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**FOSTERING AN APPROPRIATE REGIME  
FOR THE REMUNERATION OF DIRECTORS**

**Consultation document of the Services of the Internal Market Directorate General**

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## **CONSULTATION DOCUMENT**

### **OF THE SERVICES OF THE INTERNAL MARKET DIRECTORATE GENERAL**

#### **Preliminary remark**

The following document has been drafted by the services of the Internal Market Directorate General in the context of its preparation of the recommendation on fostering an appropriate regime for the remuneration of directors. This document provides initial indications of the views of the services of DG Internal Market as to the possible structure and content of this recommendation. These preliminary orientations are without prejudice to any future decisions by the European Commission in finalising its recommendation.

## 1. SUMMARY

On 21 May 2003, the Commission adopted an Action Plan announcing measures to modernise company law and enhance corporate governance in the European Union. The Action Plan recognised the need for shareholders to be able to appreciate fully the relationship between the performance of the company and the level of remuneration of directors, both ex ante and ex post, and to make decisions on the remuneration items linked to the share price. The Commission recommended the adoption in the short term of a Commission recommendation which should promote the swift application of an appropriate regulatory regime for directors' remuneration.

The services of the Internal Market Directorate General have decided to set up an open consultation process on the key elements of this future Commission recommendation. The main issues on which the Commission is seeking contributions are

- Nature of the recommendation to the Member States (4.2). The Commission's services are considering whether the recommendation should invite Member States to take the necessary regulatory measures to ensure that listed companies comply with all its provisions.
- The scope – listed companies (4.3) The Commission's services are considering whether the recommendation should only target the application of this regulatory regime to EU listed companies or also to non-listed companies.
- The scope – definition of directors (4.4). Given the diversity of board systems and denominations within the EU, the Commission's services are considering whether the recommendations should make reference to the remuneration of the members of the administrative, managerial and supervisory bodies by reason of their responsibilities. This corresponds to the terminology used in the 4<sup>th</sup> and 7<sup>th</sup> company law directives.
- The disclosure of remuneration policy (4.5). The Commission's services are considering whether each EU listed company should disclose the remuneration policy for directors to be applied for the next financial year in the annual accounts and annual report (or in the notes to the annual accounts) of the company. This would contain general information about the remuneration policy, about the performance-related elements of directors' remuneration, supplementary pensions and contract policy. The Commission is also considering whether such information should be an explicit item on the agenda of the annual general meeting and whether it should be submitted to the vote.
- Disclosure of the remuneration of individual directors (4.6). The Commission's services consider that disclosure of the remuneration of individual directors of the company, both executive and non-executive or supervisory directors, in the preceding financial year is an important way of helping shareholders appreciate the remuneration in the context of the overall performance of the company. Such information should at least include details of the salary and other fixed elements of remuneration, share option schemes, supplementary pension schemes and specific additional disclosure for non-executive and supervisory directors
- Share and share-option schemes - the role of the shareholders' meeting (4.7). The Commission's services are considering whether remuneration schemes under which directors are remunerated in shares or share options, and any substantial change in

such schemes, should be subject to the prior approval of the Annual General Meeting of Shareholders. The approval relates to the scheme in itself, i.e. the system of remuneration and the rules applied to establish the individual remuneration under the scheme, and does not relate to the individual remuneration of directors under the scheme.

**Responses to this consultative paper should be concise, focussed principally on the questions raised and provided no later than 12 April 2004. They should be sent to DG MARKET G3, European Commission, B-1049 Brussels. Responses may also be sent by e-mail to [Markt-COMPLAW@cec.eu.int](mailto:Markt-COMPLAW@cec.eu.int).**

**Unless an explicit request is made for confidential treatment, your contribution will be a document that the Commission can make public.**

## 2. INTRODUCTION

### 2.1. The High Level Group report

In its final report on “A modern regulatory framework for company law in Europe”, published on 4 November 2002, the High Level Group of Company Law experts felt that an appropriate regulatory regime for directors’ remuneration should be developed at the EU level and be applied to all listed companies across the EU. In order to avoid a lengthy legislative process, it proposed that the Commission prepare a Recommendation to Member States including at least the following elements:

