

UPCOMING CHALLENGES ON REGULATING REMUNERATION OF THE DIRECTORS AND IMPLEMENTING REMUNERATION POLICIES

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ABSTRACT

The European Parliament adopted the Directive 2017/828 as regards the encouragement of long-term shareholder engagement that grants shareholders to hold the right to vote on the remuneration policy for employees and directors. Following the collapse of large companies in the USA and common agency problem, the intent of regulators on capital markets was to ensure preconditions for stable companies, so remuneration policies were prescribed by the recommendations and through corporate governance mechanisms, such as is say on pay. In order to align interests of the companies and their directors, remuneration policy was recognized as one of the key instruments introduced by the EU legislator for financial institutions, primarily investment funds and banks. The implementation of the Directive into national legislation is mandatory, so for the first time the regulator gives shareholders the right to decide on the remuneration of directors, it gives them the option of setting the framework within the pay of directors is to be held and proposing public disclosure of remuneration policy. One of the major issues that will be imposed by the new Directive will be how and to what extent the decision on the remuneration of directors, will be left to the shareholders to vote at the general meeting. The authors in this paper analyze new system on remuneration policies, opportunities and obstacles that companies may face, as well as the challenges imposed to directors, in the implementation of the Directive in national legislation and practice.

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1. INTRODUCTION

The remuneration of members of supervisory, administrative, and management bodies and workers in companies has a particular significance, both for the performance in the best interest of the company and for strategic decision making to achieve the long-term objectives of the company. One of the fundamental conflicts of interest in most companies is the conflict between the personal interests of directors in the form of fixed and variable remuneration and the interests of shareholders and other stakeholders concerning the long-term development and prosperity of the company.¹ The basic principle - the failure is not to be rewarded – consequently causes remuneration to be one of the key instruments that make directors apt to taking greater risk in the management of the company.

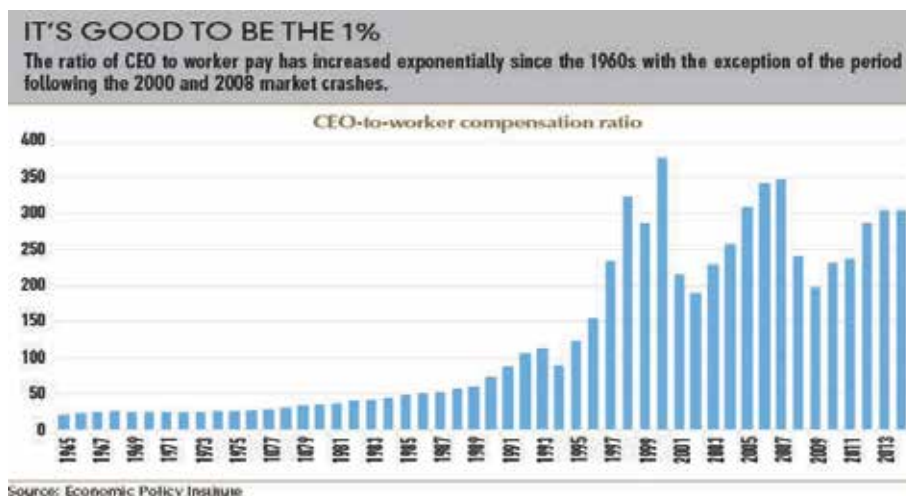
2. HISTORICAL REVIEW OF THE ISSUE CONCERNING REMUNERATION OF DIRECTORS

The big financial crisis and the accompanying media scandals have detected directors' remunerations as one of the major triggers to take excessive risk. Based on the experience of the failed markets and companies, legal regulations have been developed over the years, which contribute to a clear, simple and transparent process of rewarding the directors and enable shareholders to actively participate in determining directors' remuneration.

Due to the development of the capital market, the trend of tracking directors' remuneration and additional rewarding has begun in the United States. Over the last 50 years, the ratio of CEO to worker compensation in companies has increased by up to 380%, with a particularly significant increase recorded in the past 30 years.

¹ Conflict of Interest in the Professions (Practical and Professional Ethics) Davis, Michael, Stark Andrew, Oxford 2001,p. 137

Chart 1: CEO to worker compensation ratio²



The above graph clearly reflects the correlation between the growth in the turnover and value of companies on stock exchanges during the 1990s and the increase in CEO remunerations. Economic crises, in particular the latest one of 2008, have also pointed to serious failures concerning the wrong Directors' remuneration system - primarily in terms of lack of transparency, absence of a provision concerning bonus deferral or reclaiming of the already paid bonus. Directors' decisions are predominantly short-term in nature, motivated by accompanying bonuses, thus jeopardizing the company's long-term objectives and sustainability.

2.1. PRACTICE AND REGULATIONS FROM THE UNITED STATES OF AMERICA

Regulations limiting Directors' remuneration have started after bankruptcy of large companies during the collapse of the "Dot-com bubble" (bladder caused by the growth in the value of internet companies). US companies' total indebtedness in 2002 amounted to \$ 4.5 billion, with an average loan of \$ 11 million. There was no interest paid for approximately 50% of the loans granted to directors, whereas a large number of interest rates were below the market rate, and the loans themselves were written off entirely on a regular basis.

