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SCHEMES OF EXECUTIVE REMUNERATION AND ITS REGULATION AT THE LEVEL OF RECOMMENDATIONS

UDK: 346 (4)
Pregledni rad
Primljeno: 1. 12. 2013.

The rising level of executive remuneration (compensation) is in the focus once again. Economist and legal analysts frequently come up with the question: “*how shall the system of executive remuneration represent a sustainable structure of corporate conduct where the aspects of strategic approach ensures a long term development?*” In 2008-2009 *AIG*'s remuneration scandal (also known as the *bonus gate scandal*) highlighted that the federal aid received by the financial institution partially served remuneration interests. In addition to the “bonus payments” made to the company's own executives, the fact that *AIG* provided a portion of the federal aid to other financial institutions, including European banks, aroused general indignation. Meanwhile, the *European Union* (concerning the financial sphere) and *Switzerland* (concerning corporations generally) took a stand on reconsideration of the issue, even by limiting executive remuneration packages. This paper would like to review major theories on the application of remuneration packages and also the concerning regulation at the level of recommendations.

Key words: *best practice, bonus payment, option, perquisites, recommendation, remuneration, share*

I. PURPOSE OF REMUNERATION

Prior to the description of the individual means of remuneration, we consider it necessary to present the objectives their application aims to achieve. These objectives are also outlined by the British *UK Corporate Governance Code* within its own regulatory scope. According to the *UK Corporate Governance Code*, the purpose of remuneration is to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. Thus, the objective is to establish a rather delicate balance.¹ Similar phrasing is used by the *ASX Principles of Good Corporate Governance*, when it sets forth the factors that need to be considered upon the determination of remuneration.² In addition to the foregoing,

¹ See *The UK Corporate Governance Code (2012) D.1 (Main Principle)*

Available at (November 10, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

² See *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)*, Principle 8 Available at (November 10, 2012): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf,

the British *UK Corporate Governance Code* also emphasizes that the executive directors' remuneration package should be structured so as to harmonize their interests with those of the shareholders, as well as to provide significant incentives to achieve the highest performance.³ In this respect the *ASX Principles of Good Corporate Governance* sets forth that remuneration should motivate corporate managers in the interest of fostering the long-term development and success of the company. Furthermore, it is also essential that remuneration be clearly linked to the performance of the directors.⁴

II. THE APPLICATION AND SYSTEM OF THE VARIOUS MEANS OF REMUNERATION IN CODES OF BEST PRACTICES AND CONTRACTS

Upon the review of the regulatory efforts and the recommendations of the European Union concerning the remuneration of corporate executives, we consider it essential that henceforth the various remuneration elements constitute the subject of our analysis, with special regard to the stock exchange regulations applied in relation thereto. Naturally, the codes applied by stock exchanges (recommendations) are not legal regulations, thus they have no direct binding force (similarly to the EU recommendation issued in this respect), however, if a company disregards such codes, this may be indicative to investors and the markets. Below, we compare the content of three relevant codes (*codes of best practices*). Two of these codes – the *Corporate Governance Recommendations of the BSE* and the *Deutscher Corporate Governance Kodex* – are based on the implementation of the EU recommendations. The third code, the *ASX Principles of Good Corporate Governance* was prepared outside the European Union, nevertheless, global trends in this respect direct the attention to the similarities. The observed tendency indicates a convergence of the *content* of investor requirements and corporate governance reforms.

In the context of the means of appropriate motivation and the objectives set thereby, we need to analyze the recommendations of corporate governance codes. The *Corporate Governance Recommendations of the BSE* – responding in part to the already raised issues – call the attention to the fact that *the proportion of various interests should be determined in such a way that it encourages the beneficiaries to think strategically*. Strategic thinking has a prominent role in respect of issues related to remuneration. In addition to ensuring appropriate motivation, remuneration arrangements and contracts should also prevent prompt,

³ See *The UK Corporate Governance Code* (2012)

Available at (November 10, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

⁴ See *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)* Principle 8. Available at (November 10, 2012): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf,

short-term share price maximization implemented in lack of actual foundations. In the case of supervisory board members, remuneration of a fixed amount is suggested, and it is suggested that their remuneration should not be connected to the share price.

In relation to the individual remuneration elements, the *ASX Principles of Good Corporate Governance* emphasizes that most remuneration packages are based on the balance of fixed and incentive (varying according to performance) benefits, and proposes the consideration of the application of the following elements: fixed remuneration, performance based remuneration, share based remuneration, severance pay.⁵

According to the *Deutscher Corporate Governance Kodex*, the total remuneration of board members comprises monetary compensation elements, pension awards, other awards (in particular, those related to the termination of the activity), all types of fringe benefits (in excess of the salary), and benefits by third parties promised or granted in the financial year with regard to such person's board activity. The monetary compensation elements shall comprise fixed and variable elements. Variable elements are the one-time, annually recurring components subject to business success, and long-term, incentive components including risk elements.⁶

Management incentives should include both monetary and non-monetary elements (such as career orientation). In respect of the *monetary remuneration of the management*, the following elements are the most significant: *salary and bonuses; share options and shares subject to a prohibition of alienation;*⁷ *further compensation elements;* and the *revaluation, re-pricing of existing shares and share options.*⁸ Furthermore, *pension arrangements, golden parachute arrangements,*⁹ and *preferential loans* are also to be listed under the above category.

Additional income referred to in business jargon as *perks* (from *perquisites*) represent a significant remuneration element, which is however difficult to assess. These are incidental advantages provided to managers in excess of their benefits, frequently for the purpose of representation or comfort. Such perks are, for example, significant cost reimbursements, the use of the company's aircraft or car, the use of luxury apartments. Moreover, these benefits may include the financing

⁵ See *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)* Box 8.1. Available at (March 28, 2011): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf,

⁶ See *Deutscher Corporate Governance Kodex* 4.2.3 Available at (November 10, 2012): http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012.pdf

⁷ The share subject to a prohibition on alienation cannot be alienated by the manager provided with such shares as compensation for a specified period of time. The original name of such shares is "non-tradeable restricted stock".

⁸ See HALL, Brian J. *The Pay to Performance Incentives of Executive Stock Options*. Working Paper 6674. National Bureau of Economic Research. (1998) August, Page 9. Available at: <http://www.nber.org/papers/w6674>

⁹ Namely, the agreements on exorbitant severance packages, referred to as golden parachute arrangements.

of health insurance policies where the insurance premium is above the average, or the offering of various club memberships. These benefits are typically in kind and not monetary advantages.¹⁰ It is to be noted that although less attention is given to them, their value may be substantial.

