



THE GOVERNANCE ROLE OF THE REMUNERATION COMMITTEE

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Abstract

Executive Summary

Following the recent crises surrounding the international financial world, there has been a growth of requirements and regulations regarding the need for remuneration committees in an attempt to correct prior problems surrounding corporate governance. Recently, regulations have been evolving around this area of the corporate law; particularly, ever since such controversial cases as Walt Disney and scandals surrounding financial institutions, regulations have been developing internationally. Mostly, there have been recommendations regarding remuneration committees that addressing the structure of these committees and methods of evaluating remuneration policies.

In terms of structure, these committees vary depending on jurisdiction. In some countries, remuneration matters are decided by a supervisory board or by non-executive directors. In others, matters of remuneration can be determined by a committee delegated by shareholders.

Aside from structural differences, various jurisdictions assign different duties to remuneration committees. These duties are assigned through law or through corporate guidelines. Duties include such tasks as setting remuneration values and overseeing corporate information, and members also have an implied duty of care and loyalty.

Another area of concern for these committees is independence. Depending on the country, members can consist of independent directors or a majority of

independent members. Arguments exist for either side on whether the committee should be entirely independent to avoid bias or to have some non-independent members to ensure adequate functioning. One issue that results from having an overly independent committee are is in actually determining remuneration of directors: ensure a correlation between compensation and performance by understanding the functioning of the corporation. Furthermore, another issue linked to independence is the term timing between the remuneration committee and other corporate bodies—corporations must avoid restricting their committee to merely ratifying past decisions given this lag in timing.

It is important to understand these issues as international regulations continue to develop and evolve within the next few months and years. While some jurisdictions are headed in the right direction, some regulations might be impeding on the effectiveness of remuneration committees, contrary to their ultimate goal.

§ 1.º Introduction

1. The remuneration committee's role in the corporate governance system

I – The acknowledged significance of remuneration committees (also referred to as “compensation committees”) is increasing, especially given the recent development of literature about corporate governance on corporations and the intense flow of regulatory and recommendatory measures adopted during the last decades, recently intensified as a reaction to the international financial crisis.

The formation of remuneration committees is a manifestation of a process of recognition regarding the value of specialized committees in the corporate context. These committees promote a division of tasks and responsibilities between corporate players and, in this matter specifically, they allow a more professional and informed treatment regarding complex subjects¹.

Moreover, there are specific qualities relating to the remuneration committee that merit being mentioned. On the one hand, this type of committee promotes, in a decisive manner, the rigor and transparency of the remuneration setting process, given the segregation of the management function and the remuneration setting function, thus facilitating an adequate resolution of conflicts of interests². On the other hand, the remuneration committee may convene people that are qualified to ensure a more specialized treatment of these subjects – therefore responding to the increasing sophistication of regulation applied to remuneration and remuneration structures.

As a result, it is justified to devote attention *ex professo* to this concept, and the following pages are set to do just so.

¹ See, in general: MARCUS LUTTER, *Corporate governance aus deutscher Sicht*, ZGR Symposium zum 60. Geburtstag von Klaus Hopt (Mar.-2001) 229-232; MICHAEL KRAMASCH, *Organvergütung*, ZHR 169 (2005), 112.

² RICHARD GREENBURY (coord.), *Directors' Remuneration [Greenbury Report]* (1995), 4.3.

2. Recent regulatory evolution

I - The regulatory evolution regarding remuneration committees reflects the general trends of corporate governance regulatory sources, mainly in the last decades. Initially, regarding remuneration committees, there is a visible influence of “soft law”, in particular of corporate governance codes³. However, recently, there has been a noticeable amount of more concrete regulations that deal with these committees: in the United States and in Europe, remuneration committees were heretofore recommended, and now they are increasingly the subject of mandatory formation under legal and regulatory requirements.

In a generic reconstitution, two lines of facts are at the start of this change in the regulatory paradigm regarding remuneration committees. The first wave of regulatory interventions occurred in the 90's and at the start of the new millennium facing the progressive increasing of remuneration levels of directors (particularly in the US) and the exposure of controversial cases regarding excessive remunerations (e.g. involving managers at Walt Disney Co. (1998) and at the New York Stock Exchange (2003) ⁴). Added to these events, there was the debate concerning the change of the exercise price of call options (repricing), that came to be applied to some U.S. corporations, under the controversial claim that it only represented an update of remuneration conditions before unforeseeable market developments⁵. The problems that arose from this price change were considered relevant⁶, as it was recognized that it would undermine and impair the structure of incentives behind stock option plans⁷. The second wave of regulatory

³ PAULO CÂMARA, *Códigos de Governo das Sociedades, Cadernos do Mercado de Valores Mobiliários* n.º 15 (Dezembro de 2002), 65-90.

⁴ MICHAEL C. JENSEN/ KEVIN MURPHY/ ERIC WRUCK, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them*, ECGI - Finance Working Paper No. 44/2004 (2004); LAWRENCE CUNNINGHAM, *A New Legal Theory To Test Executive Pay: Contractual Unconscionability*, Iowa Law Review, vol. 96 (2011) e <http://ssrn.com/abstract=1762123>.

⁵ CHARLES CORRADO/ BRADFORD JORDAN/ THOMAS MILLER JR/ JOHN STANSFIELD, *Repricing and Employee Stock Option Valuation*, *Journal of Banking and Finance* 25 (2001), 1059-1082; MARY ELLEN CARTER/ LUANN LYNCH, *An Examination of Executive Stock Repricing*, *Journal of Financial Economics* 61 (2001), 207-225.