² Economic Policy Institute <http://www.futuresmag.com/2016/07/16/ceo-compensation-rational> (24.09.2018)

One of the most illustrative examples is WorldCom, which, either directly or indirectly, provided loans worth hundreds of millions of dollars, or about 20% of cash on the company's balance sheet, to its CEO Bernard Ebbers, for the purpose of profit payment in his personal brokerage account. Loans, which were to be collected by brokers' companies, had no collateral security. WorldCom filed for bankruptcy several months after the last loans had been granted.³

The perhaps most famous example in the media is the case of Enron. From 1996 to 2000, the energy giant Enron paid to their five executives the amount of more than \$ 500 million⁴. While according to the company accounting records the revenue had increased by nearly six times, and the share price had been increasing continuously, the subsequent study found that Enron "had systematically annulled the shareholder value ... the company debt had been increasing and margins had been decreasing". In the period from 1999 to 2001, Enron's CEO's had sold out shares worth \$ 17.3 million for a total of \$ 1.1 billion of their market value. It was as late as in September 2001, when shares began to fall, that one of the shareholders, Executive Director Ken Lay, convinced their employees that according to his "personal belief Enron's share was an incredible deal at current prices." Two months later, Enron's share was worthless.⁵

In order to prevent market collapse and restore investor confidence, the US legislator has adopted the Sarbanes Oxley Act already in 2002, which, in addition to the transparent financial reporting measures, introduction of the Corporate Governance Code and the prevention of accounting frauds, was the beginning of limiting the Director's remuneration. Companies were prohibited by the law to take loans to be subsequently used for loans to directors. A "Clawback" clause was also introduced, allowing for the company to reclaim the bonus already paid if proven that it had been acquired for risks undertaken that have not yielded results or have otherwise deceived the investors.⁶ The Sarbanes Oxley Act was applicable not only to companies in the United States, but also to any other companies listed on the US stock exchanges. In this way, the law was binding upon a large number of companies from the European Union as well.

Another crisis followed in 2008 after the collapse of the "housing bubble" (caused by the collapse of the real estate market). That year, as evident from Chart 1, showed a significant increase in compensations and bonuses. However, a drastic decline followed shortly after the crisis.

³ <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf> (24.09.2018)

⁴ <https://www.forbes.com/2002/03/22/0322enronpay.html#3f6f63eb7a6d> (24.09.2018)

⁵ <https://www.forbes.com/2002/03/22/0322enronpay.html#3f6f63eb7a6d> (24.09.2018)

⁶ <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf>

Once again, the answer was stricter regulations. In 2010, the Dodd-Frank Act was passed, which prescribed a provision called “say on pay”. The provision guarantees shareholders a regular opportunity to declare themselves and vote on Director’ remuneration packages at the general meeting.⁷

Based on US regulatory experience and driven by the economic crisis that had affected the European capital markets as well, provisions were introduced by the European Union into its legislative framework that encourage more active engagement of shareholders in the performance of company activities, including the issue of declaring themselves and deciding on the remuneration of directors.

3. DIRECTIVE 2007/36/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 11 JULY 2007 ON THE EXERCISE OF CERTAIN RIGHTS OF SHAREHOLDERS IN LISTED COMPANIES

Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (hereinafter: Directive 2007/36)⁸, applies to companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.

Directive 2007/36 was intended to influence the role of corporate governance, in particular the so-called mixed corporate governance, which implies “legal regulation of the obligation of financial reporting and transparency of the operations of joint stock companies and auditing of financial statements”,⁹ which has been increasingly important to day-to-day operations in the capital market, both for shareholders (shareholders), and for all stakeholders - investors, workers, suppliers and others (stakeholders).

To keep all corporate stakeholders timely informed is one of the basic principles of corporate governance and the prerequisite for more active engagement of shareholders, especially in terms of their influence on the remuneration pol-

⁷ https://www.ilr.cornell.edu/sites/ilr.cornell.edu/files/workspan/09-11-research-for-the-real-world_0.pdf

⁸ Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders of listed companies, available at - <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32007L0036>

⁹ Jurić Dionis, „Pojam i značenje korporacijskog upravljanja u dioničkim društvima“, Proceedings from the Second International Conference „Aktualnosti građanskog i trgovačkog zakonodavstva i pravne prakse“ The University of Mostar Faculty of Law, 2004, p. 337-349

icy. If financial reporting is clear and transparent, the possibility of misuse is reduced to a minimum. Until the adoption of Directive 2007/36 on the exercise of certain rights of shareholders of listed companies, as of 11 July 2007 (hereinafter: Directive 2007/36), the EU Member States have differently regulated areas related to financial reporting procedures and, indirectly, shareholder participation in the remuneration policy making.

