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Book Review

Lucian Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA, and London, UK, Harvard University Press 2004) xii + 278 pp., ISBN 0-674-01665-3
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Executive compensation has been a topic of intense debate in the United States for decades. The controversy goes back to the early 1990s when, on the one hand, the high average level of CEO pay drew critical attention from the media and the public at large and, on the other hand, prominent financial economists urged companies to structure pay packages to provide managers with incentives to increase the value of the firm in the long run, regardless of the sociological or moral discussions on the amount of compensation granted.[1] Throughout the following decade, a new executive pay pattern has emerged and become dominant: US public companies have been inclined to raise executive compensation with the specific aim of improving the sensitivity of managers' wealth to company performance.[2]

The escalation of executive compensation has renewed public criticism and prompted a steep increase in academic research on the subject.[3] The conceptual paradigm largely assumed in the theoretical and empirical literature focusing on the issue has been the so-called 'arm's-length bargaining' approach. Under this approach, executive compensation practices in publicly traded companies are viewed as if they were the product of a negotiating process between senior executives, attempting to get the best possible deal for themselves, and the board

[1] See especially M. Jensen and K.J. Murphy, 'CEO Incentives: It's Not How Much You Pay, But How', 68 *Harvard Business Review* (1990) p. 138; and M. Jensen and K.J. Murphy, 'Performance Pay and Top Management Incentives', 98 *Journal of Political Economy* (1990) p. 225.

[2] Between 1992 and 2000, the average real (inflation adjusted) pay of chief executive officers (CEOs) of S&P 500 firms more than quadrupled, climbing from \$3.5 million to \$14.7 million. This increase far outstripped that of compensation for other employees. In 1991, the average large-company CEO received approximately 140 times the pay of an average worker, while in 2003 the ratio was about 500:1. The most pronounced component of the trend has been the explosion in stock option grants, with the value of option-based compensation (on a Black-Scholes basis) increasing ninefold during the bull market of the 1990s (figures drawn from p. 1 of *Pay without Performance*).

[3] Since the early 1990s, the number of studies aimed at explaining the various features of executive compensation arrangements has grown even faster than the CEO pay packages: see K.J. Murphy, 'Executive Compensation', in O. Ashenfelter and D. Card, eds., *Handbook of Labor Economics*, Vol. 3, bk. 2 (New York, Elsevier 1999).

of directors, seeking to get the deal that would maximise shareholder value.[4] Yet, the contractual view is not the only point of view from which scholars have been looking at the phenomenon. Departing from the traditional path, a certain number of legal, organisational or sociological studies have claimed that various factors hinder directors' capacity to negotiate with senior executives on level ground. This assumption has furthermore been supported by several empirical papers by financial economists who have reported findings considered inconsistent with the arm's-length contracting view.[5]

Pay without Performance carries this critical approach towards the arm's-length perspective further, building on the evidence and developing the ideas exposed by Lucian Bebchuk and Jesse Fried in their previous works on executive pay.[6] In particular, the book has two distinguishing attributes in comparison with the previous literature on the same topic. First, it aims to provide a systematic account of all the different kinds of flawed arrangements that affect executive pay in US publicly traded companies, arrangements that the authors claim 'have been providing weaker incentives to reduce managerial slack and to increase shareholder value than would be the case under arm's-length contracting', and have created perverse 'incentives to misreport results, suppress bad news and choose projects and strategies that are less transparent to the market' (p. 10). Second, the book frames the discussion on executive pay within a broader normative analysis of the US corporate governance system. Indeed, the authors move from the flaws of the pay-setting process to question, in the last part of the book, the fundamental premise of the current US corporate governance system: the ability of boards to generally act in the shareholders' interests *vis-à-vis* the company's senior executives.

The work is divided into four parts. The first one breaks down the various reasons that should lead to the conclusion that the 'arm's-length approach' does not explain the relationship between directors and executive managers, at least as far as executive compensation is concerned. To demonstrate their assertion, the authors focus on various financial and non-financial factors that should put

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[4] In most US corporations, the board of directors is responsible for determining the compensation of the CEO and other top executives, following the indications of the internal 'compensation committee'. However, corporate by-laws may grant the compensation committee full and exclusive authority on the issue.