⁶ See article 4.2.3. *Deutscher Corporate Governance Kodex*; ASSOCIATION FRANÇAISE DE GESTION FINANCIERE, *Recommandations Sur Le Gouvernement D'Entreprise*, (2004), 3.

⁷ GUIDO FERRARINI/ NIAMH MOLONEY, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives*, cit., 291.

interventions regarding remuneration committees represented a reaction to the financial crisis initiated in 2007, in particular because, in many financial institutions, inadequate remuneration structures were detected, with a high level of importance given to short-term performance and inducing excessive risk taking⁸.

One point should be emphasized: if the reaction to the scandals in the beginning of the 21st century resulted in the need to strengthen the supervision bodies of corporations (in any governance models), the financial crisis initiated in 2007 led the corporate governance debate to focus on the need to perfect the process of remuneration setting. However, whereas the regulatory interventions at the start of the new millennium focused on corporations, this time the regulatory responses mainly (but not exclusively) targeted financial institutions, as we will demonstrate in the following analysis.

II – The revaluation of remuneration committees has been significant in the context of recent regulatory developments.

In the US, after some recommendatory interventions⁹, in 1992, the Securities and Exchange Commission established a requirement regarding the need to prepare a report concerning the remuneration structure of corporations, as to present annual information about the rationale of paid remuneration and its relation to corporate performance¹⁰. The statute established the regulatory acknowledgment of the functions to be performed by the remuneration committee, which had the task to formulate said report, signed by all respective members – although the SEC

⁸ As an recent official report stated: “*Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited*” (COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, *The Financial Crisis Inquiry Report*, (2011), xix). See also SANJAI BHAGAT/ ROBERTA ROMANO, *Reforming Executive Compensation - Simplicity, Transparency and Committing to the Long-Term*, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 393 (2009), 1-12.

⁹ JONATHAN CHARKHAM, *Keeping Better Company. Corporate Governance Ten Years On*², Oxford (2005), 240-242; NATIONAL ASSOCIATION OF CORPORATE DIRECTORS. BLUE RIBBON COMMISSION, *Executive Compensation and the Role of the Compensation Committee*, (2003).

¹⁰ Executive Compensation Disclosure, Exchange Act Release n.º 33-6962 (21 Out. 1992). See also MARTIN D. MOBLEY, *Compensation Committee Reports Post-Sarbanes-Oxley: Unimproved Disclosure of Executive Compensation Policies and Practices*, *Columbia Business Law Review* (2005), 115-137.

accepted that, in the absence of a remuneration committee, this document should be prepared by the board of directors¹¹.

The relevance of these committees increased in 2003 by the stock exchange rules established by the New York Stock Exchange, which directly required the formation of compensation committees composed by independent directors. A parallel regime, though mitigated, was adopted by the NASDAQ admission rules.

Recently, in March 2011, the SEC in the United States unanimously voted to propose new rules regarding standards related to compensation committees, in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010¹². These “listing standards” aim to enforce the independence of members on these committees and regulate their powers¹³. The proposed rules would require, among other things, standards for independence, regulation of the authority and funding of committee members, and requirements for stricter disclosures of conflicts of interest of consultants¹⁴.

In the United Kingdom, the treatment given to remuneration committees focused, at an early stage, on recommendations. The precursor Cadbury Report of 1992 already recommended to corporations the formation of remuneration committees fully or mostly composed by non-executive directors¹⁵. Further development regarding remuneration themes were brought by the Greenbury Report (1995) which resumed and developed the recommendations of the Cadbury Report¹⁶. This document was the product of a workgroup exclusively focused on remuneration issues, and dedicated an entire section to remuneration committees. The most relevant aspects that were added related to the internal regulation of the committee, the requirements applied to its member and the support to be provided for it in order to function efficiently. The recommendations established in

¹¹ Exchange Act Release n.° 33-6962, 402 (k) (3).

¹² U.S. SECURITIES AND EXCHANGE COMMISSION, *SEC Proposes Rules Requiring Listing Standards for Compensation Committees and Compensation Consultants*, Washington D.C. (30 Mar 2011), available at <http://www.sec.gov/news/press/2011/2011-78.htm>.

¹³ *Id.*

¹⁴ U.S. SECURITIES AND EXCHANGE COMMISSION. *Proposed Rules 17 CFR Parts 229 and 240: Listing Standards for Compensation Committees*, (2011), available at <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>, at 11, 20, and 47.

¹⁵ *Financial Aspects of Corporate Governance*, London (1992), 4.42.

¹⁶ RICHARD GREENBURY (coord.), *Directors' Remuneration [Greenbury Report]* (1995), at http://www.ecgi.org/codes/documents/greenbury_less_recommendations.pdf.

the Greenbury Report still remain, in its essence, in force – having been absorbed by the UK Corporate Governance Code 2012.

From the British example, the majority of corporate governance codes began to include recommendations regarding remuneration committees. This occurred namely in Germany¹⁷, France¹⁸, Belgium¹⁹, Italy²⁰ and Spain²¹. The Portuguese Corporate Governance Code²² is no exception, including in its content many prescriptions relating to remuneration committees²³.

