

Institutional shareholder advocacy and executive remuneration: rethinking the role of institutional shareholders as executive remuneration norm entrepreneurs

Kym Sheehan

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ABSTRACT: The global financial crisis has brought to public attention the difficulties associated with executive remuneration in the financial services sector. I review the efficacy of shareholder advocacy on remuneration practices. In many instances the financial firms with unsound remuneration practices were listed companies subject to shareholder scrutiny. Why were shareholders not able to achieve better remuneration practices in these institutions?

I argue that institutional shareholder representative organisations, while acting as ‘norm entrepreneurs’ in relation to executive remuneration by developing and promulgating guidance on ‘best’ remuneration practice, have not been successful entrepreneurs because the norms advocated in their guidelines were not internalised by their members, the individual institutional investors themselves. Institutional investors only support executive remuneration norms when failure to do so will result in social (or, more accurately, business) sanctions. Institutional shareholders have to appear to be responsible investors but may not be genuinely committed to ensuring good remuneration practices in investee companies. The problem relates in part to how ‘good remuneration practices’ has been defined in the relevant guidance. Problems also exist due to how the norms are enforced through engagement and voting.

With governments now stepping in to change executive remuneration norms relying on ‘vivid rhetoric’ – “extreme capitalism” and “extreme greed” – institutional shareholders have to reconsider their role as executive remuneration norm entrepreneurs. I argue that institutional investors should continue to act as norm entrepreneurs but to reconsider how they formulate norms to ensure wider adoption.

KEY WORDS: executive compensation, institutional investors, monitoring, norm entrepreneurs, regulation

Introduction

While the causes of the global financial crisis articulated in reports from government agencies (FSA 2009a,b; HM Treasury 2009a,b; House of Commons Treasury Committee 2009a,b,c,d; Walker 2009, Committee on Oversight and Government Reform 2008), international organisations (for example, the OECD (OECD 2009a and b), the Financial Stability Board (2009a, 2009b), the Community of European Bankers (CEBS 2009) and the Group of 20 (G20, 2009a, 2009b)), academics (for example, see Blanchard 2008, Braithwaite 2009, Clarke 2009, Crotty 2009, Friedman and Friedman 2009, Gerding 2009, Shin 2009 and Taub 2009) and the general press are numerous and interrelated, executive remuneration practices in financial institutions are identified by many as contributing causes. Excessive risk taking behaviour induced by remuneration schemes weighted heavily towards the generation of short-term profits indeed generated profits, but without reference to the underlying risk horizon of that profit (Institute of International Finance, 2009).

What is surprising about these practices is that they took place in several listed companies subject to institutional shareholder monitoring. Of the 622 TARP recipients coded as banks, 225 are public companies with 22 are listed on the NYSE. Seven other TARP recipients coded as insurance (for example AIG) or financial services (for example Fannie Mae and Freddie Mac) are likewise listed on the NYSE. The disclosure of the remuneration practices for the named executives (that is the CEO, senior executive (top management team) was known, as these companies were obliged to file compensation disclosures under DEF14A filings with detailed Compensation Discussion and Analysis disclosures required since 2006. In the UK, a number of financial institutions either subject to full nationalisation (for example Northern Rock) or some partial intervention (for example the Royal Bank of Scotland, HBOS and the former Lloyds TSB, now the Lloyds Banking Group) are likewise public companies and listed on the LSE. These companies too were required to disclose details of their executive directors'

remuneration within the remuneration report. This report is subject to an advisory vote annually at the AGM so shareholders could send a signal to the boards of UK financial institutions if they were displeased with the practices disclosed. By and large, they did not.¹ As monitors of executive remuneration, institutional investors collectively would appear to have a poor record when it comes to ensuring good executive remuneration practices in investee companies. Thus institutional shareholders have to accept some responsibility for these practices: to extend the sentiments expressed by the United Nations Environment Programme Finance Initiatives (UNEPFI 2009), the failure by institutional investors to collectively challenge financial institutions' remuneration practices meant the practices remained.