When establishing a system of remuneration elements, three fundamental categories can be determined: a) salary and benefits not subject to the company's performance; b) options and other incentive compensation elements subject to the performance of the company's shares; c) bonuses and other incentive compensation elements subject to the company's performance, as compared to specific accounting indices.¹¹

The fixed component of executive compensation is fundamentally the base salary, however, variable components are also significant elements. These variable components may be subject to the resolution of the general meeting or the achievement (possibly surpassing) of the set objectives. In this respect the most frequent examples are share options (and option schemes), annual bonus payments and long-term incentive schemes (*so-called LTIP*), whereby the management can receive remuneration for its performance over a period of several years, instead of annual remuneration.¹²

The amount of annual bonus payments is traditionally determined on the basis of the company's performance indices. These indices include, in particular, data based on accounting results, such as earnings, sales, or operating profit. Indices that may also be applied in this respect include return on equity,¹³ return on assets,¹⁴ return on investment,¹⁵ and economic value added.¹⁶

Long-term incentive schemes are remuneration elements similar to bonuses. However, long-term incentive schemes are provided by companies in consideration of performance over a period of several years. Such schemes can be illustrated for example by an arrangement that the bonus becomes payable, if the return on assets is at least 15% during 3 consecutive years. Long-term incentive schemes have less

¹⁰ See RAJAN, Raghuram G. – WULF, Julie, *Are Perks Purely Managerial Excess?*. National Bureau of Economic Research. Working Paper No. 10494. May, 2004. Available at: <http://www.nber.org/papers/w10494.pdf>,

¹¹ See BAINBRIDGE, Stephen M., *Book Review: Lucian Bebchuk & Jesse Fried, Executive Compensation: Who Decides? – Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, 2004), *Texas Law Review*, (2005) No. 83, Page 1621

¹² See CHEFFINS, Brian R. – THOMAS, Randall S., *Should Shareholders Have a Greater Say Over Executive Pay? : Learning From the US Experience*, *Journal of Corporate Law Studies* (2001) December, Page 278.

¹³ *ROE: Return on Equity*

¹⁴ *ROA: Return on Assets*

¹⁵ *ROI: Return on Investment*

¹⁶ *EVA: Economic Value Added* See AGGARWAL, Rajesh, *Executive Compensation and Corporate Controversy*, *Vermont Law Review* (2003) No. 4, Pages 851-852.

relevance on an annual basis, as they are to be taken into consideration, only if the specified performance objectives have been achieved.¹⁷

The portfolio comprising the above described components in specific proportions constitutes the remuneration package of the manager (executive manager).

As it was observed by professors *Charles Gibbons*¹⁸ and *Kevin J. Murphy*, career-orientation may also have a significant incentive effect, as it can provide appropriate motivation for creating a unity of interest within the company. An optimal remuneration arrangement maximizes all incentives, including implicit incentives related to career-centered advancement, as well as explicit incentives related to the remuneration package. According to the findings of *Gibbons* and *Murphy*, at the initial stages of the career it is advisable to totally separate remuneration from performance, as the prospect of a long-term career represents sufficient incentive in itself. However, with the approach of retirement age these elements tend to be less efficient.¹⁹ In light of the research conducted by *Bebchuk* and *Fried* upon the shaping of remuneration arrangements it is essential to consider that it is not in the interest of executives to limit their own compensation. Their position is typically extremely secure, very few of them lose their jobs. As they hold key positions, they do not strive for advancement either, and if they continue their activity with another company, the volume of their current remuneration package provides them with further bargaining power in respect of salary arrangements.²⁰ *Bebchuk* and *Fried* consider the strengthening of the independence of the board of directors and the increasing of the power of the shareholders as countermeasures against abuses of severance pays. At the same time, not only higher transparency, but also stringer shareholder control should be achieved in this respect; namely, that shareholders may vote on certain elements of the compensation package, and at the voting held at the annual general meeting they can adopt resolutions of binding force in relation to compensation.²¹ Such authorization for control could significantly mitigate the key issue of the determination of management remuneration, namely, the advantages resulting from executive positions. However, the delegation of independent board members into the remuneration committees and the employment of independent remuneration experts only contribute to, but are not sufficient to eliminate the problem due to its complexity.²²

¹⁷ See AGGARWAL, Rajesh, *Executive Compensation and Corporate Controversy*, Vermont Law Review (2003) No. 4, Page 855.

¹⁸ *Robert Gibbons*, Professor at MIT Sloan School of Management.

¹⁹ See ALCOUFFE, Alain – ALCOUFFE, Christiane, *Control and Executive Compensation in Large French Companies*, Journal of Law and Society (1997) March, Page 87.

²⁰ See MARTIN, Susan Lorde, *Executive Compensation: Reining in Runaway Abuses-Again*, University of San Francisco Law Review (2006) autumn, Pages 154-155.

²¹ See BEBCHUK, Lucian – FRIED, Jesse, *Pay Without a Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004), Pages 190-210.

²² See HILL, Jennifer – YABLON, Charles M., *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, University of New South Wales Law Journal (2002) No. 2, Page 307.

III. PERFORMANCE BASED REMUNERATION AND PERFORMANCE INDICES

Remuneration practices have recently been revolutionized by two techniques in the United States, which have also gained ground worldwide. These techniques are, on the one hand, the *performance based remuneration*, and on the other hand, linked to the foregoing, *remuneration by way of options*, the incentive share options.²³

Nowadays, the linking of remuneration to performance constitutes the fundamental principle of the compensation policy of large corporations. This tendency can be observed also in the *Corporate Governance Recommendations of the BSE*. The recommendation emphasizes that upon the determination of the remuneration, the responsibilities and the extent of the liability of the members must be taken into consideration. The extent to which the company was able to achieve its objectives, as well as its economic and financial condition are also to be taken into consideration.²⁴

Under the *Deutscher Corporate Governance Kodex* the full Supervisory Board determines the respective total compensation of the individual Management Board members. If there is a body which deals with Management Board contracts it shall submit proposals to the full Supervisory Board. The full Supervisory Board resolves the Management Board compensation system and reviews it regularly. In respect of the volume of the remuneration, the recommendation lays a stress on the *appropriate amount* thereof, which is determined based on a performance evaluation. According to the above code, the volume of the appropriate remuneration is primarily based on the responsibilities and personal performance of the relevant board member and the economic condition, successes and prospects of the company. The recommendation also proposes the consideration of comparative factors. The code emphasizes that upon the determination of the remuneration the remuneration practices applied by competitors comparable to the company should also be taken into consideration.²⁵

The British *UK Corporate Governance Code* also recommends that the remuneration of executive directors be structured so as to link rewards to corporate and individual performance.²⁶ As another requirement, payments or benefits should be subject to the company's performance. The *UK Corporate Governance*

²³ See HILL, Jennifer G., *Regulatory Responses to Global Corporate Scandals*, Wisconsin International Law Journal (2005) No. 3, Page 408.