III. In the European Union context²⁴, one needed to wait ten years after the Greenbury Report for the Recommendation 2005/162/EC, of February the 15th, 2005, which addressed the role of non-executive directors, to establish the formation of a remuneration committee, within the board of directors or the supervisory board - *where, under national law, the (supervisory) board is playing a role, either by making decisions itself or by making proposals for consideration by another corporate body, in the process for setting remuneration of directors, a remuneration committee should be set up within the (supervisory) board*. The Recommendation put forward additional instructions concerning the composition, role and operation of the remuneration committee. In the European context, this committee would essentially have a recommendatory mission, being responsible to present recommendations to the board of directors or supervisory board regarding remuneration matters, to which the competent body should decide according to national corporate law.

¹⁷ *Deutsches Corporate Governance Kodex*, (2010), 5.3.4.

¹⁸ ASSOCIATION FRANÇAISE DE LA GESTION FINANCIERE, *Recommandations sur le Gouvernement d'Entreprise*, (2010), II.B 2-3 e II.C.1.

¹⁹ *Code Belge de Gouvernance d'Entreprise* (2009), 5.4. and E.

²⁰ BORSA ITALIANA S.P.A./ COMITATO PER LA CORPORATE GOVERNANCE, *Codice de Autodisciplina*, (2006), 7.P.3.

²¹ COMISIÓN NACIONAL DE MERCADO DE VALORES, *Código Unificado de Buen Gobierno*, 44, 57-58.

²² The English version of the Portuguese Corporate Governance Code is available at <http://www.cmvm.pt/EN/Recomendacao/Recomendacoes/Documents/2010consol.Corporate%20Governance%20Recommendations.2010.bbmm.pdf>. In respect to the compliance of the Code, see PAULO CÂMARA/ MIGUEL ATHAYDE MARQUES/ LEONOR MODESTO, *Portuguese Market Report. Corporate Governance Index. Corporate Governance Rating* (2012)

²³ See CMVM, *Código do Governo das Sociedades*, (2010), sections II.1.5, II.5.2. and II.5.3.

²⁴ See EUROPEAN COMMISSION, *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM (2003) 284 final, 15-16.

The European recommendations regarding the remuneration committee would be developed, as a reaction to the financial crisis, by the Recommendation 2009/3159/EC, of April the 30th, 2009²⁵. This directive encourages a better technical preparation in the committee's composition, recommending that at least one member of the committees be sufficiently specialized in the remuneration subject. The Recommendation of 2009 also states that the committee's members should be present at the general meeting where the statement regarding remuneration is debated, in order to provide any needed clarification to the shareholders. It was also prescribed, so as to mitigate possible conflicts of interest involving remuneration consultants, that consultants who assist the remuneration committee should not simultaneously assist other company bodies.

An international text, representing a reaction to the financial crisis, that proved to be very influential in a recommendatory context was The Principles on Remuneration Practices of the Financial Stability Board (2009) ²⁶, followed by guidelines relating to its applications: in this document, many recommendations are made regarding the importance of the role of the remuneration committee in the design and review of the remuneration architecture²⁷.

The Basel Committee has also been very active in this area, publishing a method for the evaluation of remuneration policies of credit institutions and other additional documents, giving particular emphasis to remuneration committees²⁸.

More recently, in the financial sector, we have witnessed a hardening of regulatory standards by the European Union on her treatment of remuneration themes with the Directive 2010/76/EU of the European Parliament and of the Council, of November the 24th 2010. Among the many implications – at the same time developed in a long interpretative text prepared by the Committee of European Banking Supervisors (CEBS) (predecessor of the current European Banking

²⁵ JOÃO SOUSA GIÃO, *Conflitos de Interesses entre Administradores e Accionistas na Sociedade Anónima*, 274-291.

²⁶ FINANCIAL STABILITY FORUM, *Principles for Sound Compensation Practices* (Ab.-2009), at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

²⁷ See Principles 1 and 15 of the FINANCIAL STABILITY BOARD, *Principles for Sound Compensation Practices – Implementation Standards*, (Set.-2009), at http://www.financialstabilityboard.org/publications/r_090925c.pdf.

²⁸ See Standard 1 of BASEL COMMITTEE ON BANKING SUPERVISION, *Compensation Principles and Standards Assessment Methodology*, (2010), at <http://www.bis.org/publ/bcbs166.htm>; Id., *Consultation Report on the Range of Methodologies for Risk and Performance Alignment of Remuneration*, (2010), available at <http://www.bis.org/publ/bcbs178.pdf>.

Authority (EBA)²⁹ -, this Directive mandates that credit institutions that are significant in terms of size and internal organization, and nature, scope and complexity of activities should create a remuneration committee. According to the directive, the committee should be formed in a way that allows the formulation of informed and independent judgments regarding remuneration policies and practices, and the incentives created relating to risk, capital and liquidity management³⁰.

A similar course was established by the European Directive 2011/61/EU on alternative investment fund managers (AIFMD), concerning the formation of a remuneration committee requirement applied to alternative investment fund managers (including venture capital funds, real estate funds and hedge funds³¹) that are significant in terms of their size, or the size of the funds they manage, or internal structure and the nature and complexity of their activities³². It is expected that this solution will be extended to harmonize investment funds in transferable securities and to insurance companies, giving the content of the directives whose preparation is underway in these areas.

