

Huong Quynh Tran

SHOULD THERE BE A SALARY CAP FOR TOP MANAGERS IN THE FINANCIAL SECTOR?

Bachelor Thesis

Kajaani University of Applied Sciences
School of Business
Degree Programme in International Business

Heilbronn University
Faculty of International Business
International Business – Intercultural Study

07 November 2013

School Business	Degree Programme International Business
Author(s) Huong Quynh Tran (Matriculation number: 37300 (KUAS) – 178258 (HHN))	
Title Should There Be a Salary Cap for Top Managers in the Financial Sector?	
Optional Professional Studies	Supervisor(s) Prof. Dr. Mathias Moersch; Senior Lecturer Sami Malm
	Commissioned by
Date 07 November 2013	Total Number of Pages and Appendices 40
<p>The thesis reviews current legislation concerning executive compensation in four selected countries including United States of America, Germany, Switzerland, and United Kingdom, as well as the European Union. The common trends among those countries and the union are Say-on-Pay vote and implementation of the Financial Stability Board Principles. Afterwards plus and minus sides of some regulations (including Say-on-Pay vote, European Union’s banker bonus cap and salary cap) are examined.</p> <p>The theoretical background consists of two parts. Firstly, the concepts related to the asymmetric information topic, e.g. the terms “moral hazard” and “principal-agent problem” are described a little more carefully since they are quite relevant for the thesis’ topic. Secondly, the design of a typical executive compensation package is introduced. Although many elements of such a package are dealt with, stock options is the element that was elaborated the most, since in some perspectives it is the most complicated element among the mentioned ones.</p> <p>Regarding the question: “Should there be a salary cap for top managers in financial sector?”, the author prefers the idea of covering loopholes in existing regulations, as well as imposing serious punishment on violators of applying a salary curb for senior executive officers in the financial industry.</p>	
Language of Thesis	English
Keywords	Executive compensation, banking industry, legislation
Deposited at	<input checked="" type="checkbox"/> Electronic library Theseus <input type="checkbox"/> Kajaani University of Applied Sciences Library

ACKNOWLEDGEMENT

I would like to express my deep gratitude to Prof. Dr. Mathias Moersch for being such a great motivator and thesis supervisor. His enthusiasm and knowledge helped me to realize the interesting side of Economics and Finance field as well as motivated me to go deeply into these subjects. Special thanks to his guidance and advice during the whole thesis process.

My appreciation goes to Mr. Sami Malm – my second thesis supervisor as well as all the lecturers who have instructed me during my university study. I wish to thank the coordinators in Kajaanin ammattikorkeakoulu and Hochschule Heilbronn, who have helped me with my administrative issues. Without their help, my “first-of-its-kind” issues could have caused me much more difficulties.

Finally, I would like to thank my family, especially my parents for their care and support. Gratitude is extended to my close friends, who have been putting up with me for many years.

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I. Introduction

Since the recent financial crisis started in 2007, much ink has been spilled on the topic of how to make worldwide financial system more stable and prevent another economic meltdown from happening again due to the same reason. Beside suggestions regarding limiting leverage ratio, regulating derivative markets, and so on; regulating employees', and more particular, executives' compensation in financial industry is also a topic that attract a lot of attention of scholars, regulators as well as public. The objective of this thesis is to give an overview of legislations on executive compensation being enacted by some countries during the past few years and analyze these legislations' strong as well as weak points.

This thesis starts with a touch of basic relevant microeconomic knowledge. Following is a review of components in a typical executive remuneration package. Next, a brief outline of executive compensation enacted in the U.S. is provided. Then, legislations which have come to force recently in the United States of America (U.S.), Germany, Switzerland, European Union (EU) and United Kingdom (U.K.) are introduced respectively. Thereafter, positive and negative aspects of some regulations are analyzed. Finally, a short conclusion and some comments of the author are presented.

II. Theoretical framework

1. Basic concepts in Microeconomics field

1.1. Asymmetric information

In a considerably concise way of explaining, asymmetric information can be defined as “one of the parties to a transaction has information relevant to the transaction that the other party does not have” (Case et al. 2012, p. 398). This situation is so common that some examples of asymmetric information can be easily listed as followed: the seller of a used car knows more about the condition of his car than a customer who is interested in buying it; or a doctor is much more aware of tests that a patient really has to do than the patient himself (Wheelan 2010). Or, in a recruitment opportunity, a candidate knows more about his abilities, knowledge and skills as well as his willingness to work than the potential recruiter does (Pindyck, Rubinfeld 2013). In corporate context, managers are much better informed about the company’s financial and operational conditions than their employers – which are the shareholders in listed companies (Stewart, Brown 2011). In this particular instance, asymmetric information may even trigger illegal behaviors called insider trading when one person takes advantage of his or her privileged information and makes a trade (Berk, DeMarzo 2011). In fact, the existence of asymmetric information in daily life is so abundant that three economists George Akerlof, Michael Spence and Joseph Stiglitz were awarded the 2001 Nobel Prize in Economics for their study on this subject (Mankiw 2011).

Asymmetric information leads to a fact that the informed party may make the best of the information that it has and take advantage of the less-informed party. This manner is called “opportunistic behavior” and there are two types of them: “Adverse selection” and “Moral hazard”. It is not always straightforward to differentiate them clearly (Perloff 2009).

1.1.1. Adverse selection

Adverse selection is opportunistic behavior in which an informed party takes advantage of a less-informed party through an *unobserved characteristic* of the informed party. The situation can result in market failure where “resources are misallocated, or allocated inefficiently” (Case et al. 2012, p. 294; Mankiw 2011). Let’s look at a well-known study conducted by George Akerlof (1970) on used car market. The owner of a bad car – *lemon* – always wants to conceal his car’s problems from potential buyers. This objective is

feasible since most of these problems can only be recognized after a certain time of driving. And if the owner of a good car – *peach* - cannot prove to the buyer that his car's quality is better than a *lemon*, that buyer will consider both car indifferently and offer the same price to two owners. For certain, this price is a satisfactory price for the *lemon*'s owner but an unsatisfactory one for the *peach*'s owner. Then the good car's owner may not want to sell his car anymore and exit the market unwillingly. Eventually good products will be squeezed out of the markets unless *peach*'s owner come up with a technique to demonstrate his car's good quality (Akerlof 1970 as cited in Pindyck, Rubinfeld 2013). Similarly, the fact that banks cannot tell the low-quality credit card borrowers and high-quality borrowers apart drives the interest up and up. The reason behind is the more interest is raised, the more high-quality borrowers exit the credit market. At the end of the day, only low-quality borrowers stay (Pindyck, Rubinfeld 2013). Looking at this consequence from a broader perspective, good products may not be manufactured by the firms anymore since they are not valued at a suitable price by consumers (Perloff 2009).

Another aspect of the market failure is price discrimination where consumers have the choices to pay different prices for exactly the same products. This circumstance happens and benefits companies only when the customer cannot distinguish the products and happy to pay prices they are happiest with (Perloff 2009).

Some methods to prevent market failure due to adverse selection are listed as followed:

1.1.1.1. Restrict opportunistic behavior

Opportunistic behavior can be restricted by universal coverage. Taking a popular example in the insurance industry where unhealthy people have more tendencies to buy health insurance than healthy people. This adverse selection can be eliminated if everybody has to buy health insurance (Perloff 2009). Indeed, by insisting on mandatory participation for all people above 65, the health insurance program Medicare is one of the most successful public programs in the United States (Pindyck, Rubinfeld 2013).

1.1.1.2. Equalizing information

Equalizing information can be conducted by both parties depending on particular situation.

a. *Screening*

Screening is usually conducted by the less-informed party in the transaction. It means gathering more and more information as long as the marginal cost of collecting information does not exceed the marginal benefit generated from it. For instance, thanks to the Internet,

consumers now can search for information of almost every single product such as characteristics, price, warranty term as well as compare them to similar products without having to spending a lot time and effort. Nevertheless, these costs seem only worthy when it comes to costly spending such as a plasma TV or a laptop, not something like an adhesive tape. From an insurance company's point of view, screening means collecting the information about the contract buyer, such as information about health record of other family members or extra tests. The length and cost of this process may vary depending on the value of the contract since as mentioned, the cost of this activity is not supposed to surpass the benefit that the contract brings (Perloff 2009).

b. Signaling

Signaling is another way to equalize information, often carried out by the informed party with the aim of proving abilities and quality. For example, the firms may acquire quality certificate for its products, such as the International Standard Organization (ISO) certificate; or offer guarantee and warranty term (Perloff 2009). For the job market, education of candidates (in terms of degrees, qualification, grade-point average and so on) is considered to be a reliable signal for the recruiter since it is believed that the characteristics and skills that are needed in order to obtain a good educational background are likely to be the same as the ones that are required to achieved high productivity and industrious manner in working environment (Pindyck, Rubinfeld 2013).