Pursuant to Directive 2007/36, companies are required to ensure equal treatment of all shareholders in the same position as regards the participation and exercise of voting rights at the general meeting.¹⁰

Equal treatment of the shareholders is one of the basic premises of Directive 2007/36, which is aimed at empowering shareholder rights during their participation in the general meeting. This has been ensured by extending the transparency rules which enable shareholders to effectively supervise the decision making procedure that affects, among others, the price of their shares as well. In this regard, Directive 2007/36 provides for full and timely informing of shareholders with regard to their participation in the general meeting, the exercise of voting rights by proxy, the right to attend the general meeting via electronic means (using modern technology, with the only limitation concerning identity verification and electronic communication security) and the right to cross-border participation and voting.

4. DIRECTIVE (EU) 2017/828 AMENDING DIRECTIVE 2007/36/EC AS REGARDS THE ENCOURAGEMENT OF LONG-TERM SHAREHOLDER ENGAGEMENT

4.1. RATIONALE OF NEW REGULATIONS

However, Directive 2007/36 did not adequately respond to market requirements in terms of ensuring transparent conditions for encouraging more active engagement of shareholders.

The need for amendments has its reasoning in emphasizing the long-term development of companies, while addressing the main shortcomings identified in the implementation practice of Directive 2007/36:

- Short-term objectives of administrative bodies
- Disadvantages in supervising remunerations of board members

¹⁰ Art. 4. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ.L. 184, 14.7.2007 available at <http://data.europa.eu/eli/dir/2007/36/oj> (15.6.2018)

- Disadvantages in supervising transactions of related parties
- Shortcomings in the exercise of cross-border shareholder rights

The main objections were directed at the lack of mechanisms to prevent the administration's action aimed at short-term repayment, leading to inefficient corporate governance and adverse outcomes for strategic objectives and long-term sustainability of the company.¹¹

Almost all texts and debates, before and after the adoption of the new Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (hereinafter: Directive 2017/828)¹², have put the emphasis on the same issue - the importance of long-term objectives of a company as the basis of sustainability of the economy.¹³

4.2. FIELD OF APPLICATION OF THE NEW DIRECTIVE 2017/828

For reasons mentioned above, on 17 May 2017, the European legislator adopted Directive 2017/828 amending Directive 2007/36/EC. The aim of Directive 2017/828 is to further motivate shareholders and to facilitate their engagement in the corporate governance of companies that have their registered offices in a Member State and whose shares are listed for trading on a regulated market located or operating in a Member State.

As Directive 2017/828 has added new chapters and has significantly broadened the scope of regulation in relation to the original Directive 2007/36, it has introduced and defined in detail certain terms (e.g. institutional investor, asset managers, directors, shareholder identity information, etc.).

Apart from the widespread influence of shareholders on adopting the company remuneration policy, regulated by the provisions of Articles 9a and 9b (see *infra*), the basic areas of regulation of Directive 2017/828 are as follows:

¹¹ Action Plan of the European Commission to the European Parliament and the Council of 12.12.2012; available at - <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX-%3A52012DC0740>

¹² Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2997/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, available at <http://data.europa.eu/eli/dir/2017/828/oj> (15.6.2018)

¹³ <http://data.consilium.europa.eu/doc/document/ST-7526-2017-ADD-1/en/pdf>;
<http://blogs.uab.cat/dretmercantil/2017/06/22/directive-2017828-on-the-encouragement-of-long-term-shareholders-engagement/>;
<http://progresomicrofinanzas.org/en/12223/>
<https://companylawandgovernance.com/2017/05/28/the-amended-shareholder-rights-directive/>

1. Identification of shareholders¹⁴, transmission of information¹⁵ and facilitation of the exercise of shareholder rights¹⁶ - in terms of more direct communication of the company with its shareholders, obtaining of timely information on shareholder identification and processing of the said data; in addition to improving the transmission of information along the intermediary chain to facilitate the exercise of the rights by the shareholder, particularly in the cross-border context, a high level transparency regarding the cost of intermediaries and a ban on discrimination in terms of charges levied for domestic and cross-border exercise of shareholder rights; a more modern shareholder voting procedure in terms of shareholder rights to know whether their votes have been properly taken into account, to be provided with an electronic confirmation of receipt of the votes in the case of votes cast electronically and the possibility of obtaining confirmation that their votes have been validly recorded and counted by the company.
2. Transparency of institutional investors, asset managers and proxy advisors¹⁷ – with the aim to secure long-term results and existence of the company.
3. Transactions with related parties¹⁸ – in terms of providing adequate protection in transactions with related parties, publicly announcing material transactions, providing information on the identity of the related party and providing restrictions for directors or shareholders to participate in decision making in capacity of related parties.¹⁹

Taken as a whole, all the above mentioned is of utmost importance for the establishment of the necessary prerequisites for shareholders' participation in decision making in respect of the remuneration policy for directors, as provided for in Article 9a: The right to vote on the remuneration policy and Article 9.b: Information to be provided in the remuneration report and the right to vote on the remuneration report.

¹⁴ Directive 2017/828, art. 3.a

¹⁵ Directive 2017/828, art. 3.b

¹⁶ Directive 2017/828, art. 3.c - 3.f

¹⁷ Directive 2017/828, art. 3.g - 3.k

¹⁸ Directive 2017/828, art. 9.c

¹⁹ Apart from greater risk assumption and transactions with related parties, these transactions have been recognized as one of the elements that can contribute to the lessening of the company assets and cause potential conflicts of interest and it is therefore very important for them to be timely recognized and submitted to the shareholders for approval - as a prevention of so-called tunneling. 'Tunneling occurs either in the form of transactions that the holding company undertakes and manipulates the property of a subsidiary company ...'

