

ASSIGNMENT 1 - SEMESTER 2, 2009

Cover page

TITLE Essay topic 1

Part A

a. Provide an overview of the provisions in the Australian Corporations Act 2001 dealing specifically with directors' and executives' remuneration or emoluments;.

Part B

b. In view of the current Worldwide economic crisis, is it justifiable for governments to prescribe caps on directors' or executives' remuneration or emoluments in legislation (statutes) or is it a matter that should be left to boards of directors or shareholders to determine depending on the particular circumstances of each and every company."

UNIT CODE & NAME: MLM706 'Corporate Governance'

UNIT CHAIR: Professor Jean J Du Plessis

STUDENT NAME & NUMBER: DAVID LEE 700098839

Contact details:

David Lee

Manager - Tax & Treasury

Electrolux Home Products Pty Ltd

Direct: +61 (0)2 9317 9692 **Mobile:** +61 (0)418 220 272 **Fax:** +61 (0)2 9317 9700 **Switch:** +61 (0)2 9317 9500

Address: 163 O'Riordan Street, Mascot NSW 2020 **Mailing Address:** Locked Bag 5017, South Sydney Business Centre, Alexandria NSW 2015, Australia

www.electrolux.com.au www.thinkingofyou.com.au

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Introduction

The executive remuneration has been in the spot light for many years in different shape or form, especially with collapse high profile companies in US like Enron, and WorldCom in 2001 and more recently Leman Brothers, and Washington mutuals, and HIH/Ansett etc, in Australia. The issue has also been subject of many reports, inquiries and reviews in many countries around the world, some of which I will refer to in the essay.

In this paper, 'Part A' looks into relevant sections of the Corporation Act 2001, that deals executive remuneration, and 'Part B' concentrates on current issues regarding executive remunerations and arguments for and against legislating caps on remunerations paid to executives and lastly some recommendations to address concerns raised in curbing executive pays.

Part A

Background

The Corporations Act 2001 (Cth), (Corporations Act) is an act of the Commonwealth of Australia that sets out the laws dealing with business entities in Australia at federal, states and territories. The Corporations Law came into effect on 1 January 1991, and it is the culmination of eight separately legislated Corporation Acts in force in Australia in the Australian Capital Territory, the Northern Territory, and each of the six states of Australia. The Corporations Law, among other things, deals with the registration of foreign companies, dealings between or by companies, officers of companies, prospectus requirements, raising of capital, and take-overs (Du Plessis, McConvill and Bagaric, 2005).

The Corporations Act is the principal legislation regulating companies in Australia. Australian Securities and Investment Commission through ASIC ACT is responsible for the administration of the ACT. Section 1(2) of the ASIC Act requires ASIC to (ASIC website, Accessed July 2009):

- maintain, facilitate and improve the performance of the financial system and entities within it
- promote confident and informed participation by investors and consumers in the financial system
- administer the law effectively and with minimal procedural requirements act to enforce and give effect to the law

- receive, process and store, efficiently and quickly, information that is given to ASIC, and
- make information about companies and other bodies available to the public as soon as practicable.

The Act gives statutory force to many common law principles and imposes a number of additional fiduciary duties on directors of incorporated bodies. Breach of statutory duties draws penalties under the Act which range up to \$220,000. Under both the common law and the Corporations Act 2001, officers may also be required to pay compensation or to account for profits. In some cases directors may also be disqualified from office.

Following is a brief overview of relevant sections dealing with remuneration or emoluments of executives, executive directors and non-executive directors.

Remuneration, the remuneration report and disclosure requirement

Listed company's remuneration arrangement with its directors and most senior management is required by ASX listing rules (LR 4.10.3), Accounting standards (AASB 1046), and by Corporations Act. Sec. 300A of the Act prescribes detail of the information to be included in the director's report. The details are supplemented by corporation's regulation 2M.3.03 which in turn cross reference to accounting standard. The purpose of all this disclosure requirements is to overcome the lack of transparency surrounding company remuneration practices and to ensure the directors and senior managers' act in the best interest of shareholders. Amendments to the statutory disclosure requirements were made through 'The Corporate Law Economic Reform Program 9 (CLERP 9) Act 2004' (Austin and Ramsay, 2007, pp. 557-560).