1.1.2. Moral hazard

While adverse selection is opportunistic behavior in which an informed party takes advantage of a less-informed party through an *unobserved characteristic* of the informed party, moral hazard represents the same thing but through an *unobserved action* (Perloff 2009). Originally the term moral hazard is from the insurance industry (Münchau 2009). Therefore moral hazard examples are usually most associated with the insurance sector “when people are well insured against a particular risk, they will put little effort into making sure that the risk does not occur” (Baumol, Blinder 2012, p. 579). Some familiar situations illustrating this point are when people tend to be less cautious in protecting their own homes from burglars (such as forgetting to lock doors or not installing an alarm system) if their houses are fully insured (Pindyck, Rubinfeld 2013); or depositors have almost no

motivation to seek well-rated banks if their deposits are insured against loss by the Federal Deposit Insurance Corporation (FDIC) (Baumol, Blinder 2012).

In a quite different way of interpreting, Dowd (2009) explained that “a moral hazard is where one party is responsible for the interests of another, but has an incentive to put his or her own interests first” (Dowd 2009, p. 142). This definition seems to be completely comprehensive in the context of the financial crisis 2007-2009 with the subprime loan scandal. There was a time when a bank took responsibility for every loan that it made. Or in another way of speaking, if its debtor cannot repay the debt, the bank had to shoulder all the loss. But since the derivative market broke out, banks had had opportunity to sell the debt on or put it differently, securitize the debt. So banks received money from selling debt regardless of creditworthiness of the debtor. The more debt they sold, the more compensation their employees and managers gained. Needless to say, more and lower quality loans were made and a large proportion of them were mortgage loans. Bankers cared about their bonus rather than the financial standing of their debtors (Ferguson 2010). That behavior is definitely moral hazard. The next moral hazard is when that Ponzi scheme stopped; banks run out of capital since debtors cannot repay their loans and banks received hundreds of billions of dollars bailout from tax payers. For certain, public are furious since they perceived that they had to pay for cost of excessive risk-taking of well-paid people working in financial sector (Mussa 2009). As Mussa (2009) notes, moral hazard took place before the recent financial crisis happened is the result of bailouts *in the past*. And the bailouts carried out during the crisis 2007-2009 will indeed lead to *future* moral hazard.

However, Münchau (2009) argues that moral hazard is “a bad metaphor” in the above context. He suggests using the term “policy sustainability” (Münchau 2009, p. 128). The reason for that is as Münchau points out, not every bank got bailed out. Furthermore, he believes that the managers in financial sector did not fully foreseen the consequences of the risks that they made.

When the informed party in the transaction in the already-mentioned definition is people who are hired (“agent”) by uninformed party - people whom benefits are affected by agents’ actions (“principal”), it is called “principal-agent problem” (Pindyck, Rubinfeld 2013). Consequently, the principal cannot know if their interests are served fully by the agents (Sloman 2007). The particular type of moral hazard when the employees do not work as effectively as they could is named shirking (Perloff 2009).

1.1.2.1 Restrict job shirking behaviors

a. Monitoring

Job shirking may be alleviated through strict monitoring, which means supervising employees by videotaping their actions, reviewing computer files or taping phone conversations, for instance. Sometimes these monitoring activities take place without informing the employees themselves. Although monitoring helps to evaluate the employees' performance fairly, at an extreme extent it may create an untrusted and uncomfortable working environment as a downside. Obviously unfavorable atmosphere will result in low productivity (Perloff 2009).

b. Financial incentives

Bonding simply refers to the deposit that agent has to hand the principal in order to guarantee their good behaviors. As a typical example, bond is the deposit amount that the tenants have to give to the landlords every time they sign the rental contracts. Given that this amount can only be returned fully if the apartments are in good condition when the contracts are terminated, tenants have good incentives to keep an eye on the accommodation (Perloff 2009). Furthermore, bonds aid in preventing employees from quitting their jobs right after they receive an expensive training paid by the firms (Salop, Salop 1976 as cited in Perloff 2009).

Deferred payments work in the same way as bonds in the sense that it increases the cost of bad behaviors. Companies apply deferred payments by paying a relatively low starting salary and then raising it throughout the employees' career lives. Consequently employees who are fired due to shirking will lose the high future earnings (Perloff 2009).

Efficiency wages involves paying workers a higher wage than average so it if a worker is fired because of job shirking; he or she has difficulty in finding a new job which offers at least the same wage. Similar to bonding and deferred payments, efficiency wages increases the cost of job shirking. This method still works in cases all firms provide a high wage which leads to an overall high level of wage. Under this circumstance efficiency wages increase the cost of job shirking through increasing the cost of unemployment. That means under an overall high level of wages, during unemployment period, a worker can lose the opportunity to earn more money than under an overall lower wages (Perloff 2009).

Whereas all of the financial incentives above aim to prevent job shirking as it happens, after-the-fact monitoring put the punishment (if any) after checking and taking over the

work of the employees. For instance, in order to prevent moral hazard, the insurance company only allow claims if after examining the place of action and all the relevant facts, the company finds no trace of moral hazard. In particular, an insurance company will disallow claims if it finds out that car damages are the consequence of the driver's drunken condition (Perloff 2009).

1.1.2.2 Principal-agent problem

When it comes to the context of corporation, the common appearance of “principal – agent problem” is agency problem, which refers to the situation when managers deliberately prioritize his own self-interest rather than the shareholders' interest, even though the managers are paid by the shareholders (Berk, DeMarzo 2011). This problem may lead to consequences such as managers takes excessive risk without sufficient consideration, invests in unprofitable projects or spends corporate money on unnecessary assets (for instance: private jets). Furthermore, as already mentioned, there is asymmetric information situation between shareholders and managers. This fact combines with agency theory may result in a circumstance that if managers do not have incentives to share all information with shareholders, shareholders will not be aware of available opportunities that can potentially increase the firm's value (Stewart, Brown 2011).

For certain managers are controlled by several factors so that agency problem is mitigated. One of them is official legislation such as accounting and reporting principles established by Securities and Exchange Commission (SEC). In addition board of directors is supposed to act in the interest of shareholders and supervise managers' performance. However this factor is considered not to be strong enough due to the managerial power theory (will be introduced hereinafter) therefore there have been regulations being enacted to ameliorate the situation. For example the Sarbanes-Oxley Act (SOX) require firms to have more independent directors on the board. In addition, obviously owners of companies – the shareholders – also put a large pressure on management team and if they are not happy, they can demonstrate their dissatisfaction such as by taking part in the “Wall Street Walk” – selling out shares of companies. Moreover, large shareholders, who own a substantial amount of shares of a firm, have considerable influence in company's operations. Besides, managers' performance are pressed by specialists such as creditors or analysts who give advices to investors. Furthermore, poor performing management team usually lead to a drop in share price therefore companies become more vulnerable to hostile takeover and

managers face the threat of being dismissal. On top of that, compensation plans is definitely an incentive that encourage managers to work their best to improve competitiveness as well as value of their companies. A lot of effort has been put in enhancing the compensation plan in order to mitigate agency problem (Brealey et al. 2012).

Regarding compensation plans, in order to tackle moral hazard in general and principal-agent problem in particular, economists have elaborated on the area of mechanism design. In a concise way of speaking, mechanism design is “a contract or an institution that aligns the interests of two parties in a transaction” (Case et al. 2012, p. 395). The 2007 Nobel Prize went to Leonid Hurwicz, Roger Myerson, and Eric Maskin as a recognition of their work in this area (Case et al. 2012). In agency problem case, mechanism design resolves the principal-agent rules by aiming for “incentive compatible”, which means placing the incentives of manager align with the incentives of shareholders (Phelan, Clement 2009, p. 4).

Taking this idea one step further will lead to optimal contracting theory, which holds the crucial supposition that “the top executives and shareholders, through the board of directors, negotiate at arm’s length over pay, with each side trying to maximize its respective interests” (Schneider 2013, p. 17). According to this model, economists believe that the principal-agent problem can be lessened by asking board of directors to align executives’ interests with shareholders’ interests. This goal is reached though paying “executives in the same ‘currency’ that matters to shareholders, namely dividends and rises in share price” (Crane, Matten 2010, p. 247). This ‘currency’ is commonly known as “pay for performance” incentives in compensation package of top executives. Although this kind of incentives might have some different forms, its fundamental purpose is still to encourage top managers to ameliorate the firm’s performance so that the managers can benefit from it as well as the shareholders. As a result, the interests of shareholders and managers are believed to be more and more aligned through increasing the share of “pay for performance” incentives or long-term incentives plan in executive remuneration package. This tendency in setting executive compensation was dominant at least until the recent financial crisis (Schneider 2013).

