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PERFORMANCE BASED COMPENSATION – A PRACTICAL GUIDANCE ON REMUNERATION OF CORPORATE EXECUTIVES

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I. Remuneration tools

There are two basic tools of motivating executives, to run the corporation on behalf of shareholders. On one hand, it can be a financial motivation, on the other hand, career orientation. The basis of monetary incentives can be either accounting profitability, or the performance of shares, which is their price on the stock market[1].

Investors holding a diversified portfolio look for a CEO that acts in a way that the owner, or at least like an equity partner would. If we want such a CEO, it is necessary to grant him a suitable part of the equity[2]. Here we should paraphrase the thoughts of Professors Michael Jensen[3] and Kevin Murphy: "if you pay a CEO like a bureaucrat, he will act like a bureaucrat"[4].

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1 See **J.A. McCahery**, **L. Renneboog**, *Managerial Remuneration: The Indirect Pay-For-Performance Relation*, Journal of Corporate Law Studies 2001/1/2, pp. 317–318.

2 See **R.A. Booth**, *Executive Compensation, Corporate Governance, and the Partner Manager*, University of Illinois Law Review 2005/1, p. 278.

3 Professor emeritus of Harvard University, he specialises in business administration.

4 See **R.A. Booth**, *Executive Compensation*..., p. 278; **M.C. Jensen**, **K.J. Murphy**, *CEO Incentives – It's Not How Much You Pay, but How*, Harvard Business Review 1990/May–June, p. 138.

Nonetheless it is possible that the CEO is the one, who is the most interested in the company's fate, as a diversified investor pays less attention to the operation of individual companies, and cares more about its own portfolio[5].

From a theoretical perspective, executive remuneration is defined by the following criteria: the management's attitude towards risks; the management's motivation in the light of remuneration; and those pieces of information, by which the performance of the manager can be assessed through the performance indices of the company[6].

II. Regulation regarding the application of remuneration tools

The *Corporate Governance Recommendations* of the BSE include that the proportions of the remunerations should be determined in such a way that it encourages the beneficiaries to think strategically. So it is suggested that the remuneration scheme for members of the Managing Body, the Supervisory Board and the executive management is arranged in a way that it serves the strategic interests of the company, and thereby those of the shareholders. The proportions of the remunerations (salaries, bonuses, shares, share options, non-cash benefits, and retirement benefits) should be determined in such a way that it encourages the beneficiaries to think strategically[7]. This provision is important as remuneration schemes should not encourage those concerned to aim merely for short-term share price maximisation. In the case of supervisory board members, remuneration of a fixed amount is suggested, and it is suggested that their remuneration should not be connected to the share price[8].

According to the *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)*, most executive remuneration packages will involve a balance between fixed and incentive pay. Companies should consider the following components in formulating packages: fixed remuneration,

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5 See **R.A. Booth**, *Five Decades of Corporation Law – From Conglomeration to Equity Compensation*, Villanova Law Review 2008/53/3, p. 473.

6 See **P.L. Joskow**, **N.L. Rose**, *CEO Pay and Firm Performance: Dynamics, Asymmetries, and Alternative Performance Measures*, National Bureau of Economic Research, Working Paper No. 4976, December 1994, pp. 1–2; accessible at: http://www.nber.org/papers/w4976.pdf; 29.12.2012.

7 See Budapest Stock Exchange, *Corporate Governance Recommendations*, 2.7.5.

8 See *ibidem*, at para. 2.7.6.

performance-based remuneration, equity-based remuneration and termination payments[9].

Pursuant to the *Deutscher Corporate Governance Kodex*, the total compensation of management board members comprises the monetary compensation elements, pension awards, other awards (especially in the event of termination of activity), fringe benefits of all kinds and benefits by third parties which were promised or granted in the financial year with regard to management board work[10].

The compensation structure must be oriented toward sustainable growth of the enterprise. The monetary compensation elements shall comprise fixed and variable elements. The Supervisory Board must make sure that the variable compensation elements are in general based on a multiyear assessment. Both positive and negative developments shall be taken into account when determining variable compensation components. All compensation components must be appropriate, both individually and in total, and in particular must not encourage to take unreasonable risks. For instance, share or index-based compensation elements related to the enterprise may come into consideration as variable components[11].

III. Financial incentive

The elements of total compensation of managers are the followings: salary and bonus, stock option grants, non-tradable restricted stock grants[12], further compensation elements, and the revaluation of already granted stock options[13].

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[9] See *ASX Corporate Governance Principles and Recommendations (with 2010 Amendments)*, Box 8.1; accessible at: http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf; 28.03.2011.

