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Directors' pay regulation: "one goal two approaches"

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[Companies Act 2006 \(c.46\)s.439, s.439A](#)

****Int. J.L.M. 337* Abstract**

Purpose - This paper aims to examine the two different approaches adopted in the UK to regulate directors' remuneration. The paper also aims to explore the two approaches to understand which one better regulates directors' pay and why. It provides an account of the two approaches' evolution, effectiveness and challenges towards the regulation of directors' remuneration. The paper will also make some recommendations on both approaches and the way forward to better regulate directors' remuneration.

Design/methodology/approach - The paper reviews various corporate governance codes, its recommendations on directors' remuneration, its effectiveness and the challenges it face in regulating directors' remuneration. The paper also reviews provisions of the Companies Act 2006 on directors' remuneration, its effectiveness and challenges faced.

Findings - The paper finds that corporate governance adopts a better approach to regulating directors' pay than the Companies Act 2006 because it targets the pay setting process. However, the existence of grey areas and lack of enforcement procedure poses a challenge on its effectiveness. The Companies Act 2006 is unable to regulate directors' pay adequately because it adopts a corrective approach and it considers directors' remuneration as a management responsibility.

Originality/value - The paper offers an up-to-date assessment of the two approaches to regulating directors' pay in the UK. It highlights the challenges faced by both approaches and which approach could regulate directors pay better and its challenges. The paper further makes recommendations on how the regulation of directors' remuneration can be effective in the UK.

Keywords Corporate governance, Remuneration committee, Directors' remuneration, Shareholder vote, Directors' remuneration disclosure

Paper type General review

Introduction

Executive remuneration emerged as a controversial issue during the early 1990s. Executives of privatised utility companies received pay increases which were condemned by the public and the media as having no corresponding link to the performance of the company. The criticism of executive pay by the public and the media came under headlines such as "Fat Cats in the Dock" (Economist, 1995), "Executive Gluttony under Attack" (Cohen, 1994) and "Derailing the Gravy Train" (Sunday Times, 1995). More than two decades later, executive pay continues to be a prominent issue of corporate governance in the UK. Firstly, there is continued concern that executives are receiving excessive pay packages with no corresponding link to company performance (BBC News, 2012). Secondly, executive pay seems to be increasing even when company performance¹ is falling. Thirdly, directors' pay (banker's bonuses) was considered as partly responsible for the financial crisis in 2008 (Gregg *et al.*, 2012; Villiers, 2010), and finally, the pay gap between executives and average employee of the company continues to widen (BBC News, 2013). The increase and criticisms on directors' pay attracted the **Int. J.L.M. 338* interest of policymakers with corporate governance mechanisms making recommendations on directors' pay setting process and the s439A Companies Act (2006) highlighting shareholder responsibility to monitor directors' pay.

The two approaches used in the regulation of directors pay emerges with corporate governance concentrating on the pay setting process, while the Companies Act (2006) concentrates on enhancing shareholder engagement. The approach adopted by corporate governance mechanisms can be regarded as protecting the wider interest of a company (which includes company members, investors, creditors, customers, employees, etc.) and not only the shareholders, while the Companies Act (2006) seems to only be interested in what the shareholders think about directors' remuneration. Shareholders may not necessarily take account of others interest when voting on directors' pay, but getting pay right at the determination process will enable the remuneration committee (RC) to think carefully about the company and the interest of others when setting directors' pay. Although corporate governance and Companies Act (2006) have adopted different approaches in regulating directors' pay, they both have a common goal which is to make directors' remuneration to be perceived as fair and transparent. This paper will examine both approaches, while discussing the evolution of both approaches, the effectiveness of both approaches and the challenges of both approaches. The paper will conclude with few recommendations.

Corporate governance and the determination of directors' remuneration

Corporate governance is the system by which companies are directed and controlled (Committee on the Financial Aspects of Corporate Governance, 1992, para 2.5) to enhance transparency and accountability in the company's dealing. The recommendations made by Corporate Governance Codes on directors' remuneration are aimed at the pay setting stage. The aim is to ensure that there is transparency at the pay setting stage which should translate to what will be perceived as fair. The evolution of these mechanisms will now be considered.

Evolution of corporate governance mechanisms on the determination of

directors' remuneration

The past two and a half decades have seen the introduction and revision of reports and codes in corporate governance in which issues of executive remuneration have also been addressed. The Cadbury Report 1992 was the first corporate governance mechanism that sought to address amongst others public concerns on the rapid growth of directors' remuneration and the lack of link between pay and company performance.