After the corporate governance scandals in 2001 and financial crisis 2007-2009, economists took a closer look at executive compensation and they found out that the optimal contracting theory has failed in applying in real life. There is a considerable gap between theory and practice. As explained, optimal contracting theory supports the idea of

top executives and shareholders negotiating the compensation through board of directors. However, as Bebchuk, Fried (2003) points out, there is no rationale to believe that the board of directors will act for the interests of shareholders either. Therefore the economists came up with a new theory about executive compensation called “managerial power theory”. The main idea of this new theory is that managers indeed have a large influence over the board of directors in setting their own compensation, which leads to enormous distortions between their performance and their compensation. Consequently, the remuneration package actually ameliorates rather than alleviates the agency problem as it is supposed to (Schneider 2013).

The managerial power can be explained under several perspectives. One of them is the fact that the CEO has influence in appointing members of the board and being on a board of directors brings a person a respectable social image. Therefore the independent directors have incentives and feel beholden to go for the compensation packages that satisfy their executives in order to keep their position. Opposing CEO’s pay may result in being eliminated from the board and being “notorious” for opposing CEO’s pay may additionally harm the chances of being elected to another board. Moreover, besides the noneconomic incentives, supporting CEO’s compensation package produce economic incentives for board members as well since CEO has an effect on directors’ pay. In addition, the CEO may benefit the independent directors’ own firm or organization on behalf of the CEO’s firm (Schneider 2013). After all, “40% of directors on U.S. boards have financial, familial, and social ties to the CEO” (Hwang, Kim 2009 as cited in Mangen, Magnan 2012, p. 88).

2. Compensation components

In a nutshell, managers in general and in the financial sector in particular are paid to take risks. They are compensated to consider different projects and choose to invest in profitable ones (Monks, Robert A. G., Minow 2008; The four-letter word that colors the compensation debate 2009). As illustrated in Figure 1, the compensation package of top managers usually consists of various components ranging from base salary, bonus to long-term incentive plans. The proportion of each component varies depending on a lot of factors, such as current stage of firms in business cycle: executives are likely to receive more base salary relatively in mature firms than in growth firms (Dessler 2005).

One technical term that is utilized fairly commonly in regulations about executive compensation is “variable pay”, which is “any plan that ties pay to productivity or profitability, usually as one-time lump payments.” (Dessler 2005, p. 441). Another term that is also referred to frequently in the same context is deferred compensation (which usually refers to “an arrangement for a fixed current salary with provision for annual payments over a period of years following retirement or other termination of employment” (Lasser, J. K., Rothschild, V. Henry 1955, p. 90). Last but not least, “clawback provision” is defined as pay practices that allows employer to retrieve already-paid compensation from employee under circumstances such as employees involve in fraudulent behaviors or acts that harms employer, and so on (see Schneider 2010).

Concerning the setting pay for executive process, it has been more and more common that this issue is dealt with by compensation committee, a subcommittee of board of directors. Some main aspects of the issue that needed to be discussed are pay level, mix of compensation and how much relevant pay should be with firm performance. Once the compensation committee come up with a pay recommendation, it is submitted to the board for approval and application (Huang 2010; Mangen, Magnan 2012).

Base pay	Bonus (short- and long-term bonus)	Benefits	LTIPs	Perks
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Figure 1: Elements of a typical director level reward package. (Source: Tyson, 2006, p.295)

2.1. Base pay

Cash base compensation is the most straightforward component in the compensation package for CEOs. On average, cash pay makes up about half a CEO’s remuneration package (Huang 2010). During the period from 1992 till 2008, base salary is the least fluctuated component in terms of value compared to other components (bonus, restricted stocks and stock options) in executives’ compensation packages in U.S. banking and finance industry. To be more specific, base salary increased from \$0.3 million in 1992 to almost \$9.5 million in 2008. (Bank Executive Pay 2010). According to Jensen, Murphy (1990), in most cases, base salary is evaluated to be “an entitlement program” rather than a method to drive executives to excellent performance (Jensen, Murphy 1990, p. 141). They claimed that in order to strengthen the link between pay and performance, cash

compensation must be structured to reward good performance as well as punish poor performance.

2.2. Bonus

Normally bonus can be awarded monthly or annually, which motivates short-term performance of employees as well as managers. Short-term bonus can be more or less than a quarter of total pay with ease, or even more (Dessler 2005).

In the contrary to the common belief that cash bonuses are paid to CEOs based on performance, Grinstein, Hribaras (2004 as cited in Huang 2010) discovered that a large part of cash bonuses are paid to CEOs after acquisitions cases regardless whether these acquisitions bring benefits or loss to shareholders. Additionally annual cash bonuses have been criticized for encouraging managers to take excessive risk-taking, which results in “over-rewarding short-term result”, rather than focus on soundness of the firms in the long run (Fraser, Earle 2011, p. 75).

2.3. Benefits

2.3.1. Pensions

Pensions is defined as “[providing] an income to employees when they retire and to their surviving dependant on the death of the employee, and deferred benefits to employees who leave.” (Armstrong 2009, p. 852).

A study conducted by Bebchuk and Jackson, JR. discovered that pensions account for 34 percent of executives’ total compensation (2005 as cited in Huang 2010). It is also stated in the same study that CEO’s pensions are moderately irrelevant to their performance during their service. Supporting the same argument, Schneider (2013) suggested giving a second thought about executives’ pensions. Since the employing of Supplemental Executive Retirement Plans (SERPs) reward executives compensations regardless of their achievement, it only tends to weaken the link between pay and performance.

2.3.2. Severance pay

Severance pay is defined as “a one-time payment some employers provide when terminating an employee” (Dessler 2005, p. 484). However, when it comes to CEOs, severance pay sometimes get too generous compared to what they contribute during their service. In such situation, severance pay is called gratuitous goodbye payments to illustrate the fact that CEOs tend to receive huge sweetened severance pay even if they are fired due

to poor management performance (Bebchuk, Fried 2003). Occasionally CEOs have to depart from their companies due to being involved in legal or ethical scandals, yet they leave the firm with enormous severance pay (Schneider 2013).

2.3.3. Golden parachutes

Golden parachutes are payments that the senior managers receive when their employment is terminated due to a change in ownership or control of their companies (Dessler 2005). Treasury Secretary Timothy Geithner once suggested in a statement issued in June 2009 that golden parachutes and supplemental retirement should be reexamined to evaluate their affect in encouraging executives to perform in the interest of shareholders. (The four-letter word that colors the compensation debate 2009).

While threat of takeover is perceived as a motivation for managers to perform well since otherwise they will lose their jobs, golden parachutes may alter the original effect of threat of takeover since it awards executives huge compensation even though they did not manage to add value to their firms (Bebchuk, Fried 2003).

2.4. Long-term incentives plan

Since long-term incentive plans (LTIPs) are evaluated to have the tightest ties to performance, they are believed to serve the goal to align interests of managers and shareholders the best and therefore mitigate agency cost (Berk, DeMarzo 2011). Whereas LTIPs have a whole range of forms including “cash, stock, stock appreciation rights, and phantom stock” (Dessler 2005, p. 460), only stock and stock options will be elaborated in details below.

2.4.1. Stock

Stock is perceived to provide the most powerful link between pay and performance since once executives own stocks; they are expected to act for the interest of shareholders as well (Berk, DeMarzo 2011). However, Jensen, Murphy (1990) claims that this element of compensation package does not work as efficiently as it is expected to be unless executives owns a substantial portion of the companies’ total outstanding stocks. They also admitted that this suggestion might be difficult to implement in cases of giant conglomerate.

Awarded stocks to executives can be “restricted stock”, which is only transferable after a period time (usually two to three years) or only vested if the firms meet some performance criteria (Monks, Robert A. G., Minow 2008).

2.4.2. Stock options

Compared to other elements, stock option is the fastest expanding one in executives' compensation package (Hannafey 2003). First let's have a brief look at the basic information about this technical term: "A financial option contract gives its owner the right (but not the obligation) to purchase or sell an asset at a fixed price at some future date" (Berk, DeMarzo 2011, p. 673). When the contract guarantees the owner the right to buy the asset, it is called a call option. In the other case, it is the put option. The type of option contract that executives receive as part of their compensation package is call options and the asset here is the shares of their companies; that is, they are paid with contracts which offer them to buy the firm's shares at a fixed price in the future (Hannafey 2003). Being an equity-based compensation, the fundamental purpose of stock options is enhancing the alignment between the interests of managers and shareholders through increasing correlation between pay and performance (Baumol, Blinder 2012).