1. The remuneration policy for directors generally should be disclosed in the financial statements of the company, and should be an explicit item on the agenda of the annual general meeting. Shareholders should have the opportunity annually to debate the remuneration policy of the company on the basis of a comprehensive disclosure of the policy, without having to go through the process of tabling shareholder resolutions. However, a shareholder vote on the remuneration policy should not be an EU requirement.
2. The remuneration of individual directors of the company, both executive and non-executive or supervisory directors, is to be disclosed in detail in the annual financial statements of the company. This includes all financial and non-financial benefits derived from the company, including golden parachutes and pension rights and other perquisites. This requirement should extend to non-executive and supervisory directors. The Group considered, moreover, that remuneration of non-executive or supervisory directors in shares or share options, or which is otherwise related to the company’s performance, should not generally be prohibited, but such remuneration should disqualify the non-executive or supervisory director from being considered to be independent.
3. Schemes under which directors are remunerated in shares, share options or any other right to acquire shares or to be remunerated on the basis of share price movements, and any substantial change in such schemes, should be subject to the prior approval of the shareholders' meeting. The approval relates to the scheme as such, i.e. the system of remuneration and the rules applied to establish the individual remuneration under the scheme, and does not relate to the individual remuneration of directors under the scheme. Such remuneration should be set by the remuneration committee. When put to the shareholders' meeting for approval, the remuneration committee must properly explain the scheme to shareholders in view of the intended application and should set out the relationship of the scheme to the overall remuneration policy. It should also provide an overview of the costs of the scheme to the company in view of the intended application.
4. The annual costs to the company of share grant schemes, share options schemes and other share incentive schemes should be properly accounted for in the company’s annual accounts. The Group considered that such accounting would act as a major restraint on exorbitant share incentive schemes, and perhaps the only one that is genuinely effective, and invited the accounting standards setting bodies and the accounting profession generally to develop the appropriate standards in more detail.

## **2.2. The Commission Action Plan**

On 21 May 2003, the Commission adopted an Action Plan announcing measures to modernise company law and enhance corporate governance in the European Union<sup>1</sup>. The Action Plan recognised the need for shareholders to be able to appreciate fully the relationship between the performance of the company and the level of remuneration of directors, both ex ante and ex post, and to make decisions on the remuneration items linked to the share price. The Commission recommended the adoption in the short term of a Commission recommendation which should promote the swift application of an appropriate regulatory regime composed of **four key items**:

- disclosure of remuneration policy in the annual accounts;
- disclosure of details of remuneration of individual directors in the annual accounts;
- prior approval by the shareholder meeting of share and share option schemes in which directors participate;
- proper recognition in the annual accounts of the costs of such schemes for the company.

The Commission also announced its intention to closely monitor the application of this recommendation with a view to identifying whether any further additional rulemaking may be desirable in the medium term.

When drawing up this recommendation, the Commission will ensure consistency with other forthcoming Commission initiatives, such as the proposal to enhance corporate governance disclosure requirements and the Recommendation aimed at promoting the role of (independent) non-executive or supervisory directors, for instance on issues related to the establishment of the remuneration policy .

## **2.3. The outcome of the public consultation on the Action Plan**

The responses to the consultation on the Commission's Action Plan were very supportive of the Commission's initiative. While emphasizing that directors' remuneration in the final analysis should be the prerogative of a company and its shareholders, and not government, a large majority of respondents on the issue welcomed the Commission's announcement that it would issue a recommendation in the short term. They considered it an important principle of shareholder protection that there should be proper recognition in the annual accounts of any dilution of share capital.

A small number of respondents, however, felt that the remuneration of board members should remain a matter for national laws or corporate governance codes, and questioned the need for any intervention at EU level. Some also strongly

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<sup>1</sup> Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward COM(2003) 284 final

contested the need for details of remuneration of individual directors to be disclosed, since, they argued, investors needed to know the global cost rather than individual remuneration.