The Cadbury Report addressed the issue of executive remuneration in 3 out of its 19 recommendations. It advocated a sharp break to what was the then traditional UK corporate practice of which directors determined their own pay package. The most important recommendation the committee made was for the board to appoint a remuneration committee consisting of wholly or mainly non-executive directors (NEDs) (Committee on the Financial Aspects of Corporate Governance, 1992, para 4.42). The responsibility of the remuneration committee was to make recommendations to the board on the remuneration of the directors in all forms. This recommendation marked a big change in the process of determining executive remuneration. The Cadbury further recommended that executives should be precluded from taking part in decisions relating to their own pay to avoid issues of conflict of interest (Committee on the Financial **Int. J.L.M. 339* Aspects of Corporate Governance, 1992, para 4.42). The remuneration committee was allowed to draw advice from external sources (remuneration consultants) if necessary. All these recommendations were geared towards the determination of directors' pay because they realise that the problem of excessive pay could only be solved starting from the roots (the determination stage).

The Greenbury Report 1995 going a step further from Cadbury Report 1992 recommended that all remuneration committees should be made up of wholly NEDs (Greenbury Committee, 1995, para 4.8) The Greenbury Report went further to recommend that the REMCO should be made up of at least three NEDs or at least two NEDs in the case of small companies (Greenbury Committee, 1995, para 4.11). The Report recognised that removing a director before the expiry of his office could amount to a breach of contract for which compensation will be paid for each year remaining on the contract and, therefore, recommended directors' contracts to be reduced from three years to one year as a means of preventing excessive golden handshakes (Greenbury Committee, 1995, para 7.13). As a means of aligning directors' interest with that of the company, the Greenbury Report recommended that executive pay structure should be made up of multiple elements which includes base salary, benefits in kind, annual bonus, share options, other long-term incentive schemes and pension rights (Greenbury Committee, 1995, para 6.14). All bonus schemes, share options and long-term incentive schemes were to depend on satisfactory performance and needed shareholder approval. Annual bonuses were to be rewarded based on some financial performance measures (Greenbury Committee, 1995, para 6.19). Long-term performance schemes were to encourage the long-term success of the company subject to challenging performance criteria (Greenbury Committee, 1995, para 6.38). Performance measures were to be applied relative to what other companies in the same industry are applying (Greenbury Committee, 1995, para 6.39). The Greenbury Report failed to provide guidelines on what was to be considered as satisfactory performance, leaving the subject to the discretion of the remuneration committee. Share option schemes for directors were to be linked to long-term corporate performance and not to be offered at a discount.

The Greenbury Committee was keen on ensuring that executive remuneration be linked to company performance and was not bothered about the levels of pay so long as they were justified on the basis of company performance (Greenbury Committee, 1995, para 6.36). The Greenbury Report was the first to recommend that parts of the executive remuneration package be tied to performance as a means of aligning the interest of the executives with that of the company and the shareholder. A key concern should have been for corporate governance to ensure, through the remuneration system, that directors share the interest of shareholders in making the company successful. Performance-related remuneration can be effective in aligning interest directors' interest with that of the company, but academic research has proven that directors' pay is still not or weakly linked to company performance (Buck *et al.*, 2003; Gregg *et al.*, 1993; Main *et al.*, 1995).

Furthermore, the Report recommended extensive disclosure on remuneration matters which went notably further than the disclosure requirements in the Companies Act (1985) and the Cadbury Report as a means of ensuring greater accountability to shareholders and the public. This was intended to give the shareholders information on directors' remuneration and how it was determined. The disclosure was to include information such as the remuneration of each named director with details of the various ***Int. J.L.M. 340** components of the pay package (which include base salary, annual bonus, benefit, share options, long-term incentive plans and compensation for loss of office) to be disclosed (Greenbury Committee, 1995, para 6.14). Companies were expected to provide an explanation and justification whenever any element of remuneration package other than the basic salary was pensionable (Greenbury Committee, 1995, para 6.44). All notice periods of more than 12 months were to be disclosed and explained together with the names of the directors in the annual report. The remuneration committee were to write a report to be included or annexed to the annual report and account of the company on behalf of the board. The report had to provide information on the remuneration policy and the actual remuneration packages including share options and pension entitlement earned of each named executive, and how the executive remuneration was benchmarked with other companies (Greenbury Committee, 1995, para 5.4). Despite the extensive disclosure requirement, the Report did not set a standardised format on how the companies should disclose this information. This left the companies to adopt disclosure format that they deemed satisfactory and, thus, creating a variation in disclosure format amongst companies. Furthermore, the Report did not require shareholders to approve the general remuneration policy which meant that companies submit the amount of information the liked.

