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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE
COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE
COMMITTEE OF THE REGIONS**

**Report on the application by Member States of the EU of the Commission
2009/385/EC Recommendation (2009 Recommendation on directors' remuneration)
complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime
for the remuneration of directors of listed companies**

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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Report on the application by Member States of the EU of the Commission 2009/385/EC Recommendation (2009 Recommendation on directors' remuneration) complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies

(Text with EEA relevance)

1. OBJECTIVE OF THE REPORT

The financial crisis exposed serious weaknesses in the way financial markets are regulated and supervised. There is broad consensus that compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, contributed to the incentives that led financial institutions' engagement in overly risky business practices. Wider concerns have also been voiced about recent substantial increases in executive remuneration, the increased importance of variable pay in the composition of directors' remuneration and related short term focus of remuneration policies across all sectors of the economy.

The Commission's Recommendations on directors' remuneration in listed companies (2004/913/EC) and on the role of non executive/supervisory directors and supervisory board committee (2005/162/EC) did not address all the issues exposed in the financial crisis. In particular, the Recommendations do not require executive remuneration to be aligned with the long term interest of companies. In this light, the ECOFIN Council's conclusions of 2 December 2008 invited the Commission *"to update its recommendation so as to promote a more effective control by shareholders, and encourage a stronger link between pay and performance, including on leaving pay ("golden parachutes")"*. Therefore, the Commission adopted in April 2009 a new Recommendation (2009/385/EC) on the structure of directors' remuneration and on the process of design and operation of the remuneration policy for directors in listed companies, which sets out a series of new principles complementing the previous Recommendations.

An appropriate remuneration policy should ensure pay for performance and stimulate directors to ensure the medium and long term sustainability of their companies. The Commission's 2009 Recommendation gives further guidance in order to attain this Goal. It is based on best practices for the design of an appropriate remuneration policy. It focuses on certain aspects of the structure of directors' remuneration and the governance of directors' remuneration, including shareholder supervision.

The objective of this report is to evaluate whether Member States have acted in order to give effect to the main principles of the 2009 Recommendation on directors' remuneration. The Commission is issuing in parallel a report analysing the endorsement of the Recommendation (2009/384/EC) on remuneration policies in the financial services sector. This report also considers what measures have been taken by Member States to give effect to some main principles of the 2004 Recommendation on directors' remuneration, in particular principles related to disclosure of remuneration policy and individual remuneration of directors and the

shareholders' vote on the remuneration statement, with a view to analysing whether further steps have been taken in this field following the financial crisis.

Member States were invited to take the necessary measures to promote the application of the 2009 Recommendation by 31 December 2009, for instance through legislation or best practice rules based on the "comply or explain" principle.

"Comply or explain" gives flexibility to companies. Some companies may find that a certain recommendation is ill-suited to their specific characteristics and/or compliance with a given standard would be excessively burdensome or difficult. These companies are not required to comply with that standard as long as they disclose these deviations and provide an explanation to the market.

This Report is based on the replies of Member States to a Commission Staff questionnaire as well as the examination of national corporate governance codes and laws of the Member States. This Report is completed by a Commission staff working paper which accompanies this Report and contains the tables that indicate the extent to which Member States have followed the requirements of the Recommendation.

2. MAIN FINDINGS OF THE EVALUATION

A minority of Member States¹ has implemented at least half of the recommendations. At the moment, a number of Member States² is still working on the implementation of (some of) the recommendations in its law or Corporate Governance Code. Many Member States³ require or recommend that variable remuneration is linked to performance and promotes long term sustainability of the company. A minority of Member States requires or recommends deferment of variable remuneration⁴ and clawback⁵, while a majority recommends or requires limitation of termination payments⁶. Share based remuneration should be linked to performance criteria in many Member States, but only a minority of Member States⁷ requires or recommends vesting and non-exercise periods, which are subject to performance criteria. A minority of Member States⁸ has taken action to promote shareholder voting with regard to remuneration issues. A minority of Member States⁹ has endorsed the recommendations related to Remuneration Committees.

Endorsement of the disclosure and shareholder vote provisions of the 2004 Recommendation has increased significantly in recent years. There is also a trend among Member States to regulate these issues in a binding way.