The price at which the owner of the contract exercises that contract is called strike price or exercise price. If the strike price is equal to the current market price of the option, that option is at-the-money. The option owner does not gain or lose anything from exercising an at-the-money option. If the payoff from exercising option is negative or positive, the option is said to be out-of-the-money or in-the-money respectively (Berk, DeMarzo 2011). As a matter of fact, only in-the-money options are exercised. Normally executives receive at-the-money options, in which the strike price equals to the stock price at the date when the options are granted (Huang 2010). Nevertheless, Lie (2005 as cited in Berk, DeMarzo 2011) discovered that many executives involve in backdating options. Backdating options is a manipulation method, which refers to the action of choosing the grant date of a stock option when that date is already passed. The date that is chosen normally is the date when the market price of stock is lowest in a month, a quarter or a year. By backdating options, executives in fact receive in-the-money options instead of at-the-money options (Berk, DeMarzo 2011; Huang 2010; Murphy 2011). This behavior obviously does not help to improve performance of firms and therefore considered illegal generally (Berk, DeMarzo 2011). Yet for some reasons executives still get involved this behavior to make their own luck although the economic value that option backdating practice brings is relatively small compared to the total compensation package (Huang 2010).

Every option contract expires at a specific date - the expiration date. For untailed stock options which are traded on organized exchanges, the expiration dates are "Saturdays

following the third Friday of the month” (Berk, DeMarzo 2011, p. 673). While American option allows its holder to exercise anytime until the expiration date, the only point of time that European option holder can exercise is the expiration date. It is obvious that American option offers holders more flexibility and it is also the dominant type. Regardless of these names, American and European option are traded worldwide (Berk, DeMarzo 2011). Executives mainly are paid American options (Chhabra 2008).

In addition to already-mentioned characteristics, stock options paid to executives also have some more obligations such as they are not exchangeable to a third party, they have to be exercised before a maturity date (usually ten years from the date that they are given) and they have a “vesting period”. Vesting period is the period of time when “the option holder does not actually own the option, and therefore may not exercise it, until the option vests” (Hall 2000, p. 122). The typical vesting period are “100% vesting after two years, and 25% a year vesting over a four-year cycle” (Chhabra 2008, p. 21).

Hall (2000) categorized options plans rewarded to executives into three types. The first one is fixed value plans, which guarantee executives with the same value of options grant over the life of the plan. Although this type of plans makes it feasible and easy for companies to track the benefits that executives get from options plan and therefore adjust it, it is evaluated to provide the weakest link between pay and performance since the executives receive the same option grants’ value regardless of their performance. The second type of plans is fixed number plans, under which executives receive the same number of options every year regardless of their performance. According to Hall (2000), this kind of plans provides a strong link between pay and performance since “the value of at-the-money options changes with the stock price, an increase in the stock price today increases the value of future options grants” (Hall 2000, p. 127). The last one out of three types of options grants is called magagrant plans, which are more common in private companies and post-IPO high tech companies. Magagrant plans supply executives with a large lump-sum options, in which not only the number of options but also the exercise are fixed. This type of option plans leads to a significant change in value of options grants given changes in stock prices.

Considering the fact that executives conventionally are rewarded with at-the-money American options grants, there has been criticism questioning the real positive effects of this compensation element. The most noticeable criticism is by taking advantage of stock options, executives are likely to benefit from any rise of stock prices, even if those increases

do not significantly correlate with the management of those managers. For instance, executives may make profit even when positive signals on the market are the lags of their predecessors' work (Schneider 2013); or when the whole market are lifted thanks to crucial optimistic information (Bebchuk, Fried 2003).

Furthermore, assuming that the stock price is only the result of the current executives' effort, options grants may still not align the interests of shareholders and managers. Schneider (2013) argued that the stock options profit the executives even if rise of stock price is just temporary and does not reflect the long-term growth of the firms. In addition, options grants reward option holders even when the rise in stock market price falls behind the industry average (Hannafey 2003). Putting the problem even more seriously, managers can get involved in unethical behaviors such as providing false information to the shareholders so that the market price of stocks goes up temporarily. Then managers take advantage of that rising price by exercising their call options to have the stocks and then sell them immediately after that when the market price is still high. This is only one among many illustrations to clear the point that without strict and proper regulations, stock options can be the cause of severe moral hazard (Baumol, Blinder 2012).

A lot of effort has been put in ameliorating stock options grants in order to resolve those drawbacks. One example is premium-priced stock options, which means only out-of-the-money options are given to executives so they are able to make profit only when the stock price rise to and exceed a certain level (Rappaport, Nodine 1999). Additionally, Rappaport, Nodine (1999) suggested that indexed options should be implemented. As a result, options owners can cash in the options if their firms outperform the competitors. Another solution suggested by Chhabra (2008) proposed utilizing Asian-style option, "whose payout is based in the average price of the stock over the term of the option" (Chhabra 2008, p. 25). Chhabra (2008) believes that Asian-style option eliminates rewards due to good performance during short-run.

It might be worth mentioning here that according to a study which analyzes CEO compensation of 27 U.S. commercial banks conducted by Krause (2009), long-term compensation itself (such as stock options, stock grants, cash bonuses) does not guarantee that CEO will implement long-term perspective in creating value for shareholders. Krause (2009) suggests that goal-based long-term compensation plans achieve better results in the sense of maximizing shareholders' value.

2.5. Perquisites (Perks)

Some examples of perquisites or perks can be “company cars, free use of facilities, club membership, cheap loans, [and] housing” (Tyson 2006, p. 283). Taking cheap loans as an example: there used to be more than three quarters of the 1,500 largest U.S. firms lent money to CEO and what is noteworthy here is those loans normally had below-the-market interest rates. These inappropriate behaviors are now prohibited by Sarbanes-Oxley Act of 2002 (King 2002 as cited in Bebchuk, Fried 2003).

Another example of perquisites which is particular only for top managers’ level is loan forgiveness. Executives are likely to have opportunities to borrow from the firm to buy stocks. And if stock price falls, normally they do not have to pay the loan in full. The loan itself can often be written off when the executives leave their position (Bebchuk, Fried 2003).

In reality, perks for executives in empire firms can presented in many “original” forms such as “gold-trimmed shower curtains for a maid’s bathroom (Tyco's Kozlowski); insurance and curator's salary for a 1,650-piece art collection (Raymond James brokerage firm for Raymond James)” (Sheer, Sheer 2007, p. 37).

III. Assessment of the situation

1. Why does it matter?

The worldwide public outrage over compensation of employees in financial sector became vigorous after the recent financial crisis. Typically a number of executives working in this industries are the main target of criticism towards their enormous compensation packages. The notable point here is those executives received big paychecks while their firms went bankrupt or needed to rely on government bailout in order to survive after the mortgage bubble had burst out. To illustrate, Lehman Brothers chief executive Richard S. Fuld Jr. had earned \$350 million between 2000 and 2007 before Lehman Brothers signed its name in U.S. history as the biggest corporate bankruptcy ever (Dowd 2009). To make a long story short, during glory days, thanks to the Ponzi scheme, bankers and bank executives were paid huge paychecks for short-term profits. They gave loans to nearly whoever wanted to borrow without bothering to examine borrowers' credit worthiness. The unavoidable result is they ended up with a lot of subprime loans. Then banks earned money by selling those loans as financial instruments. However, rainy days finally came – as they certainly did, borrowers could not repay their loans and financial organizations turned out to be on the edge of bank run and could only get out of that situation by obtaining government bailout, which is typically tax payers' money. But bankers' bonuses were still untouched. Sometimes executives had to walk away but with all of their already-paid compensation plus “gratuitous goodbye” payments. Moral hazard can be seen clearly as the unavoidable consequence of lack of deferred compensation, clawback bonuses and controversial bailout (Dowd 2009; Krugman 2009).

According to the Institute of International Finance and Oliver Wyman Compensation Survey, which was carried out between December 2008 and March 2009, 98% of respondents from dominant institutions in financial sector believed “that compensation structures were a factor underlying the crisis”¹. Under pressure of public, regulators worldwide have promoted legislation to prevent disasters from repeating in the future – same as what they have always been doing every time economy comes to recessions (Murphy 2011). The regulations' salient goal this time is to prohibit excessive risk-taking

¹ Institute of International Finance, *Compensation in Financial Services: Industry Progress and the Agenda for Change (March 2009)*, available at: <http://www.iif.com/download.php?id=YgXfGGw8KEA=> (check on September 1, 2013), page 2

of bankers by amending ties between pay practices and risk management, limiting over-rewarded short-term profit, enhancing accounting principles, getting shareholders more involved in compensation practices and so on (Fraser, Earle 2011).