A review of the implementation of the Cadbury and Greenbury Reports led to Hampel Report in 1998. The Report suggested that the recommendations of Cadbury, Greenbury and Hampel be integrated into a single Code of Corporate Governance. However, Hampel did not advance the debate on executive remuneration; rather, it re-iterated and laid more emphasis on the provisions of the Greenbury Report. The recommendations of the Cadbury, Greenbury and the Hampel Reports were consolidated in the Combined Code 1998. The code was appended to the listing rules with on a "comply or explain" basis.

The Higgs Report in 1998 focused on the effectiveness of NEDs. Following the recommendation of the Greenbury Report, Higgs recommended that the remuneration committee should comprise at least three members, all of whom should be independent NEDs (Derek Higgs, 2003, para 13.11). The Higgs Report recommended that the

remuneration committee should be responsible for setting pay for executive directors, senior executives and chairman and for appointing remuneration consultants (Derek Higgs, 2003). Higgs emphasised on the NEDs independence from the board and recommended that the board identifies in its annual report its independent NEDs, explaining why they are considered independent (Derek Higgs, 2003, para 9.11).

The Combined Code 2003, 2006 and 2008 picked up on the recommendations from Cadbury to Higgs and went further from the Combined Code 1998 to recommend that a significant proportion of the executive remuneration should be structured so as to link rewards to corporate or individual performance (FRC, 2003). The Code cautioned that where the executive directors or senior management were involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest (FRC, 2003). Directors' eligibility for annual bonuses and long-term award schemes were subject to satisfactory performance and required all new long-term schemes proposed to be approved by shareholders (FRC, 2003). It also recommended the performance evaluation of the REMCO by the board annually. The Combined Code 2006 recommended that the chairperson of the company could serve on the REMCO where he/she was considered independent at the time of appointment. Apart from these few ***Int. J.L.M. 341** changes, all the provisions remained the same. The Combined Code 2008 contained the same recommendations on executive remuneration as the Combined Code 2006.

Despite the updates on the Combined Codes, executive remuneration continued to be in the spotlight with constant increase in executive pay with little or no relationship with the company's performance (Gregg *et al.*, 2012). Coupled with the banking crisis of 2007 and 2008 in the UK in which the government had to save five banks from collapsing led to the Walker Review (Walker, 1999). This committee was set up by the government chaired by Sir David Walker to look at corporate governance in the banking sector.

One significant problem that contributed to the banking crisis was the excessive risk taken by the banks. It was argued that excessive executive remuneration by the use of bonus payments encouraged excessive risk taking by the executives (Bloomfield, 2013, p. 144). Pay arrangements in the financial industries that provided bonus payment to some staff in the bank as an integral part of their pay package, encouraged recklessness in respect of valuation of assets and the calculation of profits (Bebchuk, 2012). Executive bonus rewards were linked to short-term performance rather than the long-term performance recommended by the Combined Code. The main changes of Walker Review were to ensure that performance-related remuneration is linked to long-term success and that the remuneration incentives are compatible with risk policies and systems. The Walker Review recommended that the remuneration committee should have a sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees (Walker, 1999, p. 28).

The Walker Review recommended an extension of the role of the REMCO to cover firm-wide remuneration policy. This was to ensure that the committee had appropriate oversight of the overall remuneration policy of the entity with particular focus on the risk dimension relevant to performance conditions, deferment and claw-back. The Review recognised that reward by bonuses which had been locked into the structure of corporate governance by the Greenbury Report might be an unsuitable way of rewarding the executives (Bloomfield,

2013, p. 144).

It further recommended that the remuneration committee should oversee the remuneration policy and outcomes in respect of all "high-end" employees (Walker, 1999, p. 29). The REMCO report should confirm the review of remuneration arrangements for the "high-end" group, satisfaction with the link between performance objectives remuneration structure; and disclose the principles underlying performance objectives and remuneration structures. The total remuneration of the "high-end" group, in bands, indicating numbers of executives in each band should be disclosed (Walker, 1999, pp. 31-32). Despite calls for disclosure of salaries of high-earning individuals, Walker does not require banks to name high earners because of issues of privacy - commercial confidentiality. Rather an anonymous disclosure of salary packages in excess of £1 million disclosure of high-end employees (whether board members or not) falling into bands from £1-£2.5 million, £2.5-£5 million and £5 million upwards, with details provided of the main elements of salary, cash and deferred bonus, performance-related long-term awards and pension contribution. The Review recommended claw backs to be used in cases of material misstatement and misconduct (Walker, 1999, p. 33).