²⁴ See Budapest Stock Exchange, *Corporate Governance Recommendations 2.7.1*

Available at (10. November, 2012.): http://www.bet.hu/data/cms61378/FTA_080516.doc,

²⁵ See *Deutscher Corporate Governance Kodex 4.2.2*

Available at (November 10, 2012): http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012.pdf

²⁶ See *The UK Corporate Governance Code (2012) D.1 (Main Principle)* Available at (November 10, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>,

Code also emphasizes the consideration of the application of performance indices that reflect the company's performance as compared to its competitors (for example, shareholder yield can reflect such performance). In relation to the scheduling of payments, the code proposes that grants under incentive schemes should be phased rather than awarded in one large block.²⁷ According to the *UK Corporate Governance Code*, levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role.²⁸

The *ASX Principles of Good Corporate Governance* also considers appropriate relation between performance and remuneration as essential. However, in respect of the principles governing the determination of remuneration, it emphasizes that such principles should be sufficiently transparent and understandable for investors. It attaches particular importance to performance indicators both in the case of performance based and share based remuneration schemes. At the same time, it considers the fundamental objective of remuneration to promote the long-term growth and success of the company.²⁹

Nevertheless, we are facing a significant issue, if, in order to boost the performance of the management of the company, we attach the remuneration of the management to *shareholders wealth*. This approach primarily requires that we define the meaning of shareholders wealth, and identify the most reliable indicator of the increase of the company's value. According to the *Efficient Capital Market Hypothesis*, the *market price* of securities reflects the reasonable price as closely as possible.³⁰ This hypothesis is based on the assumption that all public and accessible information are fully incorporated into share prices, therefore share prices reliably reflect the foregoing.³¹

In light of the above mentioned, we may conclude that share prices are can be considered the most reliable indicators of the performance of companies, reflecting not only previous performance, but future expectations as well. We do not agree with this opinion in its generality. Moreover, this approach is questionable also from the sole perspective of remuneration, as it shows very little of the personal performance of the manager in charge of a particular division of

²⁷ See *The UK Corporate Governance Code* (2010) Schedule A

Available at (November 10, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>,

²⁸ See *The UK Corporate Governance Code* (2012) D.1.3

Available at (November 10, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

²⁹ See *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)* Principle 8

Available at (November 10, 2012): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf,

³⁰ See MERKT, Hanno, *European Company Law Reform: Struggling for a More Liberal Approach*, *European Company and Financial Law Review* (2004) No. 1, page 8.

³¹ See STEENO, Annaleen, *Note: Corporate Governance: Economic Analysis of a „Comply or Explain” Approach*, *Stanford Journal of Law, Business and Finance* (2005-2006) No. 2, Page 397.

a company. However, the observation that the market does not always operate as efficiently as described above raises a more serious problem. Moreover, elements outside the scope of activity of the board also have an influence over share prices. Furthermore, there is a possibility that in order to receive higher remuneration, the management attempts to influence share prices in the short run. Despite all of the foregoing considerations, we are to admit that although the share price cannot be considered as the indicator of economic efficiency, it is also difficult to find any other, more precise indicator.

Accounting indicators can also be used as performance indicators, although they are frequently none the less inaccurate. Moreover, there is a possibility of abuse in respect of their application. The manipulation of accounting data by the management was a rather frequent practice following the turn of the millennium. Thus the management of the company can accelerate or delay earnings and expenses, and such manipulation may influence the results of the quarterly and annual financial statements. The most significant danger involved in the application of accounting indicators and the related manipulations is that they result in a short-term approach, which may drive the management to inflate short-term financial results to the detriment of long-term results (for example, it reduces the amount intended for advertisement and research and development).³²

With reference to the findings of an empirical research on this topic, it is to be noted that the majority of British companies rely on earnings per share³³ and the total shareholder return³⁴ when determining the performance indicator of long-term incentive schemes. 42% of the FTSE 100 companies used total shareholder return based indices, while 56% of such companies used earnings per share in their delayed long-term annual bonus schemes, according to the 2006 *Mercer* report.³⁵

IV. THE OPTION

Share options granted for remuneration purposes transfer to the management the right, but not the obligation to purchase a specified portion of the company's shares for a specified price (exercise price) until or prior to a specified date.³⁶ Thus, we may establish that the option granted for remuneration purposes are purchase options in the sense of private law-dogmatics. Frequently, employee share options can be exercised only upon the expiry of a certain vesting period

³² See: MCCAHERY, Joseph A. – RENNEBOOG, Luc, *Managerial Remuneration: The Indirect Pay-For-Performance Relation*, Journal of Corporate Law Studies (2001) December, Pages 324-326.

³³ *EPS: Earnings Per Share*

³⁴ *TSR: Total Shareholder Return*

³⁵ Mercer, Performance Measures, Moving Beyond EPS and Relative TSR, (2006) No.3.

Available at: <http://www.mercer.com/erperspectiveu>.