2. Compensation regulation in the past

In U.S. particularly, there have been quite a great number of regulations regarding executive compensation since the Great Depression. These regulations mainly focus on aspects of disclosures rules, tax policies and accounting standards. Basing on the article “The Politics of Pay: A Legislative History of Executive Compensation” written by Murphy (2011), this part will provide a brief look at these legislations, starting with disclosures rules.

In April, 1932, the Interstate Commerce Commission required pay disclosure of all railroad executives making more than \$10,000 annually. This movement was soon followed by many other U.S. regulators. And in December 1934, Securities and Exchange Commission (SEC) demanded all public traded companies to “disclose the name and all compensation (including salaries, bonuses, stock, and stock options) received by the three-highest paid executives” (Murphy 2011, p. 3). Companies had to abide this rule by June 1935 as the latest, otherwise they would be removed from stock markets. In 1978, SEC added a major expansion to this rule by requiring that firms also had to disclose the value of perks and insurance payments of five highest-paid executives instead of three highest-paid like prior. Stock options were included in disclosure report the first time in 1992, when much-more-detailed Summary Compensation Table were asked for by SEC. However, only number of options, not the value of them were required by this new rule. Followed by many accounting scandals, the 2006 Disclosure Rules strongly required more information involving executive pay packages such as detailed information on any perquisite more than \$10,000, pension benefits, severance payments, option grant dates and the date when they was approved by the board, and even the role of consultants who are involved in setting executive pay. As a result of the 2006 Disclosure Rules, the average length of proxy statements issued by 100 largest firms had fattened from 45 to 70 pages.

Regarding tax policies, there were Revenue Act issued in 1950, 1954 and 1964 regulating tax formalities of restricted stock options. Particularly, by lowering the top marginal tax rate on ordinary income from 91% to 70% (cash compensation was taxed as ordinary income while restricted stock options were taxed as capital gains – 25% – when the shares

were sold eventually), the Revenue Act of 1964 indirectly mitigate the preference of restricted stock options to cash compensation considerably. This Act combined with the Tax Reform Act of 1969 had pushed restricted stock options from the most favorite long-term incentives for twenty years to nearly disappear. Besides, about Golden Parachutes payment, Section 280(G) of the tax code belonging to Deficit Reduction Act of 1984 assigns that “if change-in-control payments exceed three times the individuals base amount, then all payments in excess of the base amount are nondeductible to the employer.” (Murphy 2011, p. 13). The next threshold of tax deductibility for executive compensation was proposed by President Bill Clinton in 1992 when he repeatedly confirmed his point of view that all compensation above \$1 million would be not tax deductible since he believed it was not reasonable at all when a man could earn more than \$1 million annually. Until that point of time, firms were able to take tax deductible for executive remuneration unlimitedly. Even before the \$1 million deductibility cap plan was really implemented, banks already came up with ways to get around it, for example by encouraging their employees to exercise options before 1993 came, trying to get their 1992 bonuses in 1992 rather than in 1993, or thinking about changing to private partnership entity. But they did not have to turn those intentions into reality because in February 1993, Bill Clinton became more flexible with his plan and corrected that only pay unrelated to the efficiency of enterprises were insensible therefore not tax deductible (Freudenheim 1993 as cited in Murphy 2011). This intention was finally converted into legislation under Section 162(m) of the Omnibus Budget Reconciliation Act of 1993. According to this Section, the one-million-dollar tax deductibility cap only applied to non-performance-based pay in compensation packages of five highest-paid executives’ in public firms. Section 162(m) defined performance-based compensation as pay for achieving goals which are set by an independent compensation committee or goals that are approved by shareholders in advance. In addition, stock options are regarded as performance-based pay provided that the exercise price is at least equal to the market price when the options are granted. In the end, it turned out that Section 162(m) actually increased executive pay rather than reduced it as the Section was supposed to. The reasons behind were companies promoted handling out stock options as remuneration since options are considered performance-based and therefore tax deductible; firms which had paid less-than-\$1-million base salaries before Section 162(m) came into force raised base salaries to exactly \$1 million (Perry and Zenner 2001 as cited in Murphy 2011); and somehow Section 162(m) encouraged immoderately generous bonus plan (Murphy and Oyer 2004 as cited in Murphy 2011). In 2002, Section

409(A) of Internal Revenue Code, which belongs to American Jobs Creation Act of 2004 broadened the definition and limited the flexibility of using deferred compensation as a reaction of regulators towards Enron corporate scandal when Enron had allowed some executives to get millions of dollars of deferred compensation just before it filed for bankruptcy.

Only two examples of accounting policies will be mentioned here. In March 2000, the Financial Accounting Standards Board (FASB) Interpretation No. 44 (FIN44) set “an accounting charge each year for the repriced option based on the actual appreciation in the value of the option.” (Murphy 2011, p. 28). This legislation had put an end to option repricing. In 2004, FASB issued FAS123R which demanded all firms to realize an accounting expense for stock options. From accounting perspective, FAS123R results in expense of stock options as compensation is now equal to expense of shares and consequently leads to the preference of restricted stocks to stock options as a compensation component.

On the whole, Murphy (2011) concluded that even though regulations involving executive pay have been bringing some more controls in this field, they seem not as efficient as expectation. There are two reasons behind this fact. First, many legislations only focus on regulating a few aspects of the whole compensation issue. Therefore they accidentally spare room for firms to get around and eventually increase pay level for executive in general. Second, legislations are said to be made due to the envy of politicians when they see executives can make much more money than they do. As a result, legislations may not serve the interest of shareholders — who are the owners of companies — and therefore do not create wealth for them as well as the society.

3. Current situation

3.1. US

3.1.1. *Executive compensation restrictions under Troubled Asset Relief Program*

U.S. government launched a program called Troubled Asset Relief Program (TARP) under the Emergency Economic Stabilization Act (EESA)² of 2008 after the financial crisis began (Horton, Vrablik 2010). This program costs \$700 billion of American taxpayers

² 110th United States Congress, *Emergency Economic Stabilization Act*. In *Pub. L. No. 110-343 122 Stat. 3765*, available online at www.gpo.gov/fdsys/pkg/PLAW-110publ343/pdf/PLAW-110publ343.pdf (checked on 8/18/2013).

(Stuhldreher 2010). According to Neel Kashkari – Interim Assistant Secretary for Financial Stability, three objectives of TARP are “to stabilize financial markets and reduce systemic risk”, “to support the housing market by avoiding preventable foreclosures and supporting mortgage finance” and “to protect tax payers” (Kashkari 2009, p. 64). TARP consists of a number of programs such as: Automotive Industry Financing Program (which aims to stabilize the U.S. automotive industry by funding companies like GM, GMAC and Chrysler); Term Asset-Backed Securities Lending Facility (which costs around \$200 billion and supports consumer finance sector by providing low-cost “credit card, auto loans, student loans and small business loans” (Kashkari 2009, p. 66); Asset Guarantee Program (which supplies guarantees for assets held by systemically important or “too big to fail” financial institutions); Targeted Investment Program (which aims to “foster financial market stability” (Kashkari 2009, p. 66). On top of that, the core program of TARP is the Capital Purchase Program (CPP). CPP’s intention is simply to purchase mortgaged-backed securities (the securitized debt that once mentioned above) from financial institutions (Horton, Vrablik 2010). According to Mr. Kashkari, in contrary to the common assumption that CPP is designed especially for unhealthy banks, this 250-billion-dollar component’s task is in fact to increase the capital in viable banks of all sizes as it is believed that investing capital in healthy banks is far more efficient than in unsound banks in terms of restoring confidence in the whole economy (Kashkari 2009). From the implementation of TARP on October 3, 2008 till March 2009, there were approximately 360 financial institutions that received exceptional assistance from American tax payers (Stimulus Act’s New Restrictions on Executive Compensation 2009). For certain when banks are fully recovered from the crisis, they are expected to repay the money that they received from TARP. In spite of that fact, the loans still come with many obligations. One of them is mandatory preferred stocks acquisition by the government from the aided banks. That means the government became the party that received dividends before the common shareholders. The second obligation concerned the limitation of elements and amount of banks’ executive compensation.