A review of the Walker Review, by the Financial Reporting Council (FRC)² led to a new code with a change of name from the Combined Code to the UK Corporate Governance Code. Parts of the Walker Report that applied to all companies were **Int. J.L.M. 342* incorporated into the UK Corporate Governance Code, and those that applied only to the banking sector were left as example of best practice. The recommendations of the Code apply to a wide range of companies, but only listed companies must comply or explain regardless of whether they are incorporated in the UK or elsewhere.

A review of the UK Corporate Governance Code 2012 led to the publication of the UK Corporate Governance Code 2014. The Code made a few changes in relation to executive remuneration. The Code recommends that executive directors' remuneration should be designed as to promote the long-term success of the company which was a supporting principle under the 2012 Code to a main principle (FRC, 2014, p. 1). This principle is emphasising on the importance of linking executive remuneration to company performance because executive pay is presumed to lack a link between pay and performance. The Code emphasised that the remuneration committee should consider demanding directors to hold shares for a period after the vesting or exercised before selling it (FRC, 2014, p. 1). Shares granted or other forms of deferred remuneration should not vest or be paid or exercised in less than three years and longer periods may be appropriate (FRC, 2010).

The effectiveness of corporate governance mechanisms

Corporate governance's approach to regulating directors' pay lies in the ability to get the pay setting process right. This could intend mean the effectiveness of the remuneration committee because it is their responsibility to set pay. This is because the approach adopted by corporate governance in regulating directors' pay is rooted in getting the pay determination process right which is the responsibility of the remuneration committee. This involves two stages, getting the right people on the remuneration committee and for the remuneration committee to set pay taking into account the recommendations of corporate

governance mechanisms. It is worth noting that almost all of the listed companies in the UK have a remuneration committee.

Evidence on the adoption of remuneration committees was provided by the study carried out by Conyon (1994) which revealed that between 1988 and 1993, the percentage of UK quoted companies with remuneration committee (RCs) had risen from 54 to 94 per cent. Conyon and Peck (1998) found out that nine out of ten companies reported REMCOs, indicating that most companies were using the REMCO to determine executive pay rather than allowing the executives to set their own pay (Kovačević, 2008).

Despite the justification of having remuneration committee to determine executive pay, past research has provided a mixed results as to the committee's effectiveness. Early studies on remuneration committee by Main *et al.* (1995) found out that executives of companies without a remuneration committee were paid 24 per cent more than executives whose board had remuneration committee. This indicated that remuneration committee has an important and positive role in controlling boardroom remuneration. Conyon (1997) examined the existence of remuneration committee and directors' remuneration and found that the presence of the remuneration committee was associated with lower growth in director remuneration, thereby supporting the findings of Main *et al.* (1995). There are strong theoretical reasons for expecting the remuneration committee to exert an influence on top executive pay for the interest of the company and its stakeholders at large. In their role to act as independent arbiters of executive remuneration, they also have to respond competitively towards market pressure and design a remuneration contract that ensures executive have an incentive to behave **Int. J.L.M. 343* consonantly with shareholder interest (Fattorusso, 2006). Contrary to the findings of Main *et al.* (1995) and Conyon (1997) above, Main and Johnston (1993), Conyon and Peck (1998), Dalton *et al.* (1999) found little evidence to support the fact that the remuneration committee tailored executive pay to produce incentive effects that are beneficial to the company and its shareholders. Studies demonstrating the ineffectiveness of the remuneration committee have more evidence than those that demonstrate its effectiveness. This is further supported by a study carried out by the High Pay Centre (High Pay Centre, 2012), demonstrating that the composition of the remuneration committee may be part of the reasons of its ineffectiveness. The high pay that executives receive because of the presence of the remuneration committee could be attributed to the lack of independence of the remuneration committee from the executives³. Ezzamel and Watson (1997) found that with the presence of the remuneration committee, directors who were underpaid relative to the market had their pay increased, but directors who were overpaid received no parallel downward adjustments. They suggested that a kind of opportunistic relationship existed between the executive and NEDs who sit on each other's committees and thereby bid up executive earnings (Conyon and Peck, 1998). This study was supported by O'Reilly *et al.* (1998) who suggested that executive pay is driven by expectations stemming from social norms in which individuals base their judgments on a self-referential point (personal preferences, situation and circumstances). Their study suggested that the remuneration committee perhaps set executive remuneration level based initially on their own level⁴ which ends up with higher pay levels. They found that the average salary of the remuneration committee members (in relation to their own executive jobs) had a positive effect on executive pay. This means that the remuneration committee is not having the desired effect on the setting of executive remuneration, consequently pushing up pay