¹ AT, BE, DE, DK, LT, IT, NL, PT, SI and the UK

² CY, CZ, EE, ES, FI, IT, PL and the UK

³ AT, BE, BU, DE, DK, FR, HU, IT, LV, LT, LU, NL, PT, SE, SI, SK, and the UK.

⁴ AT, BE, DE, DK, LT, IT, PT, SE and SI.

⁵ AT, DE, DK, FI, FR, LT, NL, SE and SI. However, CY, CZ, EE, ES, IT and the UK are planning recommendations/legislation in this field.

⁶ AT, BE, DE, DK, EE, FR, IE, IT, LT, LU, NL, PT, SE, SI and the UK. However, AT, BE, DE and FR limit termination payments to a maximum number of total annual remuneration, instead of fixed remuneration as recommended.

⁷ BE, DK, IE, IT, LT, PT and the UK.

⁸ BE, DE, DK, IE, LT, NL, SI, SK and the UK.

⁹ AT, BE, DE, DK, IT, LT, NL, PT and SI endorsed a number of those recommendations.

3. ASSESSMENT OF THE APPLICATION OF THE RECOMMENDATION

Endorsement of the recommendations is assessed by area. Member States which have implemented (some of) the recommendations, have mostly included them in their Corporate Governance Codes. A number of Member States¹⁰ is still working on legislative proposals and/or revision of its Corporate Governance Code to include (some of) the recommendations. Information provided by member States further suggests that some Member States did not see a need to introduce (all) recommendations in their legislation or Corporate Governance Code as there did not appear to be significant problems with remuneration in their Member State¹¹.

3.1. Structure of remuneration policy

Most Member States either recommend or require that variable remuneration is linked to performance criteria. However, not all national recommendations and/or laws stipulate explicitly that performance criteria should be predetermined and measurable¹². Furthermore, a majority of Member States recommends or requires the promotion of the long term sustainability of the company through the choice of performance criteria, but only a minority of Member States recommends or requires the inclusion of non-financial performance criteria to determine variable remuneration.

About half of the Member States recommend or require companies to set limits on the variable part of remuneration. However, only a few Member States explicitly encourage companies to withhold variable remuneration in case of underperformance.

A minority of Member States recommend or require deferment of a major part of variable remuneration, in the sense that a major part of variable remuneration is awarded on the basis of multiyear performance criteria or definitive award of a major part of variable remuneration is postponed for a number of years upon the fulfilment of performance criteria after time. Information provided by Member States suggests that one of the reasons for the low endorsement rate is that not all Member States are familiar with the concept of deferment¹³, and may have understood it in a different way.

A minority of Member States has endorsed the recommendation with regard to clawback arrangements, meaning contractual arrangements with directors which permit the company to reclaim variable remuneration which was paid on the basis of data that proved to be incorrect, or a provision in law which allows companies to do so. This issue is more often regulated in law than other matters covered by the Recommendation. A number of Member States has published legislative proposals to amend the law in this respect¹⁴. Together with planned revisions of Corporate Governance Codes, this would result in endorsement of the recommendation by a majority of Member States.

¹⁰ CY, CZ, EE, ES, FI, IT, PL and the UK

¹¹ Among others EE and SK

¹² Some Member States assert however that they have implicitly recommended this.

¹³ Deferment of variable remuneration means that it is awarded on the basis of multiyear performance criteria or its definitive award is postponed for a number of years upon the fulfilment of performance criteria after time, and should at least apply to variable remuneration in cash. (Variable remuneration in equity is addressed by the recommendations with regard to share based remuneration.)

¹⁴ Also, some Member States are preparing a revision of their Corporate Governance Code, which will recommend the possibility of clawback of variable remuneration.

With regard to termination payments, a minority of Member States recommends or requires that they are limited to 2 years of fixed remuneration. However, some Member States allow that termination payments are also based on (average) variable remuneration¹⁵. Other Member States are more stringent, as they recommend a limitation to one year of fixed remuneration¹⁶. Most Member States, which recommend or require limitation of termination payments, also recommend or require that they should not be paid if the termination is due to inadequate performance¹⁷.