With regard to the recognition in the annual accounts of the cost of share options schemes, some highlighted this as a controversial issue on which the International Accounting Standards Board was in the course of developing a new international financial reporting standard.

The Commission Action Plan announced the Commission's determination to organise an open, public consultation, where appropriate, on the major initiatives following from the Action Plan.

Against this background, the services of the Internal Market Directorate General have decided to set up an open consultation process on the key elements of a future Commission recommendation on fostering an appropriate regime for the remuneration of directors.

**Responses to this consultative paper should be concise, focussed principally on the questions raised and provided no later than 12 April 2004. They should be sent to DG MARKT G3, European Commission, B-1049 Brussels. Responses may also be sent by e-mail to [Markt-COMPLAW@cec.eu.int](mailto:Markt-COMPLAW@cec.eu.int).**

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### **3. WHY FOSTER AN APPROPRIATE REGIME FOR DIRECTORS' REMUNERATION?**

Over the last two decades, there has been some popular unease with cases of non-transparent, uncontrolled and excessive levels of remuneration of executive board members on both sides of the Atlantic. Three factors contributed to this:

- ⇒ the increase in equity-based remuneration, and in particular the use of share options, especially in an environment of strong performance of equity markets;
- ⇒ an increasing concern over the granting of generous compensation packages to departing directors;
- ⇒ the lack of transparency in the reporting of executive rewards.

The development of modern systems of remuneration, including performance-related remuneration, was originally intended to align the interests of executive directors with the interests of shareholders. Grants of shares, share options or other rights to acquire shares or by payments which vary with the share price, were seen as containing a strong incentive to align the interests of shareholders and executive directors, as such systems link pay to shareholder returns. Share options can also act as a powerful incentive to join a company and to stay in the company provided the option plan is structured over an appropriate length of time.

The structure of equity-based pay, however, contains some inherent weaknesses which can damage the linkage between pay and performance and create conflicts of interest between directors and shareholders. They are related to the difficulty of choosing an appropriate indicator of performance, the link between the exercise of the options and the performance of the company, the possibility for share options to be repriced, the lack of transparency in the cost of award of share options to directors or the (inherent) incentives of designing overly sophisticated, complex or opaque structures and the associated risks of manipulation of that process.

Remuneration through grants of shares and rights to acquire shares does not, therefore, fully remove the conflict of interest between shareholders and directors. Stronger shareholder activism could help keep remuneration packages within acceptable limits and challenge them where the link between pay and performance is too weak. In order to exercise a more active engagement, shareholders need to have full and accurate information combined with the appropriate mechanisms to express their views. A governance framework is therefore needed to ensure that shareholders receive full and adequate information and are able to hold directors to account effectively, in particular in this area where directors face a clear conflict of interest.

#### **4. MAIN PROPOSALS**

##### **4.1. Amount, composition and determination of the remuneration**

Remuneration policy for directors is a major component of sound corporate governance. The amount and structure of the remuneration of executive directors should be such that qualified and expert managers can be recruited, retained and motivated while the remuneration of non-executive and supervisory directors should take into account their responsibilities, their time commitment and the scope of their tasks. The amount and structure of directors' remuneration is therefore a matter that must be left to the decision of each individual company. The recommendation should reiterate this principle of non-interference in the determination of the amount and structure of directors' remuneration.

The recommendation does not deal with the creation, composition or role of remuneration committees when the board of directors appoints one. This will, however, be covered by another Commission recommendation on the strengthening of the role of (independent) non-executive and supervisory directors.

***Do interested parties agree that the recommendation should not deal with the issues of the amount and structure of the directors' remuneration?***

##### **4.2. Recommendation to the Member States**

Both the High Level Group report and the Commission Action Plan stress the need for Member States to put in place an appropriate regulatory regime for directors' remuneration. The recommendation would therefore invite Member States to take the necessary regulatory measures to ensure that listed companies comply with all its provisions. This would contrast with the approach prevailing in some Member States where the issue is treated in the relevant Corporate Governance Code.