[5] See, among others, L.J. Barris 'The Overcompensation Problem: A Collective Approach to Controlling Executive Pay', 68 *Indiana Law Journal* (1992) p. 59; E.W. Orts, 'Shirking and Sharking: a Legal Theory of the Firm', 16 *Yale Law and Policy Review* (1996) p. 265; C.M. Yablon, 'Bonus Questions – Executive Compensation in the Era of Pay for Performance', 75 *Notre Dame Law Review* (1999) p. 271.

[6] See L. Bebchuk, J. Fried and D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', 69 *University of Chicago Law Review* (2002) p. 751; L. Bebchuk and J. Fried, 'Executive Compensation as an Agency Problem', 17 *Journal of Economic Perspectives* (2003) p. 71.

managers in the position to have considerable influence over the board of directors. Among these factors, a key role is attributed to the CEOs' power over the process that leads to the appointment of directors on the board:[7] fearing not being re-elected – Bebchuk and Fried posit – directors are reluctant to displease CEOs, especially over the compensation issue (p. 25). Furthermore, Bebchuk and Fried recall that past experiences show that CEOs can directly or indirectly benefit individual directors of the company in various ways, using their capacity to channel the company's resources towards the directors' own field of activity (pp. 27-31). And even putting aside the aforesaid economic incentives that directors have to favour managers, Bebchuk and Fried maintain that social and psychological factors[8] and the heavy reliance on compensation consultants (who have their own interest in pleasing executive managers of the company) would provide for further distortions of the pay-setting process in favour of executive managers (pp. 31-34), especially considering that countervailing forces that could make it costly for directors to favour executives appear to be rather ineffective.

On this latter feature, Bebchuk and Fried examine each of the various factors that could spur directors to pursue shareholders' interests over those of executives, claiming that these factors in fact provide insufficient incentives for directors to act in the shareholders' interests, at least with regard to executive compensation. Stock-based compensation for independent directors (a practice that has become the norm in the United States) is acknowledged to be a useful incentive, but the fraction of shares currently granted on average to independent directors is considered too small to align non-executive directors' interests with those of shareholders.[9] The same conclusion of futility is reached with regard to 'reputational costs' for directors: they are not deemed to be an effective constraint on directors' deferential approach towards executives, at least as long as pay arrangements are structured in ways that do not provoke public outrage and the regulation does not put shareholders in a position to influence director selection (pp. 34-44). In addition, the legal constraints that should compel boards and executives to negotiate at arm's-length are considered inadequate (pp. 45-52). Indeed, Bebchuk and Fried emphasise that: (i) legal suits against the board for breach of fiduciary duty in the case of excessive executive pay are not a credible threat in light of the courts' reluctance to limit directors' discretion in relation to

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7 'Nominating committees' tend (and are also advised by the majority of business experts) to consult with the CEO before choosing the candidates that are placed on the company's slate submitted to a shareholders' vote.

8 The factors taken into consideration by Bebchuk and Fried are: friendship and loyalty among directors, collegiality and team spirit within the board, deference towards the CEO, 'cognitive dissonance' that might affect independent directors who are or were executives themselves and a lack of sufficient time and information.

9 Moreover, in the last part of the book, Bebchuk and Fried express some concerns about the potential conflict of interests that could stem from directors' equity-based pay.

compensation design issues;[10] (ii) the requirement of a shareholder vote on stock option plans[11] is a useful but insufficient means because equity-based compensation is just one of the various ways by which executives may get excessive payment; and (iii) 'precatory resolutions' can provide only a limited constraint on board discretion as long as they are merely advisory. Finally, the attention of the authors turns to market forces currently at work to argue that, with regard to executive compensation, these forces cannot be relied on to align the interests of managers and shareholders (pp. 53-58). Labour market and product market competition – the argument goes – are not effective constraints, since the direct benefit of higher compensation to executives is substantial, while its effect on the likelihood of dismissal or business failure is typically small and, moreover, is perceived by executives as a weaker threat, considering the substantial payments ('golden goodbye') that are granted to departing managers even when they have performed poorly. Furthermore, the disciplinary force of the market for corporate control is assessed to be fairly weak: directors and managers are substantially sheltered from the threat of hostile takeovers by existing rules and arrangements that allow for strong anti-takeover defences and for further substantial compensation (so-called 'golden parachutes') in the case of changes of control.