levels that are not related to company performance. Johnston's (2007) study, which examined the association between market forces and internal control on the remuneration contracting process, found out that the appointment of executives to the remuneration committee is not associated with an opportunistic behaviour to set pay in their self-interest. The study also found out that the appointment of at least three NEDs to the committee was associated with lower levels of chief executive officer (CEO) remuneration. Their findings demonstrate that having executives on the remuneration committee could still restrain excessive executive remuneration. This study was further supported by another study by Gregory-Smith (2009) who examined remuneration committee and CEO influence on the remuneration setting process. He found out that the composition of the remuneration committee did not affect CEO remuneration levels. These findings suggested that using remuneration committees in setting the remuneration of executives did not achieve a significant link between executive pay and company performance (Daily *et al.*, 1998).

The remuneration committee is expected to design reward structures with a significant part of it based on challenging performance conditions so as to align executive pay with the company's performance which seems unattainable from past studies (Canyon and Peck's, 1998). Main and Johnston (1993), analysing the composition of the remuneration committee and its role in the setting of executive pay, found out that the presence of the remuneration committee was associated with higher levels of executive remuneration with no corresponding link to company performance. Canyon and Peck's (1998) study found out that the independence of the remuneration committee **Int. J.L.M. 344* from the executives is associated with higher CEO remuneration levels and stronger pay for performance relationship. This study tends to suggest that the lack of the remuneration committee's independence from the executives may result in a weak link between executive pay and company performance. Benito and Canyon (1999), analysing the determinants of directors' remuneration, found weak evidence that the presence of the remuneration committee led to stronger pay for performance relationship. Capezio *et al.* (2011), examining the role of the remuneration committee of 663 large companies from 1999 to 2006, found no evidence that independent remuneration committees were associated with better alignment of total CEO remuneration to company performance. The relationship between executive pay and company performance is one of the crucial outcomes that are expected of the remuneration committee when setting pay. These results demonstrate that the remuneration committee is ineffective in the determination of executive pay.

The inability of the remuneration committee to restrain executive pay was further demonstrated by Main *et al.* (2007). They found that, first, the remuneration committee felt constrained in their choice of pay design by institutional cultures and values particularly with regards to long-term incentive schemes. Second, the remuneration committee does not allocate sufficient time to calibrate or confirm remuneration plans. Finally, most of their actions are dominated by a perceived need to justify high pay outcomes. Ogden and Watson (2012) examined how the remuneration committee's decisions on executive pay are influenced by the remuneration consultants. They found out that the remuneration committees are proactive in managing pay policy and ensuring that pay is regarded as appropriate and not over generous (Ogden and Watson, 2012). They also found out that the remuneration committee's understanding of the wider pay environment makes them to

increase pay so as to avoid losing its executives who may seek for higher pay in other companies (Ogden and Watson, 2012). This findings provides more support to the earlier research on the fact that the remuneration committee and not able to restrain executive pay.

The remuneration committee, as discussed earlier in the paper, is an important committee of the board in the determination of executive remuneration. However, it is not effective in its role of restraining executive remuneration because they are not completely independent from the board. This ineffectiveness is reflected in the fact that executive remuneration continues to increase with seemingly no link to company performance, and the gap between executive pay and average employee pay. Although corporate governance approach of getting the pay setting process right is a good strategy, the non-effectiveness of the remuneration committee is making the approach ineffective too.

Challenges face by corporate governance

The first challenged faced by corporate governance is on how to establish an independent remuneration committee that will be free from the influence of the executives of the company. Some of the NEDs that sit on the remuneration committee are executive directors' of other companies. Although it can be argued that their experience as executives gives them a greater inside to understand and set directors pay, this also places the NEDs in a sympathising position, as they identify their interest with those of the directors. Furthermore, benchmarking practice could influence the directors to set a generous pay package because they are aware that it will also affect their pay **Int. J.L.M. 345* packages in the company where they act as executive directors through the process of benchmarking.

