director election issue) is also now on the US reform agenda. The Shareholder Bill of Rights included a provision to this effect.[160] One day after the introduction of this Bill, the SEC ended over 50 years of prevarication,[161] by voting[162] to propose SEC Rule 14a-11, which would grant shareholders access to the company's proxy materials to nominate directors.[163] In late July 2009, another Bill dealing specifically with executive pay, the *Corporate and Financial Institution Compensation Fairness Act* of 2009, was passed by the US House of Representatives.[164] Many of the provisions in the

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158 See US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives" (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf), s 14A.

159 These provisions include, for example, elimination of staggered boards; separation of the position of CEO and Chairman in public company boards and the presence of a risk committee for public company boards. US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives" (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf).

160 See US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives", (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf), s 4.

161 The issue was first addressed by the SEC in 1942. For a history of the debate, see Sundquist, "Comment: Proposal to Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal" (2004) 30 *Wm. Mitchell L. Rev.* 1471, 1473*ff*.

162 In a 3-2 split along party lines.

163 See US Securities and Exchange Commission, Press Release, *SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors*, 20 May 2009 (available at http://www.sec.gov/news/press/2009/2009-116.htm); Nathan, "The Battle for Shareholder Access: The Current State of Play", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 30 May 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/05/30/the-battle-for-shareholder-access-the-current-state-of-play/).

164 US House, 111th Congress, "H.R. 3269, Corporate and Financial Institution Compensation Fairness Act of 2009". The Bill was passed by the House of Representatives on 31 July 2009, and has been referred to the Senate Committee on Banking, Housing and Urban Affairs. It proposes to amend the *Securities Exchange Act* of 1934 to allow an annual, non-binding shareholder vote on executive compensation, and a similar non-binding vote on "golden parachute" compensation. Other reforms are also contained within the Bill, including a proposal to require financial institutions to disclose information on their pay structures, and on

Shareholder Bill of Rights, including the non-binding shareholder vote and the director election issue, have now been incorporated into a more comprehensive draft Bill on financial services regulation, the *Restoring American Financial Stability Act* of 2009.

These reform proposals have provoked fierce criticism within the US.[165] According to one commentator the director election issue, for example, is nothing short of "a knockdown, drag out political brawl".[166] The reforms have also been condemned as an illegitimate encroachment of federal legislation into the traditionally state-based domain of corporate law.[167]

### 4.3 The UK Response

In the post-Enron period, the London Stock Exchange acquired considerable cachet as a centre for international capital raising.[168] This development challenged New York's historical dominance and caused consternation in the United States, resulting in several reviews to consider the decline of US competitiveness in financial markets.[169] By 2008, however, the picture had again altered, with the collapse of Northern Rock

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how these structures relate to risk. See generally Luce and O'Connor, "Control of Executive Pay is Handed to Regulators", *Financial Times,* 1 August 2009, 6; Bebchuk, "Regulate Financial Pay to Reduce Risk-taking", *Financial Times*, 4 August 2009, 7.

165 See, for example, Lipton, Lorsch and Mirvis, "Schumer's Shareholder Bill Misses the Mark", *Wall Street Journal*, 12 May 2009, A15; Mitchell, "Protect Industry from Predatory Speculators", *Financial Times*, 9 July 2009, 9.

166 See Grundfest, "The SEC's Proposed Proxy Access Rules: Politics, Economics and the Law" (2010) 65 *Bus. Law.* 361.

167 See, for example, Paredes, "The Proper Limits of Shareholder Proxy Access", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 30 June 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/06/30/the-proper-limits-of-shareholder-proxy-access/). See also Veasey, "What Would Madison Think? The Irony of the Twists and Turns of Federalism" (2009) 34 *Del. J. Corp. L.* 35, 42-51, discussing federalism tensions in contemporary US corporate governance.

168 See, for example, Furse, "Sox is Not to Blame – London is Just Better as a Market", *Financial Times*, 18 September 2006, 19.