[10] See *Deutscher Corporate Governance Kodex*, 4.2.3; accessible at: http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012.pdf; 29.12.2012.

[11] See *ibidem*, at para. 4.2.3.

[12] Non-tradable restricted stocks cannot be traded for a previously determined period of time.

[13] See **B.J. Hall**, *The Pay to Performance Incentives of Executive Stock Options*, Working Paper 6674, National Bureau of Economic Research August 1998, p. 9; accessible at: http://www.nber.org/papers/w6674.pdf; 28.03.2011.

We can include in this list the pension agreements, *golden parachutes*[14] and preferential loans also.

We can also consider the so-called *perquisites (perks)*, *additional benefits* as remuneration tools. These are benefits of a discretionary nature, incidental to the regular salary of managers, such as large cost allowances, the use of the corporate jet or car, or the use of luxury apartments. Perquisites may also be the financing of extraordinary health insurance or club memberships. These are generally non-monetary compensations[15], but they can be of a significant value.

If we wish to categorise remuneration tools, we can identify three basic categories: a) salary and benefits that do not depend on the performance of the company; b) options and other incentive compensation tools that depend on the performance of the company's share price; c) bonuses and other incentive compensation tools, which are based on the performance of the company, determined by particular accounting indicators[16]. Therefore the description of the fixed element in executive remuneration fits the salary the most (which is fixed between reviews). There are variable components as well, which depend on the achievement of certain targets (or on the overachievement thereof). The most frequent variable payments are share options (option plans), annual bonuses and *long term incentive plans (LTIP)*, which reward the management for their multi-annual achievements, instead of focusing on yearly performance[17].

The amount of annual bonuses is typically connected to the measures of firm performance. Accounting information usually serves as a basis of performance measures. Such accounting information is for instance earnings, sales or operating income. Return on equity[18], return on assets[19], return on investment[20]

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14 In other words the agreements on severance payments of a stupefying amount.

15 See **R.G. Rajan**, **J. Wulf**, *Are Perks Purely Managerial Excess?*, National Bureau of Economic Research, Working Paper No. 10494, May 2004; accessible at: http://www.nber.org/papers/w10494.pdf; 28.03.2011.

16 See **S.M. Bainbridge**, *Executive Compensation: Who Decides? – Book Review Essay:* **L.A. Bebchuk**, **J. Fried**, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge – London, 2004) Texas Law Review 2005/83/6, p. 1621.

17 See **B.R. Cheffins**, **R.S. Thomas**, *Should Shareholders Have a Greater Say Over Executive Pay?: Learning From the US Experience*, Journal of Corporate Law Studies 2001/1/2, p. 278.

18 ROE: Return on Equity.

19 ROA: Return on Assets.

20 ROI: Return on Investment.

and economic value added[21] are common performance measures. Product or plant quality, market share, growth rate, performance relative to competitors, etc. also can serve as performance measure[22].

Payments made as a part of long term incentive plans are similar to bonuses, but they are awarded for multi-annual performance. For instance, payment is made pursuant to the long term incentive plan if return on assets is at least 15% in three consecutive years. Long term incentive plans do not have a great significance from a yearly perspective, as they only have to be considered if the previously set targets have been accomplished by the management[23]. The above remuneration tools are included in the remuneration package of the (executive) managers, in pre-determined combinations.

IV. Career orientation

Career orientation – as we have mentioned before – can have a serious incentive effect. This was firmly underlined by Professors Gibbons[24] and Murphy, as in their opinion, this tool is also suitable for strengthening the unity of interests between the shareholders and the management. The optimal remuneration contract maximises all incentives, including implicit ones, which are attached to the progress of the career, and also explicit ones, which are attached to the remuneration package. Gibbons and Murphy concluded that it was advisable to entirely separate remuneration from performance at the beginning of a career, as the possibility of a successful career is enough stimulus. This implicit motivation gets less effective, as the manager approaches retirement[25].

According to Professors Bebchuk and Fried, it is not in the interest of top managers to limit their own compensation. Only very few of top managers lose their jobs, they do not force promotion, and if later on they end up working for another company, they still significantly profit of currently having a large

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21 EVA: Economic Value Added.