³⁶ See AGGARWAL, Rajesh, *Executive Compensation and Corporate Controversy*, Vermont Law Review (2003) summer, Page 853.

and/or subject to the fulfillment of certain conditions (for example, a minimal increase of the share price).³⁷

In the United States the spreading of share option based remuneration played the most important part in the massive increase of executive compensation amounts. However, this remuneration element is less significant in Europe, where its application was always met with reserve. Professionals were further strengthened in their reserve by the fact that the previously mentioned *Royal Ahold* company, which practiced remuneration in the form of substantial share options, collapsed due to an audit scandal almost simultaneously with the US companies.³⁸

Professors *Thomas E. Copeland*³⁹ and *J. Fred Weston*⁴⁰ however examined the advantageous effects of remuneration in the form of share options. Their research published in 1992 presents three hypotheses to support the presumption that following the announcement of options for remuneration purposes share prices will increase. According to the *incentive hypothesis*, the advantage provided to shareholders by the option scheme exceeds the costs of shareholders incurred in respect of the manager incentive provided on the basis of such option schemes. The *signaling hypothesis* may have significance from the perspective of the value judgment of investors. Accordingly, if the managers take over the shares of a company, they will accept a portion of their remuneration in options, which clearly signals that they are confident about the company's (future) performance. The *tax hypothesis* points out the favorable tax status⁴¹ of option arrangements. According to such hypothesis, the after tax pay-offs of a salary and *share option* plan are superior to those of a salary and *bonus* plan.⁴² Moreover, it can be observed that options have a favorable effect on the company's liquidity. They

³⁷ European Commission - Enterprise Directorate-General, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU*, Final Report of the Expert Group, (2003) June 7.

Available at: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

³⁸ See HILL, Jennifer G., *Regulatory Responses to Global Corporate Scandals*, Wisconsin International Law Journal (2005) No. 3, Page 408.

³⁹ *Thomas E. Copeland*, researcher at the *Matthew B. Ridgway Center for International Security Studies* at Pittsburgh University.

⁴⁰ *J. Fred Weston*, Professor Emeritusa at the *University of California Los Angeles (UCLA)*.

⁴¹ See ERCSEY, Zsombor – SZILOVICS, Csaba, *Innovation in Tax Systems*, CD material of the conference on „Intellectual capital as competitive advantage”, Lifelong Learning Foundation – Selye János University, Faculty of Economy, Komarno (Slovakia), 2010

⁴² KELLS, Stuart – ROGERS, Mark, *Executive Remuneration, Board Structure, Corporate Strategy and Firm Performance: A Taste of the Literature*, Melbourne Institute of Applied Economic and Social Research - The University of Melbourne, Melbourne Institute Working Paper (October, 1997) No. 22, Pages 12-13.

Available at: <http://www.melbourneinstitute.com/wp/wp1997n22.pdf>,

have the significant advantage that, unlike cash bonuses,⁴³ they do not result in an immediate drain on liquidity, while their incentive effect is immediate.⁴⁴

The danger of the application of share options lies in the fact that the share price increase, which is in the interest of the management, is implemented without a parallel value-increasing investment project.

Furthermore, remuneration by way of options may motivate the management to reduce the amount of dividend payments and repurchase the company's own shares (this being a suitable means of increasing demand and share prices). The increase of paid dividends results in the decrease of the value of stock options. This is the reason why CEOs holding substantial stock options prefer share repurchase to dividend payment (as it was pointed out by Jolls in a 1998 analysis)⁴⁵.

The profits to be earned by way of options are, to a significant extent, subject to share price increase. Therefore, it represents a serious risk that in order to increase share price the management is willing to launch extremely risky transactions. Moreover, similarly to the decrease of share prices, their increase is also frequently due to reasons other than the performance of the management. Such reasons may include industry developments or a strong capital market.⁴⁶ The exercising of the option, and the acquisition of the company's share by the management have further effects, since as a result of the foregoing, the management of the company can obtain significant voting rights, and this may contribute to the cementation of their positions. From an investment technique perspective, the concentration of the management's significant interests within a single company may also result in excessive risk avoidance.⁴⁷

In relation to remuneration in the form of options there is a possibility that the management can manipulate share prices so as to achieve higher compensation. In the course of such manipulation the management may reduce the share price before the granting of the option, and then increase it upon the exercising of the option. According to certain researches – for example, the findings of professors

⁴³ Cf. SZILOVICS, Csaba, *Stability and Calculability Regarding the Transformation of the Hungarian Legal Order 1985-2005*, in: JAKAB, András – TAKÁCS, Péter – TATHAM, Allan F. (eds.), *The transformation of the Hungarian legal order 1985-2005: transition to the rule of law and accession to the European Union*, Kluwer Law International, The Hague, 2007, Pages 169-170.

⁴⁴ European Commission - Enterprise Directorate-General, *Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU, Final Report of the Expert Group* (2003) June 21.

See: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

⁴⁵ See HALL, Brian J., *The Pay to Performance Incentives of Executive Stock Options*, National Bureau of Economic Research - Working Paper 6674 (1998) August, Page 25.

Available at: <http://www.nber.org/papers/w6674>,

⁴⁶ See MCCAHERY, Joseph A. – RENNEBOOG, Luc, *Managerial Remuneration: The Indirect Pay-For-Performance Relation*, *Journal of Corporate Law Studies* (2001) December, Pages 326-327.

⁴⁷ LOEWENSTEIN, Mark J., *The Conundrum of Executive Compensation*, *Wake Forest Law Review* (2000) No. 1, Page 13.

*David Aboody*⁴⁸ and *Ron Kasznik*⁴⁹ – in (typically Anglo-Saxon) countries, where capital markets have high proportions of free float shares, due to the advantages following from its position, the management may not only be willing to use such manipulations, but it also has the appropriate means to do so.⁵⁰ According to their position, there is empirical evidence verifying that *CEOs* schedule the announcement of news so that they precede (bad news) or follow (good news) the granting of options.⁵¹ Naturally, similar manipulations and insider trading are considered unlawful in most countries; nevertheless, it may happen that the director secures for himself the grant of an option when he considers that stock exchange rates are low.⁵²

It is to be noted as a significant principle that future options (that is, options exercisable within e.g. 4 years) may represent substantial incentives, while immediately exercisable options represent only minimal incentive.⁵³ The acceptance of the option is a significant signal to the market (*signaling hypothesis*), since such acceptance and the nature of the option indicate that the management, being aware of the actual economic condition of the company, have confidence in getting their money by exercising the option right. This may lead to the conclusion that the option specified in the remuneration contract subject to certain conditions provides appropriate incentive for the particular manager to continue his activity at the company. Therefore, it can be established that the disclosure of the remuneration contracts of the management and the remunerations of the form of options may provide information on the economic position and prospects of the company.