See more in Jurić, Dionis, *Pravo manjinskih dioničara na podnošenje tužbe u ime dioničkog društva protiv članova uprave i nadzornog odbora*; Collection of Papers of the University of Rijeka Faculty of Law (1991) v. 28.no.1.541-586 (2007)

4.3. REMUNERATION POLICY - SHAREHOLDER (ACTIVE) ENGAGEMENT

Having in mind the shortcomings of the current remuneration regulations, as one of the key instruments for harmonizing the interests of the company with the interests of the company directors, appropriate mechanisms have been introduced by the European Union through Directive 2017/828 concerning shareholder participation in the company remuneration policy making process. Using the so-called 'push approach', it highlights the importance of an active shareholder and, by establishing a clear, understandable and comprehensive review of the company remuneration policy, it seeks to encourage and awaken them in the direction of taking over social corporate responsibilities with the aim to contribute to the long-term sustainability of the company.

In the preamble to Directive 2017/828, Clauses 28 to 49, guidance has been introduced with regard to remunerations, for each Member State to introduce in their national legislation. Directive 2017/828 respects the diversity of corporate governance systems of the EU Member States related to the determination of responsible bodies within companies for the determination of the remuneration policy and on the remuneration of individual directors. The importance is emphasized of the remuneration policy of companies to be determined in an appropriate manner and the right is introduced of shareholders to express their views regarding the remuneration policy of the company.

The latest financial crisis of 2008 showed that shareholders, for personal reasons, had supported the management in excessive short-term risk undertakings. Having recognized the issue of short-term objectives, linked to high premiums that had been contracted and paid, in the preamble to Directive 2017/828 the legislator explicitly stipulates for the first time that the remuneration policy must be based on long-term interests and sustainability of the company and should not be linked entirely or mainly to short-term objectives. In addition to the financial performance criteria, the remuneration policy should also be based on non-financial performance criteria, such as environmental, social and governance factors. It also prescribes the possibility of introducing and describing the different components of directors' pay through the remuneration policy as well as the range of their relative proportions, i.e. the variable part that directors can achieve. There has been a possibility left for a frame to be designed by the remuneration policy within which the pay of directors is to be held. It is not prescribed as an obligation but only as a possibility and leaves each Member State free will to decide in which way the provisions in question will be incorporated into their national legislations. Specifically, transparency in terms of directors' total remuneration greatly contributes to the high level corporate governance, but at the same time affects the competence of the su-

pervisory board and limits the scope for contracting remunerations with board members.

In order to prevent the circumvention of the requirements laid down by this Directive 2017/828 by the company, Member States are obliged to provide for the disclosure of the remuneration awarded or due to individual directors not only from the company itself, but also from any undertaking belonging to the same group. Otherwise, there would be a risk that companies try to provide directors with hidden remuneration via a controlled undertaking. In such a case, shareholders would not have a full and reliable picture of the remuneration granted to the directors by the company and the objectives pursued by Directive 2017/828 would not be achieved.

Directive 2017/828 introduces two new articles: Article 9a Right to vote on remuneration policy and Article 9.b Information to be provided in the remuneration report and the right to vote on the remuneration report.

Under the aforementioned provisions, shareholders will have the right to express their views on the remuneration policy twice – for the first time (*ex ante*) when voting (binding or advisory) on the remuneration policy and for the second time (*ex post*) when voting on the remuneration report in respect of the most recent financial year.

4.4. RIGHT TO VOTE ON REMUNERATION POLICY

The main objective in regulating the voting rights consists in the obligation of the company to determine the remuneration policy applying to the directors and to provide the shareholders with the right to vote at the general meeting on the subject remuneration policy.²⁰

Vote by a shareholder may have a binding or advisory character.²¹ It is interesting in this regard to see which approach will be applied by the Croatian legislator, i.e. in the case of an alternative legal solution offer (either-or)²², how transparent and socially responsible the reaction of national companies will be. It is yet to be seen whether the Croatian legislator will avail themselves of

²⁰ Directive 2017/828, Art. 9.a, para 1

²¹ Directive 2017/828, Art. 9.a, para 2 - 3

²² A similar solution was selected when the Company Law was amended in 2007, when the option was introduced for a choice to be made between the monistic and dualistic structure of the management as a body of a joint-stock company.

See more: Academician J. Barbić Pregled odredaba Zakona o trgovačkim društvima o monističkom ustroju organa dioničkog društva, Croatian Law Review, 7 (2007), p. 44-53

legal solutions from the German legislation or will conduct an independent public debate with a view to obtaining the bottom-up feedback from national economic entities (e.g. Irish approach²³).

In any event, the aim of Directive 2017/828 is to have directors' remunerations paid by companies exclusively in accordance with their remuneration policy adopted at the general meeting, no matter whether the decision of the shareholders is binding or advisory.