Institutional investors play a key role in any market-based regulatory system for executive remuneration in three ways: by promulgating guidance on what are best or good remuneration practices, by engaging with companies on that guidance and by voting on remuneration-related resolutions where permitted by law (Sheehan 2009). If, as the evidence noted above suggests, this market-based system is not working, then institutional investors are partly to blame. I argue that the first way in which institutional investors are to blame relates to their role as norm entrepreneurs, that is, people interested in changing social norms (Sunstein, 1996, p. 909). In devising and promulgating principles and rules on executive remuneration, institutional investors have encouraged performance-based pay without setting any meaningful limits on what quantum of remuneration is acceptable, given firm performance, and what amount is excessive, given strong firm performance. Furthermore, some of the so-called principles are actually treated by investors and companies alike as rules. This means that principles designed for flexible application become ossified into narrow interpretations that can result in poor remuneration practices.

The second way institutional shareholders are responsible relates to inconsistent monitoring and enforcement via engagement and voting. The opportunity for shareholder engagement in a

market-based system depends in part on the extent of legal rights given to pass resolutions on remuneration. Given such rights exist (as in UK and Australia), then engagement can occur pre-AGM (initiated by institutional investors or representative organisations) or outside the AGM season (initiative by remuneration committees). Voting against remuneration resolutions does not communicate the relevant norm, but signals disagreement. The regulatory conversation (Black 2002) that follows a significant vote against is where the norms – the principles in the various guidelines - are translated into agreed rules for that company.

With governments now stepping in to change executive remuneration norms relying on “vivid rhetoric” (Sunstein, 1996, pp. 949-950) such as “extreme capitalism” and “extreme greed”, institutional shareholders have to reconsider their role as executive remuneration norm entrepreneurs. Do these shareholders want to still play this role or should they abdicate the role of executive remuneration norm entrepreneur to governments and prudential regulators? With the US Senate yet to approve ‘say on pay’ legislation in that jurisdiction, this question has gained further importance as the ‘say on pay’ adopted in both the UK and Australia relies heavily upon shareholder rule-making, engagement and voting (Sheehan, 2009).

This paper argues that institutional investors should continue to play a role, but reduce the number of norms to focus on a narrower list than currently reflected in detailed guidelines (for example, ICGN 2006, ABI 2007, ACSI 2009). It begins by examining the question of norm entrepreneurs before considering how institutional investors are norm entrepreneurs. It will then argue that institutional investors have failed as norm entrepreneurs for executive remuneration before considering whether there is scope left to play such a role, given the intervention of governments and prudential regulators into the area of executive remuneration in the financial services industries, if not in listed firms more generally.

What do we mean by ‘norm entrepreneurs’?

There are two aspects to this question: what are ‘norms’ in executive remuneration and thus who are the ‘norm entrepreneurs’.

Norms in executive remuneration

‘Norms’ have been defined as “informal social regularities that individuals feel obligated to follow because of an internalised sense of duty, because of fear of external non-legal sanctions or both” (McAdams, 1997, p.340). Sunstein notes that norms are “social attitudes of approval and disapproval, specifying what ought to be done and what ought not to be done” (Sunstein, 1997, p. 914). In respect of corporate law, Ferran notes that the success of social norms lacking a legal backing “depends on most individuals in the business, investment and financial communities approving of compliance and disapproving of non-conformity” (Ferran, 2001, p. 404). Eisenberg argues that the norms observable in corporate law can be categorised into three kinds: behavioural patterns, practices and obligational norms (Eisenberg, 1999, p. 1254).