22 See **R. Aggarwal**, *Executive Compensation and Corporate Controversy*, Vermont Law Review 2003/27/4, pp. 851–852.

23 See *ibidem*, at p. 855.

24 Robert Gibbons: professor of management at MIT Sloan School of Management.

25 See **A. Alcouffe**, **C. Alcouffe**, *Control and Executive Compensation in Large French Companies*, Journal of Law and Society 1997/24/1, p. 87.

salary[26]. In this context, Bebchuk and Fried found the solution for abuses with excessive remuneration payments in increasing the independence of the board of directors and in enhancing the powers of the shareholders. The above should be carried out by increasing transparency and enabling shareholders to vote on the elements of remuneration packages and to adopt mandatory resolutions with regard to remuneration at the annual shareholders' meeting[27]. As for the setting of management remuneration, it is a problem that managers have a very advantageous position in the company, which cannot be completely neutralised by delegating independent directors to the remuneration committees or by involving independent remuneration experts[28]. Anti-takeover strategies also usually protect incumbent management from losing their position.

V. Performance-based remuneration and performance indicators

Lately two techniques revolutionised remuneration policy in the United States, which have also become popular in other countries, such as Australia and some parts of Europe. Firstly, it is performance-based remuneration; secondly, it is – closely related to the first one – options as remuneration, incentive share options[29].

These days connecting management remuneration to performance is one of the principles of the remuneration policy in modern companies, which is also demonstrated by the *Corporate Governance Recommendations* of the Budapest Stock Exchange. The recommendations stipulate that when determining the remuneration of members of the Managing Body and the executive management, it is suggested that the responsibilities of the given members, the level

[26] See **S.L. Martin**, *Executive Compensation: Reining in Runaway Abuses-Again*, University of San Francisco Law Review 2006/41/2, pp. 154–155.

[27] See **L.A. Bebchuk**, **J. Fried**, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge – London 2004, pp. 190–210; **S.L. Martin**, *Executive*...

[28] See **J. Hill**, **C.M. Yablon**, *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, University of New South Wales Law Journal 2002/25/2, p. 307.

[29] See **J.G. Hill**, *Regulatory Responses to Global Corporate Scandals*, Wisconsin International Law Journal 2005/23/3, pp. 407–408.

of their responsibility, the extent to which the company has reached its goals and the company's economic, financial situation are considered[30].

The *Deutscher Corporate Governance Kodex* clearly sets forth that the total compensation of the individual members of the management board is determined by the full Supervisory Board at an appropriate amount based on a performance assessment, taking into consideration any payments by group companies. Criteria for determining the appropriateness of compensation are both the tasks of the individual member of the Management Board, his/her personal performance, the economic situation, the performance and outlook of the enterprise as well as the common level of the compensation taking into account the peer companies and the compensation structure in place in other areas of the company. If the Supervisory Board calls upon an external compensation expert to evaluate the appropriateness of the compensation, care must be exercised to ensure that said expert is independent of respectively the Management Board and the enterprise[31].

According to the British *UK Corporate Governance Code*, a significant proportion of executive directors remuneration should be structured so as to link rewards to corporate and individual performance[32]. The Code also sets forth as a requirement that the performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company. The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases[33]. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive

[30] See Budapest Stock Exchange, *Corporate*..., 2.7.1.
[31] See *Deutscher*..., 4.2.2.
[32] See *The UK Corporate*..., D.1 (Main Principle).
[33] See *ibidem*, at D.1 (Supporting Principle).

schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. As regards the payment of remuneration, the Code provides that grants under executive share option and other long--term incentive schemes should normally be phased rather than awarded in one large block[34]. It is also set forth that levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role[35].

ASX Corporate Governance Principles and Recommendations (with 2010 Amendments) emphasise as well that there should be a clear relationship between performance and remuneration, and that the policy underlying executive remuneration be understood by investors. Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives. Executive directors' and senior executives' remuneration packages should involve a balance between fixed and incentive pay, reflecting short and long-term performance objectives appropriate to the company's circumstances and goals. The Recommendations highlight that the company should design its remuneration policy in such a way that it motivates senior executives to pursue the long-term growth and success of the company. It is also stated that remuneration policy should demonstrate a clear relationship between senior executives' performance and remuneration[36].

If we link executive remuneration to shareholder wealth in order to enhance the performance of the management, firstly we have to define shareholder wealth and also the most trustworthy indicator of the company's performance. According to the *efficient capital market theory*, the market price of a security will reflect the reasonable and fair price as accurately as possible[37]. In more precise terms, the theory is based on the presumption that all public and accessible information is quickly incorporated into the share price, therefore it will fully reflect the effects of such information[38].

Consequently, the share price could be a good indicator of the company's performance, which does not only reflect the previous performance, but it also indicates future expectations. On the other hand, one cannot objectively

[34] See *ibidem*, at Schedule A.

[35] See *ibidem*, at D.1.3.

[36] See *ASX Corporate...*, Principle 8.