169 See Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation*, 30 November 2006, revised version released 5 December 2006, xi; McKinsey & Company, *Sustaining New York's and the U.S.' Global Financial Services Leadership*, Report to MR Bloomberg & CE Schumer (2007).

tarnishing London's much vaunted principle-based, or "light touch", regulatory system.[170]

Since that time, UK regulatory responses have focused particularly on the banking and financial sector, which required massive government funding to avert collapse.[171] Two reviews commissioned by the UK government are noteworthy. The first was the Turner Review into the global banking crisis.[172] In October 2008, the government asked Lord Turner, Chairman of the Financial Services Authority (FSA), to undertake a systematic examination of the banking crisis, assess whether regulatory deficiencies were a contributing factor and make reform proposals.[173] The 2009 Review[174] recommended radical strengthening of financial system regulation and supervision, including increased capital requirements.[175] Remuneration constituted an important feature of the report. The Turner Review considered that bank regulators around the world had, in the past, paid insufficient attention to remuneration structure and its potential for creating unacceptable incentives for risk-taking.[176]

The FSA also took specific action concerning executive remuneration, writing directly to CEOs of financial institutions concerning remuneration policies.[177] This "Dear CEO" letter commenced by stating:-

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170 See Masters, "Northern Rock Woes Take Toll on City's Reputation", *Financial Times*, 27 August 2008, 03.

171 See HM Treasury, *Speech by the Financial Services Secretary to the Treasury, Paul Myners, to the Association of Foreign Banks*, 11 June 2009.

172 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

173 See Turner, *Turner Review Press Conference: Speaking Notes and Slides for the Press*, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0318_at.shtml).

174 See *ibid*, for an overview of findings of the Turner Review. See also Hill and Leahy, "FSA Bids Farewell to Light-touch Financial Regulation", *Financial Times*, 19 March 2009, 17.

175 The Turner Review's recommendations have been described as a "watershed" in this regard. See Wolf, "Why the Turner Report is a Watershed for Finance", *Financial Times*, 20 March 2009, 11.

176 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), 2.5(ii), "Remuneration: Requiring a risk-based approach", 79-81.

177 FSA, CEO Letter, *Remuneration Policies*, 13 October 2008 (available at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf).

> There is widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis … The FSA shares these concerns.[178]

The letter urged all targeted firms to consider their remuneration policies in the light of the financial crisis, to ensure that those policies reflected "sound risk management".[179] It included an annexure, which outlined criteria for good and bad remuneration policies, against which firms could assess their own policies.[180] In March 2009, in conjunction with the release of the Turner Review,[181] the FSA published a Consultation Paper[182] and draft code on remuneration practices (FSA draft code).[183] The FSA subsequently published its final code of remuneration practice, applying directly to large banks, building societies and broker dealers, from early 2010 onwards.[184]

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178 *Id*, paras [1]-[2].

179 The letter further stated that non-alignment of remuneration policies with sound risk management was unacceptable, and would necessitate "[i]mmediate action" to change those policies. *Id*, para [6].

180 "Annex: Criteria for Good and Bad Remuneration Policies", *id*, 4-5.

181 See FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), 2.5(ii), "Remuneration: Requiring a risk-based approach", 80-81.

182 FSA, Consultation Paper 09/10 (CP09/10), *Reforming Remuneration Practices in Financial Services* (March 2009).

183 FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf). The Code was originally published on 26 February 2009. See also FSA, Press Release, *FSA Publishes Consultation Paper on Remuneration,* FSA/PN/038/2009, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/038.shtml). For background to the Code on Remuneration Practices, and the consultation process, see FSA, Consultation Paper Newsletter 09/10, *Reforming Remuneration Practices in Financial Services* (March 2009).

184 See FSA, Media Release, *FSA Confirms Introduction of Remuneration Code of Practice*, FSA/PN/108/2009, 12 August 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/108.shtml).

The second important UK report is the Walker Review, which was released in late 2009.[185] The report focused on improving general corporate governance in the banking and financial sector, with specific measures to strengthen boards and to increase institutional investor activism as a protective mechanism.[186] The Walker Review recommended the adoption of a Stewardship Code "to enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities".[187] Principle 4 of the Stewardship Code provides that institutional investors should establish guidelines for the purposes of engaging in activism.[188] Greater shareholder empowerment has been a far less contentious issue in the UK than in US, although some UK commentators have raised the issue of whether institutional investors are appropriate "guardians of corporate governance".[189]

## 5. Central Regulatory Themes

A number of central themes emerge in this panoply of regulatory responses and reform proposals around the world. These themes, many of which are inter-connected, include:- (i) risk-based approach to executive pay; (ii) long-term focus and sustainability; (iii) re-evaluation of the concept of interest alignment in executive pay; (iv) re-evaluation of performance measures; and (v) income inequality.