Provided the binding nature of the vote by the shareholders' at the general meeting on the remuneration policy, where no remuneration policy has been approved and the general meeting does not approve the proposed policy, the company may continue to pay remuneration to its directors in accordance with its existing practices and shall submit a revised policy for approval at the following general meeting.

Where an approved remuneration policy exists and the general meeting does not approve the proposed new policy, the company shall continue to pay remuneration to its directors in accordance with the existing approved policy and shall submit a revised policy for approval at the following general meeting.²⁴

In the case of an advisory nature of the vote of shareholders at the general meeting on the remuneration policy, companies shall pay remuneration to their directors only in accordance with a remuneration policy that has been submitted to such a vote at the general meeting. Where the general meeting rejects the proposed remuneration policy, the company shall submit a revised remuneration policy to a vote at the following general meeting.²⁵

Member States may allow companies, in exceptional circumstances, to temporarily derogate from the remuneration policy. Derogation from the adopted policy is allowed exceptionally (i) temporarily, (ii) in exceptional circumstances, (iii) if it is necessary to serve the long-term interests and sustainability of the company as a whole or to assure its viability, and (iv) provided that the

²³ The public debate procedure was launched by the Republic of Ireland competent Ministry for Business, Enterprise and Innovation on the occasion of mandatory incorporation of Directive 2017/828 in the Irish legislation as early as in December 2017 (see more at - <https://dbei.gov.ie/en/Consultations/Consultations-files/Consultation-on-the-Transposition-of-Directive-EU-2017-828.pdf> <https://www.computershare.com/News/Irish%20SRD%20Consultation%20-%20CPU%20Response%20FINAL%202018.pdf>). The public debate, with a detailed and broad spectrum of questions, was going on until and including 9.2.2018.

²⁴ Directive 2017/828, Art. 9.a, para 2

²⁵ Directive 2017/828, Art. 9.a, para 3

policy contains the procedural conditions under which such derogation may apply and the precise elements of the policy it may derogate from.²⁶

The possibility of temporary derogation from the remuneration policy by the company has been provided only as a possibility, not the obligation, for the Member State. The way the Croatian legislator is going to react with regard to this issue is an open question as yet.

An analogy may be drawn here with the current legal solution within the Croatian law whereby the supervisory board is authorized to reduce remunerations to members of the board if the circumstances within the company have aggravated to the extent that any further payments of such remunerations would represent a serious injustice to the company (see *supra*). However, Directive 2017/828 does not explicitly provide for the possibility of derogation only in the form of remuneration reduction. As an *argumentum a contrario*, according to the cited provision it is also possible for remunerations of the members of the administration to be temporarily increased. In addition, the term ‘temporary’ derogation opens up space for arbitrary decision-making on the time the derogation from the adopted policy is to apply and the emergence of different practices within individual Member States may be easily presumed.

The remuneration policy is to be submitted to a vote by the general meeting at every material change and in any case at least every four years.²⁷

Regarding the content, the remuneration policy must be: (i) clear and understandable and shall explain how the pay and employment conditions of employees of the company were taken into account when establishing the policy; (ii) contain the information of its contributing to the company’s business strategy and long-term interests and sustainability and shall explain how it does so; and (iii) contain different components of fixed and variable remuneration, including all bonuses and other benefits in whatever form, which can be awarded to directors and indicate their relative proportion.

Where a company awards variable remuneration, the remuneration policy shall set clear, comprehensive and varied criteria for the award of the variable remuneration. It shall indicate the financial and non-financial performance criteria, including, where appropriate, criteria relating to corporate social responsibility and explain how they contribute to the objectives set out. It shall specify information on any deferral periods and on the possibility for the company to reclaim variable remuneration (clawback).

²⁶ Directive 2017/828, Art. 9.a, para 4

²⁷ Directive 2017/828, Art. 9.a, para 5

The remuneration policy shall indicate the duration of the contracts or arrangements with directors and the applicable notice periods, the main characteristics of supplementary pension or early retirement schemes and the terms of the termination and payments linked to termination. The remuneration policy shall explain the decision-making process followed for its determination, review and implementation, including measures to avoid or manage conflicts of interests and, where applicable, the role of the remuneration committee or other committees concerned. Where the policy is revised, it shall describe and explain all significant changes and how it takes into account the votes and views of shareholders on the policy and reports since the most recent vote on the remuneration policy by the general meeting of shareholders.²⁸

Apart from providing for the transparency of the voting procedure, Directive 2017/828 provides for the policy together with the date and the results of the vote to be made public without delay on the website of the company and to remain publicly available, free of charge, at least as long as it is applicable.²⁹

4.5. INFORMATION TO BE PROVIDED IN AND RIGHT TO VOTE ON THE REMUNERATION POLICY

In addition to ensuring the company shareholder right to vote, it is of utmost importance to control the implementation of the remuneration policy. In this connection, the companies shall draw up (i) a clear and understandable remuneration report containing (ii) a comprehensive overview of the remuneration, including all benefits in whatever form, awarded or due during the most recent financial year to individual directors, including to newly recruited and to former directors. The aim of such a detailed and broadly ranged regulation is to reduce the possibility of manipulation in reporting.³⁰

Where applicable, the remuneration report shall contain the following information regarding each individual director's remuneration:

1. The total remuneration split out by component, the relative proportion of fixed and variable remuneration, an explanation of how the total remuneration complies with the adopted remuneration policy, including how it contributes to the long-term performance of the company, and information on how the performance criteria were applied.