Sec 9 of Corporation ACT defines remuneration as follow:

Remuneration of an officer or employee of a corporation: A benefit given to an officer or employee of a corporation is **remuneration** if and only if the benefit, were it received by a director of the corporation, would be remuneration of the director for the purposes of an accounting standard that deals with disclosure in companies' financial reports of information about directors' remuneration. (*Corporations Act*).

remuneration report means the section of the directors' report for a financial year for a listed public company that is included under subsection 300A(1). This section requires, board policy discussion, performance condition, and detailed remunerations disclosure of

directors and five highest paid executives to be reported. This includes all benefits received, receivable or otherwise made available (*Corporations Act*).

Termination payments

Sec 200A - 200J of corporation Act deals with Termination payments. This section restricts a company giving benefits in connection with retirement from board or managerial office which generally needs membership approval. ss 200F, G, and H 200H provide exceptions to this rule.

Generally, the *Corporations Act 2001* (Cth) (*Corporations Act*) prohibits the payment of a benefit in connection with a person's retirement from a board or managerial office unless the company gets shareholder approval or a specific statutory exception applies.

The exceptions to the need for shareholder approval apply in respect of payments made in consideration for the agreement to take office, damages payments for breach of contract and payments for past services rendered, and are subject to a formulaic cap under the *Corporations Act*.

The upper limit on payments which can be made under the exceptions to the shareholder approval requirement are for executives with:

- three years' service or more, the person's average annual remuneration over the past three years multiplied by the number of years' service (capped at seven years), and
- with less than three years' service, the total remuneration paid to the person during the period of service.

If a recipient receives a benefit unlawfully it's deemed to have received it in trust (s. 200J) for the company with strict liability and is accountable accordingly (*Corporations Act*).

Related party transactions

Sec 207-230 – regulates the related party transactions, its purpose is to protect the interest of public company members as a whole by requiring member approval for giving financial benefits to related parties that could endanger those interests (*Corporations Act 2001*).

Part B:

Illustration by David Simonds (Times Oline)



Issues with executive remuneration

Many concerns have been expressed about various aspects of executive remuneration some of them are (various reports and submission to Productively Commission Review 2009):

- the independence of the board of directors or remuneration committee from executives, especially the CEO;
- the quantum of base pay, annual bonus and long term incentives compared to average earnings and historical executive remuneration levels;
- a perceived lack of transparency between remuneration and performance, due, for example, to complexity or confidentiality ;
- the short-term focus and/or excessive risk taking induced by some performance hurdles;
- the ability for measures of performance to be manipulated, and
- termination benefits provided in circumstances of individual or company underperformance, and many more which are outside the scope of this paper.

Financial crisis and executive pays

The executive remuneration has been in the spot light for many years in different shape or form (specially with collapse high profile companies in US like Enron, and Worldcom in 2001 and more recently Lemman Brothers, and Washington mutuals, and HIH/Anset etc, in Australia), and it has been subject of many reports, inquiries and reviews in many countries around the world. However in recent time due to worldwide economic/financial crisis which was climaxed in Oct 2008 with the collapse of Lemman Brothers in the US and resulted in a credit freeze worldwide, it has gained more attention with governments and

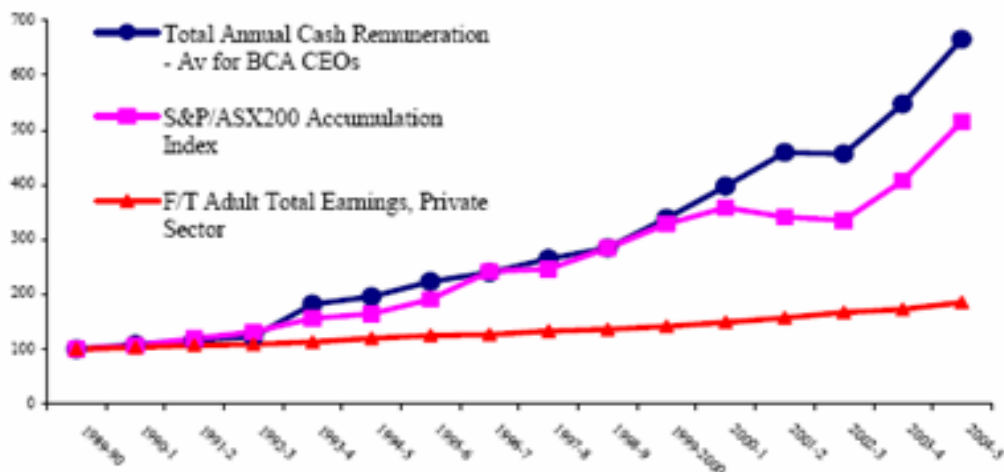
general public being concerned as to what role did executive compensation really played in this crisis.