### (i) Risk-based Approach to Executive Pay

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185 See Walker Review, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, 26 November 2009 (available at http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf).

186 *Ibid.*

187 *Id*, 153.

188 *Id*, 156.

189 See Webb, Beck and McKinnon, "Problems and Limitations of Institutional Investor Participation in Corporate Governance" (2003) 11 *Corporate Governance: An International Review* 65.

A major theme in the current re-evaluation of executive pay involves the idea that executive pay, rather than being a corporate governance tool,[190] is itself a risk-management problem. The Turner Review into the global banking crisis, for example, adopted a predominantly risk-based approach to executive remuneration design,[191] highlighting the danger posed by remuneration packages creating unacceptable incentives for risk-taking.[192] This message also reverberated through the FSA draft code,[193] which had an almost exclusively risk-based focus,[194] viewing executive remuneration as a critical element of corporate risk.[195]

Financial institutions have been singled out as a special case within the context of this risk-based approach, and it has been argued that they should therefore be subject to greater governmental intervention in executive pay than corporations generally. Professor Lucian Bebchuk has argued that enhanced regulation of pay in financial institutions is justified on the basis of moral hazard concerns,[196] and because failure of

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190 On this view of executive remuneration, it is seen as a mechanism for aligning shareholder and management interests.

191 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

192 *Id*, 2.5(ii), "Remuneration: Requiring a risk-based approach", 79-81. See also the APRA Discussion Paper, which states that recent international financial failures have raised awareness of "unsound risk-seeking behaviour" in some remuneration practices, which have prompted financial regulators around the world to seek to manage this risk effectively. APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009), 6.

193 FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf). The Code was originally published on 26 February 2009. See also FSA, Press Release, *FSA Publishes Consultation Paper on Remuneration,* FSA/PN/038/2009, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/038.shtml). For background to the Code on Remuneration Practices, and the consultation process, see FSA, Consultation Paper Newsletter 09/10, *Reforming Remuneration Practices in Financial Services* (March 2009).

194 Almost every proposed rule and principle in the FSA draft code related in some way to the implementation of effective risk management. *Ibid.*

195 According to the FSA, for example, "[t]he risks arising from the way employees are recruited and managed, including the risks posed by remuneration policies, constitute some of the most important risks faced by firms". FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf), 3.

196 This is due to the fact that shareholders have perverse incentives to prefer higher levels of risk-taking than is socially desirable, given that taxpayers, rather than shareholders, will bear the costs of failure. See Bebchuk, "Regulate Financial Pay to Reduce Risk-taking", *Financial Times*, 4 August 2009, 7; Wolf, "Reform of Regulation Has to Start by Altering Incentives", *Financial Times*, 24 June 2009, 11. See also Walker, *Walker Review: A Review of Corporate*

such institutions imposes substantial costs on taxpayers.[197] The Walker Review also raises this issue, noting, in its interim review, that the taxpayer has provided UK banks with nearly £1.3 trillion in funding, resulting in a reduced tolerance for "unsafe remuneration policies".[198] The Walker Review also recommended that the remuneration committee's responsibility should be extended to cover all aspects of remuneration policy on a firm-wide basis.[199]

**(ii) Short-termism versus Long-termism**

The corporate scandals and collapses over the last decade highlighted a range of problems and inadequacies in the structure of executive remuneration, including the danger of providing incentives for short-termism.[200]

Many recent regulatory responses and proposals exhibit concern about the issue of short-termism. Short-termism was raised, for example, as a significant problem by the Productivity Commission,[201] and the ASA has stated that "[s]hort-term incentives … are questionable as incentives for CEOs".[202] There is correspondingly a strong

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*Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [1.3], referring to the problems of moral hazard and public interest externalities in the financial industry sector.

197 Bebchuk, *ibid*. For an opposing view, however, see Zingales, "Pay Regulation is Not the Best Way to Address Moral Hazard", *Financial Times*, 17 August 2009, 08.

198 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [7.1].

199 See Walker Review, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, 26 November 2009 (available at http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf), *.

200 See, for example, Hill, "Deconstructing Sunbeam – Contemporary Issues in Corporate Governance" (1999) 67 *U. Cin. L. Rev.* 1099, 1123-1125; Hill and Yablon, "Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict" (2002) 25 *UNSW L.J.* 294. For discussion of executive pay in bubble markets, see Bolton, Scheinkman and Xiong, "Executive Compensation and Short-Termist Behavior in Speculative Markets" (2006) 73 *Rev. Econ. Stud.* 577.