Corporate Governance mechanisms operate on a "comply or explain" basis and forms part of the listing rules (FSA, 2007). This simply means that were a company does not comply with the recommendations of corporate governance mechanisms, they should provide a reason as to why they did not. A departure from the Code does not automatically mean a breach of the Code (FSA, 2007). Academic studies that have examined the rule demonstrate that companies are not adequately explaining the reason for non-compliance or not giving reasons at all (Thornton, 2013). Therefore, the biggest challenge of corporate governance mechanism is the enforcement of the recommendations.

Another challenge faced by the corporate governance mechanisms failure to define what company performance is and the which performance measures companies should use that measure what will be considered as long-term performance of the company and short-term performance. Companies tend to use different performance measures as well as past studies tend to use different performance measures when investigating the link between pay and performance. This use of different performance measures tend to produce mixed results, even though, generally, pay has been proven to be weakly related to directors' pay (Conyon and Murphy, 2000). The UK Corporate Governance Code allows the remuneration committee to appoint remuneration consultants to advice on pay if needed. However, the remuneration committee may have limited knowledge on how the remuneration consultants arrived at their conclusions.

The Companies Act 2006 and the determination of directors' remuneration

The Companies Act (2006) adopts a "corrective" measure towards directors' remuneration. This is because it does not make provisions on how pay should be set, but on what the shareholders should do, if they think that directors' pay is excessive. This clearly shows the stand point of the Companies Act as not wanting to get involve in directors pay, as it is considered as a matter for the company's management. The question is "*if directors' pay was a matter for the management, why did the Companies Act get involved.*" To answer this question, the next section will consider the evolution of the role of law in directors' pay.

Evolution of the role of law on the determination of directors' remuneration

The Companies Act (2006) operates on the basis that directors' by default have no lawful entitlement to remuneration (*Hutton v. West Cork Railway Co* [1883], 23 Ch D 654) unless otherwise than stated in the company's articles of association or in a separate contract (Villiers, 2010). The UK legislature's interest in executive remuneration began in the early 1990s when the level of executive pay was rapidly increasing with tenuous links between pay and performance. In late 1994, the 70 per cent pay rise given to the then CEO (Mr Cedric Brown) of British Gas plc generated public outcry and made headlines in the press such as "Fat Cat in the Dock" (Economist, 1995) and "Derailing the Gravy Train" (Sunday Times, 1995). Mr Brown's large pay rise was criticised as at the time the company was implementing voluntary redundancies in relation to its employees. Parliament having previously argued that executive remuneration was a matter for the market and the shareholders (Case Study, 1996) required Mr Brown to defend his pay **Int. J.L.M. 346* increase to the House of Commons Employment Committee. From this time onwards, the role of law made provisions on directors' remuneration with the aim of bringing transparency and accountability to directors pay and not to curb directors' pay. This was done introducing two major provisions into the then Companies Act (1985), requiring listed companies to disclose information on directors pay and giving shareholders a non-binding vote on directors' remuneration report.

Before the Companies Act (2006), disclosure requirements under Companies Act (1985) were limited. Section 232 merely required the directors to disclose the emoluments of the highest paid directors and chairman, the aggregate emoluments of all directors and loss of office payments. The information did not have to specify who the highest paid director was or the remuneration of individual directors. The Act did not provide a method of disclosure, and also, the remuneration for the highest paid director was not broken down to the various components of the remuneration package. Consequently, monitoring executive remuneration was a difficult task, as the information available to the shareholders was limited (Roach, 2004). Owing to the limitations in the Companies Act (1985), the Directors' Remuneration Report Regulations 2002 (DRRR 2002) inserted several new provisions into the Companies Act (1985), which were later largely transplanted into the (Companies Act, 2006). Further disclosure requirements have been introduced into the Companies Act (2006) by the Enterprise and Regulatory Reform Act (2013). These greater disclosure requirements have been placed on the directors in relation to their remuneration as a

means to create an open and effective framework to increase transparency and accountability in the pay setting process and the quality of information disclosed (Ferri and Maber, 2010). The shareholders having access to information on executive remuneration will enable them to make informed judgements when voting on the remuneration report at a general meeting. Companies are required to disclose in their annual accounts aggregate directors' remuneration⁵. The rules relating to the disclosure of director's remuneration are contained in the Companies Act (2006), the Small Companies and Groups (Accounts and Director's Report) Regulations 2008⁶ (for unquoted companies) and the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008⁷ (for quoted companies).