Keller and Stocker in an article in *The National Law Journal* (November 2008), titled, “Executive compensation. Role in the Financial Crisis” states that “How could the masters of the world's most sophisticated banks and financial institutions stake the lives of their businesses on collateralized debt obligations and mortgage-backed securities that have proved to be so toxic?” they argued that the answer may lie in the murky world of executive compensation.

Evolution of executive pays

As shown in figure 1 and table 1 below, executive pay from 1989 – 2005 in Australia has increased by 564% while at the same period full time adult earning has increased only by 85%. (Sheilds, 2005). This is even worse in the US, where in 1980 average CEO pay of a publicly listed company was 42 time of an average worker and by 2007 it jumped to 344 time of an ordinary workers pay (figure 2).

Figure 1: Growth Indices for Average Total Cash Remuneration of BCA CEOs, Total Shareholder Return and Private Sector Average Ordinary Time Total Adult Earnings, 1990-2005 (1990 = 100), (Sheilds, 2005).



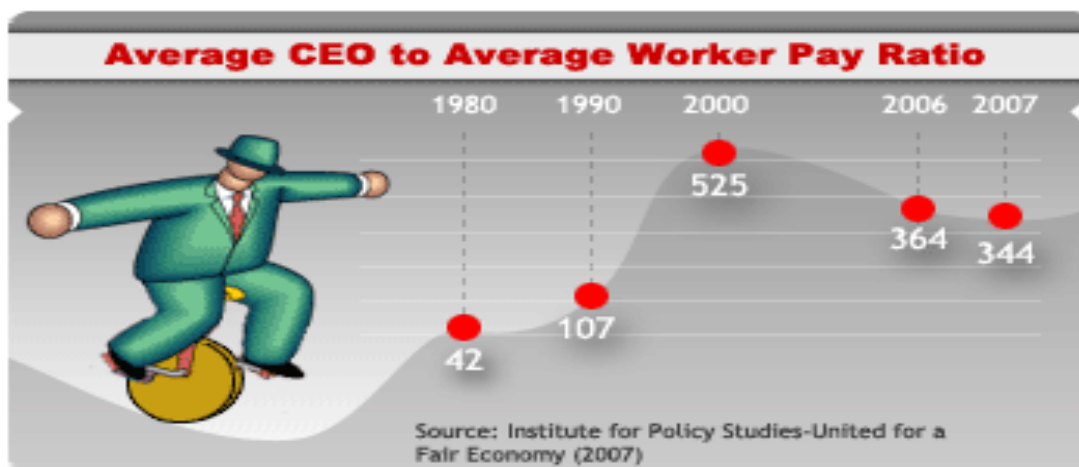
Sources: Company Annual Reports; *Connect4* Database; S&P/ASX200 Accumulation Index, Reserve Bank of Australia; Australian Bureau of Statistics: Average Weekly Earnings, Australia (6302.0).

Table 1: BCA CEO Cash Remuneration, Shareholder Return and Adult Earnings: Trend Comparisons, 1990-2005, (Sheilds, 2005).

Year	Number of BCA firms in annual sample	Average BCA CEO total cash remuneration (\$AU million, unadjusted)	Full time adult total earnings, private sector, (May Quarter, seasonally adjusted & annualised) (\$AU, unadjusted)	Ratio of CEO remuneration to average earnings
1989-90	30	514,433	29,198	18:1
1990-91	30	560,667	30,040	19:1
1991-92	35	597,857	31,184	19:1
1992-93	33	631,364	31,798	20:1
1993-94	31	934,355	33,067	28:1
1994-95	34	1,008,735	34,928	29:1
1995-96	34	1,148,421	36,494	31:1
1996-97	38	1,234,625	37,170	33:1
1997-98	39	1,363,144	38,745	35:1
1998-99	47	1,464,324	39,816	37:1
1999-00	45	1,744,988	41,371	42:1
2000-01	42	2,041,921	43,414	47:1
2001-02	46	2,363,594	45,087	52:1
2002-03	45	2,343,796	48,896	48:1
2003-04	46	2,813,377	50,393	56:1
2004-05	49	3,420,507	54,080	63:1
Gross increase (non-inflation-adjusted) 1990-2005		564%	85%	
Average annual growth (non-inflation-adjusted) 1990-2005		13.5%	4.2%	

Sources: Company Annual Reports; *Connect4* Database; S&P/ASX200 Accumulation Index, Reserve Bank of Australia; Australian Bureau of Statistics: Average Weekly Earnings, Australia (6302.0).