3.2. Share-based remuneration

Many Member States regard share based remuneration as a form of variable remuneration. As a consequence, award of shares or share options is often linked to performance criteria. However, only a number of Member States recommend or require that shares should not vest for at least three years after their award and share options should not be exercisable for a similar period. Some Member States recommend or require a vesting period only for shares¹⁸. Others recommend or require a restriction only on the right to exercise share options¹⁹.

The Commission also recommended that vesting of shares and the right to exercise share options should be subject to predetermined and measurable performance criteria. This means that after shares or share options are awarded (whether on the basis of performance or not) shares vest, or the right to exercise share options is awarded, only if performance criteria have been met. A minority of Member States have implemented this recommendation. Information provided by Member States suggests that some have understood the recommendation in a different way, in the sense that award of share based remuneration should be subject to performance criteria instead of vesting and the right to exercise after the initial award. This could be a reason for the low endorsement rate of this recommendation.

3.3. Disclosure of remuneration policy and shareholders' vote

Many Member States recommend or require minimum standards for disclosure. Mostly, this takes the form of a list of elements which should be included in the disclosed remuneration policy. In the 2004 Recommendation, the Commission also recommended minimum standards for disclosure. Many Member States have taken those standards into account. In the 2009 Recommendation, the Commission recommended additional elements which should be disclosed in the remuneration policy and also recommended more generally that the remuneration policy should be clear and easily understandable. A minority of Member States recommends or requires explicitly that the disclosed remuneration policy should be clear and easily understandable. Some Member States have taken a different approach to reach this goal and have issued a standard template for the disclosure. Also a minority of Member States recommend or require the inclusion of all elements, recommended by the Commission in the 2009 Recommendation, in the disclosed remuneration policy. Moreover, there is a tendency among Member States to introduce new recommendations or requirements as regards the disclosure in the remuneration policy of elements relating to variable remuneration, including

¹⁵ AT, BE, DE and FR.

¹⁶ IE, NL, SI and UK

¹⁷ However, DK and SE do not recommend this, as they consider it incompatible with the function of termination payments as safety net in case of immediate termination of the contract.

¹⁸ FR, LU and SE

¹⁹ CY, DK, NL and PT

long term performance criteria and performance measurement, and conditions of share-based remuneration.

In a minority of Member States there is a recommendation or legislative provision which promotes shareholder voting on remuneration policy. These recommendations and provisions take different forms. Some recommend or require of companies that they better facilitate shareholder voting. Other Member States recommend (sometimes under ‘comply or explain’ obligations) to shareholders or institutional investors that they make considered use of their rights. It should further be noted that the mere fact that shareholders have a right to vote on remuneration policy does, in the Commission’s view, not qualify as encouraging shareholder voting on remuneration policy.

3.4. Remuneration Committee

With regard to expertise and integrity of the Remuneration Committee, a minority of Member States recommends or requires that one member of the Remuneration Committee has expertise in the field of remuneration policy²⁰. A few Member States recommend or require instead that every board member, supervisory or non-executive board member or member of the Remuneration Committee has, in general, sufficient qualifications, knowledge and/or experience with regard to his functions. One Member State²¹ recommends that the Remuneration Committee has access to the necessary skills to fulfil its role. However, this could also have the result that a Remuneration Committee seeks external advice. With regard to external consultants, a minority of Member States recommends or requires that the Remuneration Committee ensures that any consultant they hire, does not at the same time advise the company. Two Member States²² instead recommend or require disclosure of the other services that a consultant provides for the company. One Member State²³ recommends that the Remuneration Committee, when hiring a consultant, ensures that there is no conflict of interest regarding other assignments that the consultant may have. Concerning independent judgment of members of the Remuneration Committee, only a few Member States have explicitly recommended or required that, in exercising its functions, the Remuneration Committee exercises independent judgment and integrity. It seems that most Member States are of the opinion that this follows automatically from the recommendation or requirement that the majority (or totality) of the members of the Remuneration Committee are independent. The Commission’s recommendation however, was intended to strengthen the independent thinking of the members of the Remuneration Committee, once they have been selected in accordance with applicable criteria (such as independence criteria).

With regard to the role of the Remuneration Committee, only a few Member States recommend or require that it periodically reviews the remuneration policy for executive directors, whereas one Member State²⁴ gives this task to the supervisory board. A number of Member States seem to be of the opinion that this task is already included in the Remuneration Committee’s task to propose a remuneration policy. Where the national legal

²⁰ Some Member States have indicated that they found ‘expertise’ difficult to define.