Under Section 439 of the Companies Act (2006), shareholders were only entitled to a non-binding vote on the remuneration report. This meant that if the shareholders voted down the remuneration policy of a company that company was not compelled to act on it. The response to the shareholder non-binding vote was not impressive there was a need to strengthen the shareholder voting rights. The Enterprise and Regulatory Reform Act (2013) inserted Section 439A into the Companies Act (2006) which requires the remuneration policy of quoted companies to be approved by the members of the company by an ordinary resolution. Quoted companies are required to produce a remuneration report that is split into three distinct sections, namely, a statement from the chair of remuneration committee; the policy report; and the implementation report. The statement from the chair of the remuneration committee will summarise the major decisions on directors' remuneration, any major changes made during the year on directors' remuneration and the context in which those decisions were made (Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation, 2008). The policy report (Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation, 2008) section sets out the proposed future remuneration policy which must be approved by a shareholder binding vote at least once every three years. The objective **Int. J.L.M. 347* of the policy report is to provide shareholders with adequate information, to get involved in the remuneration setting process. However, the policy sets out the terms on which executives will be paid and not the actual amount (specific figure) that may be paid to an executive in any particular circumstances. The implementation report of the remuneration report will provide a detailed explanation on how the existing remuneration policy was implemented in the relevant financial year - the implementation report must be put to an annual non-binding shareholder vote (Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation, 2008). Quoted companies are required to divide disclosure information into two parts, which is audit-related information related to payments actually made to executives in the financial year (Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation, 2008) and non-audit-related information relating to the company's remuneration policy (Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation, 2008).

The effectiveness of the role of law

The shareholder binding vote together with other powers⁸ given to the shareholders under the Companies Act (2006) represents an important mechanism of the shareholder voice in the UK.

However, shareholders lack the time and expertise needed to understand the report except for institutional investors who can afford pay someone to interpret the report for them. Consequently, an average shareholder who owns only a tiny percentage of the company's shares will need to incur the cost (time and money to pay experts to interpret the report) to be able to make informed decision on the remuneration policy when voting or, as is most likely, will simply abstain from voting (Roach, 2004). Shareholders who do not understand the remuneration process could only probably look at the level of remuneration and what they get as dividends to cast a vote for or against a remuneration report. The twenty-first century remuneration packages have developed to be more complex and technical as opposed to the past century remuneration packages. The complexity and technicality of these remuneration packages is almost defeating the very purpose of the disclosure requirements which was to provide shareholders with information on executive remuneration.

Shareholder's voting on remuneration policy has been facilitated by the disclosure requirement introduced in 2002. However, only few companies saw their remuneration reports voted down with many shareholders abstaining from voting. Furthermore, shareholders' ability to have an influence on management will depend on the proportion of the votes which they can exercise and the use they make of these votes. Shareholder voting power is, therefore, predominantly aimed at institutional investors, as they hold large numbers of shares in a company more than an ordinary shareholder. The UK Stewardship Code (FRC, 2012) states that institutional investors should seek to vote at all annual general meetings (AGMs) where practicable.

However, despite the concentration of equity ownership in the hands of institutions, shareholder voting on executive remuneration report has not increased a great deal. Only a small proportion of Financial Times Stock Exchange (FTSE) 100 companies shares are held by UK long-term investors. The majority of FTSE 100 companies' shares are in the hands of overseas shareholders (as shown in the Table I) or short-terminist

Table I. Beneficial ownership of FTSE 100 companies and others 2012			
UK equity share ownership 2012	FTSE 100	% of total UK quoted shares companies	Other
Sector			
Rest of the world	54.5	45.9	53.2
Insurance companies	6.2	6.5	6.2
Pension funds	4.7	4.6	4.7
Individuals	9.0	20.3	10.7
Unit trust	9.3	11.2	9.6
Investment trusts	1.7	1.9	1.7

Other financial institutions	6.6	6.5	6.6
Charities, churches, etc.	0.6	0.5	0.6
Private non-financial companies	2.6	0.1	2.3
Public sector ⁹	2.9	0.1	2.5
Banks	1.8	2.4	1.9
Total	100.0	100.0	100.0
Source: Share Ownership - Share Register Survey Report 2012			

***Int. J.L.M. 348** investors such as hedge funds that do not really care about what the executives take home as remuneration (Saunders, 2012).

From the Table I, it indicates that more than 50 per cent of FTSE 100 shares are held by overseas shareholders who may not be able to monitor the board because of the large number of companies they have in their portfolio.