Figure 2: 2008 Trend CEO pay,



Source: The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) – (Trend in CEO pay, 2008)

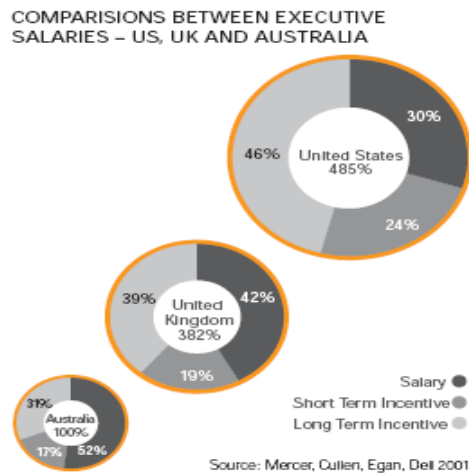
Case against more regulation or cap on executive pay

a) The Business Council of Australia (BCA) Position on Executive Pay

In June 2004, in response to the proposed *CLERP9* legislation, and in particular the proposal to allow shareholders a non-binding vote on proposed CEO remuneration packages, the council executive released a 'position paper' on the issue (BCA, 2004) which can be summarised as follows:

- The market for executive labour differs from that for 'average workers' in that the supply of executive skills is 'extremely small'.
- Critics devote undue attention to pay in a small number of large companies and overlook the lower level of remuneration paid by smaller firms.
- Australia listed companies have no choice but to offer rewards comparable to those offered by unlisted firms trading locally, yet the CEOs of unlisted firms are not subject to disclosure rules, and generally face fewer stakeholder demands, pressures and responsibilities, while the greater scrutiny applied to listed companies may serve to keep their executives' salaries 'artificially low' and hence may produce 'a lesser quality of corporate leadership'.
- Australian companies compete in the global economy and global labour markets and, to attract 'the best executive talent', must therefore align executive salaries with 'international benchmarks'.
- The level of remuneration paid to CEOs of Australian-based companies is lower than that paid in 'other countries' (i.e. the USA and the UK).
- The average tenure of Australian CEOs is both shorter than that of CEOs elsewhere and continuing to fall, the implication being that Australian boards are already particularly vigilant regarding CEO under-performance, while CEOs are under unusually strong pressure to deliver results quickly.
- Unlike other employees, executives 'lack specific protections from dismissals'; hence securing contractual provision for compensation for early termination is a legitimate concern for any incoming CEO.

Figure 3: Comparative executive salary UK, USA, an AU



b) The Australian Institute of Company Directors (AICD) position Executive Pay

In a press release on 12 Feb 2009 AICD has called on company boards to critically assess their approach to executive remuneration ([AICD, Feb 2009](#)). It stated that the Global Financial Crisis has highlighted the difficulties faced by listed company boards in setting appropriate executive remuneration structures and incentives for CEOs and other senior executives. It also acknowledged that there have been mistakes made, which have contributed to public concern about the size of executive salaries and termination payments which fuelled calls for regulation and other restraints.

According to ACID it is the board, not shareholders or government, where the responsibility for remuneration setting and monitoring should continue to reside.

See **Appendix 1** for summary of the ACID guideline.

Case for more regulation or cap on executive pay

a) The Australian Council of Trade Unions (ACTU)

ACTU in its submission to Productivity Commissions, (2009) has suggested the following measures to deal with some of the concerns that have been raised regarding executive remuneration ([ACTU submission, 2009](#)) :

- binding ‘say on pay’ for executive remuneration
- shareholder approval of senior executive employment arrangements and termination benefits, and

- disclosure by government and institutional shareholders of their voting policy and position on the issue.

In its submission ACTU explains that the executive remuneration is out of control citing that between 1990 and 2005, the average cash remuneration of CEOs in Top 50 listed Australian companies rose by 564 percent, from \$514,000 to \$3.4 million, or 10.7% per annum adjusted by inflation. During the same period, average full-time earnings only rose 85%, or 1.4% per annum adjusted for inflation (see also Figure 1 and Table 1 above). The result is that top CEO pay has jumped from a multiple of 18 times average full-time earnings to a multiple of 63. The ballooning of executive remuneration is contributing to greater income inequality in Australia. In 1993, the top 10% of wage earners earned 5.6 times what the bottom 10% earned. However, by 2006, the top 10% of employees were earning 7.6 times more than the lowest paid workers (ACTU submission, 2009).