²⁸ Ibid.

²⁹ Directive 2017/828, Art. 9.a, para 7

³⁰ Directive 2017/828, Art. 9.b, para 1

2. The annual change of remuneration, of the performance of the company, and of average remuneration on a full-time equivalent basis of employees of the company other than directors over at least the five most recent financial years, presented together in a manner which permits comparison;
3. Any remuneration from any undertaking belonging to the same group as defined in point (11) of Art. 2 of Directive 2013/34/EU³¹, in order to minimize the space for mismanagement, and to enable shareholders to have a full and reliable picture of total remunerations paid to directors.
4. The number of shares and share options granted or offered, and the main conditions for the exercise of rights including the exercise price and date and any change thereof;
5. Information on the use of the possibility to reclaim variable remuneration;
6. Information on any deviations from the procedure for the implementation of the remuneration policy and on any derogation applied, including the explanation of the nature of the exceptional circumstances and the indication of the specific elements derogated from.³²

According to the preamble to Directive 2017/828, directors remain on a company board for a period of six years on average (although in some Member States that period exceeds eight years).³³ In this connection, it is of crucial importance to evaluate the remuneration and the results of directors' performance not only on an annual basis but also during the relevant period. Thereby, the shareholders, as well as other stakeholders are provided with a mechanism to correctly assess the link between the remuneration and the long-term results. In most cases it is only possible after a period of several years to evaluate whether the awarded remuneration was in line with the long-term interests of the company.

The remuneration report should be clear and understandable and should provide a comprehensive overview of the remuneration of individual directors during the most recent financial year. Shareholders should be granted the right to vote on the company' remuneration report, in order to ensure compliance between the implementation of the remuneration policy and the policy itself. Where the shareholders vote against the remuneration report at the general meeting, the company should explain, in the following remuneration report, how the vote of the shareholders was taken into account.³⁴

³¹ According to Art.2, para 11 of Directive 2013/34, „group” is defined as ‘parent undertaking and all its subsidiary undertakings’

³² Ibid.

³³ Directive 2017/828, preamble, para (39)

³⁴ Directive 2017/828, preamble, para (31)

Shareholders have the right to hold an advisory vote at the annual general meeting³⁵ on the remuneration report of the most recent financial year and the company shall explain in the following remuneration report how the vote by the general meeting has been taken into account.

For small and medium-sized companies³⁶ exception has been provided for, as an alternative to a vote, whereby the remuneration report of the most recent financial year is to be submitted for discussion in the annual general meeting as a separate item of the agenda. The respective Member States are to ensure for such an exception to be included in their national legislation and to prescribe that in such cases companies should explain in the following remuneration report how the discussion in the general meeting has been taken into account.³⁷

There are exceptions provided for in respect of the disclosure of the data regulated by Regulation (EU) 2016/679 (GDPR Regulation)³⁸ and personal data relating to the family situation of individual directors.³⁹ Specifically, in relation to Regulation 2016/679, data relating to the family situation of directors are considered to be particularly sensitive.

Since pursuant to Directive 2017/828, and in order to provide a full review of the directors' remunerations, the remuneration report should reveal the amounts of remuneration received on the basis of the family situation of individual directors (e.g. family allowance or child allowance), it should be noted here that in accordance with the applicable regulations in Croatia, the variable remuneration means any remuneration other than the pay or any remuneration that has not been provided for by the company internal act to apply to all employees.

Talking about director's family situations, variable remuneration is considered to refer to child tuition fee as well as to other expenses that directors are entitled to under "bonus packages". Therefore, pursuant to Regulation (EU)

³⁵ Directive 2017/828, Art. 9.b, para 4

³⁶ Small and medium-sized undertakings are defined in Art. 3, para 2 and 3 of Directive 2013/34/EU and they correspond to small and medium-sized entrepreneurs, in compliance with Art. 5 of the Accountancy Act. Small companies meet 2 out of 3 criteria as a minimum: (i) balance sheet total: EUR 4.000.000; (ii) net turnover: EUR 8.000.000; (iii) average number of employees during the financial year: 50. Medium-sized undertakings meet 2 out of 3 criteria as a minimum: (i) balance sheet total: EUR 20.000.000; (ii) net turnover: EUR 20.000.000; (iii) average number of employees during the financial year: 250.

³⁷ Ibid.

³⁸ Regulation 2016/679 of the European Parliament and of the Council, available at - <https://eur-lex.europa.eu/legal-content/hr/TXT/?uri=CELEX:32016R0679>

³⁹ Directive 2017/828, Art. 9.b, para 2

2016/679, such data enjoy special protection and it is proposed that only the remuneration reports are only entered the remuneration amounts without specifying the basis on which it was awarded to the director.