However, the fact that the undiversified options of the management are significantly more exposed than the investments of the majority of shareholders involves a risk for the management. For shareholders holding diversified portfolios the primary objective is to maximize the amount of the obtainable yield. In this context, shareholders do not shy away from expecting the undertaking of significant risks by the companies in the shareholder's portfolio. If any of these companies suffers substantial losses, the extraordinary profit gained as a result of the assumption of risk by another company can easily compensate such loss.

⁴⁸ *David Aboody*, Professor of Accounting at the *University of California Los Angeles (UCLA)*.

⁴⁹ *Ron Kasznik*, Professor of Accounting at *Stanford University Graduate School of Business*.

⁵⁰ See HILL, Jennifer – YABLON, Charles M., *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, *University of New South Wales Law Journal* (2002) No. 2, Pages 308-309.

⁵¹ See PERRY, Tod – ZENNER, Marc, *CEO Compensation in the 1990's: Shareholder Alignment or Shareholder Expropriation?*, *Wake Forest Law Review* (2000) Page 141.

⁵² See BOOTH, Richard A., *Executive Compensation, Corporate Governance, and the Partner Manager*, *University of Illinois Law Review* (2005) No. 1, Pages 285-290.

⁵³ See BAINBRIDGE, Stephen M., *Book Review: Lucian Bebchuk & Jesse Fried, Executive Compensation: Who Decides? – Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, 2004), *Texas Law Review*, (2005) No. 83, Page 1623.

Based on the foregoing, we may come to the intriguing conclusion that managers exposed to their options are more interested in the future of the company than the shareholders.⁵⁴ However, in light of the corporate scandals and hazardous financial ventures of recent years, there is a possibility that the above principle cannot prevail in practice. In this respect, the techniques allowing the management to avoid the risks affecting their compensation due to exchange rate decrease are also instrumental. The gaining ground of techniques such as derivative trade and various deferred trading techniques indicate the above efforts.⁵⁵ Furthermore, in order to prevent the abuse of insider information, the prohibition of the immediate sale of shares acquired by way of the exercising of the option might be of relevance.⁵⁶

Moreover – as it was pointed out by *Eli Ofek*⁵⁷ and *David Larry Yermack*⁵⁸ – it is also to be considered corporate executives frequently sell their previously acquired shares when they receive the new shares subject to a limitation on alienation, or the new option schemes.⁵⁹

V. INDEXED OPTIONS

The optimization of the incentive power of options is essential in order to establish an appropriate remuneration policy. Such optimization can be achieved by way of *specifying well-reasoned vesting conditions*. The performance of the management is more precisely reflected, if the amount of the proceeds achievable from the option is subject to the *performance of the company* as compared to its competitors. This solution eliminates the risk of undeserved or excessive compensation, which may result from the management taking advantage of market processes, instead of increasing the company's efficiency. In this context indexed options represent significant means, which contribute not only to the elimination of the risk of excessive compensation, but this method can also reduce the risks undertaken by the management. It represents a risk in respect of the remuneration of the company's management that such remuneration is influenced by external

⁵⁴ See: BOOTH, Richard A., *Executive Compensation, Corporate Governance, and the Partner Manager*, Legal University of Illinois Law Review (2005) No. 1, Pages 276-277.

⁵⁵ See: HILL, Jennifer – YABLON, Charles M., *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, University of New South Wales Law Journal (2002) No. 2, Page 308.

⁵⁶ European Commission - Enterprise Directorate-General, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU, Final Report of the Expert Group* (2003) June 8, Page 15.

Available at: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf,

⁵⁷ *Eli Ofek*, Professor of Finance at the *University of New York, Leonard N. Stern School of Business*.

⁵⁸ *David Larry Yermack*, Assistant at the Department of Economics at the *University of New York, Leonard N. Stern School of Business*.

⁵⁹ See PERRY, Tod – ZENNER, Marc, *CEO Compensation in the 1990's: Shareholder Alignment or Shareholder Expropriation*, *Wake Forest Law Review* (2000) No. 1, Pages 139-140.

factors, such as the general issues of the given business and sector, or negative market developments and recessions. Thus, even in the case of a drop in exchange rates, it is possible that the management of the company took all measures within its power to protect the interests of the company. Consequently, the performance of the management cannot be evaluated purely on the basis of share price changes. However, their relative performance can be measured based on the proportion of dividend paid by (similar) companies operating within the same industry to their shareholders, or as compared to the exchange rate changes of the securities of such companies. Such relative performance can provide a sufficiently objective basis for the determination of remuneration.⁶⁰

In the case that the management receives additional compensation only after the company specific share price increase, namely, the share price increase as compared to competitors, this may contribute to a compensation scheme rewarding only the management's own activity and results. However, this method cannot eliminate certain company specific issues, which can hardly be attributed to the performance of the management. Moreover, there is a possibility that in the middle of the option period the company lags behind in the competition with rival companies, thus the management may deem the company's prospects rather gloomy. In such case the indexed option would provide the management with little incentive, as they can no longer exert any substantial influence on the position of the company. The foregoing situation can be avoided by adjusting the exercise price to a specific segment of competitors, e.g. the back rear segment, the back quarter segment through the instrumentality of a partial index.

We also need to present the operational mechanism of indexed options. If the share price of the companies within a given market segment increases on the average by 10%, the exercise price of the option will increase accordingly. It is obvious that in such case substantial payments can be made, only if the company performs significantly better than its competitors. Rendering the exercising of options subject to specified conditions can also have considerable incentive effect. In this case the option granted as remuneration can be exercised by the management of the company, only if they achieve specified performance targets.⁶¹

Naturally, the indexed option should carry with itself a significant chance of payment, thereby motivating the management. However, while the probability of payment is 80% in the case of average options, it is only 50% in the case of indexed options. Therefore, when devising an indexed option, the probability of payment needs to be increased, so as to ensure the appropriate incentive power.⁶²

⁶⁰ See: FERRARINI, Guido and MOLONEY, Niamh, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, European Company and Financial Law Review (2004) No. 3, Pages 264-266.

⁶¹ See BEBCHUK, Lucian Arye – FRIED, Jesse M. – WALKER, David I., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, The University of Chicago Law Review (2002) No. 3, Pages 799-801.

⁶² See BEBCHUK, Lucian Arye – FRIED, Jesse M. – WALKER, David I., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, The University of Chicago Law Review (2002) No. 3, Pages 808-809.