Behavioural patterns appear from Eisenberg’s analysis to be almost instinctive responses or habits, “that neither entail a sense of obligation nor are self-consciously adhered to or engaged in”, with behavioural practices “distinguishable from behaviour patterns by self-conscious adherence, yet lacking any sense of obligation” (Eisenberg, 1999, p. 1256). Obligational norms are distinguishable by the sense of obligation that is both self-consciously imposed yet responds to external criticism of non-compliance. The internal sense of obligation relies upon “complex phenomenon of internalisation of normative behaviour” (Scott, 2002, p. 1604). A shaming sanction can be an effective style of external criticism (Gopalan, 2007a, 4) although internalisation of the norm may be more effective in ensuring compliance (Gopalan, 2007b, 775). Executive remuneration is seen to be a *social* practice occurring within a market environment with legislative interventions designed to ensure market efficiency (Hill 1996, Cheffins 1997). Norms are thus likely to play a pivotal role in shaping remuneration practices.

What norms exist for executive remuneration? Gopalan suggests three competing norms: greed is good, pay equity is desired, and contributions to performance should be reflected in pay outcomes (Gopalan, 2007b, p. 783). Bebchuk and Fried suggest a fourth norm: the tendency to conform to remuneration arrangements in other firms (Bebchuk and Fried, 2004, p. 75). Greed drives quantum in remuneration when boards agree to executive demands for more and more remuneration. In other words, ethical egoism (Rodgers and Gago, 2003, p. 191) combines with managerial power to create an opportunity for rent extraction (Bebchuk and Fried, 2004, p. 76).

Pay equity in executive remuneration likewise drives quantum, not only in terms of 'who should get what' - what constitutes a just reward for the specific rewardee based on the 'justice evaluation' of the particular situation - but also how justice evaluations shape future conduct (Jasso and Meyerson Milgrom, 2008, pp. 124-125). This pay equity can be reflected in terms of differentiating pay within the firm (Swanson and Orlitzky, 2006), as well as between firms, or within the community of stakeholders that surrounds a firm (Harris, 2006). Distributive justice arguments take different forms which Harris summarises as justice as fairness; justice reflecting the capabilities approach of Amartya Sen and Martha Nussbaum;² and justice in acquisition and transfer of property, based on the work of Robert Nozick. Of these three approaches, Harris uses Rawls' notions of the 'difference principle' and the 'open position'³ to focus on the processes by which the firm firstly selects the executive and then justifies the distribution of compensation to that executive and to the firm's other stakeholders. The challenges of setting pay levels at hire to achieve pay equity can be achieved *in form* by matching levels and structures within the firm or other firms, but undermined *in substance* by guaranteeing bonus payments or through the use of golden parachute provisions (cf Evans and Hefner, 2009). It is reflected in notions that 'The Talented' can justifiably receive higher wages if all agree to it and the amount paid reflects the market (Shaw, 2006). The role of the market in setting executive remuneration levels is acknowledged (Holmstrom, 1981) and seemingly

accepted without question (Dine 2006). Thus pay equity is likely to be referenced to the external market, with some consideration of internal sensitivities to other members of the top management team, while disregarding the pay-gap between senior executives and entry level employees.

While some would like executive remuneration to be based on objective criteria such as ‘a metric, value or standard rather than some arbitrary decision made by ill-informed board members’ (Petel 2003, p. 388), selecting these criteria is not a neutral exercise.⁴ Any number of benchmarks could be chosen: average worker salary, company size, market comparison by industry and size, and value generation (Kandel, 2009). This leads to the third norm identified above: pay for performance. Carried to its extreme, this norm implies that no limits should exist on pay if performance is unlimited. This norm, if internalised, would justify extreme risk taking on the basis of enhancing performance, with the executive entitled to be rewarded for outperforming some previously set benchmark. Remuneration practices around short-term incentives are based on annual budgets, with performance described as ‘threshold’, ‘on target’ and ‘stretch’.⁵ The ‘performance’ part of this norm is contestable: is it individual performance or company performance or both that should be paid for, over and above the ‘coming to work’ salary? If it is company performance, should that be expressed solely in terms of financial performance indicators? If it is individual performance, is it truly possible to say what difference any one individual made in an organisation of thousands, albeit that individual is the CEO?⁶ Where it is a mix of these criteria, say one-third individual performance, two-thirds financial performance, is that the right mix? If paying for performance seeks to address to agency problem, it might not be working (Harris 2009) and that may be due to companies choosing the wrong performance measures.⁷

The fourth norm about conformity around pay practices relates both to structures that match other firms, as well as sanctioning benchmarking practices in relation to quantum. It is related

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to the norms of pay equity and pay for performance. This norm is not only internalised by executives but by remuneration committees and can be reflected in the adoption of a standard set of remuneration practices across firms, irrespective of firm size and industry (Banks, 2009).