In the banking sector, many of the banks performed poorly in recent years, but the sector received high support on their remuneration reports casting doubts on the effectiveness of institutional investors in using their voting rights on executive remuneration issues. For example, Barclays Bank in 2011 received a 75 per cent approval for its remuneration report from investors despite their poor performance in stock and dividend returns (Clarke, 2011a). However, Dong and Ozkan (2008), studying institutional investor and executive pay in UK companies, found out that there exist two classes of institutional investors - one being dedicated (in remuneration context meaning voting) and the other transient (not voting). Their findings showed that the dedicated institutional investors do restrain the level of executive pay and strengthen the pay performance relationship. These dedicated institutional investors use their expertise and votes to monitor the management. The transient institutional investors make no appreciable difference neither to the pay levels of the executive remuneration or strengthen the pay performance relationship indicating that they have failed to regulate executive remuneration (Villiers, 2010).

Shareholder pro-activism can greatly reduce the influence shareholder could have on the pay determination process in a company. This disengagement by the shareholders also reduces the importance of the voting powers vested on the shareholders on remuneration matters. Consequently, shareholder binding vote may not be more effective than a shareholder non-binding votes and the setting of executive remuneration would still be inappropriately regulated. Before the shareholder vote on the remuneration report was introduced in 2002, the Cadbury Committee (Committee on the Financial Aspects of Corporate Governance, 1992) had expressed their scepticism on more powers given to the shareholders on remuneration issues. They predicted that ***Int. J.L.M. 349** many of the shareholders will simply abstain from voting, and those that vote to defer in almost every

case to the judgment of directors and the remuneration committee. This scepticism of the Cadbury Committee has come true, as evidence from over the years is proving that shareholders are incapable of monitoring and curbing excessive directors' pay.

The effect of directors' remuneration disclosure has been an increase on pay levels (Clarke *et al.*, 1998). Clarke *et al.*'s (2011b) study of 342 company chairmen on listed companies of all sizes found out that half of the chairmen of UK companies were of the opinion that pay disclosure had resulted in an increase in pay levels. This is because the executives had used the availability of remuneration data through disclosure requirements from other companies to compare their pay levels of those of their peers. Executives may tend to demand for more pay in cases where they were paid less than their peers, or threaten to leave the company to other company that would offer a better pay level and structure than his current company.

The challenges faced by the role of law

The challenges faced by the Companies Act (2006) on directors' remuneration is the fact that they do not want to get involved in remuneration issues, as it is considered a matter for the company's board of management. Consequently, the law cannot make provisions as to what the directors' should be paid or what elements should make up the remuneration package. The non-use of shareholders voting rights to monitor directors' remuneration seems to have defeated the role of law's approach to regulate pay. This has left the role of law ineffective which is justified by continues increase in directors' remuneration in the UK.

Recommendations and conclusion

Corporate governance mechanisms has adopted a better approach to regulating directors' pay which should be encouraged. Directors' remuneration can only be successfully regulated if the pay setting process is right. Although there are grey areas that corporate governance has not addressed yet, its challenge is on the lack of enforcement. The Companies Act (2006) position on directors' pay could be considered as a house whose foundation is built on sand which cannot withstand the storm when it hit. Although the shareholders' votes are intended to indirectly influence the pay setting process, shareholders have not been using the powers to influence pay setting process. The basic provisions needed to get the right pay package such as who should set pay, are missing in the Companies Act (2006); therefore, as a strict matter of law, directors' still set their own pay in which there is a potential for conflict of interest. There is a need for corporate governance mechanisms to address the grey areas and more recommendations to strengthen enforcement. The Companies Act (2006) may insert a provision on the enforcement of corporate governance mechanisms, or provisions on basic rules on the determination of directors' pay. It is difficult from the current stage of the two regulatory forms to adequately curb excessive directors' pay in the UK.

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1. The results of activities of an organisation or investment over a given period of time.
 2. The body established by the government to oversee the operation of the Code.
 3. The independence of the remuneration committee as discussed earlier in p. 113.
 4. Levels at which they are paid in the companies where they act as executives.
 5. CA 2006, s 412.
 6. SI 2008/409.
 7. SI 2008/410.
 8. Such as the requirement of shareholder approval for service contracts over two years in length (s 188), the ability to remove a director from office by ordinary resolution (s 168), and the requirement that certain payments for loss of office obtain shareholder approval (s 217).
 9. The results of activities of an organisation or investment over a given period of time.