VI. OPTIMAL OPTION CONTRACTS

The details and conditions in relation to the granting of options are contained in the *option plan*. In the case of the majority of options there is a vesting schedule, which is determined under the option plan. For example, 10% of the option is vested on a six monthly basis, thus the full vesting period will be five years, with a further five year maturity period.⁶³ Option plans may prescribe a minimum period for the retaining of the option, and following the exercising of the option the retaining of the share. Generally speaking, employee stock options are mostly “*American type*” options. At this point it is to be noted that there is an overall difference between American and European type options. In the case of American type options, the owner of the option can exercise the option at any time within a specified time period. In the case of European type options, the owner of the option is obliged to wait until the end of the specified period and then decide whether to exercise the option.⁶⁴

It is also a frequently used technique that options can be exercised only within short time intervals. Such time interval usually occurs shortly after the presentation of the annual financial statement or the general meeting. The option contract may also include provisions which ensure that managers cannot sell their shares immediately upon exercising the option. Such contracts ensure that corporate executives retain their securities for a further specified minimum time period. There may be stipulations ensuring that the right to exercise the option is rendered subject to relevant performance indicators of the company, for example, the minimum increase of share prices. In this case, if the specified increase in share prices is achieved within the time interval stipulated in the option plan – but only in such case – the option will become exercisable. In the case of long-term options it is particularly important that the performance objectives to be achieved are sufficiently attractive.⁶⁵

Upon formulating the option contract it is to be taken into consideration that, due to its approach aimed at the avoidance of risks, the management will certainly strive to convert the option into cash as soon as possible. The management may be willing to do so, even if this results in a significant decrease in the value of the option, as compared to the value that could be achieved otherwise. Therefore,

⁶³ See AGGARWAL, Rajesh, *Executive Compensation and Corporate Controversy*, Vermont Law Review (2003) summer, Page 853.

⁶⁴ European Commission - Enterprise Directorate-General, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU - Final Report of the Expert Group* (2003) June, Page 12.

Available at: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

⁶⁵ European Commission - Enterprise Directorate-General, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU, Final Report of the Expert Group* (2003) June, Page 14.

Available at: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

in certain cases the optimal compensation contract should include a provision stipulating that following its transfer, the option may not be converted to any other value for a definite period of time.

Such solution is also justified by the fact that based on a related empirical research, 10 year options granted by the forty largest US companies were exercised within the average of 5.8 years. Consequently, it is advisable to include in compensation contracts a clause which guarantees that for a definite period of time the manager acquiring the option must not reduce or minimize the financial risk in respect of the option, and must not sell, or otherwise alienate such option. Therefore, stock options provided for compensation purposes are typically not vested at the time when they are granted, namely, managers cannot immediately exercise them. Subject to the provisions of the inserted clause, managers may need to wait for several years before they can exercise their options. Furthermore, the transfer of stock options frequently provides only partial entitlement, for example, only a certain percentage of the options vest each year.⁶⁶

The determination of the exercise price is an essential element of corporate stock option plans. There are three possible solutions for determining the exercise price. According to empirical observations in the US, the majority of options granted to the management are so-called *at the money options*, that is, the exercise price is close to the share price effective on the date of the granting of the share on which the option is based. A relatively small number of companies (approx. 2%) issue so-called *in the money options*, in the case of which the exercise price is lower than the share price effective on the date of the granting of the option. An even smaller number of companies (approx. 1%) issue so-called *out of the money options*, also called premium options. In this latter case, the exercise price is higher than the share price effective on the date of the granting of the option. It can be generally established that the majority of companies apply several year option plans, in which they use a fixed number of shares (that is, they annually grant a fixed number of shares), or adopt a fixed value plan (that is, they annually grant shares of a fixed value).⁶⁷ Another research also indicates that 95% of companies issue at the money options.⁶⁸

In the case of a major market crisis (such as the 2008/2009 financial crisis), it may raise problems that due to the lower share prices, companies applying fixed

⁶⁶ European Commission - Enterprise Directorate-General, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU, Final Report of the Expert Group* (2003) June, Page 14.

Available at: http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

⁶⁷ See HALL, Brian J., *The Pay to Performance Incentives of Executive Stock Options* - Working Paper 6674, National Bureau of Economic Research (1998) August, Page 8.

Available at: <http://www.nber.org/papers/w6674>

⁶⁸ See BEBCHUK, Lucian Arye – FRIED, Jesse M. – WALKER, David I., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, *The University of Chicago Law Review* (2002) No. 3, Page 817.

value plans are to provide a larger number of shares as fixed value compensation. This practice may increase the dilution of shares, namely, the management acquiring the shares could obtain increasingly significant voting power. In the case of companies granting a fixed number of shares the value of the compensation will decrease simultaneously with the foregoing.⁶⁹ However, in the case of a possible crisis, it is not an optimal message either for the market, or in terms of PR, if a company increases the number of shares granted as compensation. It can be proposed only in the case of companies with excellent performance that they only moderately increase the number of shares granted in light of the market downturn.

Upon examining employee preferences, we may establish that the most popular solutions are at the money options and in the money options. According to a study by professors *Brian J. Hall*⁷⁰ and *Kevin J. Murphy*, managers prefer smaller options of lower exercise prices to larger options of higher exercise prices. In this respect it was also demonstrated that in the case that the option is added to the already existing compensation scheme, as a further element, without the decrease of other elements, in the case of options with the highest incentive power the exercise price is much the same as the market price effective on the date when the option is granted. If the stock option is not attached to the already existing compensation package, the maximum incentive can be achieved, if the exercise price is lower than the market price effective on the date when the option is granted. High exercise prices jeopardize payment, which in turn reduces incentive power for managers who tend to avoid risks.⁷¹ In summary, we may further establish that options are more valuable from the perspective of the employee, if they fall within the category of at the money options and in the money options. However, from the (subjective) perspective of the employer out of the money options and at the money options seem to be the most cost-efficient. *We may conclude from the foregoing that options are to be issued at the money.* This conclusion also corresponds to the findings of professors *Bebchuk, Fried* and *Walker*.⁷²

In relation to the re-pricing of option, we are to refer to a further observation by professors *Bebchuk, Fried* and *Walker*. According to their study, options are typically re-priced in the case of market downturns. Re-pricing proves ineffective in the case of market growth, although this would be necessary in relation to the objective evaluation of manager performance. On the other hand, re-pricing presumed by the management may have a distorting effect on their incentives.⁷³

⁶⁹ Mercer, Executive Remuneration Perspective Europe - Managing Executive Remuneration in an Economic Downturn (2008) No. 4.