Norm entrepreneurs

The previously noted definition of norm entrepreneurs from Sunstein ('people interested in changing social norms') warrants further examination. As Gopalan notes, 'norm entrepreneurs do not create new norms for altruistic reasons: acting as a norms entrepreneur can result in economic benefits' (Gopalan, 2007a, p.31). Clearly if institutional investors are to play such a role, economic benefits have to exist, a point often raised in relation to responsible investing (for example, see UNEPFI 2004, UNEPFI and Mercer 2007, Robbins 2009, Wen 2009) and shareholder activism (for example, see Chiu, 2008). What economic benefits exist for institutional investors in setting norms for executive remuneration? Clearly norms relating to share-based payments are highly relevant, if such plans are dilutive or do not adequately link remuneration outcomes to performance as experienced by shareholders (such as shareholder return).

Furthermore, it is possible to exploit dissatisfaction with existing norms to create new norms and this is more likely when a tipping point has been reached to push norms in new directions (Sunstein, 1996, pp. 929-930).⁸ Whether this push in a new direction represents incremental change or fundamental change depends in part on how the entrepreneurs exploit the dissatisfaction and perhaps to a larger measure upon whether behaviour with the norm is no longer acceptable, even in private moments.⁹ Exploiting such private dissatisfaction is what Sunstein argues can be used to bring about fundamental change by

Signalling their own commitment to change, creating coalitions, making defiance of the norms seem or be less costly and making compliance with the new norms seem or be more beneficial. (Sunstein, 1996, p. 29).

If institutional investors want to be norm entrepreneurs for executive remuneration, it is important to consider how each of these activities can be undertaken by them individually. While questions of the business practises of fund managers lie outside the scope of this paper, the above suggests that some congruence between the norms sought in investee companies with respect to remuneration practices and these practices in fund managers (whether in the fee structure offered to clients, or at the level of individual executive remuneration and incentives) is necessary.

Institutional investors as norm entrepreneurs

Braithwaite and Drahos see norms as a generic category that includes rules, principles, standards and guidelines (Braithwaite and Drahos 2003). This broad view therefore includes the types of statements about remuneration practice made by institutional investors. The norms of remuneration are found in guidance issued by institutional investors organisations (such as the Association of British Insurers or ABI, the National Association of Pension Funds or NAPF, the Australian Council of Super Investors or ACSI, the ICGN) and individual institutional investors (such as Artemis, Barclays Global Investors, Baillie Gifford & Co, F&C Investments in the UK and Fortis Investments, Aviva Investments Australia Ltd in Australia). The norms covered by institutional investors are not restricted to remuneration practices but also the other activities within the regulated remuneration cycle of disclosure, engagement and voting. Based on an analysis of the regulatory framework in Australia, there is much overlap with other rule markers in the areas of disclosure and voting, with governments typically legislating heavily in these two activities (Sheehan, 2009).

How institutional investors decide on the appropriate norms is also relevant to the norms thus created. Based on my own research, it is clear that institutional investor representative organisations adopt a consensus approach to norms setting. For an institutional investor organisation, typically a specialist committee will be tasked with developing a draft set of

guidelines for circulation and comment from the members before a final set of guidelines is reached.¹⁰ Bebchuk and Fried suggest changes in executive remuneration practices are typically towards more management-friendly practices (Bebchuk and Fried 2004, p. 76). Given institutional investors are setting remuneration norms via their guidelines, how are changes in practice not reflecting shareholder-friendly practices? What is not clear is whether the norms espoused in these guidelines reflect widespread existing practices (that is norms that are already followed by most companies) or represent aspirations of what practice should be (norms followed by only the better performing companies). Perhaps the consensus view of the appropriate norms set by shareholders might reflect cognitive biases amongst institutional investors. How institutional investors are remunerated might be reflected in the norms they set, such as accepting that executives should be paid for achieving short-term performance, or that executive performance is best measured by relative total shareholder return. Institutional investors might be preferring practices they can readily understand rather than practices that are necessarily better.