[37] See **H. Merkt**, *European Company Law Reform: Struggling for a More Liberal Approach*, European Company and Financial Law Review 2004/1, p. 8.

[38] See **A. Steeno**, *Note: Corporate Governance: Economic Analysis of a „Comply or Explain" Approach*, Stanford Journal of Law, Business and Finance 2006/11/2, p. 397.

evaluate the work of a manager responsible for one specific department within the company solely on the basis of the share price, the company's performance at the stock exchange does not necessarily reflect his or her personal activities. Furthermore, share price is influenced by many factors beyond the scope of the managements activities. It is also possible that in the hope of a high remuneration, the management manipulates or influences the share price (for example avoids dividends and favours share repurchases). The problem is that although share price, as an indicator of corporate performance (and shareholder wealth) is far from perfect, it is also very hard to find a different – more accurate – indicator[39].

Accounting criteria can also be used for such purposes, although they tend to be inaccurate (because they are based on historic accounts, they do not fully capture the direct relationship between executive action and firm performance), and their application might also facilitate potential abuses. It is possible that the management manipulates accounting data, for example press forward or delay incomes or expenses, and thereby manipulate the results of quarterly and annual reports. The greatest jeopardy of using accounting information as a basis for the calculation of executive remuneration is that the management may increase short-term results (profitability) as opposed to long-term ones. (For example it reduces the amounts intended to be spent on advertising or research and development)[40].

VI. Stock option remuneration and its risks

Stock options as remuneration grant the right to the managers – but not the obligation – to buy a certain part of the company's shares for a pre-determined price (exercise price) on, or before a given date[41]. Options granted as remuneration are in fact call options. It is quite frequent that employee stock option may only be exercised following the lapse of a vesting period and/or

[39] **G. Ferrarini**, **N. Moloney**, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, European Company and Financial Law Review 2004/1/3, p. 251; **J.A. McCahery**, **L. Renneboog**, *Managerial...*, pp. 324–327.

[40] See **J.A. McCahery**, **L. Renneboog**, *Managerial...*, pp. 324–327.

[41] See **R. Aggarwal**, *Executive...*, p. 853.

if certain conditions have been fulfilled (for example a minimal increase of the share price)[42].

Stock option grants led to the drastic increase of CEO compensations in the USA, whereas in continental Europe the intense application of stock options in the field of executive remuneration has been regarded with suspicion. We should note that the one European company that used great stock options for the remuneration of its managers was a Dutch company, the *Royal Ahold*. This company collapsed due to an accounting scandal approximately in the period of the *Enron and the Wordcom scandals*[43]. This also points out how important it is to act with due care when applying share options as part of a remuneration.

It is a risk of applying share options as executive remuneration, that the increase of the share price – that is in the interest of the management – takes place without value generating investment projects. The management is still motivated to avoid paying dividends and to buy further treasury shares (and thereby increase share prices). If the CEO holds a share option, paying dividends will not be an indifferent issue for him or her, except if the options are dividend protected, which is not very frequent. As the amount of paid dividend increases, so drops the value of the share option. Therefore, CEOs that hold large share options favour the share buybacks – purchase of treasury shares – (as it is pointed out in Jolls's analysis of 1998[44]) to paying dividends[45].

It is also a peril of share options that the management might engage in more risky – even overly risky – transactions for the increase of the share price. The increase of the share price is also often caused by developments in the industry, or a strong stock market, and lesser by the individual performance of the managers[46]. According to different opinions however, managers tend to retain their power by acquiring significant voting rights in the company.

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[42] **European Commission, Enterprise Directorate-General**, *Employee Stock Options – The Legal and Administrative Environment for Employee Stock Options in the EU*, Final Report of the Expert Group (June 2003), p. 7; accessible at: http://ec.europa.eu/enterprise/policies/sme/files/support_measures/stock_options/final_report_stock_en.pdf; 28.03.2011.

[43] See **J.G. Hill**, *Regulatory...*, p. 408.

[44] See **C. Jolls**, *Stock Repurchases and Incentive Compensation*, NBER Working Paper 6467 (1998).

[45] See **B.J. Hall**, *The Pay...*, pp. 24–25.

[46] See **J.A. McCahery**, **L. Renneboog**, *Managerial...*, pp. 326–327.

Due the concentration of their investment in one specific company, they might become more risk-averse[47].