ACTU goes on to say that the existing regulations have failed in preventing the rent-seeking behaviour of company executives and directors. It argues that the major flaw has been the voluntary nature of 'regulation' to date. As expected, non-binding pay guidelines and non-binding shareholder votes on executive pay have had little or no effect on corporate behaviour (ACTU submission, 2009).

b) The Australian Council of Super Investors (ACSI)

The Australian Council of Super Investors (ACSI) also in its submission to the Productivity Commission has suggested a requirement for more explanation and transparency of the links between pay and performance (ACSI submission, 2009).

Actions taken in Australia to curb executive pays

On 18 March 2009, (Commonwealth Treasury) the Treasurer, Wayne Swan, and the Minister for Superannuation and Corporate Law, Senator Nick Sherry, made a joint announcement proposing reform of the Corporations Act 2001 (Cth.).

See '**Appendix 2**' for more details

Recommendations and conclusion

In conclusion, corporation's legislation, the listing rules of the ASX and the general law do provide significant protections and disclosure for shareholders and other stakeholders regarding executive remuneration, these include:

- obligations on directors to act in the best interests of the company;
- the prevalence of board remuneration committees (in order to meet their obligations in the context of executive remuneration, boards frequently take external advice regarding the reasonableness of remuneration, together with financial and legal advice);
- the presence of independent directors on boards;
- requirements for shareholder approval of some termination payments and the provision of benefits to related parties;
- restrictions on the provision of 'change of control' benefits ;
- restrictions on the issue of securities and certain termination payments;
- specific disclosure requirements for CEO employment arrangements and general disclosure requirements in respect of remuneration including the requirement for an annual 'remuneration report' setting out general policy regarding remuneration and how this is linked to performance, as well as specific information regarding remuneration provided to certain executives, and
- the non-binding vote by shareholders on the remuneration report, or 'say on pay'.

However despite this, the current protection and disclosure rules and AICD guideline of good corporate governance, considering the facts presented above, it is obvious more that more need to be done, to curb exuberant executive pays. The board of directors of many public companies have failed to adequately address the issue. Therefore some tightening of the rules and some caps of various type of executive remunerations maybe necessary, in order to bring the executive pays closer to those of ordinary workers, without restricting private enterprises in there ability to attract and retain the best executive talent. Some of the recommendations are:

- linking bonuses to long term performance rather than short term;
- a right of 'clawback' of termination and other payments in certain circumstances, such as where future earnings or performance are not achieved;
- use of both quantitative and qualitative objectives to measure performance,

- changes to the tax treatment for employers and employees in regard to executive remuneration above \$1 million, i.e. higher tax rate for the employee and, non tax deductibility of pays above this level for the employer ;
- limits on termination payments to executives, as suggested by government as part of the Productivity Commissions review ;
- Making the non-binding vote by shareholders on the remuneration report, or 'say on pay' binding;
- have in place a remuneration policy that covers various matters including alignment of remuneration arrangements with the long-term financial soundness of the institution and its risk management framework,
- establish a board remuneration committee comprised entirely of independent directors with the requisite skills and knowledge to perform its functions.
- amending the Corporations Act to cap termination payments at one year's average base pay unless shareholder approval is obtained
- extending the Corporations Act shareholder approval requirements to cover termination payments made to any 'key management personnel', and
- expanding the definition of 'termination benefit' under the Corporations Act to catch all types of payments, benefits and rewards given on termination (other than statutory superannuation).

It would also be useful to have a uniform mandatory good corporate governance code that applies to all listed and unlisted public companies.

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Appendix 1

ACID guideline includes:

- “Stress testing” of proposed incentive arrangements prior to accepting them or agreeing to variations to understand the impact of changes in economic or market circumstances.
- Adopting an appropriate mix of base pay, short-term incentives and long-term incentives and considering other possibilities, such as base pay and long-term incentive plan only, combined with superannuation.
- Linking incentive elements to an appropriate set of performance measures, ensuring that they promote long-term performance of the company and wealth creation for its owners.
- Ensuring the issue of termination payments, particularly for non-performance, is addressed when drafting the executive’s contract.
- Having executives involved in setting their own remuneration.
- Putting in place arrangements which promote excessive risk-taking or “short-termism”.
- Providing for additional termination payments beyond the date of termination and statutory entitlements where an executive’s employment is terminated for misconduct.
- Changing performance hurdles in executive pay contracts in mid-stream without exceptionally good reason.
- Engaging with shareholders and other relevant stakeholders on their company’s approach to remuneration and where a material change in remuneration arrangements has been made.
- Whether to have a discretionary bonus rather than a bonus which the board is contractually obliged to approve regardless of changed circumstances.
- Whether they should place an upper bound on short and long-term incentive rewards.
- Putting in place arrangements where a percentage of a CEO’s long-term equity incentive benefit is withheld for a period beyond the term of the employment contract.
- Examining the range of performance measures available other than just comparative market data.