The specific norms

To identify the relevant norms for institutional investors, I focussed upon the guidelines issued by the ABI, NAPF, ACSI and IFSA, that is the two main institutional investor representative organisations in the UK and Australia respectively.

The first norm identified above by Gopalan – greed is good – is conflated with the second norm, pay equity – to arrive at a norm of paying sufficient to attract, retain and motivate executives without paying too much (ABI 2007, NAPF 2007) or ensuring the pay is reasonable and aligned with shareholder interests (ACSI, 2009). It is important to note that the guidelines do not expressly say ‘greed is good’, nor do they say ‘greed is bad’. The guidelines suggest that deciding what is ‘too much’ requires some sense of pay equity as well as a sense of paying only for performance. For example, the ACSI guidelines suggest that an appropriate

comparator group for benchmarking remuneration is one based on industry, size and business focus (ACSI 2009, p. 18). Thus the ACSI guidelines endorse a norm of market-based remuneration. This means that in profitable times, when human capital is scarce, shareholders will tolerate pay that is in line with the market, given firm performance. If the market rate at this time is generous, perhaps excessive by community standards, shareholders will accept it. Conversely in leaner times, such as the present, market-based remuneration should be reflecting the decreased profitability of companies, although the human capital market for ‘the Talented’ might still be tight.

The third norm of pay for performance receives more detailed attention in shareholder guidance, not merely in terms of measures of performance, but also in norms such as no rewards for failure (ABI 2007, ACSI 2009), no ex-gratia termination payments (ABI 2007, ACSI 2009), reasonable contractual provisions for terminations or no hedging of unvested performance-based remuneration (ACSI 2009). Thus a norm exists that the alignment of shareholder and executive interests is both valuable and achievable by remuneration structures with performance measures linked to shareholder return. A further norm is that variable remuneration should be paid only for achieving *superior* performance (for example, ACSI 2009, p. 18). However, as noted earlier, actual short-term incentive plans begin to payout for ‘threshold’ performance against an undisclosed (either ex ante or ex post) target. Institutional investors might reasonably question why they have been unsuccessful in achieving this norm in practice.

The fourth norm of conformity in pay practices derives in part not only from how remuneration consultants undertake the task of advising remuneration committees, but also the actions of institutional investors in enforcing their own guidelines (Sheehan 2007). A norm of market-based remuneration would encourage conformity of pay practices and it is likely that proxy advisor scrutiny of remuneration reports further encourages this as companies learn which pay

practices will pass through that filter. That conformity exists is not necessarily a bad thing; however it makes it difficult for a norm entrepreneur to introduce a new norm unless there are a number of firms who are identified as leaders and who readily adopt that norm. Others, seeing their example and that institutional investors are reacting positively to that practice, will also adopt it (Seidl, 2007).

Failed entrepreneurs?

The problems noted in the introduction about remuneration in the financial services sector are not isolated examples of a failure as norm entrepreneurs. Even in jurisdictions where an advisory vote exists, such as Australia and the UK, the evidence suggests that, in the absence of an external pressure to monitor such as poor investment performance or government pressure,¹¹ institutional investors turn a blind eye to remuneration practices. Firstly, executive remuneration has continued to grow both in the UK and Australia since the introduction of the vote.¹² I accept that some growth is to be expected: what is not readily apparent is why the rate of growth is as high as it is, nor why the gap between average earnings and CEO earnings has widened.