IV – In Portugal, it is also patent the increasing of regulatory and recommendatory interventions regarding remuneration committees. Apart from articles 399 and 429 of the Portuguese Companies Act, establishing, in general terms, the committee, the Law n. 28/2009, of June 19th, states that the remuneration committee or the board of directors should annually submit a statement concerning the remuneration policy to the shareholders general meeting. These regulatory elements will be analyzed later on³³.

²⁹ CEBS, *Guidelines on Remuneration Policies and Practices* (2010), p. 31-33, at <http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf>.

³⁰ Annex V section 11 of Directive 2006/48/CE, amended according to Directive 2010/76/EU, par. 24.

³¹ See DIRK ZETZSCHE (ed.), *The Alternative Investment Fund Managers Directive: European Regulation of Alternative Investment Funds*, Wolters Kluwer (2012).

³² Annex II, n. 3, of AIFMD. See PAULO CÂMARA, *The AFM's Governance and Remuneration Committees*, in DIRK ZETZSCHE (ed.), *The Alternative Investment Fund Managers Directive: European Regulation of Alternative Investment Funds*, Wolters Kluwer (2012), 237-251.

³³ See Law n. 28/2009, 19th June. See also PAULO CÂMARA, *Say on Pay: O dever de apreciação da política remuneratória pela assembleia geral*, *Revista de Concorrência e Regulação* n.º 2 (2010), 321-344.

In a sub-legislative context, it should be mentioned that CMVM's Regulation n. 1/2010, Banco de Portugal's Regulation n. 1/2010 and Instituto de Seguros de Portugal's Regulation n. 5/2010-R – complemented with a range of recommendations regarding remuneration included in the CMVM's Corporate Governance Code of 2010, Banco de Portugal's Regulation n. 2/10/DSBDR and ISP's Regulation n. 6/2010 – with indications regarding these committees respectively aimed at corporations, credit institutions and financial companies managing discretionary assets, and to insurance and reinsurance companies and managers of pension funds.

§ 2.º Structure and Functions

3. Structure

I – The remuneration committee does not have the same configuration in comparative terms. In relevant legal systems, one would identify three main types, depending if the remuneration committee is formed as:

- committees delegated by the board of directors;
- committees delegated by the supervisory body; or
- committees delegated by the shareholders general meeting³⁴.

II – In comparative terms, the most common model focuses on the allocation of attributions to a committee, appointed by the board of director, to deal with matters relating to the remuneration of its members (remuneration committees)³⁵.

³⁴ See, in Italy, STEFANO CAPIELLO, *La Remunerazione degli Amministratori. "Incentivi Azionari" e Creazione di Valore*, Milano, (2005), 146-190.

³⁵ GÉRARD HERTIG/ JOSEPH MCCAHERY, *On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture*, ECGI Law Working Paper n.º 25/2005, <http://ssrn.com/abstract=676417>, 17-18; LUCIAN BEBCHUK/ JESSE

This model involves important sub-types regarding its compositions and functions.

The members of these remuneration committees are mostly or exclusively, depending on jurisdictions, independent directors³⁶. This option is adopted by the United Kingdom³⁷; in the US, it is frequently the inclusion of independent members exclusively³⁸; in France, however, it is considered sufficient the presence of a majority of independent members³⁹.

Equally relevant is noticing that these committees, in some legal systems, take on decision functions (as in the case of the United Kingdom⁴⁰), whereas other countries prefer to confer them the role of presenting proposals on remuneration matters, where the final decision belongs to the board of directors. This is the case in France⁴¹ and Italy⁴².

This structural model of the remuneration committees is so widely spread that, sometimes, it is represented as the only one in international texts (e.g. European) and legal literature; which, as we will demonstrate, is Anglo-centric and incorrect.

III – The dualistic model of governance, which combines the existence of an executive board of directors and a general and supervisory board⁴³, typically confers, to this supervisory board, or in a committee composed by some of its

FRIED/DAVID WALKER, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, cit., 13-28; MICHAEL JENSEN/ KEVIN MURPHY, *Remuneration: Where we've been, how to get there, what are the problems, and how to fix them*, ECGI WP n.º 44 (2004).

³⁶ See *infra*, 16.

³⁷ FINANCIAL REPORTING COUNCIL, *Combined Code on Corporate Governance*, (2006), B.2.1.

³⁸ See *Wall Street Reform and Consumer Protection Act (2010)*; LUCIAN BEBCHUK/ JESSE FRIED/DAVID WALKER, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, cit., 13-14.

³⁹ Regarding the French regime, see AFEP/MEDEF, *Le gouvernement d'entreprise des sociétés cotées*, (2003), 13. e 15.1; KLAUS HOPT/PATRICK LEYENS, *Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United States, France, and Italy*, ECGI Law Working Paper n.º 18 (2004), 17.

⁴⁰ FINANCIAL REPORTING COUNCIL, *Combined Code on Corporate Governance*, (2010), D.2.2.

⁴¹ AFEP/MEDEF, *Le gouvernement d'entreprise des sociétés cotées*, (2003), 15.3.

⁴² COMITATO PER LA CORPORATE GOVERNANCE, *Codice di Autodisciplina*, (2006), 1.C.1. d).

⁴³ PAULO CÂMARA, *O Governo das Sociedades e a Reforma do Código das Sociedades Comerciais*, in *O Código das Sociedades Comerciais e o Governo das Sociedades*, Coimbra, (2008), 110-119.

members, the attribution to settle the directors' remuneration. One may find examples of this arrangement in Germany and Italy⁴⁴.