Appendix 2

Actions taken in Australia to curb executive pays

On 18 March 2009, (Commonwealth Treasury) the Treasurer, Wayne Swan, and the Minister for Superannuation and Corporate Law, Senator Nick Sherry, made a joint announcement proposing reform of the *Corporations Act 2001* (Cth) (Corporations Act) in respect of termination payments. (Freehills, June 2009):

- amending the Corporations Act to cap termination payments at one year’s average base pay unless shareholder approval is obtained
- extending the Corporations Act shareholder approval requirements to cover termination payments made to any ‘key management personnel’, and

- expanding the definition of 'termination benefit' under the Corporations Act to catch all types of payments, benefits and rewards given on termination (other than statutory superannuation).

The Productivity Commission is aiming to release its executive remuneration issues paper by early April 2009. The final report will then be submitted to the government by 18 December 2009.

In addition, at the request of the Federal Government, the Australian Prudential Regulation Authority (APRA) has released draft principles to guide businesses engaged in the financial services industry in considering executive pay which require boards to (Freehills, June 2009):

- have in place a remuneration policy that covers various matters including alignment of remuneration arrangements with the long-term financial soundness of the institution and its risk management framework, and
- establish a board remuneration committee comprised entirely of independent directors with the requisite skills and knowledge to perform its functions

The United States

President Obama made headlines around the world, with the announcement of strict new regulations on executive compensation for financial services firms and companies set to receive part of the US government's \$700 billion financial rescue plan, the Total Asset Relief Program (TARP).

Companies have received government assistance either through generally available programs, such as the government's capital-injection effort, or through specifically designed rescue packages tailored to their business needs. Companies in the later category receiving 'exceptional assistance', such as Bank of America Corp. and Citigroup Inc., have been subject to more onerous conditions in respect of executive remuneration (Freehills, March 2009).

. Most recently, the American Recovery and Investment Tax Act of 2009 was signed into law on 17 February 2009, revising restrictions on executive remuneration.

Europe

European companies wishing to receive government financial support have also been subject to conditions relating to executive compensation (Freehills, March 2009).

In Switzerland, UBS AG, the only Swiss bank to receive a government bailout so far has announced that senior executives would not be receiving bonuses for 2008 and any compensation arrangements are to be subject to government oversight.

In Norway, the senior executives in the banking sector are taking action ahead of any government-imposed cap, promising to voluntarily freeze their salaries.

President Sarkozy in France has placed restrictions on golden parachutes for executives of company's benefiting from state handouts and has established an oversight committee to

oversee executive compensation. Similar measures are also being taken in Ireland and Germany.

UK regulation

The UK Financial Services Authority (FSA) has been the first regulator to publish an industry wide comprehensive code of practice on remuneration.

On 26 February 2009, the UK's financial regulator, the FSA published its code of practice on executive remuneration. The code follows a letter which the FSA sent out to all bank and building society Chief Executive Officers in October 2008. This letter set out a number of guiding principles for financial institutions to adhere to when determining executive remuneration structures. The code is largely consistent with these principles, although there is some slight variation (Freehills, March 2009).

Whilst the Cadbury Report (1992) made several recommendations on good practice, the general opinion was that it did not go far enough with regards to executive pay (Association of British Insurers 1994). The Cadbury Report's prime recommendation connected with pay was the establishment of a Remuneration Committee. This committee was to be more independent, consisting of wholly (or mainly) non-executive directors; furthermore, the pay setting procedures were to demonstrate greater transparency.

Greenbury Report (1995) reinforced the Cadbury approach by extending the role and the independence of the remuneration committee, which should be composed entirely of non-executive directors and report directly to shareholders via the annual report and accounts (including the chair of remuneration committees attending the company's AGM). The remuneration committee were to cover all aspects of remuneration including service contracts, severance pay, bonuses, incentive schemes and disclosure of these in the remuneration committee's report.