Secondly, institutional shareholders appear inconsistent in their voting intentions. A couple of specific examples from Australia illustrate the problem. While shareholders voted against Macquarie Banking Group's 2007 remuneration report in numbers, they overwhelmingly supported the 2006 remuneration report, although the performance in 2007 was superior to that achieved by the bank in 2006 and any structural issues identified in 2007 also existed in 2006. Qantas Airways Limited's 2005 remuneration report contained evidence of high termination rewards to its then chief executive Geoff Dixon, yet was overwhelmingly supported.¹³

Furthermore evidence from the first three years of the vote in the UK suggests that some companies achieved a better than median result on the advisory vote, notwithstanding a lack of compliance with 'best practice' as determined by shareholder guidance (Sheehan 2007).

While the public might be concerned about the absolute quantum it is not clear that institutional investors share this concern, or that they are necessarily troubled by what Mitchell et al describe as ‘undeserved high rewards’ (Mitchell et al, 2005, p. 444). When examining the norms actually espoused by a select group of institutional investors, it is clear that absolute quantum is not the issue, but quantum relative to the market, given firm performance, is. Thus a remuneration norm of greed is good is not challenged by institutional investors under circumstances of good company performance. Pay equity as a norm is endorsed by institutional investors through their norm of setting pay at market levels. While information on the market may not be provided by companies, it is typically provided by proxy advisors in their analysis of the remuneration report. If the proxy advisors do not find the pay is outside the market rate, given firm performance, it will not warrant adverse comment or a voting recommendation against the report. Finally, pay for performance as a norm is accepted by companies and institutional investors. Thus pay that broadly reflects performance, using metrics identified by shareholders as relevant, will be accepted by them.

Therefore many of the norms of executive remuneration internalised by company management are endorsed by institutional investors and practices that conform with the norms are endorsed. This suggests either that the norms encourage the wrong behaviours (greed is fine if performance exists), the content of the norms is unclear (for example pay for performance as an institutional investor norm appears tolerant of allowing companies to begin paying for performance that is less than superior) or that monitoring of uptake of the norms is weak. Furthermore, a preference for institutional investors for behind the scenes engagement (Roberts et al, 2006), means that a shame sanction, even if imposed, lacks a public dimension.

Rethinking the role of the institutional investor as norm entrepreneur

While institutional investors have in the past set many norms for executive remuneration, and have taken the lead in doing so, governments are increasingly playing a role in 2009, with

organisations such as the Financial Stability Board setting overarching principles for remuneration for local adoption (FSB, 2009b). Of the six principles articulated by the Group of 20, principle five is a point of difference with existing statements and would seek to cap variable compensation as a percentage of total net revenues ‘when it is inconsistent with the maintenance of a sound capital base’ (G20, 2009b). In one sense, institutional investors have nothing to fear from entry of an additional norm entrepreneur for executive remuneration. Prudential regulators are setting new norms and have legal avenues available to sanction non-compliance that exceed the shaming sanction that institutional shareholders can impose via advisory votes. Furthermore prudential regulators can extend their sanctioning to broader aspects of remuneration practice than available to shareholders via binding votes on remuneration.

The risk for institutional investors is that governments and prudential regulators will become the new ‘outsiders’ whose outrage matters to boards and companies (*cf* Bebchuk and Fried 2004), and to whom companies will be most responsive. Governments and prudential regulators want financial stability, prudent risk management practices and remuneration structures and payouts that are not going to attract voter demands for action. They may be prepared to trade-off performance gains for these goals. Furthermore, it is unclear that prudential regulators are actually concerned about quantum issues, with differences emerging between the prudential regulators such as FSA and APRA and their respective governments who appear very concerned about quantum (for the UK, see FSA 2009b, Unknown (Sunday Times) 2009; for Australia, see Trowbridge 2009, APRA 2009, Rudd 2008).

Some questions going forward

To determine whether institutional investors can continue to play a role as norm entrepreneurs in the face of government intrusion, institutional investors must ask themselves a series of questions. I do not offer any answers to these questions in this paper; rather I suggest that

answers are necessary before deciding how best to act in a newly emerging regulatory environment for executive remuneration.