In Portugal, given the intense flexibility of this model of governance, this possibility is directly established by law, the company is allowed to designate by contract, as the competent body in these matters, the shareholders general meeting or the committee appointed by that body (article 429 of the Portuguese Companies Act).

IV – Lastly, there is also a governance model that allocates competency in remuneration matters of directors to the shareholders general meeting or to a committee delegated by that body.

This is a model that removes directors from the decision regarding their remuneration, given the risk of bias⁴⁵, and, consequently, it emphasizes the participation of other company's bodies' members or institutional investors in the decision process concerning remuneration of the members of the board of directors.

Even though this model is currently isolated in comparative terms⁴⁶, it has the deepest foundations in the historic process of corporation creation⁴⁷. This model is based on the distinction between management functions and remuneration setting functions; on the other hand, it may lead to the composition of a committee with a less technical profile as it does not require previous qualifications of its members, except regarding their independence.

⁴⁴ In Germany, see Art. 4.2.2. of the *Deutscher Corporate Governance Kodex*. In Italy, see art. 2409-*terdecies*, n.º 1 a) Cod. Civ..

⁴⁵ STEFAN WINTER, *Management- und Aufsichtsratsvergütung unter besonderer Berücksichtigung von Stock Options – Lösung eines Problems oder zu lösendes Problem?* em PETER HOMMELHOFF/ KLAUS HOPT/ AXEL V. WERDER, *Handbuch Corporate Governance*, cit., 337-339; NIGEL MAW et al., *Maw on Corporate Governance*, Dartmouth, Aldershot, (1994), 17.

⁴⁶ In Spain, see art. 130 da LSA and CÁNDDIDO PAZ-ARES, *El enigma de la retribución de los consejeros ejecutivos*, InDret Vol. 1 (2008) e em RMV n.º 2 (2008), 15-88; Id, *Ad impossibilia nemo tenetur (o por qué recelar de la novísima jurisprudencia sobre retribución de administradores)*, InDret Vol. 2 (2009).

⁴⁷ ELI HECKSCHER, *The Mercantilism*, 2 Vols., Garland Publishing: New York/ London, (1935), 360-372; HENK DEN HEIJER, *De VOC en de Beurs/ The VOC and the Exchange*, Amsterdam (2002), 20-26; FRANKLIN GEVURTZ, *The Historical and Political Origins of the Corporate Board of Directors*, University of the Pacific – McGeorge School of Law, (2004), 22-23; ARIBERTO MIGNOLI, *Idee e problemi nell'evoluzione della "company" inglese*, *Rivista delle Società* (1960), 639.

V – This system is the one that is in force in Portugal when it comes to the classical and the Anglo-Saxon governance model. In the Portuguese legal system, in the corporate context, article 399 of the Companies Act states that it is the responsibility of the shareholders general meeting or of a committee appointed by the shareholders general meeting to settle the remuneration of each director, according to the performed functions and the economic situation of the company (n.º 1). The same norm adds that the remuneration may be fixed or partially consist of a percentage of the company's net income, but the maximum percentage level awarded to directors should be authorized by a specific norm included in the company's contract (n.2). It bears mentioning that said percentage may not be based on reserve distributions or on the part of the profit that, by law, may not be distributed to shareholders (n.3).

Regarding the dualistic model, the responsibility on this matter lies with the general and supervisory board or with a committee appointed by this body, or, in the cases that the company's contract allows it, with the general meeting or a committee appointed by that body.

VI – It is important to underline that the Portuguese legal system distinguishes itself in allowing the creation of a remuneration committee in any given corporation, irrespective of activity, size, shareholder structure or share price. This aspect constitutes a remarkable difference when compared to other legal systems that only deal with listed companies or credit institutions regarding the creation of a remuneration committee.

4. Unity or plurality

The law does not forbid the creation of more than one remuneration committee within the same company, and, in reality, some Portuguese companies have done so. This possibility is particularly relevant when the company seeks to form

separate remuneration committees, one that deals with directors' remuneration and the other with the members of other corporate bodies.

Similarly, in the dualistic model, the following may coexist: the remuneration committee delegated by the general and supervisory board, which settles the remuneration of the members of the executive board of directors, and a remuneration committee delegated by the shareholders general meeting, which is responsible to set the remuneration of members of other corporate bodies.

Therefore, there is clearly the legal possibility of the existence of a dual structure of remuneration committees. Another question is whether, in terms of functions, the coexistence of two decision structures regarding remuneration is justified. The advantages of separation may lie in the increasing differentiation between the remuneration of directors with executive functions, and, on the other hand, the remuneration of members of other corporate bodies. However, a sole remuneration committee allows a more integrated and coherent vision of corporate decisions on remuneration matters⁴⁸.

5. Organization and legal duties of its members

I – The law does not establish rules regarding the organization of these committees. As in any corporate structure, recommendations usually include the existence of internal regulations, periodically reviewed, and minutes of meetings, to ensure its effectiveness.

The remuneration committee may not be established in the company's by-laws. Indeed, in the classical and Anglo-Saxon models, the law considers a nomination resolution to be sufficient (article 399 of the Portuguese Companies Act). On the contrary, the need to establish, in the by-laws of the company, the remuneration committee, is required in the dualistic model regarding directors' remuneration, when that function is allocated to a committee appointed by the general meeting (article 429 of the Portuguese Companies Act).

⁴⁸ See *infra*, 7.