***Do interested parties agree with the Commission that the recommendation should invite Member States to take the necessary regulatory measures to ensure that listed***

*companies comply with all the provisions to foster an appropriate regime for directors' remuneration?*

#### **4.3. Scope – Listed companies**

The Commission's Action Plan does not specify whether the recommendation should only target the application of this regulatory regime to listed companies or also to non-listed companies. The High Level Group had been more explicit and recommended that the four elements of the regulatory regime should apply to all listed companies across the EU. EU Listed companies would be defined as companies with a registered office in one of the EU Member States and whose securities are admitted to trading on a regulated market according to the provisions of the Investment Services Directive (Dir 93/22/EEC).

*Do interested parties share the view that the scope of the recommendation should cover EU listed companies as defined above or should it cover all EU companies?*

#### **4.4. Scope – definition of directors**

Unless specified, the recommendation aims to apply to the remuneration of both executive and non-executive and supervisory directors. Given the diversity of board systems and denominations within the EU, the recommendation would make reference to the remuneration of the “*members of the administrative, managerial and supervisory bodies by reason of their responsibilities*” (hereafter referred to as “*directors*”). This corresponds to the terminology used in the 4<sup>th</sup> and 7<sup>th</sup> company law directives.

*Do interested parties share the view that this recommendation should deal with the remuneration of the members of the administrative, managerial and supervisory bodies by reason of their responsibilities?*

#### **4.5. Disclosure of remuneration policy**

The fundamental principle is that each EU listed company should disclose the remuneration policy for directors to be applied for the next financial year in the annual accounts and annual report (or in the notes to the annual accounts) of the company. Such disclosure should not necessarily take the form of a remuneration report although publication of such a report should be considered as best practice. This would allow shareholders to have the opportunity to debate with the board the remuneration policy of the company on the basis of a comprehensive disclosure of the policy, without having to go through the process of tabling shareholder resolutions.

The focus should clearly be on forward-looking disclosure of remuneration policy. A statement of the company's policy on (both executive and non-executive) directors' remuneration for the following financial year should include at least the following elements:

##### *4.5.1. General Information*

- Details and explanation of the relative importance of the basic and performance-related (or variable) components of remuneration.

#### 4.5.2. *Performance-related elements of remuneration- entitlement to shares or share options*

- A description of the performance criteria on which any right to options, shares or other variable components of remuneration is based;
- A justification of why such performance criteria were chosen and additional information on performance linkage;
- When any entitlement to share, share options or other incentives is not related to performance, an explanation of why this is the case;
- The main parameters and rationale for any annual bonus scheme and any other non-financial benefits;

#### 4.5.3. *Pensions*

- A description of current pension or early retirement schemes for executive directors.

#### 4.5.4. *Contracts*

- Details of and an explanation of the company's policy on contracts, especially on the duration of contracts, and notice periods;
- Details of provisions for termination payments (and other payments linked to early termination) under such contracts for executive directors.

#### 4.5.5. *Remuneration policy setting process*

- Information should also be provided concerning the preparatory and decision-making process used for determining the company's remuneration policy for directors.

Such information should be an explicit item on the agenda of the annual general meeting (AGM). Some Member States have introduced provisions requiring a compulsory or advisory vote by the Annual General Meeting on the report on the remuneration policy. The recommendation might include a provision that the AGM should vote – at least in an advisory capacity – on the remuneration policy.

***Do interested parties agree that the disclosure of remuneration policy should be forward looking (i.e. next financial year) and should contain at least the elements mentioned above?***

***Do they agree that such information should be a separate item on the AGM agenda?***

***And should there be a requirement for at least an advisory vote on the remuneration policy at the Annual General Meeting?***

## 4.6. Remuneration of individual directors

It is important to give shareholders the information on the basis of which they can hold directors accountable for the remuneration they extract from the company. Disclosure of the remuneration of individual directors of the company, both executive and non-executive or supervisory directors, in the preceding financial year is therefore important to help them appreciate the remuneration in the light of the overall performance of the company. Such information should be disclosed in detail in the annual financial statements of the company.