Firstly: *do institutional investors truly want to be norm entrepreneurs for executive remuneration?* From experience, such investors know that monitoring executive remuneration is no easy task. Remuneration structures are complex, remuneration reports are overly long, with myriad details and seemingly no easy way to make sense of them. This might explain why government initiatives to give institutional investors greater say on remuneration decisions are not a cure-all: investors may not believe that all remuneration practices warrant their close inspection. Proxy advisory firms, widely retained by institutional investors, undertake the detailed reading and analysis of remuneration reports and disclosures. Institutional investors use these reports to identify the potential remuneration outliers. Depending upon the mandate given to the fund manager, deciding not to follow a proxy advisory firm's voting instruction might require an ex-post explanation to the pension/superannuation fund client. Thus the room to manoeuvre is really with firms that are identified as potential outliers and the quality of the proxy advisory firms' screening processes are critical. Why not leave it entirely up to the proxy advisory firms to set remuneration norms, given they are doing so currently by default through their screening activities?

However, if the answer to the first question is yes, what norms really matter to institutional investors? Of the norms identified earlier, arguably it is pay for performance that matters most to institutional investors. Governments are concerned with extreme levels of remuneration and have political imperatives to seek to limit this remuneration. Governments also have the legislative powers to mandate disclosure and voting on particular resolutions. Shareholder norm-setting in these areas is probably a sub-optimal use of resources because, given a choice to comply with a shareholder norm on disclosure or a legal requirement on disclosure, the latter will prevail. Thus shareholders may want to devote less time to creating detailed disclosure

principles, focussing instead on remuneration practice principles and the norms underlying these principles.

What territory is covered by others and thus monitored by them? Proxy advisory firms would seem to cover most of the details of remuneration, while the media can play a role in highlighting particularly high payments and the overall market.¹⁴ Furthermore, the FSA's amendments to the Handbook and the proposed APRA principles show that prudential regulators will look at the remuneration setting process within firms (the remuneration committee), the remuneration structures including the balance between fixed and variable remuneration, the performance criteria for bonus pools (profit) and longer term incentives (EPS and TSR), risk-adjustments, deferral periods and claw back of payments.¹⁵ These are many of the same things institutional investors have typically focused on although the universe for such regulators is limited to the financial services industry and then particular firms within that industry. Risks from this intrusion into executive remuneration practice will arise should there be irreconcilable conflict between a requirement of the prudential regulatory framework and a norm of remuneration practice set by institutional investors. The former will prevail.

A further point that should be given consideration is the inexperience of prudential regulators as remuneration monitors. Institutional investors either individually, collectively through representative organisations or even through the use of proxy advisory firms, are seasoned monitors of remuneration. Prudential regulators undertaking monitoring of executive remuneration for the first time are on a steep learning curve.

What territory is best covered by institutional investors? Clearly company performance is pivotal for institutional investors, and so pay for performance type measures might best be described and monitored by these investors. A number of these investors will have access to company management in relation to company performance issues, although the mismatch cycle between remuneration disclosures and performance discussions might make it less likely that

the routine briefings or conference calls would be used to raise remuneration-type issues. Furthermore, institutional investors are better placed than governments and prudential regulators to make assessments of company performance, provided appropriate risk disclosures are available to such investors.

Conclusion

The above analysis offers no ready solutions for institutional investors. Indeed it may be impossible for institutional investors to reject the role of norm entrepreneur in light of initiatives such as the UN PRI and government pressures within individual jurisdictions to be active owners. This creates an opportunity for institutional investors to further refine this role to focus on executive remuneration norms that truly matter to institutional investors, knowing that others will be monitoring and enforcing other aspects of remuneration. Lobbying these other actors in response to formal requests for submissions on policy changes creates the opportunity to influence the norms set by other actors, although many institutional investors and superannuation/pension funds seem to prefer undertaking such activities via representative groups and not directly. However, this avenue should not be overlooked as a way of ensuring investor-preferred norms are adopted.¹⁶

In their own norm setting activities, institutional investors can return to some core activities, based on their interests in firm performance. It is unlikely that other monitors have either the expertise or intense interest in doing so. Therefore, in setting norms for executive remuneration, the opportunity presented by the global financial crisis is for institutional investors to rethink norms of company performance (Enderle and Tavis 1998, cf Jensen 2001), and how remuneration can be best aligned to achieve this.