However – and without diminishing the role of internal regulations of these committees - given the relevance of remuneration matters, it is considered a manifestation of good governance practices that the existence of remuneration committees should be included in the company's statutes irrespective of the governance model.

II – From the moments of their appointment, the committee's members are subject to the legal duties connected to the functions to be performed. Among those duties, it is included: the duty to set the remuneration of the members of corporate bodies; the duty to establish the remuneration policy and to periodically review it; the duty to oversee the information provided by the company regarding remuneration; and the duty to provide information – to the supervisory board and, when necessary, to the shareholders general meeting – about the activities of the committee⁴⁹.

In the United States, in addition to these aforementioned duties, the Dodd-Frank Act requires that the committee be given adequate resources to perform the exclusive duty to hire and oversee the work of advisors such as compensation consultants, legal counsel and others⁵⁰.

In spite of not being expressly stated *ex lege*, the members of the remuneration committee are subject to general duties of loyalty and care. Regarding the duties of loyalty, it is important to note that the recent Directive n. 2010/76/UE, of November the 24th 2010, focusing on credit institutions and investment companies, states that the remuneration committee should take into account the long term interests of the shareholders, investors and other stakeholders⁵¹.

As a direct consequence of the duty of care, one should mention the duty of gathering information that all members of the remuneration committee are subject to, in conjunction with corporate structures, the other bodies and existent corporate committees. The issue is the need to acquire sufficient knowledge over

⁴⁹ See CEBS, *Guidelines on Remuneration Policies and Practices*, 28.

⁵⁰ SIMONE M. SEPE, *Making Sense of Executive Compensation*, (2011), 36 Delaware Journal of Corporate Law 17.

⁵¹ Annex I, 24. 2 par. Directive n. 2010/76/EU.

the company's activity and all the other relevant elements for the design of the remuneration structure and its execution⁵².

As a consequence of their functions, members of the remuneration committee should collect information concerning the remuneration practices applied in the sector, as to better adjust the practiced remuneration levels⁵³.

The content and intensity of those general duties of care and loyalty deserve, however, an adaptation according to the adequacy principle (article 64.^o, n. 1), especially regarding the availability duty. Indeed, it is not required that members of the remuneration committee should occupy this post exclusively, as it is possible to combine it with other posts, as long as it does not undermine said loyalty obligations.

III – The recommendation concerning the presence in the general meeting of at least one representative of the remuneration committee is also relevant. The CMVM includes this recommendation in its Corporate Governance Code (II.1.5.6.), although it does not specify if it applies only to the annual general meeting or to all general meetings. Considering the goal of this recommendation, the following interpretation seems correct that it only applies to general meetings where remuneration issues are being discussed or are subject to deliberation. That is the line adopted by the European Recommendation 2009/3159/CE⁵⁴.

§ 3.^o Composition

6. Qualitative composition; independence

I – The assignment, through delegation, of decision powers in remuneration matters to the remuneration committee is followed by the recommendation that

⁵² CEBS, *Guidelines on Remuneration Policies and Practices*, cit., 28.

⁵³ See also *infra*, 8.

⁵⁴ See *supra*, 2.

its members - in listed companies - should be independent. According to section II.5.2. of the Portuguese Corporate Governance Code: *Members of the Remuneration Committee or alike shall be independent from the Members of the Board of Directors and include at least one member with knowledge and experience in matters of remuneration policy.*

The concept of independence is resumed in II.5.III of the same Code, which states that *it should not be hired to support the Committee in the exercise of its functions any natural or legal person which provides or has provided, over the past three years, services to any structure subject to the Board of Directors, to the Board of Directors of the company or that has to do with the current consultant to the company. This recommendation also applies to any natural or legal person who has an employment contract or provides services.*

The independence theme is relevant, namely because, according to a recent report produced by the OECD, this is one of the biggest liabilities of the national corporate governance system⁵⁵.

II – The concept of independence of the remuneration committee members is different from the one used in the Companies Code regarding members of the supervisory bodies (article 414, n. 5 of the Portuguese Companies Act), being sufficient that the members of the remuneration committee be independent from the members of the board of directors.

One should consider the composition of the remuneration committee. Although the original version of the Companies Code stated that the remuneration committee should be composed by shareholders, currently, the remuneration committee may be composed, in part or altogether, by non-shareholders – which, although opening doors to specialists on the matter, poses the risk that those posts will be occupied by people without the necessary knowledge regarding the company's activity.

⁵⁵ OECD/ CORPORATE GOVERNANCE COMMITTEE, *Peer Review. Board practices: Incentives and governing risks*, (2011), 74.

These difficulties significantly increase in the case of a company with a widespread ownership structure. These are the situations where the remuneration setting model by shareholder appointment may lead to functional adversities.

Thus, this raises the question on how, in functional terms, may the general meeting or the remuneration committee performs the functions that are allocated to them.

Interestingly, section 952(a) of the Dodd-Frank Act in the United States requires the SEC to adopt new rules by July 2011 providing that committee members meet enhanced independence standards⁵⁶. Specifically, boards will be directed to consider the compensation received by the compensation committee and also whether the compensation committee member is affiliated with the company or any of its subsidiaries⁵⁷.

III – The only way to ensure an adequate functioning of this body is to provide an adequate functional cooperation within the company.

Said cooperation does not undermine the attributions allocated to the remuneration committee. This collaboration is essential in two fundamental stages: in the preparation of the decisions of the remuneration committee; and in their execution. In both stages the inter-company collaboration is due in order to achieve an adequate functioning of that committee.