201 See Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 4, 11.

202 See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009, "The ASA Position", para [6].

focus on the need to promote long-term and sustainable corporate performance. The Walker Review stated that, in view of the massive injection of taxpayer funding into the UK banking system, it is imperative that remuneration practices should be restructured to provide incentives for sustainable performance.[203]

#### (iii) Re-evaluation of the Concept of Interest Alignment in Executive Pay

The "alignment of interests" paradigm for executive pay, which became dominant over the last two decades, sought to solve the agency problem between management and shareholders by using remuneration techniques to align their interests.[204]

Following the global credit crisis, however, the rhetoric accompanying the alignment goals of executive remuneration has shifted, and alignment with shareholder interests is no longer treated as the sole touchstone. The US Treasury stated that 2009 EESA guidelines[205] were designed to ensure that the remuneration of executives in the financial community is aligned, not only with the interests of shareholders and financial institutions, but also with the taxpayers providing financial assistance to those institutions.[206] In Australia, the APRA announced that it would require boards to adopt a remuneration policy aligning remuneration arrangements with "the long-term financial soundness of the regulated institution and its risk management framework".[207] Finally, the Productivity Commission's Terms of Reference[208]

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203 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [7.1].

204 See Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68(3) *Harvard Bus. Rev.* 138. See also Yablon, "Bonus Questions – Executive Compensation in the Era of Pay for Performance" (1999) 75 *Notre Dame L. Rev.* 271.

205 See US Department of the Treasury, Press Release, *Treasury Announces New Restrictions On Executive Compensation*, 4 February 2009 (available at http://www.treasury.gov/press/releases/tg15.htm); Davis Polk & Wardell, "New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf), 1.

206 See US Department of the Treasury, *ibid*.

207 APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009), 6.

required it to report on mechanisms that would better align the interests of management with the interests of both shareholders and "the wider community".[209]

### (iv) Re-evaluation of Performance Measures

The incentives provided by remuneration structures have real consequences. Professor Niall Ferguson has made this point cogently in describing how 17th century Dutch domination of the spice trade in Indonesia was partly attributable to remuneration practices. According to Professor Ferguson, the Dutch East India Company, unlike its British rival, rewarded managers on the basis of gross revenue rather than net profits, thereby encouraging the Dutch to maximise business volume by rapid expansion.[210]

As a corollary to the burgeoning risk-based/long-term approach to executive pay, there has been a dramatic re-evaluation of appropriate measures of performance. The current regulatory responses to the issue of executive pay strongly favour the adoption of performance criteria which promote long-term and sustainable goals.[211] The FSA has also suggested finetuning performance measures to include non-financial metrics, including adherence to effective risk management and compliance requirements.[212] In Australia, the AICD Guidelines stress the need to have appropriate performance measures that promote long-term corporate goals and sustainability (through, for

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208 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), "Terms of Reference", 33.

209 *Id*, 19-20, 22-23.

210 Ferguson, *Empire: How Britain Made the Modern World* (2004), 19.

211 See, for example, Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf), Section II, "Remuneration Policy", para [3.2].

212 See FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009, (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf), 6-7. See also FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), 30-31, where the FSA reports that respondents to the FSA *Draft Code on Remuneration Practices* were universally in favour of this principle.

example, deferred remuneration elements),[213] and that are resistant to manipulation by executives.[214] The AICD, too, contemplates performance that is both financial and non-financial, using improved workplace safety as an example of a non-financial performance metric that might be appropriate for some companies. [215]

#### (v) Income Inequality

The issue of income inequality arises frequently in several of the Australian responses to executive pay. The ASA states that the gap between the pay of Australian CEOs and the general workforce has become "huge", and is the subject of justifiable criticism.[216] The Productivity Commission raised the issue of equitable distribution within the corporation itself, querying the organizational effects of large pay disparities between executives and other employees.[217] The AICD suggested that the board of directors should consider the impact of material pay disparities between the CEO and other executives within the context of the corporation's culture and succession planning.[218] The issue of income disparity also has resonance in the UK, in terms of the Walker Committee's recommendation that remuneration committee's

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213 AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 19, 22, 24.