Notes

1. For example, the voting record for Royal Bank of Scotland since 2003 shows that the lowest level of support received for the remuneration report was 84% in 2003, followed by

85% in 2005. In all other years from 2003 to 2009, the remuneration report has received over 90% of votes in favour of the resolution to adopt it.

2. According to Harris, this approach would simply ask how executive remuneration enhances individual capabilities or deprivations for the firm's stakeholders: Harris, 2006, p. 76.
3. Different remuneration payments for the CEO and the entry level worker are justified if they represent the best allocation of the firm's money and are to every stakeholders' advantage, and, more importantly, that the CEO position is open and available to all.
4. This is recognised in initiatives such as the Walker Review with its draft Code of conduct for remuneration consultants in the UK: Walker, 2009, 131-136. Although primarily this aims to neutralise the effects of conflicts of interest on the advice given, its emphasis on transparency in selecting comparator groups recognises that professional judgment is involved and any advice is context-specific.
5. This comment is based on observed remuneration practices in a sample of 109 S&P/ASX 200 companies in Australia for the period 2005-2007. The S&P/ASX 200 is an index of the 200 largest entities by market capitalisation listed on the ASX.
6. As one remuneration committee chairperson remarked to me during interviews in 2009, 'People underestimate the impact the CEO has on an organisation.'
7. The search for the appropriate performance measures might be a quest for the Holy Grail. As one UK-based remuneration consultant said in response to my question 'what are the most appropriate performance measures for executive performance?' – 'if I knew the answer to that I'd be lying on a beach somewhere', implying he could become very wealthy by solving this dilemma.

8. The year 2009 could be such a tipping point, although arguably it will take another two to three years to see the outcomes from current regulatory initiatives such as the FSA's new remuneration code.
9. A particular challenge in the area of executive remuneration, illustrated by evidence of persistent high levels of bonus payments in the financial services industry in the USA and UK. There is also the moral issue for CEOs of accepting high pay: Moriarty 2009.
10. When asked what makes the practices described in these guidelines 'best', representatives in both the UK and Australia told me it was the fact that it represented a consensus view that made it best.
11. For example, the Rewards for Failure initiative by the Department of Trade and Industry (as it was then known) in the UK in 2003 gave institutional investors seeking to change the termination provisions in executive contracts leverage. At the time of writing, changes proposed to the termination payments legislation in Australia (House of Representatives 2009) are likely to also create an impetus for a change in related norms.
12. For example, the Productivity Commission has noted that CEO pay for the ASX 100 has grown in real terms by an average of 8-9 per cent per annum over the period from 1993 to 2008. They note this equates to remuneration of 17 times average annual earnings in 1993 to 50 times average annual earnings in 2008: Productivity Commission 2009, p. 30. This phenomenon has also been observed in the USA: Ferris and Wallace 2009, House of Representatives (USA) 2009, p. HR9212.
13. In the last month, Mr Dixon's termination payments have again attracted media attention when it was revealed that he received AUD\$11 million in payments for the financial year ended 30 June 2009, even though he worked a mere four months during that period.

14. A number of newspapers run annual features on executive remuneration, for example the Australian Financial Review, the Guardian newspaper in the UK and the Wall Street Journal (in conjunction with a third party remuneration advisory firm).
15. This list is a composite list from FSA 2009b, annex B and APRA 2009.
16. A clear example of such success is the proposed amendments to the termination payments threshold in Australia to the 12 months base salary advocated publicly by ACSI since 2005. The current termination payments threshold is up to seven times average annual remuneration received over three years.

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