One should also consider the possibility that the management (CEOs) might attempt to press down share prices (and issue less optimistic forecasts) prior to granting options and to push them up when exercising the options. In firms with dispersed ownership managers have a positional advantage, and as a result thereof – for example according to the studies of professors David Aboody[48] and Ron Kasznik[49] – managers do not only intend to carry out such manipulations, they also have the means to do so[50]. There are pieces of empirical evidence proving that CEOs schedule the disclosure of news relevant to the company, so that they precede (bad news) or follow (good news) the granting of options (or the exercise thereof).[51]

Such manipulations and insider trading are obviously unlawful; still it can occur that management may seek to have options granted when it thinks that the company's stock is trading at a low[52].

It is an important principle as well that options which may be exercised in the future (for example after a period of 4 years), may represent a serious motivation, whereas options that may be exercised right away provide minimum incentive[53]. Accepting the option and the nature thereof can be an important sign to the market, as these demonstrate that the manager, who is fully aware of the realistic situation of the company, trusts in its performance as much as to accept a portion of its pay in options (*signalling theory*). Therefore the remuneration agreement can provide sufficient motivation to the manager to carry out further activities in the company; the share option ensures adequate remuneration[54]. Consequently, in our opinion, disclosing that the management has accepted a remuneration agreement facilitates the evaluation of the realistic situation of the company.

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[47] See **M.J. Loewenstein**, *The Conundrum of Executive Compensation*, Wake Forest Law Review 2000/35/1, p. 13.

[48] David Aboody: Professor of accounting at University of California, Los Angeles.

[49] Ron Kasznik: Professor of accounting at Stanford University Graduate School of Business.

[50] See **J. Hill**, **C.M. Yablon**, *Corporate*..., pp. 308–309.

[51] See **T. Perry**, **M. Zenner**, *CEO Compensation in the 1990's: Shareholder Alignment or Shareholder Expropriation?*, Wake Forest Law Review 2000/35/1, p. 141.

[52] See **R.A. Booth**, *Executive*..., pp. 285–290.

[53] See **S.M. Bainbridge**, *Executive*..., p. 1623.

[54] **R.A. Booth**, *Executive*..., pp. 285–290.

Based on the *efficient capital market hypothesis*, another problem can emerge. If managers are paid in share options, or if their remuneration is linked to the performance of the shares on the stock market, managers may have a stake in holding back negative news or to embellish financial results[55].

On the other hand, the risk of the management is a lot higher than of most shareholders, as their options are not diversified, and also because their human capital is invested in a single venture. A diversified shareholder is more interested in maximizing the profit of his portfolio. If one of the companies suffers losses as a consequence of that, it is possible to make up for that loss in other companies. So diversified shareholders prefer the maximizing of return, even it is connected with extraordinary risk-taking. Following that line of thought, it is possible that the (undiversified) manager is even more interested in the welfare of the company it manages than the shareholders thereof[56].

Nonetheless, reality does not necessarily confirm that. The reason for that is that due to derivatives trading and hedging techniques, the management can eliminate from its remuneration the element of risk originating in the decrease of the share price[57]. In order to prevent abuses of insider information, it might be important to restrict the immediate resale of shares acquired within the exercise of the stock options[58].

VII. Indexed share options

It is important to define thoroughly considered terms of transfer with regard to the options. It is a good solution for optimising the motivational force to link the advantages it carries to the relative performance of the company compared to the market or to a particular peer group. This way the risk of excessive remuneration and unearned remuneration are eliminated. For the above reasons we find indexed options important, although many other facts support their application. The management cannot do anything against external circumstances, such as the general problems of the given industry, negative market

[55] See **G.L. Salamon**, **D.E. Smith**, *Corporate Control and Managerial Misrepresentation of Firm Performance*, Bell Journal of Economics 1979/10/1, pp. 319–320.

[56] See **R.A. Booth**, *Executive*..., pp. 276–277.

[57] See **J. Hill**, **C.M. Yablon**, *Corporate*..., p. 308

[58] See **European Commission, Enterprise Directorate-General**, *Employee*..., p. 8 and 15.

trends or recession. It is possible that despite of the fall of the share price, the management has done an excellent job. Consequently, one cannot always assess performance objectively on the basis of the share price. Relative performance however, can be measured in the rates of dividends paid to the shareholders of (similar) companies in the same industry, or by comparing the prices of such companies' securities. This could be a fair ground of remuneration[59].