Having laid down the determinants that should make directors beholden to CEOs, and having assumed that countervailing forces are unlikely to impose tight constraints on executive compensation, the book puts forward its portrait of the forces that in fact shape the pay-setting process. According to the explanation thereby provided, labelled as the 'managerial power approach', CEOs have been using their influence over the board of directors to structure their pay package in ways that allow them, on the one hand, to extract *rents* (i.e., extra value beyond what they would obtain in an arm's length transaction with the board of directors) and, on the other hand, to hide or justify (to *camouflage*) excessive compensation that would otherwise prompt market penalties and social outrage were it given in the form of usual upfront cash compensation. Executive pay is therefore a by-product of the agency problem between managers and shareholders rather then the remedy to the problem.

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[10] On the one hand, the recent decision in the *Disney* case (*In Re The Walt Disney Company Derivative Litigation*, 2005 Del. Ch. LEXIS 113, 9 August 2005), currently under appeal before the Delaware Supreme Court, seems to be consistent with this assessment, since it confirms the high burden of proof imposed on the shareholder plaintiffs to rebut the 'business judgment rule'. On the other hand, positive conclusions as regards the potential use of litigation may be drawn from another recent Delaware case (*Official Committee of Unsecured Creditors of Integrated Health Services, Inc.* v. *Elkins*, 2004 Del Ch. LEXIS 122, 24 August 2004) and from an empirical analysis of a large number of executive compensation cases, which found that in public companies plaintiffs have won significant victories in 32 per cent of the cases in that sample (R. Thomas and K.J. Martin, 'Litigating Challenges to Executive Pay: An Exercise in Futility?', 79 *Washington University Law Quarterly* (2001) p. 593).

[11] A practice already implemented in most US public companies even before the new listing requirements of the major US stock exchanges made it mandatory in 2003.

The empirical premise of this approach is presented in the second and third parts of the book, where factual evidence is pointed out to prove that 'managerial power' comports with the outcomes of the pay-setting process. With regard to statistical correlations, the book refers to a series of previous academic studies that would show that compensation packages tend to be more favourable to managers – they tend to provide higher pay or to be less sensitive to performance – in those companies in which managers have relatively more power (i.e., where the board is relatively ineffectual, there is no large outside shareholder or managers are protected by anti-takeover defences). It then provides a detailed and anecdotal account of a series of common pay practices that, while irreconcilable with the arm's-length model of contracting, seem consistent with the managerial power approach. First, Bebchuk and Fried go through the various forms of executive pay not related to company performance by which managers have been able to extract rents.[12] Then, they focus at length on the determinants of the steep increase of performance-based compensation that took place in the 1990s. CEOs and senior executives – the authors maintain throughout the third part of book – have exploited the favourable approach that scholars and investors in the 1990s had towards pay-for-performance in order to obtain additional performance-related compensation (i.e., bonus and equity-based compensation plans) without off-setting reductions in their cash compensation. At the same time, they have been able to structure such performance-related compensation plans with flawed arrangements that in fact have decoupled pay from performance (i.e., have enabled executives to get substantial rewards regardless of their effective contribution to the firm's value) and have even provided them in some cases with perverse incentives to adopt corporate strategies detrimental to shareholders.

To prove their assumptions, Bebchuk and Fried separately examine the major weaknesses of non-equity and equity-based plans. As for the first, they give account of common flaws of current bonus plans, which allow substantial room for the use of 'creative accounting' and lack any form of 'relative performance' measure (that is, performance compared to that of competing firms), thereby leaving managers substantial scope to be rewarded even in cases of negative performance in absolute terms or in the case of performance well below the industry average (pp. 121-136). With regard to equity-based plans, after having recalled that the assessment of these kind of plans is strictly dependent on the terms that regulate key features such as the 'exercise price' and the 'vesting period', the authors argue that the terms commonly used in stock option plans