Available at: <http://www.mercer.no/summary.htm?idContent=1331175>

⁷⁰ *Brian J. Hall*, Professor at *Harvard University*

⁷¹ MURPHY, Kevin J., *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, *University of Chicago Law Review* (2002) summer, Page 864.

⁷² MURPHY, Kevin J., *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, *University of Chicago Law Review* (2002) summer, Page 864.

⁷³ MURPHY, Kevin J., *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, *University of Chicago Law Review* (2002) summer, Page 865.

In light of the foregoing, it is advisable that corporate executives are given no prior assurances regarding possible re-pricing.

For example, according to *Warren Buffett*⁷⁴, growing rich by way of a ten year at the money option does not require too much effort. If no dividends are paid for a ten years, instead such funds are invested by the management of the company into government bonds, share prices will, in all probability, increase during those years. As a result, with the general increase in market prices, the “at the money option” will become an “in the money option” during those years.⁷⁵

VII. RESOLUTION ON SHARE OPTION BASED REMUNERATION

The increasing significance of share options, the high level of compensation achievable by their application, the complicated nature of such schemes and the risks involved in their application rightly raise the issue which organ of the company is to exercise control over option based benefits? For this reason, we consider it is necessary to review the regulations of some relevant corporate governance codes in this respect.

According to the *Corporate Governance Recommendations of the BSE*, in the case of share based compensation schemes the elements of the schemes are approved by the general meeting, and in the case of the board of directors and the members of the supervisory board also the amount of actual benefits. In the case of the members of the management, the approval of the amount of the actual benefits falls within the scope of authority of the board of directors, instead of the general meeting. The Recommendations of the BSE emphasize the significance of ensuring that shareholders receive appropriate access to information. Consequently, the provisions of the Recommendations propose that prior to voting shareholders should be provided with detailed information on the share-based remuneration schemes (and any possible amendments thereto) and the costs such schemes entail. The source of shares intended to be granted as compensation should also be identified. In the case of share based compensation schemes, the prior approval of the general meeting is required for the determination of the relevant parts of the compensation contract. The Recommendations also propose that the company determine the compensation schemes for the board of directors, the supervisory board and the management in such manner, that it serves the strategic interests of the company, and thereby those of the shareholders.⁷⁶

⁷⁴ *Warren Edward Buffett* the “*Sage of Omaha*”, investor, businessman, one of the wealthiest persons in the world. His investment institute is *Berkshire Hathaway*.

⁷⁵ See: BEBCHUK, Lucian Arye – FRIED, Jesse M. – WALKER, David I., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, *The University of Chicago Law Review* (2002) No. 3, Page 819.

⁷⁶ Budapest Stock Exchange, *Corporate Governance Recommendations 2.7.4*

Available at (November 25., 2012).: http://www.bet.hu/data/cms61378/FTA_080516.doc

The recommendations of the British *UK Corporate Governance Code* apply the method of the delayed vesting of share based benefits due to the above described reasons. Therefore, the code especially emphasizes that shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Moreover, the recommendation proposes that directors should be encouraged to hold their shares for a further period after vesting or exercise by means further to the foregoing compensation.⁷⁷ In relation to long-term compensation schemes, the recommendation emphasizes that such schemes should be approved by the shareholders.⁷⁸ According to the code, as a principal rule, the remuneration for non-executive directors should not include share options, apart from exceptional cases.⁷⁹

The *Deutscher Corporate Governance Kodex* also sets forth that relevant comparison parameters should be used in the case of share options and other similar schemes (for example, several year prohibition on the alienation of the company's shares). However, it is also essential that such comparison parameters cannot be changed in the future and provide a stable standard for performance. Moreover, for extraordinary developments a possibility of limitation (cap) must in general be agreed upon by the supervisory board.⁸⁰

According to the *ASX Principles of Good Corporate Governance*, share based remuneration based remuneration can be an effective form of the compensation and motivation of corporate executives. However, in this respect the code considers it necessary that companies link such compensation to performance targets. It is to be noted that the Australian code expressly refers to the fact that the 'short-termism' of corporate executives may result in abuse. Therefore, it is essential to design share based remuneration portfolios in advance.⁸¹

⁷⁷ *The UK Corporate Governance Code* (2012) Schedule A

Available at (November 25, 2012):, <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

⁷⁸ *The UK Corporate Governance Code* (2012) Schedule A

Available at (November 25, 2012): <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

⁷⁹ *The UK Corporate Governance Code* (2012) D.1.3

Available at (November 25, 2012): , <https://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>

⁸⁰ *Deutscher Corporate Governance Kodex* 4.2.3

Available at (November 25, 2012):, http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012.pdf

⁸¹ *ASX Principles of Good Corporate Governance* Box 8.1

Available at (November 25, 2012): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf,

VIII. SHARES SUBJECT TO PROHIBITION OF ALIENATION

According to the position assumed by *Hall* and *Murphy*, the so-called non-tradeable restricted stock offer an alternative more efficient than the option based remuneration of the management.⁸² This remuneration method can be interpreted as an option of zero exercise price. In this case the company's shares are granted to the management as remuneration, and such shares cannot be alienated for a specified period of time. As a result, it is the primary interest of the management to ensure the appropriate increase of the share price within such time period, in order to achieve the highest possible remuneration. The ownership of the shares also provides the management with the right to receive dividends. This solution could prove to be optimal, since the promoting of an optimal dividend policy is far more desirable for the management, if they hold non-tradeable restricted stock. In contrast, holding an option right does not entitle the holder to dividends, thus it rewards only the increase of share prices. Consequently, the management will strive to increase only the share price. However, the management can achieve such objective by paying low dividends and re-purchasing shares to the detriment of investor interests.⁸³

As a further advantage of non-tradeable restricted stock, they represent a relatively more stable incentive than stock options. The incentive power of stock options is based on the amount of the difference between the exercise price and the market price. In such cases the option provides appropriate incentive power as long as the market price significantly exceeds the exercise price of the option. However, the incentive power diminishes when the market price drops significantly below the exercise price. In such case the scheme loses its value and attractive force. The management cannot obtain any pecuniary advantage through a loss-making scheme. At this point the option as incentive force becomes pointless. Such options are called *underwater options*.⁸⁴ In this case the company may be forced to reduce the exercise price of the option by re-pricing, or issue new, supplementary options at a lower exercise price. When applying such solutions, it may prove difficult to determine the optimal extent of re-pricing. Non-tradeable restricted stock is suitable also for the settlement of such issues. Moreover, they can also reduce the chances of the management undertaking excessive risks in relation to specific transactions.