If the management receives an additional compensation only for a relative increase of the share price – the increase compared to that of the peer firms or the market – it is easier to award their own efforts and performances. An objection can be raised against this method, namely that certain problems can emerge that are definitely specific to the company, but are hardly attributable to the activities of the CEO. It is also possible that in the middle of the option period, the CEO reckons that the company is behind its competitors. In this case, the indexed option provides little incentive, as the CEO would figure he could not do much to make up for the fallback. It has been suggested to link the exercise price of the option by a partial index to a certain segment of the industry, for example to the rear segment, or the last quarter of peer companies. Such a proposition is aimed at eliminating the above problem of motivation. At this point we wish to underline the mechanism of the indexed option's operation. Indexed option means that if the share price of the peer companies in the respective market segment increases on an average by (for example) 10%, the exercise price of the option, which is usually the grant date market price, will be increased accordingly. Consequently, one can only reach a high income by outperforming the competitors. Another useful tool could be if we condition the exercise of the options. For instance, the management cannot exercise the option, if it does not comply with certain performance criteria[60].

VIII. The optimal share option agreements

The details and conditions of granting options are set forth by the options plan. Most options have a vesting schedule, which is defined in the options

[59] See **G. Ferrarini**, **N. Moloney**, *Executive*..., pp. 264–266, 274–275.

[60] See **L.A. Bebchuk**, **J.M. Fried**, **D.I. Walker**, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, University of Chicago Law Review 2002/69/3, pp. 799–801.

plan. For instance, 10% of the option grant is transferred in every 6 months, so the total transfer period is 5 years, with a further 5 years time to maturity[61].

Generally we can conclude that employee stock options are rather of the "American style" (they can, in principle, be exercised at any time after vesting). One should note the general differences between American style and European style options. In case of an American style option, the holder may exercise the option any time within a predetermined period. In case of European style options, the holder must wait until such period expires, and then he can decide if he wishes to exercise the option or not[62].

Despite that, it may occur that options can only be exercised for a short period of time, generally shortly after the presentation of the annual balance or of the shareholders' meeting. Those provisions might be important as well, which forbid to the manager to sell the share right after acquiring it, and also oblige him or her to keep the security for a certain period of time[63].

An observation demonstrates that 10-year executive stock options have been exercised on an average after 5.8 years in 40 large companies in the United States[64]. We can therefore conclude that it is advisable to include in the compensation agreement that within a certain period of time, the executive acquiring the option cannot reduce or minimise the financial risks of the option, also cannot sale or in any other way transfer the option. Thus share option with a remuneration purpose generally are not transferred at the time they are granted, in other words, the manager cannot exercise them right away, he or she has to wait with that, often many years. Often employee stock options vest partially, consequently only a certain percentage of the options vest each year[65].

It is obviously necessary to determine the exercise price in the options plan[66]. According to empirical studies from the United States, a great part of the options granted to the management are so-called *at-the-money* options, which means that their exercise price is close to the underlying share price in the time of the granting of the options. Only a few companies (approximately 2%) grant *in-the-money* (discount) options, in which case the exercise price is lower than the price prevailing on the day of granting the option. An even smaller number

[61] See **R. Aggarwal**, *Executive...*, p. 853

[62] See **European Commission, Enterprise Directorate-General**, *Employee...*, pp. 12, 15.

[63] See *ibidem*, at p. 15.

[64] See **L.A. Bebchuk**, **J.M. Fried**, **D.I. Walker**, *Managerial...*, pp. 825–827.

[65] See **European Commission, Enterprise Directorate-General**, *Employee...*, pp. 13–14.

[66] See *ibidem*, p. 14.

of companies (approximately 1%) issue *out-of-the-money* options, which are also called premium options. In their case the exercise price is higher than the price prevailing on the day of granting the option. A significant majority of companies have share options plans covering several years[67].

Employees mostly prefer at-the-money and in-the-money options. According to a study of Professors Hall[68] & Murphy, executives certainly favour smaller options of a lower exercise price to larger options of a higher exercise price. Furthermore, it was also proven that if the option is added to an existing compensation plan as an extra element, without reducing other elements, the option has the highest incentive power if the exercise price more or less corresponds to the market price prevailing on the day of granting the option. If the share option is not connected to an existing remuneration package (it is not an additional element to existing compensation), the incentive power is the highest if the exercise price is lower than the market price prevailing on the day of granting the option. The reason for that is that high exercise price reduces the payout probabilities, which abates the incentive power among undiversified, risk-averse executives[69].

As a summary, from the perspective of employees, at-the-money and in--the-money options are the most valuable. From the (incorrect) perspective of the employer however, out-of-the-money or at-the-money options seem more cost-efficient. So options usually will be granted with an exercise price that corresponds to the grant-date market price[70].

With respect to the repricing of options we should present an observation made by Professors Bebchuk, Fried and Walker. They realised that options are usually only repriced after a market downturn, and not in times of upswing. On the other hand, possible repricing distorts the motivation of managers[71], so the management should not be assured of the possibilities of repricing.