[12] The arrangements identified as evidence of camouflaged rents granted to executives are: gratuitous payments when executives decide (or are asked) to leave, postretirement payments and benefits that are channelled through non-transparent forms (i.e., 'supplemental' executive retirement pensions, deferred compensation, postretirement perks and guaranteed consulting fees) and executive company loans granted at significantly below market rates and in many cases subsequently forgiven by the company (pp. 87-117).

clearly indicate that managers influence the design of stock options, avoiding cost-effective arrangements that would maximise shareholder value.[13]

The managerial power explanation of executive compensation is completed in the fourth part of the book with a series of normative proposals. Accounting treatment of stock options, enhanced disclosure on all forms of compensation, voting on specific features of compensation agreements and definition through shareholders resolution of the outer limits of executive pay within which boards can autonomously decide without shareholder approval are the regulatory measures advocated to improve executive compensation (pp. 189-200). As the latter measures mentioned make clear, these changes are tightly connected to a broader proposal on corporate governance reform put forward by Bebchuk and Fried. Indeed, the authors move from the failure of the executive pay process to argue that the only way to ensure that directors effectively supervise executives is to make the first more accountable towards shareholders rather than just lessening directors' dependence on executives. Hence, they conclude by proposing a set of rules – sketched out in the last chapter of the book and drawn from their previous works – that aim at 'empowering shareholders' through two main changes: granting shareholders access to electoral challenges to incumbent directors on terms broader than those proposed by the US Securities Exchange Commission (SEC)[14] and removing the current state rules and corporate arrangements that give the board veto power over changes to the company's basic governance arrangements.

The managerial power hypothesis and the consequential proposals of reform presented in the book are the subject of an ongoing academic debate in the United States. Summing up the various views that have been expressed, it can be said that, while Bebchuk and Fried are widely credited for having recalled in the academic and public debate that managers' influence plays a significant role in corporate governance at large and in the current pay-setting process in particular,[15] at the same time *Pay without Performance* seems to overstate both

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[13] In particular, Bebchuk and Fried reach this conclusion focusing at length on: the lack of any kind of term that would eliminate managers' windfalls from stock price increases that are unrelated to their own performance (such as indexing the stock options' exercise price to market movements); the uniform practice of setting the stock options' exercise prices equal to the company's stock price on the date of the grant, although exercise prices should be set according to firm-specific factors; the widespread practice of 'repricing', that is, reducing exercise prices when the company stock price has fallen well below the exercise price and thereby reducing the *ex ante* incentive effect of stock options; the lack of arrangements that would limit managers' ability to 'unwind' (i.e., to immediately exercise the just-vested options and sell the acquired shares) and would therefore prolong the incentive effect, while screening out the risk of excessive short-termism (pp. 137-185).

[14] Following the comments received and the appointment of the new SEC President, the proposal (SEC Release Nos. 34-48626) is very unlikely to be brought forward by the SEC.

[15] S.M. Bainbridge, 'Executive Compensation: Who Decides?', 83 *Texas Law Review* (2005) p. 1615; W.B. Bratton, 'The Academic Tournament over Executive Compensation', 93 *California Law Review* (2005) p. 1557; J.E. Core, W.R. Guay and R.S. Thomas, *Is U.S. CEO*

managers' power and the need for a sweeping corporate governance reform as the solution to the problem.

As regards the first feature, various academic comments on the book have emphasised that many of the compensation practices identified by Bebchuk and Fried as evidence of managerial power may in fact have a benign explanation and could be regarded as optimal contractual arrangements[16] once they are examined in the light of the existence of information costs, transaction costs and the existing US legal and regulatory system, rather then comparing them with an ideal world (the so-called 'nirvana fallacy') where the other factors that affect corporate performance are screened out.[17] Moreover, it is noted that Bebchuk and Fried's claim that executive pay is not linked to performance would be incorrect, since it does not take into consideration that, due to their large holdings of stock and options, US managers' wealth varies strongly with their firm's stock price and that therefore they do have very large pay-performance incentives.[18]