- (A) limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution;
- (B) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements

of earnings, gains, or other criteria that are later proven to be materially inaccurate; and

(C) a prohibition on the financial institution making any golden parachute payment to its senior executive officer during the period that the Secretary holds an equity or debt position in the financial institution. (EESA § 111 (b)(2))

...the Secretary shall prohibit, for such financial institution, any new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. [EESA § 111 (c)]

All in all, EESA prohibited all kinds of compensation that encourage top managers to take excessive risk. Clawback concerning bonuses can also be carried out if the performance criteria that were relied on turned out to be unreliable. The easiest way to follow restrictions on performance bonus without dramatically decreasing the total compensation of executives is to give up the bonus and increase base salary (The four-letter word that colors the compensation debate 2009). Regarding “Golden Parachutes”, EESA prohibited TARP recipients to provide golden parachutes to top five executives (also known as senior executive officers – SEOs – as defined in EESA § 111(3)) upon several defined cases.

On February 4, 2009, a set of restrictions was proposed by Treasury and applied to prospective banks which received support under TARP. This set of guideline contains a \$500,000 annual pay cap for executives of those participating financial institutions (Stuhldreher 2010, Stimulus Act's New Restrictions on Executive Compensation 2009).

Limit Senior Executives to \$500,000 in Total Annual Compensation – Other than Restricted Stock: ... limiting the total amount of compensation to no more than \$500,000 for these senior executives except for restricted stock awards. [U.S Department of the Treasury 2/4/2009]

This proposal received certain attention from the public. Some people argued that if that regulation was passed, the \$500,000 annual income would be still too generous compared to household's yearly median income in New York City, which was \$47,581. This fact is hard to be acceptable for most people from the perspective that executives of banks which receive bailout from taxpayers' money earn nearly ten times more than a median household

does (Son 2009). However, this Treasury guidance is never enacted (Stimulus Act's New Restrictions on Executive Compensation 2009).

On February 17, 2009, the final bill – American Recovery and Reinvestment Act (ARRA, also known as stimulus act³) was signed by President Obama. This Act puts down more restrictions on executive compensation of all TARP recipients, regardless of whether they were current or prospective participants. In contrary to the Treasury guidance proposed a few days before, the stimulus act focuses on bonus payments and does not tighten salary cap. The Golden Parachute Prohibition is even expanded under ARRA compared to it is under original EESA when any golden parachute payment is forbidden to any of top 10 executive officers (Stimulus Act's New Restrictions on Executive Compensation 2009). ARRA specifies that “any bonus would have to be in the form of long-term incentives, such as restricted stock, and may not be cashed out until all the TARP money is fully repaid” (Schramm 2009, p. 108). Several important points that Section 7001 of ARRA modified Section 111 of EESA as followed:

(B) A provision for the recovery by such TARP recipient of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees of the TARP recipient based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

(C) A prohibition on such TARP recipient making any golden parachute payment to a senior executive officer or any of the next 5 most highly-compensated employees of the TARP recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. [ARRA § 7001]

Instead of the proposed \$500,000 salary cap, ARRA put restrictions on bonuses as limiting it to one third of the salary.

(D)(i) A prohibition on such TARP recipient paying or accruing any bonus, retention award, or incentive compensation [...], except that any prohibition developed under this paragraph shall not apply to the payment of long- term

³ 111th United States Congress, *American Recovery and Reinvestment Act*. In *Pub. L. No. 111-5 123 Stat. 517*, available online at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ5/pdf/PLAW-111publ5.pdf> (checked on 8/9/2013)

restricted stock by such TARP recipient, provided that such long-term restricted stock [...]

(II) has a value in an amount that is not greater than 1/3 of the total amount of annual compensation of the employee receiving the stock... [ARRA§ 7001]

Being tied to many strings on both executive compensation and dividend payments, it is graspable that participating TARP financial institutions want to payback their CPP funds as soon as possible in order to get out of the deal (Horton, Vrablik 2010). The restrictions also make banks which want to apply for TARP assistance be reluctant and have to reconsider (Stimulus Act's New Restrictions on Executive Compensation 2009).

In addition to the already-mentioned restrictions, TARP participants have to hold an annual nonbinding shareholder “say-on-pay” vote (Stimulus Act's New Restrictions on Executive Compensation 2009). More details about “Say-on-Pay” will be discussed hereinafter.

3.1.2. Say-on-Pay vote

In the wake of contentious corporate scandals happened at Enron and WorldCom in the early of 2000s, the Sarbanes-Oxley Act (SOX) was enacted by the U.S. Congress as a practice to enhance the factuality of information being given to shareholders and boards of directors (Berk, DeMarzo 2011). Additionally, this legislation is another tool for shareholders to supervise actions of boards of directors and management team. SOX was followed by a number of legislations which aim to ameliorate the right of shareholders, including Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act in short⁴) (Lieder, Fischer 2011).

On July 21, 2010, the Dodd-Frank Act (amends the Securities Exchange Act of 1934) was approved and fully implemented in 2011 (Earle 2011; Mangan, Magnan 2012; Wilson et al. 2011;). Applying to all listed companies in U.S. (“regardless of jurisdiction of incorporation”), this Act contains a set of new requirements of executive remuneration and corporate governance practices at companies in most industries, not only for financial industry as its primary purpose (Earle 2011; Wilson et al. 2011, p. 15). Section 951 of Dodd-Frank Act covered one crucial topic, which is to give the shareholders more rights and more participation in deciding board members and approving executive compensation. The former is called “Proxy access”, which allows shareholders to nominate candidates for

⁴ 111th United States Congress, *Dodd-Frank Wall Street Reform and Consumer Protection Act*, available online at <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf> (checked on 9/9/2013)

directors (Earle 2011). Proxy access is expected to mitigate the influence of powerful CEOs which was stated in managerial power theory (Mangen, Magnan 2012). The latter consists of three non-binding shareholder votes: Say-on-Pay, Say-on-Frequency and Say-on-Golden Parachutes. To be more detailed, through Say-on-Pay, shareholders have the opportunity to show if they agree with “the compensation of the company’s named executive officers as disclosed in the executive compensation sections of the annual proxy statement” (Mangen, Magnan 2012, p. 61). Shareholders do not vote for director compensation under Say-on-Pay. Section 951 of Dodd-Frank Act mandates Say-on-Pay “not less frequently than once every 3 years” (Dodd-Frank Act § 951). During the first Say-on-Pay vote, shareholders also have the right to vote on Say-on-Frequency, which questions if shareholders prefer to have Say-on-Pay vote every one, two or three years. The Dodd-Frank Act requires Say-on-Frequency vote is offered to shareholders at least every six years (Dodd-Frank Act § 951). Last but not least, Say-on-Golden Parachutes vote is proposed when the ownership or control of the firm is changed as said, or to be more specific, when there is “a proposed acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of its assets” (Earle 2011, p. 64). The Golden Parachutes disclosure must be presented in an easy to understand form. The Securities and Exchange Commission (SEC) included the following figure along with the regulations:

Name	Cash (\$)	Equity (\$)	Pension/ NQDC (\$)	Perquisites/ Benefits (\$)	Tax Reimbursement (\$)	Other (\$)	Total (\$)
PEO							
PFO							
A							
B							
C							

Figure 2: Golden parachute compensation. (Source: Earle 2011, p. 64)

All in all, abiding by the Dodd-Frank Act, non-binding Say-on-Pay vote once at least every three years is mandatory to all U.S. listed companies. Yet TARP recipients must organize Say-on-Pay vote annually. On top of that, the Dodd-Frank Act added a new section to the Exchange Act requiring SEC to set regulations requiring issuance of “proxy material information that shows the relationship between executive compensation actually paid and the issuer’s financial performance” (Lieder, Fischer 2011, p. 391).