²¹ LU

²² IE and UK. The UK has indicated that introducing legally binding provisions to prevent conflicts of interest of remuneration consultants would be inconsistent with requirements for other service providers.

²³ SE

²⁴ EE

framework recommends or requires that the Remuneration Committee prepares a remuneration policy annually, it seems natural that the committee uses the opportunity to review the previous remuneration policy before proposing (a possibly identical) remuneration policy for the coming year. However, the Commission's recommendation was intended to strengthen the existing functioning of the Remuneration Committee by encouraging active monitoring and review of the remuneration policy, with a view to proposing changes, both in a system where the remuneration policy should be proposed annually, and there where that is not the case.

A minority of Member States recommends or requires that the Remuneration Committee ensures proportionality in remuneration between individual executive directors and between executives and other employees of the company. Some Member States however recommend or require proportionality in remuneration between companies within the group, which is not exactly the same. A few Member States recommend or require that the Remuneration Committee reports and is present at the Annual General Meeting. Some Member States however require the presence of one or more members of the Remuneration Committee.

4. Developments with regard to the application of the 2004/2005 Recommendations

Since the 2007 Commission Staff Report on the application of the 2004 Recommendation, about half of the Member States²⁵ has taken legislative initiatives²⁶ with regard to directors' remuneration. Some of these initiatives addressed only one specific aspect of it, such as termination payments, but most initiatives were related to disclosure of remuneration policy, individual remuneration and/or the shareholders' vote on directors' remuneration. Most of these Member States already had provisions on these issues in their Corporate Governance Codes and chose to strengthen the provisions by making them binding, while some Member States introduced these provisions in their legal framework through new laws. Some Member States are still engaged in the legislative process²⁷. Apart from legislative initiatives, a number of Member States who did not have recommendations on disclosure of remuneration policy, individual remuneration of directors and/or the shareholders' vote in its Corporate Governance Code in 2007, when the Commission Staff issued its report on the application of the 2004 Recommendation, has by now introduced such recommendations. However, there are still a few Member States who do not recommend or require this. It should further be noted that with regard to disclosure of the remuneration policy or report, there are differences among the Member States as regards its recommended or required content. Furthermore, the effect that is given to an advisory shareholder vote may differ among Member States.

With regard to the 2005 Recommendation on independent directors, which includes recommendations on the creation and role of the Remuneration Committee, there are a few Member States who do not recommend or require the installation of such committee and there are differences in the recommended or required tasks and functioning of the Remuneration Committee among the Member States where such committee is recommended or required.

²⁵ AT, BE, CZ, DE, DK, EE, ES, FR, HU, IE, IT, LV, PT, SI, SK

²⁶ Or other binding measures, such as listing rules.

²⁷ CZ, EE, ES and IT

5. CONCLUSION

The 2009 Recommendation has been taken into account by a number of member States. Ten Member States have endorsed at least half of the recommendations²⁸. However, most recommendations have been implemented by a minority of the Member States. At the moment, a number of Member States²⁹ is still working on the implementation of (some of) the recommendations in its law or Corporate Governance Code. With regard to the content, the recommendations on variable remuneration have been in general been implemented to a greater extent than the recommendations on the Remuneration Committee.

However, endorsement of the disclosure and shareholder vote provisions of the 2004 Recommendation has increased significantly in recent years. There is also a trend among Member States to regulate these issues in a binding way. Nonetheless, there are still significant differences among Member States as regards disclosure of a remuneration statement or remuneration policy, the content of the remuneration statement and the level of detail and disclosure of individual remuneration. With regard to the shareholders' vote, there are differences with regard to the object of the vote and whether the vote is binding or not, while it appears that there are differences with regard to the follow-up which is given to a negative advisory vote.

In consequence, the Commission intends to consider whether further measures are needed to improve the coherence and effectiveness of EU action in this area. To this end, a series of questions have been included in the Commission's Green Paper on Corporate Governance in Financial Institutions.

²⁸ AT, BE, DE, DK, IT, LT, NL, PT, SI and the UK
²⁹ CY, CZ, EE, ES, FI, IT, PL and the UK