With reference to the second critical aspect mentioned above, legal scholars who have focused their attention on how to improve corporate rules affecting executive pay without raising the other costs of the corporate governance system have claimed that a wholesale expansion of shareholder power would be unjustified and potentially counterproductive, while different, less radical remedies might prove more effective.[19] Following this path, it is emphasised in particular that flawed pay practices may derive from directors' lack of information and incentives to effectively perform their duty, rather than complicity with managers. Hence, specific measures are advocated in order to bolster the independence and competence of the compensation committee as well as its accountability towards shareholders.[20]

Compensation Inefficient Pay Without Performance?, Vanderbilt University and University of Pennsylvania Working Paper (2004); J.N. Gordon, *Executive Compensation: What's the Problem, What's the Remedy? The Case for 'Compensation Discussion and Analysis,* Working Paper, Columbia Law School and European Corporate Governance Institute (ECGI) (2005); M.C. Jensen and K. Murphy (in collaboration with E.G. Wruck), *Remuneration: Where We've Been, How We Got Here, What are the Problems, and How to Fix Them*, ECGI Finance Working Paper (2004), all available at: <http://www.ssrn.com>. For further discussion of *Pay without Performance*, see the Columbia Law School 'Symposium on Executive Pay', 15 October 2004, available at: <http://www.law.columbia.edu>.

16 I.e., they 'minimise agency costs and the cost of residual divergence' since they anticipate and minimise the costs of managerial power and other agency costs.

17 Along this line of thought, see Core, Guay and Thomas, op. cit. n. 15; Bainbridge, loc. cit. n. 15; and Gordon, op. cit. n. 15, all noting that current practices may be due to favourable tax treatment or may induce and protect managers' investments in firm-specific human capital. On the use of 'golden parachutes' and stock options as 'equilibrating' or 'adaptive' devices within the US corporate governance system in general, see M. Kahan and E.B. Rock, 'How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law', 57 *University of Chicago Law Review* (2002) p. 871.

18 Core, Guay and Thomas, op. cit. n. 15.

19 Bainbridge, loc. cit. n. 15; Gordon, op. cit. n. 15; Jensen and Murphy, op. cit. n. 15.

20 Gordon, op. cit. n. 15; Jensen and Murphy, op. cit. n. 15.

Last but not least, it is to be recalled that, following a different line of thought, Henry Manne, while sharing the view that managerial power is the problem of the current US corporate system, has argued that a 'return to something like the pre-Williams Act market for corporate control' would be the only solution to the executive pay problem and to the other alleged flaws of the corporate governance system, since "direct democracy in the form of a proxy fight" would have 'little chance of solving the problem'.[21]

In this review, it is not possible to address *seriatim* each of the various academic opinions expressed with reference to the book. It can be noted, however, that Bebchuk and Fried also recognise that the risks of executive pay malpractices could be reduced by the 2003 reform of major US stock exchanges listing requirements and by some provisions of the 2002 Sarbanes-Oxley Act.[22] Moreover, it is to be recalled that Bebchuk and Fried do not rule out the possibility that managerial power in some cases derives from the board's misperceptions and lack of incentive, rather than conscious favouritism (p. 78). Finally, they recognise that 'reputational costs' could in theory play a role in compelling directors to supervise managers (p. 36), especially in the absence of booming markets (p. 74). If we match all these factors with the enhanced attention that investors, analysts, the media and the courts[23] now focus on executive pay, and add to the picture that recognition of share-based payments in financial statements has recently become mandatory,[24] while the SEC has proposed rules that would require better disclosure of any kind of compensation,[25] we have sufficient arguments to reach the conclusion that the executive pay problem does not seem to stand by itself as an adequate reason to reform the current regulation of directors' ballot,[26] since more focused and tailored measures have been recently taken and can be further implemented. That obviously does not exclude that there could be a case for the wide reforms proposed by Bebchuk and Fried, were it proved that there is a more general problem of 'managerial power' in the US

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21 H. Manne, 'The Follies of Regulation', *The Wall Street Journal*, 27 September 2005.

22 Indeed, the new listing rules have tightened the requisites for 'independent directors', increased the role of independent directors in the nominating process and assigned the task to hire compensation consultants exclusively to the compensation committee (*Pay without Performance*, pp. 26-29). The Sarbanes-Oxley has prohibited executive loans, with some exceptions, and has introduced 'stricter disclosure rules that will reduce firms' ability to let managers profit from trading on private information' (ibid., p. 183).