3.1.3. Financial Stability Board Principles

a. Background information about Financial Stability Board

In 1999, the Financial Stability Forum (FSF) was established as the outcome of a study commissioned by G7 Finance Ministers and Central Bank Governors. The objective of that study was to find out new structures to make the best of international cooperation in order to make international financial system more stable.⁵ In 2008, the FSF was extended to the Financial Stability Board (FSB) by G-20 Finance Ministers.⁶ The FSB consists of 24 countries, international organizations (such as European Central Bank and European Commission), international standard-setting bodies and other groupings (for example: Basel Committee on Banking Supervision).⁷ Gadinis (2013) claims the original purpose of FSB is likely to be fulfilled thanks to the fact that the FSB involves political leaders of major economies worldwide; therefore FSB promotes “political intervention in financial regulation” replacing “regulatory independence” (Gadinis 2013, p. 176). Although the documents issued by FSB are not binding, they are considered as standards for financial sector regulators worldwide to follow (Fraser, Earle 2011). The FSB’s proposals are presented in various forms (such as Guidance and Recommendations; Consultation Documents and Principles and Standards) and cover a wide range of topics in financial field, such as framework for systematically important financial institutions and over-the-counter derivatives markets reforms.

b. Financial Stability Board Compensation Principles

Regulating compensation practices is also one of FSB’s concerns so in April and September 2009, the FSB published “FSB Principles for Sound Compensation Practices”⁸ and “FSB Principles for Sound Compensation Practices – Implementation Standards”⁹ respectively. The covered subjects were mainly about corporate governance (encouraging independent remuneration committee), alignment of compensation with risk taking, compensation policies (such as supporting mix of compensation: “more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments ...”¹⁰ and

⁵ *History*, FIN. STABILITY BD., <http://www.financialstabilityboard.org/about/history.htm> (checked on Aug 24, 2013)

⁶ *Ibid.*

⁷ *FSB Member Institutions*, FIN. STABILITY BD., http://www.financialstabilityboard.org/about/fsb_members.htm (checked on Aug 24, 2013)

⁸ Fin. Stability Bd., *FSB Principles for Sound Compensation Practices (2 April 2009)*, available at http://www.financialstabilityboard.org/publications/r_0904b.pdf (checked on Aug 24, 2013)

⁹ Fin. Stability Bd., *FSB Principles for Sound Compensation Practices – Implementation Standards (25 September 2009)*, available at http://www.financialstabilityboard.org/publications/r_090925c.pdf (checked on Aug 24, 2013)

¹⁰ Fin. Stability Bd., *FSB Principles for Sound Compensation Practices – Implementation Standards*, page 3

promoting deferred compensation: 40 to 60 percent of variable compensation should be deferred payments and paid over a period of years.¹¹)

c. Implementation of Financial Stability Board Compensation Principles

The FSB Principles is presented in U.S through two regulations, which are Agency Guidance and Dodd-Frank Act (Fraser, Earle 2011).

- Agency Guidance

The Final Guidance on Sound Incentive Compensation Policies (also known as the Agency Guidance) was issued on June 21, 2010 by the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Super and the Federal Deposit Insurance Corporation (FDIC). The Guidance focuses on regulating compensations practices so that these practices will not indirectly push financial organizations on the edge of vulnerability financially (Board of Governors of the Federal Reserve System 2010). There are three principles that were indicated in the Guidance: Balanced Risk-Taking Incentives; Compatibility with Effective Controls and Risk-management; and Strong Corporate Governance. The first principle aims to “make compensation more sensitive to risk” so that employees are not over-rewarded for taking excessive risk (Federal Register 6/25/2010, p. 36408). Four methods that were believed to help reach that goal are: Risk Adjustment of Awards, Deferral of Payment, Longer Performance Periods; and Reduced Sensitivity to Short-Term Performance (Federal Register 6/25/2010). The second principle suggests that risk management controls should intervene the compensation processes and furthermore, once it is the case, risk management controls must be independent (Fraser, Earle 2011). The last principle emphasizes the important role of strong corporate governance in having sound compensation practices, showing in means such as paying more attention to compensation practices for senior executives (Federal Register 6/25/2010).

Another point about the Guidance that should be noticed is the larger the financial institutions, the stricter the Guidance is going to apply. In addition, the Agency Guidance does not state any specified number such as a salary cap as well as compulsory compensation designs (Fraser, Earle 2011).

- Dodd-Frank Act

¹¹ Fin. Stability Bd., *FSB Principles for Sound Compensation Practices – Implementation Standards*

FSB Principle 1 and 2 emphasized the influence of an independent remuneration committee and Section 952 of Dodd-Frank Act has adopted this standard. In fact, according to section 952, every member of the compensation committee has to be a member of the board of directors and independent. The term “Independence” in this case was also specified described in paragraph (3) of the same section. Furthermore, Section 956 prohibits any compensation arrangement that leads to excessive compensation and material financial loss. This Section only applies to financial institutions with more than one billion dollars of assets (Fraser, Earle 2011).

3.2. Germany

3.2.1. Say-on-Pay

Following movements around executive compensation, Germany witnessed the enactment of the Act on the Adequacy of Executive Compensation (*Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG*) on 31 July 2009. Although this Act also mandates a Say-on-Pay for all listed German companies, the nature of this shareholder vote is advisory, which is different from Say-on-Pay vote in UK or U.S (Lieder, Fischer 2011). As Lieder and Fischer (2011) pointed out, the reason behind this difference could be the dissimilarity between corporate governance in U.S. and U.K (one-tier board) and that in Germany (two-tier board). It should be noted that big Germany companies have two boards of directors, which are supervisory board (*Aufsichtsrat*) and management board (*Vorstand*) (Brealey et al. 2012). The management board is in charge of managing the firm while the supervisory board “appoints, supervises, and advises the members of the management board.” (Mallin 2010, p. 215). The supervisory board should have a sufficient number of independent members as well as not consist of more than two members of the management board (Mallin 2010). The supervisory board, “as the institutionalized monitoring body of the large stock corporation, is in any event responsible for determining managerial remuneration...” (Lieder, Fischer 2011, p. 386).

3.3. Switzerland

3.3.1. Say-on-Pay

Under the Swiss Code of Obligations (SCO), boards of directors have responsibility to make decision on executive compensation on their own. Therefore involving shareholders in this process may not be legal. However, a non-binding shareholders vote is nothing against the current law. The “2007 Proposal” acting as a proposed reform of SCO enlarges the scope of shareholders’ meeting’s decisions when it allows shareholders’ meeting to

resolve on “(A) the directors’ compensation (but not on the management’s compensation) and (B) the grant of shares or option rights to employees” (Lieder, Fischer 2011, p. 395). The “2008 Proposal” requests all listed Swiss companies to organize mandatory and binding shareholders’ vote on directors’ compensation as well as mandatory but non-binding shareholders vote on management’s compensation (Lieder, Fischer 2011).

On October 31st, 2006, Mr. Thomas Minder, a Swiss entrepreneur initiated a “popular initiative” on restrictions on executive compensation. As a matter of fact, Swiss constitutional law allows citizens to propose a modification to the Swiss Constitution through launching a “popular initiative”. Provided that the proponents can gather at least 100,000 signatures backing their proposals up within 18 months, their “popular initiative” will be put in popular vote (Swiss Constitution, Article 129 para. 1 as cited in Lieder, Fischer 2011). The so-called “Minder Initiative” or “Rip-Off Initiative” succeeded in matching this requirement (Swiss Official Record 2008 as cited in Lieder, Fischer 2011; Revill 2013). Consequently, on March 3rd, 2013, the popular vote was held and it turned out that 68% of Swiss voters support Minder Initiative in spite of effort of opponent lobbyists such as Economiesuisse – a business group (Winters et al. 2013). This success of Mr. Minder grants shareholders of companies listed in Switzerland a *binding* say-on-pay vote on remuneration package of executives and directors. Furthermore, golden parachutes and payments being given out when executives come or leave firms are all prohibited. The obligation is completely serious when violations could end up “in fines equal to up to six years of salary and a prison sentence of up to three years.” (Minder 2013). So far Minder Initiative paved the way for one of the strictest regulation on executive pay all over the world and this regulation will come into force on 1 January, 2014.¹²

3.3.2. 12:1

The fight for shareholder democracy does not stop there. Following the same procedure as Thomas Minder, the Young Socialists group has achieved a popular vote to “limit executive salaries to 12 times those of a company's lowest-paid employee.” or in another way of speaking, what an executive makes in a month should not be more than what his lowest-paid employee makes in a year (Revill 2013). The referendum is expected to be organized on November 24, 2013 (Sprich et al. 2013). If being approved, the 12:1 compensation ratio

¹² Swiss Federal Council, *Press Release on March 26, 2013 (in French)*, available at <http://www.ejpd.admin.ch/content/ejpd/fr/home/dokumentation/mi/2013/2013-03-261.html> (checked on Aug 24, 2013)

will not only apply for executives in financial industry, but also in business sector. The ratio 12:1 seems to be relatively small amid the very large gap between “fat cats” compensation and lowest-paid workers. As an illustration, this ratio rocketed from 14:1 in 1998 to 93:1 in 2011 at largest Swiss companies, according to the Swiss Federation of Trade Union (Revill 2013). However, Swiss Economy Minister Johann Schneider-Ammann persuaded Swiss citizens to vote “No” for the 12:1 Initiative since he believed that if the proposal got approved, it would affect negatively on Switzerland’s attractiveness as a place to do business and scare investors away (Sprich et al. 2013).

