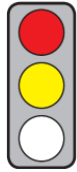


## MAIN ISSUES

**Objective of the Recommendation:** The Commission wishes to ensure that the remuneration of directors of listed companies is based on their performance and promotes the long term sustainability of companies.

**Parties Affected:** Listed companies and their managing boards, directors, supervisory boards and shareholders.



**Pros:** As long as comprehensive information on the remuneration policy of a company is not made available, shareholders are not capable of assessing the related financial risks.

**Cons:** (1) State intervention into the remuneration of directors is not justified where there are no systemic risks inherent in the sector concerned.

(2) Whether or not the performance of directors is to be measured along either short-term or long-term achievements and what constitutes appropriate remuneration should be decided solely by shareholders and supervisory boards.

## CONTENT

### Title

**Recommendation C(2009) 3177** of 30. April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the Regime for the **remuneration of directors of listed companies**

### Brief Summary

#### ► General

- The Recommendation affects directors of all listed companies seated in the EU (No. 1.1.). This includes all members of administrative, managerial or supervisory bodies of listed companies (No. 1.1. in conjunction with No. 2.1. of the Recommendation 2004/913/EC).
- According to the Commission, the remuneration structures for the above-mentioned group “have become increasingly complex” and are too focused “on short-term achievements” and “in some cases have led to excessive remuneration” which was “not justified by performance” (Recital 2).
- Therefore the Commission recommends a remuneration policy that is more performance-oriented and generates incentives to maintain the economic sustainability of companies in the medium and long-term (Recital 6).
- The Recommendation contains detailed rules on variable components of remuneration, termination payment and the criteria for remuneration practices.
- The Recommendation addresses all Member States. They should take “all appropriate measures” to ensure that the listed companies concerned adhere to the Recommendation (No. 1.2.).
- However, the Commission acknowledges that the “form, structure and level of directors’ remuneration” continue to be “matters primarily falling within the competence of companies, their shareholders and, where applicable, employee representatives” (Recital 3).

#### ► Variable components of remuneration

- Variable components of remuneration are components of the total annual remuneration that are subject to predetermined and measurable performance criteria (No. 3.2.).
- Performance criteria should in particular:
  - promote the long-term sustainability of the company and
  - include non-financial criteria that are “relevant to the company’s long-term value creation” (No. 3.2.).
- Companies should set maximum limits to variable components of remuneration. The non-variable component of remuneration should be sufficient to allow the company to withhold variable components of remuneration when performance criteria are not met. (No. 3.1.)
- Deferral periods should be set in which a maximum part of the variable remuneration components is withheld and not paid out. The level of this part should be determined in relation to the weight of the variable component compared to the fixed remuneration. (No. 3.3.)
- Contractual recovery provisions should be agreed upon, entitling the company to reclaim variable components of remuneration that were awarded on the basis of data which subsequently proved to be manifestly misstated (No. 3.4.).

#### ► Share-based remuneration

- Shares, share options or remuneration based on share price movements should be assignable or exercisable not before three years after their award (No. 4.1.).
- Each share-based remuneration should be subject to predetermined and measurable performance criteria and the long-term economic sustainability of a company (No. 4.2.).

- Directors should be obliged to retain a predetermined number of shares until the end of their mandate. The number of these shares should be fixed at twice the value of the total annual remuneration. (No. 4.3.)
- The remuneration of non-executive directors or supervisory directors should not include any share options (No. 4.4.).
- ▶ **Termination payments**
  - Termination payments are payments that are awarded to executive directors or members of the managing board of a company in case of early termination of a contract; they include payments related to notice periods and non-competition clauses (No. 3.5.).
  - Termination payments should “in general” not exceed two fixed total annual remunerations (No. 3.5.).
  - Termination payments should not be paid if the contract was terminated due to inadequate performance (No. 3.5.). Generous termination payments (“golden parachutes”) should not be a “reward for failure” but a “safety net in case of early termination of the contract” (Recital 7).
- ▶ **Disclosure of remuneration policy: “Remuneration Statements”**
  - Listed companies should already be disclosing their remuneration policies for directors to the public by way of “remuneration statements”. These statements should be clear and easily understandable so as to facilitate the shareholders’ assessment of their remuneration approach and to strengthen the company’s accountability towards its shareholders. (No. 5.1., Recital 9)
  - Remuneration statements should in future be complemented by the following information (No. 5.2.):
    - an explanation of how the choice of performance criteria for calculating the variable remuneration components contribute to the long-term interests of a company;
    - an explanation of the methods applied to assess whether performance criteria have been fulfilled;
    - information on deferment periods prior to the payment of variable components of remuneration;
    - information on the company’s termination payment policy;
    - information on vesting periods for share-based remuneration and rules on retaining issued shares;
    - information on the peer groups examined when establishing a company’s remuneration policy.
- ▶ **Role of shareholders**