The purpose of processing personal data of the directors by the company and their inclusion in the remuneration reports is to enhance corporate transparency and directors' accountability as well as to improve shareholder oversight over directors' remuneration. These personal data are made publicly available in accordance with Directive 2017/828 for a period of 10 years from the publication of the remuneration report.⁴⁰

After the general meeting, the companies shall make the remuneration report publicly available on their website, free of charge, for a period of 10 years, and may choose to keep it available for a longer period provided it no longer contains the personal data of directors. The statutory auditor or audit firm shall check that the information so required has been provided.⁴¹

According to Directive 2017/828, to directors of the company is imposed collective responsibility for ensuring that the remuneration report is drawn up and published in accordance with the requirements of that Directive. Member States shall ensure that their statutory measures apply to the directors of the company for breach of the duties.⁴²

4.6. APPLICABLE REGULATIONS IN CROATIA REGARDING DIRECTORS' REMUNERATION

According to positive legislation in Croatia, the principles for deciding on the remuneration of the directors of the company fall within the competence of the supervisory board. Pursuant to Article 247 of the Companies Act, the supervisory board determines the criteria for the total remuneration of directors (fixed and variable remuneration). It is limited by two criteria, i.e. by the adequacy of the work performed by the individual director and by the financial standing of the company.⁴³ The basic assumption for the company's successful determination of the remuneration policy for the directors is the independence of the supervisory board.

⁴⁰ Directive 2017/828, Art. 9.b, para 5

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ Companies Act (NN 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 125/11, 152/11, 111/12, 68/13, 110/15), Art. 247

The shareholders of the company, except in electing the members of the supervisory board, have no influence on the creation of the remuneration policy for the directors. Independence is defined here as the absence of any material conflict of interest, as one of the basic assumptions for reducing or completely eliminating the possibility of mismanagement of the company.⁴⁴ Members of the supervisory board are required to determine all the essential components for determining all the awards (rewards, reimbursement of expenses and special benefits, and the content of basic and additional rewards). When deciding on the essential elements of contracts of remuneration of directors, the decision of the members of the supervisory board should not be negative, having particularly in mind the duty to determine severance payments, if the member of the supervisory board is acting within the scope of the applicable recommendations.

However, in German law, for example, the determination of the severance payment in an inappropriate or unjustifiable amount for a director who withdraws from duty draws the civil liability of a member of the supervisory board and possibly even criminal liability for embezzlement. The German Supreme Court explicitly stated in the Mannesmann case that the subsequent granting of special payments to directors which had not been determined by the employment contract constituted a violation of the loyalty and caused damage to the company assets, since that remuneration had the character of the reward only and does not provide any future benefit for the company. In Croatian legislation, such crimes are determined by the Criminal Code (economic criminal crimes) and by the Capital Markets Criminal Law and the Companies Act.⁴⁵

The supervisory board is authorized to reduce the remuneration to the directors if the company's circumstances are significantly aggravated so that further payment of such remunerations would constitute a serious injustice. However, there have been no simple, quick and clear mechanisms established in this case either of shareholder participation in deciding on the remuneration of directors.

4.7. REMUNERATION POLICY AS PRACTICED BY CREDIT INSTITUTIONS IN CROATIA

Financial institutions are highly regulated as industry everywhere in the world, including in Croatia. Therefore, the obligation concerning the remuneration policy already applies to credit institutions.

⁴⁴ Prof. Hana Horak, PhD and Kosjenka Dumančić, univ.spec.: Neovisnost i nagrađivanje članova nadzornih odbora i neizršnih direktora, Collection of Papers of the Faculty of Law of Split, year 48, 1/2011, p. 34

⁴⁵ Prof. Hana Horak PhD et al., p. 44

Following the latest financial crisis in 2008 and a series of recommendations, the European Commission has adopted Directive 2013/36 EU of the European Parliament and of the Council of 26 June 2013 on access to credit institutions and prudential supervision of credit institutions and investment firms⁴⁶, which lays down the obligation for companies to adopt the remuneration policy. In this connection, the European Banking Authority as the supervisory authority issued guidelines on the content of the remuneration policy. The Directive has been implemented in the Law on Credit Institutions (NN 15/18) in Articles 37 and 100, and the Decision of the Croatian National Bank on Employee Remuneration, 2017 (hereinafter referred to as the Decision) detailed all the prescribed guidelines and prescribed a large part of the requirements arising from Directive 2013/36.

The decision prescribes the obligation of credit institutions relating to the establishment and implementation of a remuneration policy, introduces the principle of proportionality for companies to meet their obligations in a way and to the extent that is appropriate to their size, internal organization and the nature, scale and complexity of their activities. It prescribes that remuneration policies must exercise adequate and effective risk management and should not encourage the takeover of risks that exceed the level of credit risk acceptable to the credit institution. The remuneration policy must be consistent with the long-term interests of the credit institution and include measures to prevent conflicts of interest. The decision also forbids any circumvention of the provision on remuneration by providing directors with hidden variable remuneration via a controlled undertaking or contrary to the objective and purpose of the Decision.