214 *Id*, 18-19.

215 *Id*, 19, n 8.

216 See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009.

217 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 10. The Commission asks, for example, "[d]o big disparities serve to motivate or de-motivate other employees?" *Ibid*. See also Yablon, "Overcompensating: The Corporate Lawyer and Executive Pay" (1992) 92 *Colum L Rev* 1867, 1877, n26, discussing the impact of significant pay differentials within organisations. According to Professor Yablon, although adverse morale effects are difficult to quantify, "this does not mean, however, that they should be ignored".

218 See AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 24-25. The recommendation of the Walker Committee that the remit of the remuneration committee should, where necessary, extend to cover all aspects of remuneration policy on a firm-wide basis is also interesting in relation to this debate. See Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009), (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Recommendation 28.

responsibility extend to setting compensation policy and packages on a firm-wide basis.[219]

## 6. Conclusion

We are in the midst of a complex, and developing, story about executive remuneration, corporate governance and regulation. The current focus on executive pay reflects the fact that, in the face of the global financial crisis, business once again has "a legitimacy problem".[220] Over the last two decades, there has been tension between an efficiency, and an accountability, model of corporate governance.[221] The global financial crisis has prompted a remarkable level of government intervention in financial markets[222] and brought accountability to the forefront.

A wide range of reforms are now on the table around the world. Yet, regulation is not a one way street; rather, it is a dynamic and relational process.[223] The regulatory developments concerning executive pay has inevitably provoked some commercial pushback. In the light of the stringent rules relating to executive remuneration introduced in the US bail-out context, for instance, many institutions have recently escaped the federal funding net. In mid-2009, ten large US financial institutions, including JP Morgan Chase & Co, Goldman Sachs Group Inc (Goldman Sachs) and Morgan Stanley, repaid approximately US$68 billion in federal aid to avoid TARP

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219 *Id*, para [7.8]; Recommendation 28. See also AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 22, which recommend examining executive remuneration in the context of general employment contracts within the firm.

220 Plender, "Mind the Gap: Why Business May Face a Crisis of Legitimacy", *Financial Times*, 8 April 2008, 9.

221 See Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L.J.* 367, 397-398.

222 See Plender, "Shut Out", *Financial Times*, 18 October 2008, 11.

223 See, for example, Skeel, "Governance in the Ruin" (2008) 122 *Harv. L. Rev.* 696, 696, discussing law's complex "iterative process of action and strategic reaction" as identified in Milhaupt and Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World* (2008), 6.

regulatory restrictions.[224] This development, and the easing of the global financial crisis, has been accompanied new upward pressure on executive pay and the return of big bonuses on Wall Street,[225] which is, however, again under pressure in the light of recent SEC fraud charges brought against Goldman Sachs.[226] It is yet to be seen whether the global financial crisis, and the unfolding regulatory environment, will result in a long-term cultural shift in relation to executive pay and income inequality in the common law jurisdictions discussed in this paper.[227]

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224 See Sidel and Solomon, "Treasury Lets 10 Banks Repay $68 Billion in Bailout Cash", *Wall Street Journal*, 10 June 2009, A1. See also Bowley and Dash, "The Banks Push Back", *New York Times*, 29 April 2009, 1.

225 In July 2009, for example, Goldman Sachs announced its best ever quarterly profit and said that it had allocated US$11.4 billion for employee salaries. See generally Bowley, "$3.4 Billion Profit at Goldman Revives Gilded Pay Packages", *New York Times*, 15 July 2009, 1; Lucchetti, "Big Pay Packages Return to Wall Street – Compensation on Track to Soar as Earnings Recover from Crisis", *Wall Street Journal*, 2 July 2009, C1; Dash, Citigroup Has a Plan to Fatten Salaries", *New York Times*, 24 June 2009, 1. See also Bebchuk and Cohen, "Back to the Good Times on Wall Street", *Wall Street Journal*, 31 July 2009.

226 See Murphy and Sakoui, "The US Against Goldman Sachs: Details of Case Against Bank Remain Vague", *Financial Times*, 30 April 2010, 21.

227 See Gordon, "Misperceptions about the Magnitude and Timing of Changes in American Income Inequality" (September 2009, NBER Working Paper 15351), 32-33; Piketty and Saez, "Income Inequality in the United States, 1913-1998" (2003) 118 *Quarterly J. Econ.* 1, 35.