In short, it seems safe to conjecture that the independence of the remuneration committee does not result on self-sufficiency on remuneration matters⁵⁸. On the contrary: the independence and composition of the committee suggest a functional dependence to other company structures. This is not to say that the support coming from other structures leads to the impairment of the attributions of the remuneration committee – a result the law does not allow.

⁵⁶ MARTIN P. DUNN AND DAVID M. LYNN, *SEC Disclosure Developments*, (25 Apr 2011), PLI Order No. 2879: Corporate Law and Practice Course Handbook Series, 2.

⁵⁷ *Id.*

⁵⁸ See also *infra*, § 6.º, 11.

IV – The companies legal regime accepts that part of the remuneration of the directors may be a percentage of the company’s net income (article 399.º, n.2). Moreover, it mandates that the maximum percentage of the company’s net income to be used with that purpose should be established in the company’s contract.

The law does not elaborate on how the directors’ remuneration and the performance evaluation will interconnect.

For the purposes of this analysis, it is not relevant to examine if the mentioned legal absence is or is not unwelcome – i.e., whether this loophole should have been addressed by legal requirements or recommendations⁵⁹. Remember that the Corporate Governance Code expressly states that *the remuneration of the Members of the Board of Directors shall be based on performance assessment, determined by a performance assessment carried out by the company’s competent bodies*⁶⁰.

It is important to underline that this is not a secondary issue, in the sense that one of the main goals of directors’ remuneration is precisely to provide adequate incentives to promote the optimization of the executive directors’ performance⁶¹. The dynamic provided by the remuneration linked to performance (pay-for-performance) may constitute a powerful governance instrument, in the way that it strengthens the alignment of interests between the executive director⁶² and the company, promoting the creation of value⁶³.

Also, in quantity terms, the remuneration’s variable component of directors is usually important. According to data from 2006, the variable component was, on average, 47,4% of the total remuneration of listed companies⁶⁴.

⁵⁹ GUIDO FERRARINI/ NIAMH MOLONEY, *Executive Remuneration in the EU: the Context for Reform*, ECGI WP n.º 32 (2005).

⁶⁰ II.1.5.1.

⁶¹ GUIDO FERRARINI/ NIAMH MOLONEY, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives*, cit., 270, 273. See also *supra*, § 2.º, 2.

⁶² See art. 422.º-A, art. 423.º-D, art. 440.º, n.º 3 e 374.º-A, n.º 3) Portuguese Companies Act (CSC).

⁶³ REINIER KRAAKMAN / PAUL DAVIES/ HENRY HANSMANN/ GÉRARD HERTIG/ KLAUS HOPT/ HIDEKI KANDA/ EDWARD ROCK, *The Anatomy of Corporate Law. A Comparative and Functional Approach*, cit., 51-52, 67-68.

⁶⁴ INSTITUTO PORTUGUÊS DE CORPORATE GOVERNANCE, *Livro Branco sobre Corporate Governance em Portugal*, 118.

For clarifying purposes of questions related to variable remuneration, it is not sufficient to generally state, as Portuguese law does⁶⁵, that part of the net income of the company may be allocated to the remuneration of directors.

To illustrate this issue, there are complex problems behind the selection of performance criteria⁶⁶, or, in the case of stock options, their structure⁶⁷ or the setting of the exercise price⁶⁸. Likewise, the allocation of the variable bonus to the members of the board of directors involves certain knowledge of the company that usually evades the remuneration committee. The adequate design of the variable remuneration should equally counteract the risk of unlawful use of privileged information and the establishment of a short-term vision by the board of directors⁶⁹.

Regarding the Portuguese legal system, this issue affirms in irrefutable terms, again, the need of collaboration between the remuneration committee and other company's structures⁷⁰.

It should not be asked of a delegated body, which is recommended to be composed of independent members of the administration, to be able, by itself, to establish the criteria for the allocation of the global amount.

A solution to this problem would be to promote a change of the recommendations in force, so that the remuneration committee may include a non-independent member.

Portuguese recommendations follow the British example where it advocates the inclusion of only independent members. In many recommendatory texts, however, it is considered sufficient that the remuneration committee may be composed by a

⁶⁵ Art. 399.º, n.º 2 Portuguese Companies Act (CSC).

⁶⁶ INSTITUTO PORTUGUÊS DE CORPORATE GOVERNANCE, *Livro Branco sobre Corporate Governance em Portugal*, cit., 27-28; GUIDO FERRARINI/ NIAMH MOLONEY, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives*, cit., 281-284.

⁶⁷ WILLIAM KLEIN/ JOHN COFFE Jr., *Business Organization and Finance. Legal and Economic Principles*⁹, New York, (2004), 182; STEFAN WINTER, *Management- und Aufsichtsratsvergütung unter besonderer Berücksichtigung von Stock Options – Lösung eines Problems oder zu lösendes Problem?*, cit., 339-349.

⁶⁸ GUIDO FERRARINI/ NIAMH MOLONEY, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives*, cit., 289.

⁶⁹ STEFANO CAPIELLO, *La Remunerazione degli Amministratori. "Incentivi Azionari" e Creazione di Valore*, cit., 52-58.

⁷⁰ See *supra*, § 4.º, 8.

majority of independent member (for example in Spain⁷¹ and on the CEBS/ EBA guidelines⁷²).