Shareholders, in particular institutional shareholders, should be “encouraged” to attend general meetings and to make use of their voting rights regarding the remuneration policy of a company (No. 6.1.).
- ▶ **Remuneration Committee**

The role of remuneration committees – which the administrative or supervisory boards of listed companies (should) establish in order to receive supervision in designing their remuneration policy – should be strengthened. The Commission therefore recommends as follows:

  - The remuneration committee should ensure that the remuneration of individual executive or managing directors is proportionate to the remuneration of other executive or managing directors (No. 9.3.).
  - At least one of the members of the remuneration committee should have knowledge of remuneration schemes (No. 7.1.).
  - External consultants of the remuneration committee should not advise directors of the company at the same time (No. 9.2.).
  - Committee members should be obliged to attend general meetings in order to report on the exercise of their functions to shareholders (No. 9.5.).
  - The committee should periodically review the remuneration policy and its implementation (No. 8.1.).

### Changes Compared to the Status Quo

- ▶ The Recommendation complements Recommendation 2004/913/EC of the Commission, which aims at the full disclosure of remuneration policy by way of remuneration statements. The latter, however, contained neither proposals regarding the design of fixed and variable remuneration for directors nor any rules for termination payments.
- ▶ The Recommendation 2005/162/EC already contains an invitation to listed companies to support their administrative and supervisory boards through the establishment of remuneration committees. However, regarding the composition of such committees said Recommendation contains only a provision that they should not be composed of company directors. Recommendations as regards the qualifications and expertise of committee members, a code of practice for fixing the level of remuneration and criteria regarding the design of remuneration recommendations are not included.

### Statement on Subsidiarity

According to the Commission, different national rules can impede the internal market and thus lead to distortion of competition; this effect could be avoided only through Community action.

### Political Context

The debate on the appropriateness of the remuneration of managers has been going on for years. The current financial crisis has added significantly to the widespread public incomprehension of high bonus payments. As a

result of this debate, the EU Commission felt the need to revise the Recommendation on remuneration for managers and directors of listed companies and to issue the Recommendation on remuneration policies in the financial services sector [C(2009) 3159; cp. [CEP-Policy Brief](#)].

### Options for Influencing the Political Process

Leading Directorate General:  
Consultation Procedure:

DG Internal Market  
The DG Internal Market has consulted the relevant interest groups in the form of a "Round Table" on 23. March 2009.

## ASSESSMENT

### Economic Impact Assessment

#### Ordoliberal Assessment

Without doubt, variable remuneration schemes (bonus models) play a major role for directors of listed companies. Furthermore, the Commission's assumption that many of these remuneration structures have become increasingly complex and too focused on short-term achievements is correct.

However, **the Commission's Recommendation should remain what it actually is: non-binding. For the implementation of the Recommendation in the form of binding rules would constitute a massive intervention into the freedom of contract, for which there is no convincing justification.**

State regulation of the remuneration of managers is justifiable only where third parties must be protected from damages. If the remuneration schemes of banks do not incorporate possible risks, this can result in – as best demonstrated by the current financial crisis – the stability of financial markets being endangered and can lead to substantial losses in all sorts of investments.

**Such systemic risks are not inherent in companies outside the financial sector.** Hence, a regulation of remuneration for directors is not necessary there. They should remain a result of the negotiations by the parties affected, namely the managers, supervisory boards and company owners. The market value of a manager's labour and the preferences of shareholders will affect the outcome decisively. To this end, the Commission's **recommendation to set bonus maximum levels is to be rejected by all means.**

The Commission's proposal **to link the criteria of "good performance" to the long-term economic sustainability of a company is not necessarily always in the interest of shareholders.** In certain cases it might make more sense to aim at short or medium-term goals. Company owners should therefore possess the maximum possible freedom in determining performance criteria. Only then can the company-specific requirements for the management and differentiated performance criteria be met.