As Warren Buffett[72] observed in this regard, getting rich with at the money options vesting over a ten-year period does not take much effort. For instance, if

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67 See **B.J. Hall**, *The Pay...*, p. 8.
68 Brian J. Hall: professor at Harvard University.
69 See **K.J. Murphy**, *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, University of Chicago Law Review 2002/69/3, p. 864.
70 See *ibidem*, at p. 864.
71 See *ibidem*, at p. 865
72 Warren Edward Buffett ("the Wizard of Omaha"): investor, business man, one of the richest people in the world. His investment company is called Berkshire Hathaway.

the CEO does not pay dividend for ten years, but purchases government bonds with the company's earnings, the share price will (probably) increase during this period. As market prices in general increase, the at-the-money option will become an in-the-money option in the future[73].

IX. Decision-making regarding share option remuneration

The increasingly important role of options, the fact that a high level of remuneration can be achieved by them, the complicity of option schemes and certain risks they carry raise a justified question that which body of the company should supervise the granting of options. Therefore we should review how each relevant corporate governance code regulates this issue.

According to the *Corporate Governance Recommendations* of the Budapest Stock Exchange, in the case of share-based remuneration schemes, the structure should be approved by the general meeting, as well as the amount of actual remuneration in the case of Managing Body and Supervisory Board members. In the case of the members of the executive management, the level of actual remuneration is not the responsibility of the general meeting. In order to ensure that shareholders are sufficiently well-informed, the Recommendations set forth that before voting, shareholders should be provided with detailed information on the share-based remuneration schemes (and any amendments to them), how the company provides the necessary shares and what cost this entails[74].

Pursuant to the provisions of *The UK Corporate Governance Code*, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. It is also recommended that directors be encouraged by other means as well to hold their shares for a further period after vesting or exercise[75]. Any new long-term incentive schemes which are proposed should be approved by shareholders[76]. Remuneration for non-exe-

[73] See **L.A. Bebchuk**, **J.M. Fried**, **D.I. Walker**, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, University of Chicago Law Review 2002/69/3, pp. 819–820.
[74] Budapest Stock Exchange, *Corporate*..., 2.7.4.
[75] *The UK Corporate*..., Schedule A.
[76] *Ibidem*, Schedule A.

cutive directors should not include share options or other performance-related elements, only in exceptional cases[77].

The *Deutscher Corporate Governance Kodex* also emphasises the importance that share or index-based compensation elements (such as shares of the company with several years of transfer restraint) are related to relevant comparison parameters. Changing such performance targets or the comparison parameters retroactively shall be excluded. For extraordinary developments a possibility of limitation (cap) must in general be agreed upon by the Supervisory Board[78].

According to the ASX Corporate Governance Principles and Recommendations (with 2010 Amendments), equity-based remuneration can be an effective form of remuneration when linked to performance objectives. It is declared however that equity-based remuneration has limitations and can contribute to 'short-termism' on the part of senior executives. Accordingly, it is important to design appropriate schemes[79].

X. Shares under transfer restraint as a remuneration tool

According to the views on management remuneration of Hall & Murphy, the so-called "non-tradable restricted stocks may represent a more efficient tool", which can also be interpreted as options with a zero exercise price. In other words, "these shares are given to the management as remuneration, but they cannot transfer these securities for a definite period of time"[80]. Naturally it is in the interest of the managers to ensure an adequate share price increase and thereby the greatest possible remuneration for themselves. If the management owns non-tradable restricted stocks, it is much more motivated to promote an optimal dividend policy. As options only reward the increase of the share price, in the case of options the management will be less inclined to pay dividend and more to repurchase shares[81].

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77 *Ibidem*, D.1.3.

78 See *Deutscher*..., 4.2.3.

79 See *ASX Corporate*..., Box 8.1.

80 **R. Aggarwal**, *Executive*..., p. 853

81 See **B.J. Hall**, **K.J. Murphy**, *The Trouble with Stock Options*, Journal of Economic Perspective 2003/17/3, pp. 49–70, 60.

The fact that the management board owns shares of the company is in itself a relatively stable motivational force compared to options, as the incentive value thereof depends on the difference between the exercise price and the market price. Therefore, as long as the market price significantly exceeds the exercise price, the option provides a good motivational force, but as soon as the market price falls behind the exercise price by a substantial degree, the manager loses his or her chance to turn the construction to his or her advantage. Consequently, the option loses its function as a motivational tool. Such *underwater options*[82] urge companies to reduce the exercise price of the option (to reprice them) or to issue a new, supplementary option with a lower exercise price. In this case, it is obviously the degree of repricing that may cause problems. Such phenomena can be prevented by the use of non-tradable restricted stocks, which also encourage the management to enter into riskier transactions as well[83].