This is identical to the requirements laid down in Directive 2013/36. The Decision prescribes additional requirements for credit institutions. The additional requirements imposed by the Decision are the limitation of the amount and deferral of the variable remuneration, and the application of the “*malus*” or claw-back clause. Namely, the Decision prescribes that the relationship between the variable and the fixed portion of the total remuneration of a particular worker is to be determined in the maximum amount of the variable remuneration which does not exceed the fixed portion on an annual basis. Only exceptionally, credit institution may determine the amount of the variable portion of the remuneration up to double the amount of the fixed portion of individual worker’s remuneration, provided the adoption of such a decision by the general meeting of the company.

⁴⁶ <https://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A32013L0036> (24.09.2018)

Credit institutions are obliged to defer at least 40% of the variable portion of the remuneration, or exceptionally 60% where high amount is involved, for a maximum of 3 years, in order to evaluate the business risk undertaken by every worker in the performance of jobs. Where it is established that the risk undertaken by a worker has caused damage or has not achieved the expected profit, the credit institution may apply the *malus* (clawback) clause and withhold the payment of the deferred portion of variable remuneration up to 100% if the envisaged performance criteria have not been met.

Credit institutions are prescribed mandatory establishment of a board within the supervisory board to review the remuneration policy and propose decisions to the supervisory board. The remuneration committee may consist of members of the supervisory board and also of external independent experts and such a practice would be effective in other undertakings as well.

A part of the requirements of Directive 2017/828 has not been included in the Decision and will pose challenges for companies as well as for credit institutions. So far, Croatian legislation has not prescribed the obligation to adopt the remuneration policy by the general meeting or to make it publicly available. It is not known yet whether the Croatian legislator will decide to prescribe the recommendation for the remuneration policy to determine the extent of directors' remuneration and thereby the basis for variable remuneration as well.

5. CONCLUSION

With regard to the pronounced need for an “actively engaged shareholder” being encouraged to take on social responsibility through the long-term viability of the company, one of the key issues is raised - whether a Croatian legislator will take a cogent or dispositive approach to incorporating the provisions of Directive 2017/828 in relation to the mandatory or advisory nature of the shareholders' vote on the remuneration policy at the general meeting of the company.

If the latter solution is adopted, it will be interesting to see the behavior of the companies because of the fact that companies, also in the case of the dispositive approach taken by the Croatian legislator, do not have any obstacles to prescribe independently by their internal acts the binding nature of the shareholder vote.

The above said refers primarily to the members of the managing and supervisory bodies of the company, to their possible readiness to change the ratio of strengths when deciding on remuneration in favor of the shareholders of the company, on the one hand; and subordinately to the openness and transparency towards (potential) investors in the company.

In both cases, the incorporation of the provisions of Article 9a of Directive 2017/828 will require more active engagement of the shareholders themselves.

The Croatian legislator may opt for an alternative approach (either-or). In that case, the question remains open as to whether and to what extent the market is to be valued by those undertakings that appreciate and encourage active participation of shareholders in adopting the remuneration policy, as opposed to those who assume a more passive attitude.

Pursuant to Directive 2017/828, remuneration policy should contribute to the business strategy, long-term interests and sustainability of the company. Although the public disclosure of variable remuneration awarded to directors contributes to the transparency toward investors, the public disclosure of reward amounts as well as the public disclosure of the remuneration policy will be the biggest challenge for companies to be faced with. How far in detail the companies will go in prescribing the criteria, conditions and ways of measuring success and in discussing all that at the general meeting, and in making them publicly known thereafter, will be a specific test of the transparency of companies towards investors.

In addition, among the challenges that companies will encounter in practical implementation is the issue of how the performance of a director should be determined and measured, while maintaining the balance between frequently opposed long-term interests of shareholders and short-term objectives of the directors. In what way the remuneration policy will prescribe the measuring of the appetite for undertaking the risk of a director in business decision-making and what the acceptable business risk will be for the company in relation to long-term objectives will be left upon the shareholders to decide. Differing attitudes toward business ethics and moral standards are just as hard to observe, but undeniably play a role in the CEO's propensity to manage risk⁴⁷. Where applicable to a company, determining the results of directors' performance on the basis of non-financial criteria will include environmental, social and governance factors that will require listing in the remuneration policy.

This will require an even greater expertise and involvement of shareholders in the operation of the company during the debate and voting on the remuneration policy, which can consequently be reflected in the increasing demand for professional services (lawyers, brokers, financial experts, etc.).

Everything mentioned above applies in the same way to the attitude the Croatian legislator will take in prescribing the possibility of temporary derogation

⁴⁷ Luc Thevenoz, Rashid Bahar, *Conflict of interest – Corporate Governance & Financial Markets*; Kluwer Law international 2007; p 157

from the adopted remuneration policy. Whether a temporary derogation will be allowed and to what extent it will be regulated by law and to what extent it would be left to arbitrary decision on the companies themselves –remains one of the challenges at this moment. However, it is certain that, from the remuneration policy, it will be possible to see the basic strategic guidelines for the development of the company, because by defining long-term interests and non-financial criteria, shareholders will express their clear views on where and how they see the future of the company.

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