**Deadlines for the exercise of share options or the forced retention of shares** until the termination of employment **could endanger the incentive compatibility of employment contracts.** Managers would be encouraged in the form of incentives to focus solely on their performance for this period of time, thereby ignoring any possible negative consequences.

**The Commission's proposal to reject termination payments for "inadequate performance" is too general.** It assumes that companies have corresponding rights of retention. Yet companies are not normally obliged to agree on termination payments by contract at all. Such agreements merely reflect the power of the negotiation position a manager holds when entering a new company. Even in the case of an early contract termination, such agreements – apart from extreme cases – must be complied with (*pacta sunt servanda*). **Whether or not the originally agreed termination payments are "excessive" should be decided by the shareholders.**

In principle, the recommended extension of the content of public "remuneration statements" as regards the remuneration policies of companies is to be welcomed. **The more transparent a remuneration policy, the better shareholders can** assess the value of their shares and **rule out that remuneration schemes set incentives for undertaking unintended risks.** However, this transparency should not be statutorily prescribed. For companies tout for the capital of investors and in so doing compete with other companies and other forms of capital investments. This competition ensures that listed companies cannot ignore the natural demand of shareholders for detailed information.

#### Impact on Efficiency and Individual Freedom of Choice

If the Recommendation was implemented in the form of binding rules, listed companies would have difficulties fulfilling the remuneration wishes of managers in the future. Then talented managers would turn to less regulated companies, such as for instance unlisted companies. Such a drain of human capital would equal a discrimination of listed companies.

#### Impact on Growth and Employment

Not relevant.

#### Impact on Europe as a Business Location

Not relevant.

## Legal Assessment

### Legal Competence

The Commission is entitled to issue Recommendations to Member States to ensure the proper functioning and development of the common market (Art. 211 TEC).

### Subsidiarity

Recommendations of the Commission do not constitute binding measures (Art. 249 (5) TEC). It is left to the Member States' own decision whether or not to follow them. Therefore, the question of subsidiarity is not addressed.

### Proportionality

Not applied.

### Compatibility with EU Law

Unproblematic.

### Compatibility with German Law

In Germany, since 2005 capital companies and groups have been obliged to include the remuneration of each member of the managing board in an Annex to their balance sheet (§§ 285 (1) No. 9, 314 (1) No. 6 German Commercial Code – *HGB*). However, the general meeting may resolve to abstain from publishing names (§§ 286 (5), 314 (2) HGB).

Regarding the remuneration of managing boards of public limited companies, on 18. June 2009 the German Bundestag adopted an amending “Act on the Appropriateness of Executive Remuneration” (*VorstAG*) which, however, does not serve to transpose the EU Recommendation. The Act is to set incentives for remuneration structures so as to promote the economic sustainability of company management. In so doing, the German legislator is in line with the EU-Commission, even if certain details allow for separate provisions, which is relatively unproblematic due to the non-binding nature of the EU Recommendation.

The main changes resulting from the *VorstAG* are as follows:

- The entire supervisory board decides on the remuneration of management boards. The establishment of remuneration committees is no longer admissible.
- If the supervisory board fixes an “inappropriate” remuneration it is obliged to reimburse at least “the surplus amount compared to an appropriate remuneration” in the form of a minimum compensation.
- The supervisory board must cut remuneration if and when the financial situation of a company “deteriorates” and a continuation was considered “unfair”.
- Incentive-oriented remuneration promises must be in an “appropriate” relation to the tasks and performances of the management and must set long-term behaviour incentives for a sustainable company development.
- Share option rights may be exercised four years after being vested at the earliest (to date two years).

## Alternative Policy Options

Not foreseeable.

## Possible Future EU Action

Not foreseeable.

## Conclusion

Where Member States decide to dictate to all listed companies the principles of remuneration policy recommended by the Commission, as has happened in Germany, they massively intervene into the freedom of contract. Even if some margin for determining the structure and level of management remuneration nevertheless remains, the prescribed focus on long-term economic sustainability of companies and maximum limits for variable components of remuneration results in an inappropriate degree of paternalism of the supervisory boards and shareholders. Since outside the financial services sector there are no systemic risks inherent in remuneration policies, there is no justification for these interventions into the freedom of contract.