With regard to executive directors or members of the management board, the annual financial statements should include all financial and non-financial benefits derived from the company, including

### 4.6.1. *Salary and other fixed elements of remuneration*

- The total amount of salary paid or due to the director for the services performed under the preceding financial year;
- The total amount of bonuses paid and total estimated value of non-cash benefits;
- The compensation paid to the director in connection with the termination of his activities.

### 4.6.2. *Share options*

Detailed information should be required about the share options granted to each director. The right balance should nevertheless be struck between the relevance of the information and the need to avoid unnecessary detail. Information should in particular distinguish those options that have been exercised, those that have expired unexercised and those of which the terms and conditions have changed during the preceding financial year.

Such information should at least include for each director:

- The number of share options granted by the company during the financial year and their conditions;
- The number of share options exercised during that year; and for each of them the number of shares involved and the market price of the shares in relation to which it has been exercised;
- Any change in the terms and conditions of existing share options during the financial year.

### 4.6.3. *Supplementary pension schemes*

For each person who has served as a director during the relevant financial year, the following information should be disclosed:

- When the pension scheme is a defined-benefit scheme, changes in the director's accrued benefits under that scheme during the relevant financial year;

- When the scheme is a defined-contribution scheme, details of the contributions paid or payable by the company in respect of that director during the relevant financial year.

#### 4.6.4. *Specific additional disclosure for non-executive and supervisory directors*

For non-executive directors or supervisory board members, the annual accounts should contain full and detailed information on the amount and structure of the remuneration of individual members including

- The structure of their remuneration policy and the extent to which it is performance-related;
- Where share options or any other share-based schemes have been granted to non-executive or supervisory directors, a report on the reasons underlying the decision to grant such schemes to non-executive or supervisory directors.

***Do interested parties consider that the disclosure of the remuneration of individual directors should include all financial and non-financial benefits as described above?***

***Do they consider that other information related to individual directors' remuneration should also be disclosed?***

#### **4.7. Role of shareholders' meeting**

Variable remuneration schemes under which directors are remunerated in shares, share options or any other right to acquire shares or to be remunerated on the basis of share price movements, and any substantial change in such schemes, should be subject to the prior approval of the Annual General Meeting of Shareholders. The approval relates to the scheme in itself, i.e. the system of remuneration and the rules applied to establish the individual remuneration under the scheme, and does not relate to the individual remuneration of directors under the scheme.

Approval of the Annual General Meeting of Shareholders should be obtained at least for the following:

- Grant of share-based schemes (including share options) to executive and non-executive directors;
- Performance criteria when granting of such schemes is linked to performance criteria;
- the determination of their maximum number and the main conditions of the granting process; and the term within which options can be exercised;
- the conditions for any subsequent change in the exercise price of the options, if appropriate and in accordance with the law.

The relevant information including either the full text of the schemes or a description of its principal terms should be communicated to the shareholders prior to the meeting. When put to the shareholders' meeting for approval, the scheme must be properly explained in view of its intended application, and the relationship of the scheme to the

overall remuneration policy should be set out. It should also provide an overview of the costs of the scheme to the company in view of the intended application.

***Do interested parties agree that grants of share-based schemes to directors should be subject to the prior approval of the general meeting of shareholders and that relevant information on such schemes should be communicated to shareholders prior to the meeting?***

#### **4.8. Recognition of stock options in the annual accounts**

Concerns have been expressed about the lack of transparency in the cost of the award of stock options and other share-based payments to directors. The International Accounting Standards Board (IASB) is currently considering how to bring the cost of options onto the profit and loss accounts of listed companies. The approach followed by the IASB provides some guidance for valuation and recognition of these instruments.

The IASB is expected to adopt this standard by 31 March 2004. All listed companies would have to comply with it by 1 January 2005.

It is therefore proposed to consider how to deal with this last issue after the adoption of the relevant IAS.