In this context, it would be considered adequate to include a non-executive director in the remuneration committee – a solution that provides a sufficient, yet not excessive, connection to the executive management.

V – It is also important to analyze one practical obstacle linked to independence of judgment of the members of the remuneration committee: the time coincidence between their term and the term of the other company's bodies.

It is not unusual for the lists of members of the company's bodies to be presented to the elective general meeting to be preceded by negotiations between the candidates. Because of that reason, in some situations, the time coincidence of the appointment of new members of company's bodies and the term of the members of the remuneration committee may, in practical terms, diminish the period of the decision process and the effective influence performed by the committee.

It is clear that, in the legal context, the remuneration committee has the power to confirm or change the remuneration conditions previously adjusted⁷³. As established by the Supreme Court, the remuneration settled by non-competent bodies is invalid⁷⁴. However, the issue here is addressed in a purely functional perspective – taking into consideration the recommendation of MICHAEL JENSEN in that *remuneration committees must take full control of the remuneration process, policies, and practices*⁷⁵. Therefore, in this context, it is impoverishing to the vocation of the remuneration committee to restrict their role to ratifying decisions made by others.

⁷¹ MANUEL ANTONIO DOMÍNGUEZ GARCIA, *Retribución de los administradores de las sociedades cotizadas. La Comisión de Retribuciones*, em *Derecho de Sociedades Anónimas Cotizadas* (dir. RODRIGUEZ ARTIGAS et al.), II, Navarra, (2006), 1082-1083.

⁷² CEBS, *Guidelines on Remuneration Policies and Practices* (2010), 32.

⁷³ MENEZES CORDEIRO, *SA: Assembleia geral e deliberações sociais*, Coimbra, (2007), 143; Id., *Código das Sociedades Anotado*, cit., 979.

⁷⁴ See decision STJ 27-Jun.-2002 (MOITINHO DE ALMEIDA).

⁷⁵ MICHAEL C. JENSEN/ KEVIN MURPHY/ ERIC WRUCK, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them*, cit., 51-52.

On the one hand, the solution could be found in a link of continuity between the composition of the new remuneration committee and its predecessor, through the keeping in function of at least one member of the committee. However, this is a committee appointed by the general meeting and the imposition of a member may not be feasible (mainly in situations of transition of domain). Worst odds would have the creation of a term lag between each member of the committee – given the inconvenience generally accepted regarding staggered boards⁷⁶.

It seems a lag would be advantageous between the start of the exercise of functions of the remuneration committee and the board of directors. It would reinforce the role of the remuneration committee in preparation of new remuneration packages of future members of the company's bodies, and it would increase its *de facto* independence.

Therefore, the time lag between the term of the members of the remuneration committees and the term of the members of the board of directors would significantly increase the conditions of the efficient functioning of the remuneration committees.

7. Technical capacity

Links may be detected between the evolutionary path, in a Portuguese law context, of the audit committee and of the remuneration committee – in the sense that in both cases those company's bodies go through three fundamental stages of evolution: exclusive composition by shareholders; the permission of inclusion of non-shareholders; and recommendations promoting the inclusion of specialists⁷⁷.

The progressive centrality of the remuneration committees has been followed by a trend of increasing professionalization of the members. The evolution of recommendatory provisions has added to this situation. In this context, according to section II.5.2. of the Corporate Governance Code, *members of the Remuneration*

⁷⁶ See LUCIAN BEBCHUK/ ALMA COHEN/ CHARLES C. Y. WANG, *Staggered Boards and the Wealth of Shareholders: Evidence from a Natural Experiment* (2010), <http://ssrn.com/abstract=1706806>.

⁷⁷ PAULO CÂMARA, *Modelos de Governo das Sociedades Anónimas*, cit., 213.217.

Committee or alike shall be independent from the Members of the Board of Directors and include at least one member with knowledge and experience in matters of remuneration policy. Similar recommendations have been established in the banking and insurance areas⁷⁸.

In the case of consultants in remuneration matters being included in the remuneration committee, they should have no significant ties with the company's management, to accommodate their independence (as stated in II.5.3.⁷⁹).

8. Quantitative composition

Generally, it is unadvisable for the remuneration committee to be composed by just one member – according to Portuguese law, this possibility seems not to be permitted (article 399 of the Portuguese Companies Act refers to “a committee”). Moreover, only in the cases established by the law, is it possible to form company's bodies composed by only one member (article 278, n.2 of the Portuguese Companies Act).

As a reconstitution of the reasoning of this solution, the obstacles involving company's bodies with just one member relate to the greater vulnerability to impediments of a personal nature; a greater probability of a reduction of the independence in the exercise of functions; and the no use of people with good qualifications on remuneration matters in the committee.

Apart from this, there are no established rules regarding the quantitative composition of the remuneration committee. However, regarding efficiency, it seems that there are no advantages to having a large committee. The usual trend, observed in Portugal and in most jurisdictions, is the composition of these committees standing at three members⁸⁰.

⁷⁸ See Art. III.2 of Carta Circular 2/10/DSBDR Banco de Portugal and art. III.2 da Circular n. 6/2010 of Instituto de Seguros de Portugal.

⁷⁹ Cfr. *supra*, 16.

⁸⁰ In the US, see BARRY REITER, *The role of compensation committees*, FindLaw (2004). The British *Institute of Chartered Accountants* also recommended remuneration committees composed of three members, except in