23 The cases and the literature mentioned *supra* in n. 10 give account of the higher scrutiny that is dedicated to executive pay by shareholders and the courts.

24 See the US accounting standard FAS 123(R), approved by the US Financial Accounting Standards Board.

25 See SEC release 34-53185.

26 On the debate over directors' ballot reform, see the opinions expressed at the Yale Law School Symposium 'Reassessing Director Elections', 7 October 2005, available at: <http://www.law.yale.edu>, and at the Harvard Law School 'Symposium on Corporate Elections', October 2003, available at: <http://www.ssrn.com>.

corporate governance system.[27] But this kind of evidence is beyond the scope of the book.

The US experience and debate proves to be a useful point of reference for Europe, where executive pay structure has been increasingly drawing the attention of investors, business experts, policy makers and legal scholars. As the recent literature has pointed out, the principal-agent model predicts that executive pay has different features depending on the companies' ownership and governance structure. On the one hand, the presence of a controlling shareholder or a blockholder should reduce (but not eliminate) the need for incentive-driven pay and eliminate the risks of managerial influence in its design. On the other hand, the presence of a blockholder creates a new risk: pay arrangements could be used by blockholders to buy up managers' complicity for the extraction of private benefits of control at the expense of minority shareholders.[28]

Consistent with these predictions, EU Member States' executive pay levels, structures and regulations differ quite substantially in correlation with different ownership patterns.[29] In those Member States where dispersed ownership dominates and the agency problem between managers and shareholders is therefore more pronounced, we find the heaviest reliance on incentive-driven contracts and the highest level of sophistication with regard to legal controls on conflicts of interest that may arise in the pay-setting process. Meanwhile, in continental Europe, where a higher concentration of controlling or blockholding shareholders is reported, executive pay has traditionally rested less on performance-related compensation and the legal framework has been somewhat more lenient, especially with regard to disclosure.[30] However, in recent years – due to market pressure and the ensuing growing reliance on professional/outside managers even

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27 On this issue, see B. Holmström and S.N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, ECGI Finance Working Paper (2003), available at: <http://www.ecgi.org>. For an overview of different views expressed with regard to the proposed reforms of the current US corporate governance system, see S.M. Bainbridge, 'Director Primacy and Shareholder Disempowerment', 119 *Harvard Law Review* (2006) p. 1735; L.E. Strine, 'Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America', 119 *Harvard Law Review* (2006) p. 1759; and L.A. Bebchuk 'Letting Shareholders Set the Rules', 119 *Harvard Law Review* (2006) p. 1784.

28 G. Ferrarini, N. Moloney and C. Vespro, *Executive Remuneration in the EU: Comparative Law and Practice*, ECGI Law Working Paper (2003), available at: <http://www.ecgi.org>; G. Ferrarini and N. Moloney, 'Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives', in G. Ferrarini, K.J. Hopt, J. Winter and E. Wymeersch, eds., *Reforming Company and Takeover Law in Europe* (Oxford, Oxford University Press 2004).

29 For data, see M. Becht, P. Bolton and A. Roell, *Corporate Governance and Control*, ECGI Finance Working Paper (2002), available at: <http://www.ecgi.org>; Ferrarini et al., op. cit. n. 28.

30 See G. Ferrarini and N. Moloney, *Executive Remuneration in the EU: The Context for Reform*, ECGI Working Paper (2005), available at: <http://www.ecgi.org>.

in concentrated ownership companies – incentive-driven pay practices have become more common even in continental Europe, and tighter requirements on pay-setting and pay disclosure have begun to be implemented.[31] The picture is evolving. Although EU Member States' practices and regulations on executive pay can still be broken down into two distinct blocks, there is some evidence of convergence – by means of state regulation or best practices – towards the main underpinnings of the US pattern: enhanced disclosure and the establishment of a compensation committee as the key body in charge for setting executive pay. This trend is furthermore encouraged by the 2005 Recommendations issued by the European Commission on Executive Pay and on Non-Executive Directors, which rest on three pillars: disclosure of remuneration policy and of individualised director pay, a compensation committee and a shareholders' vote (advisory or mandatory according to the state's choice) on the remuneration policy statement. This is not the place to give account of the specific provisions of the Recommendations;[32] it suffices to emphasise that the US academic debate on executive pay shows the complexity of and the interrelation among the various corporate governance solutions. It therefore corroborates the scepticism and the warnings expressed by some academics about the opportunity to carry out harmonisation[33] – although with very flexible prescriptions such as those of the Recommendations – across the different systems of corporate governance and corporate ownership present in the European Union. In particular, two brief notes drawn from the US experience can be added to the arguments already brought forward to give account of the risks of centralised EC harmonisation *vis-à-vis* spontaneous convergence.