As a negative feature of this solution, we can point out that such remuneration will lead to the immediate dilution of the shares and thereby the amount of dividend per share will be reduced, and also the voting rights of the management will be overly increased.

XI. The role of the public and the regulation of disclosure obligations

Transparency can have a remarkable role in matters of remuneration. In order to ensure transparency, it is important that the information related to remuneration and the underlying principles are accessible to the shareholders. Such access can be provided by disclosing remuneration practices or by disclosing a so-called remuneration report (statement). Disclosure forces the body that is responsible for setting remuneration to sufficiently support and justify the remuneration practice, and it can also reveal the function and activities of the remuneration committee. Disclosure also improves the shareholders' opportunities to monitor and promotes the more active supervisory functions of institutional investors. Investors are enabled to extensively adjudge the activities of those who participated in the setting of the CEOs compensation, and also the results of the negotiations[84].

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[82] So-called underwater options.

[83] See **B.J. Hall**, **K.J. Murphy**, *The Trouble*...

[84] See **G. Ferrarini**, **N. Moloney**, *Executive*..., pp. 287–301.

It is an indispensable condition of the exercise of shareholder rights related to remuneration and of the controlling functions of publicity that the so-called remuneration statement is disclosed.

Corporate Governance Recommendations of the Budapest Stock Exchange stipulate that on the remuneration principles and the actual remuneration of the members of the Managing Body, the Supervisory Board and the executive management the company should provide information (Remuneration Statement) for shareholders which should be submitted to the general meeting. The Remuneration Statement should contain the remuneration of each member of the Managing Body, the Supervisory Board and the executive management. It is also recommended that, after considering all the factors influencing the company's operations, in a manner acceptable to the company, the company should provide information to the public in a "Remuneration Statement" in its annual report and on its website on the remuneration guidelines applied by the company, in which it informs its owners about the remuneration provided for members of the Managing Body, the Supervisory Board and the executive management. It is recommended that the Remuneration Statement should explain the guidelines relating to the members of the Managing Body, the Supervisory Board and the executive management, according to which their performance is evaluated and their remuneration is established. The disclosure should contain the amount of aggregate remuneration of the Managing Body and the Supervisory Board, detailing the fixed and variable components, any other benefits, and an outline of the guidelines for the remuneration system, as well as major changes as compared to the previous financial year[85].

According to the *Deutscher Corporate Governance Kodex*, the total compensation of each member of the management board is to be disclosed by name, divided into fixed and variable compensation components, except if the general meeting has decided otherwise in a resolution passed by three--quarters majority. Disclosure shall be made in the Notes or the Management Report. A compensation report as part of the Management Report outlines the compensation system for Management Board members. The outline shall be presented in a generally understandable way[86].

[85] Budapest Stock Exchange, *Corporate*..., 4.1.1, 2.7.7.

[86] *Deutscher*..., 4.2.4, 4.2.5.

Conclusion

In order to formulate a reasonable and efficient remuneration policy, the relevant legal and economic theories, as well as practical (empirical) observations need to be taken into consideration. It is important that the established policy be at the same time suitable for motivation and in line with results, representing the performances on which such results are based. The foregoing aspects should be taken into consideration also upon selecting the appropriate remuneration components; however, it must be borne in mind that the nature of the motivation may be subject, to a significant extent, to the characteristics of the corporation, sector specific features, moreover, the individual circumstances of the executive officers.

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WYNAGRODZENIE ZALEŻNE OD EFEKTÓW – PRAKTYCZNE ASPEKTY WYNAGRADZANIA OSÓB ZARZĄDZAJĄCYCH SPÓŁKAMI KAPITAŁOWYMI

(Streszczenie)

W ostatnich dziesięcioleciach nastąpiły istotne zmiany w zakresie wynagrodzeń osób zarządzających firmami. Nie tylko tendencja wzrostu tych wynagrodzeń, lecz także znaczące przejście w kierunku uwzględniania czynników opartych na wyniku i (szczególnie) wartości rynkowej firmy, sprawiły, że zjawisko to zwróciło uwagę prawników i ekonomistów. W artykule tym autorzy, w oparciu o obowiązujące regulacje prawne, chcieliby rzucić światło na praktyczne aspekty określania wysokości uposażeń osób zarządzających korporacjami.

Słowa kluczowe: prezes zarządu, zarządzanie spółkami kapitałowymi, członek zarządu, opcja, wynagrodzenie