In order to see the whole picture, we should briefly mention the disadvantages of the foregoing solution. As a drawback, we may refer to the fact that such

⁸² *non-tradeable restricted stock*

⁸³ See HALL, Brian J. – MURPHY, Kevin J., *The Trouble with Stock Options*, Journal of Economic Perspective (2003) summer, Pages 49-70.

⁸⁴ *underwater options*

share grants may result in the *immediate* dilution of shares,⁸⁵ thereby reducing the amount of the dividend per share as well. Moreover, the provision of an excessively large number of such shares may result in a drastic increase in the management's voting rights (while no voting rights can be exercised in respect of option based remuneration.)

IX. PUBLICITY AND DISCLOSURE OBLIGATION

The control mechanisms of publicity have a key role in corporate governance. This is particularly true as regards the issue of remuneration. In order to ensure the operation of such control mechanisms it is essential to prescribe that information regarding remuneration and the principles of the remuneration policy are accessible to the shareholders. This objective can be achieved by the publication of the remuneration policy or the so-called *remuneration statement* (statement). The control of publicity renders it necessary for the body determining remuneration to sufficiently support and justify the principles of the company's remuneration practice. Moreover, certain aspects of publication may also indicate the increasing importance of the role of *remuneration committees*. Corporate governance provides more possibilities for shareholders to exercise control functions, moreover, it may promote a more active control by institutional investors. As a result of the foregoing, shareholders may have a more extensive overview of the remuneration of corporate executives, as well as the various aspects of formulating the remuneration policy. However, insufficient or deficient compliance with the publication obligations may cause significant damages, due partly to the fact that the determination of remuneration is a rather complex process. In our view, the primary principle of compliance with the publication obligations is that investors should *understand* the internal processes in light of the disclosed data.

Therefore, the publication of the so-called *remuneration statement* is an indispensable condition of the exercising of shareholders' rights and publicity control. The above principle is kept in view by the majority of corporate governance recommendations.

According to the relevant provisions of the *Corporate Governance Recommendations of the BSE*, the company should prepare a report for the owners, which report is to be submitted to the general meeting. The report should present the remuneration of executive officials and the members of the management, namely, the Recommendations of the BSE propose the full disclosure for each person separately. The remuneration committee provides for the preparation of the annually published remuneration statement.⁸⁶

⁸⁵ It is an unquestionable advantage of this solution that the extent of dilution can be precisely determined (numerically), while in the case of share options such dilution is subject to the changes in share prices.

⁸⁶ Budapest Stock Exchange, *Corporate Governance Recommendations* 3.4.5.,

Available at (November 25, 2012): http://www.bet.hu/data/cms61378/FTA_080516.doc,

According to the *Deutscher Corporate Governance Codex*, the total compensation of each member of the board of directors is to be disclosed by name, divided into compensation components subject to and independent of performance and long-term incentive compensation elements, with the proviso that disclosure may be dispensed with if the General Meeting has passed a resolution to this effect by *three-quarters* qualified majority.⁸⁷

The Australian *ASX Principles of Good Corporate Governance* stipulates that companies should provide disclosure in relation to their remuneration policies to enable investors to understand the costs and benefits of those policies and the link between remuneration paid to the board of directors and key executives and corporate performance. The related (specified) data shall be disclosed under the *corporate governance* section of the annual report.⁸⁸

X. CONCLUSION

Executive remuneration is one of the most topical aspects of corporate governance, the significance of which has substantially increased in light of the postmodern corporate scandals. In order to formulate a reasonable and efficient remuneration policy, the relevant legal and economic theories, as well as practical (empirical) observations need to be taken into consideration. It is essential that the established policy be at the same time suitable for motivation and in line with results, representing the performances on which such results are based. The foregoing aspects should be taken into consideration also upon selecting the appropriate remuneration components; however, it must be borne in mind that the nature of the motivation may be subject, to a significant extent, to the characteristics of the company, sector specific features, moreover, the individual circumstances of the executive officials. If we wish to determine the relation between and the appropriate proportion of fixed and share based compensation components, we are also to consider that the characteristics resulting from the operation of capital markets may render the evaluation of actual performance significantly more difficult. In light of the foregoing we may conclude that remuneration and compensation, as the components of the system of corporate governance, will remain in the center of interest in the future. There are still lessons to be learnt and improvements to be made in respect of best business practices, even upon drawing the consequences of the scandals brought about by the 2008/2009 financial crisis.

⁸⁷ *Deutscher Corporate Governance Kodex* 4.2.4 and 4.2.5

Available at (November 25, 2012): http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012.pdf

⁸⁸ *ASX Principles of Good Corporate Governance* Recommendation 8.4

Available at (November 25, 2012): http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf

OBLICI EGZEKUTIVNIH NAKNADA I NJIHOVA REGULACIJA NA RAZINI PREPORUKA

Rast egzekutivnih kompenzacija ponovno pobuđuje pažnju. Ekonomisti i pravni analitičari sve se češće pitaju: 'Kako će sustav egzekutivnih naknada biti održiva struktura vođenja firme tamo gdje aspekti strateškog pristupa osiguravaju dugoročni razvoj?'. Skandal kojega je AIG imao 2008-2009 (poznatiji pod imenom bonus gate scandal) otkrio je da se je federalna pomoć koju su dobivale financijske institucije djelomice koristio radi pokrivanja isplatnih interesa. Opću je indignaciju izazvala činjenica da je AIG pored 'isplate bonusa' u korist egzekutivaca kompanije dio federalne pomoći osigurao i drugim financijskim institucijama, uključujući i europske banke. U međuvremenu su EU (u financijskoj sferi) i Švicarska (općenito prema svim poduzećima) zauzeli stajalište o ovome pitanju na način da su ograničili pakete egzekutivnih naknada. U tekstu autor prikazuje glavne teorije primjene tih paketa za isplatu te razmatra regulativu na razini preporuke.

Ključne riječi: *dobra praksa, bonus isplate, pretpostavke, preporuka, isplata, dionički udio*