The first one regards the provision of the Recommendation on Executive Pay requiring that shareholders' approval should be obtained only for equity-based incentives and for any other 'long-term incentive schemes for which directors are eligible and which is not offered under similar terms to all other employees'.

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31 E.g., in Germany, where on 10 August 2005 a law was enacted that requires listed companies to disclose the compensation granted to each of the members of the *Vorstand* (management board) (*Gesetz über die Offenlegung der Vorstandsvergütungen*). However, a provision within the new German law allows companies to forgo the disclosure requirement (for a maximum period of five years) if shareholders holding 75 per cent of the voting capital agree with a management resolution limiting disclosure. In Italy, whose regulations already required a high standard of disclosure, the new version (2006) of the 'corporate governance code' for listed companies (required on a 'comply or explain' basis) and Art. 16 of the so-called 'Law on Savings' (L. n. 262/2005) have strengthened corporate governance checks on executive pay and further enhanced the degree of transparency. In Sweden, pay disclosure has recently been improved by a revised 'comply or explain' Swedish governance code (2005).

32 See Ferrarini and Moloney, op. cit. n. 30.

33 See L. Enriques, *Company Law Harmonization Reconsidered: What Role for the EC?*, ECGI Law Working Paper (2005), available at: <http://www.ecgi.org>. Specifically on the European Community's attempt to harmonise executive pay regulation, see Ferrarini and Moloney, op. cit. n. 30.

Setting aside for a moment the concerns raised with reference to the need for a shareholders' vote,[34] it is to be stressed that confining this voting requirement only to the 'long term' and not to any 'incentive schemes' could introduce an unintended and troublesome regulatory distortion, since it could induce companies to adopt 'short-term' incentives, like annual bonuses based on accounting results, which present potential drawbacks that are the same, if not even greater, than those presented by equity-based incentives.[35]

Second, it should be noted that the Annex of the Recommendation on Non-Executive Directors bans any form of performance-related compensation for independent directors. Such exclusion does not adequately take into account that equity-based pay could foster independent directors' incentives (to collect adequate information and devote sufficient time to their duty), as empirical evidence in the United States seems to suggest[36] and Bebchuk and Fried also concede in the book.[37] Therefore, this ban can be pointed out as a further example of how a centralised law-making process can screen out efficient solutions already present in the market: rather than a rigid exclusion it would have been more appropriate to let companies choose to opt out from the prohibition (in the manner of the UK Combined Code on Corporate Governance[38]), requiring them to adopt pay arrangements that would make independent directors' incentive-driven pay contingent on terms (i.e., vesting period, exercise price, unwinding conditions and so on) different from those that discipline performance-related pay for executives, so as to create a benign 'conflict of interests' between the two categories of corporate actors.

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[34] See Ferrarini and Moloney, op. cit. n. 30.

[35] On the drawbacks of bonus-based schemes, see, among others, Jensen and Murphy, op. cit. n. 15.

[36] See D. Yermack, 'Remuneration, Retention, and Reputation Incentives for Outside Directors', 59 *Journal of Finance* (2004) p. 2281.

[37] See p. 34 (and accompanying footnotes). However Bebchuk and Fried eventually express scepticism towards this solution (pp. 205-206).

[38] The Combined Code on Corporate Governance (which is prescribed on a 'comply or explain' basis) requires listed companies to explain in the annual remuneration statement the reasons for granting performance-related incentives to non-executive directors, makes these grants conditional on a shareholders' vote and allows directors to sell their shares no earlier than one year after they have left the company (§§ A.3.1 and B.1.3).

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