3.4. EU

3.4.1. *Bankers’ bonus cap*

On April 16, 2013, being supported by almost every member (except for the UK), the new regulation on bankers’ bonuses was passed by the European Parliament (Fairless 2013; Frac 2013; Scott, Kanter 2013). This provision is part of the Fourth Capital Directive (CDR IV) (also known as Basel III), which consists of a Directive and a Regulation, being enacted on July 17, 2013 (European Commission 2013). Basically, the bonus cap provision will cap the annual bonuses of bankers at one times their annual salary or two times the salary given the explicit approval of their shareholders (Fairless 2013). The CDR IV expresses this point as followed:

(g) institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration, whereby the following principles shall apply:

(i) the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage;

(ii) Member States may allow shareholders or owners or members of the institution to approve a higher maximum level ... [which] shall not exceed 200 % of the fixed component of the total remuneration for each individual ... [Article 94 (1) of the Directive of CRD IV].

Yet up to a quarter of total variable remuneration, which are deferred for at least five years, can be exempted from this bonus cap.

(iii) Member States may allow institutions to apply the discount rate [...] a maximum of 25 % of total variable remuneration provided it is paid in

instruments that are deferred for a period of not less than five years. [Article 94 (1) of the Directive of CRD IV].

This bonus curb is applied for bankers whose annual salary more than €500,000 (Treanor 2013a). More controversially, the regulation covers all European banks' employees worldwide as well as Europe-based employees of foreign banks (Guerrera 2013). Put it differently, Barclay's employees working in its subsidiaries in U.S. as well as Bank of America's employees working in its subsidiaries in U.K. are also affected by this provision, as stated in the Directive: "... for institutions at group, parent company and subsidiary levels, including those established in offshore financial centres." (Article 92 (1) of the Directive of CRD IV). The new curb will apply to bonuses paid out from 1 January 2014 provided that the performance is not undertaken after that date (Fairless 2013): "... require institutions to apply the principles laid down therein to remuneration awarded for services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013" (Article 162(3) of the Directive). In spite of that fact, Stanger and Carr (2013) believe that the first bonus round that will be affected by this curb is likely to take place in 2015.

Although the curb provision is believed to "put an end to the culture of excessive bonuses, which encouraged risk-taking for short-term gains," as well as require banks to "make a contribution" to pay "the bill after the financial crisis", said José Manuel Barroso, president of the European Commission (Scott, Kanter 2013); banks – as dynamic as they are – already came up with several ways to get around the regulation. Obviously, the most straightforward method to increase bonus – which is limited by the amount of base salary – is to increase the base salary itself. Douglas Flint, chairman of HSBC – the largest bank in Europe, admitted that enlarging yearly salary was the most-likely alternative (Goodway 2013). Another getting-round method is to pay bankers with "non-monetary" perquisites, such as cars and houses. On top of that, moving employees away from Europe is also an option to "crack" the rule for U.S. banks (Guerrera 2013). And for European banks, the alternation of that option could be relocating headquarters (Fairless 2013).

3.4.2. Implementation of Financial Stability Board Compensation Principles

EU had issued Third Capital Requirements Directive (CRD III), which went into effect from 1 January 2011. According to Fraser, Earle (2011), CRD III¹³ mainly reflects the FSB Principles, yet stricter in three crucial aspects below:

1. 50% of total compensation (both upfront and deferred) must be paid in shares or share-like forms.
2. The CRD III rules apply not only to banks but also other types of organizations in financial sector such as hedge funds, private equity funds.
3. The institutions above also have to public obligatory disclosures, starting in 2011.

CRD III has a point in common with the Agency Guidance: the more important the financial institutions are to the whole system, the stricter these rules apply to them.

3.5. UK

3.5.1. *Say-on-Pay*

UK is known as the origin of current Say-on-Pay movement (Gordon 2009 as cited in Lieder, Fischer 2011). In the wake of criticism about remuneration practices after the privatization of former state-owned firms in the 1980s and 1990s (Greenbury as cited in Lieder, Fischer 2011), “Greenbury Code” was enacted in 1995 with two principal new methods “(1) the establishment of a remuneration committee to deal with executive pay and (2) an audited remuneration report that disclosed compensation data” (Lieder, Fischer 2011, p. 381). These two crucial innovations were implemented at once by the London Stock Exchange, especially the requirement about disclosure of each director’s compensation package with information ranging from base salary, annual bonuses to any payments in case of termination of contracts (Lieder, Fischer 2011). In 2002, the Companies Act of 1985 was significantly amended. Consequently, every listed company in UK is obligated to publicize a “Directors’ Remuneration Report” annually as well as organize non-binding Say-on-Pay vote on that report. This report requires further information on senior executive compensation besides the information required in the Greenbury Code. Furthermore, information about the remuneration committee, external compensation consultants and compensation policy of the firms must be included. Moreover, a stock price performance is essential in the report with the aim of assessing the efficiency of pay-for-performance

¹³ European Parliament, *Directive 2010/76/EU (24 November 2010)*, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:01:en:HTML> (checked on Aug 24, 2013)

incentives (similar to the requirement of Dodd-Frank Act mentioned) (Lieder, Fischer 2011).

4. Advantages and disadvantages of some regulations

4.1. Say-on-Pay

Mangen and Magnan (2012) argue that Say-on-Pay can enhance the pay practices in firms. However, they also emphasize that Say-on-Pay “is no panacea” and it can raise other problems regarding compensation practices (Mangen, Magnan 2012, p. 94).

4.1.1. Advantages

As explained earlier, the optimal contracting theory is questioned since it cannot guarantee that the board of directors will try its best to act on the interest of shareholders. The situation can get even worse in case of powerful CEOs. Mangen and Magnan (2012) argue that Say-on-Pay creates social pressures (coming from the society), political pressures (coming from the firms) and functional pressures (coming from the nature of pay settings itself) so that board of directors can be more resistant. All these pressures are result of an undeniable fact that Say-on-Pay does hand more power to shareholders, therefore they can have a more direct method to demonstrate their dissatisfaction with pay practices offered by the boards. Prior to Say-on-Pay, if shareholders are unsatisfied with pay practices, they can only oppose by selling their shares or taking part in Just Vote No campaigns – withholding their votes so that directors may lose their position (Mangen, Magnan 2012). Say-on-Pay’s role is even more vital when firms’ large shareholders are long-term investors such as organizations and funds. Through Say-on-Pay, these institutional shareholders can effectively “combine their ownership power with their new structural power to increase their sway over pay setting.” (Mangen, Magnan 2012, p. 92). Furthermore, another cause that results in suboptimal compensation practices is the board may not have access to the accurate information regarding executive compensation. Say-on-Pay clears this ambiguity by bringing more information to discussion table. This information comes from researches that are conducted by the institutional shareholders. Institutions have various reasons, such as their ownership stakes and responsibility towards clients, to do their own researches in this field. Consequently, information regarding pay practices will be less subjective as there are more perspectives involved (Mangen, Magnan 2012).

Although Say-on-Pay is non-binding in all the countries in which it is implemented (except for Switzerland), it does create pressure to management board to avoid “No” vote. A

considerable proportion of negative votes, even though less than 50 percent, still shows abundant shareholders' unhappiness and makes the board to give a second thought about pay practices (Earle 2011).

4.1.2. Disadvantages

Nevertheless, Say-on-Pay does have drawbacks. First, as Mangan and Magnan (2012) noticed, Say-on-Pay may benefit shareholders but harm other stakeholders due to the gap between two groups' interests. Compared to other stakeholders such as debtors and bondholders, shareholders' appetite for risk is bigger. Therefore they prefer compensation packages that encourage CEO to take more risk (Bolton et al. 2006 as cited in Mangan, Magnan 2012). The appetite for risk is even more significant when it comes to institutional shareholders when they tend to have small and risky firms in their portfolios (Bennett 2003 as cited in Mangan, Magnan 2012). Consequently, Say-on-Pay may unintentionally give more power to people who may impair other stakeholders' interests. Along with this reason, business ties between companies and institutional shareholders also worsen the conflicting interests since business ties tend to alleviate shareholders' opposition towards management. In short, Say-on-Pay plus different appetite for risk plus business ties may equal to the core of pay practices problem shifts from powerful CEOs to powerful shareholders. On top of that, it is believed that firms tend to communicate with key shareholders in prior to Say-on-Pay vote to avoid uncomfortable result at shareholders' meeting (Earle 2011). A resolution for conflicting interests is signaling to the board so that the board can be aware of existing conflicting interests (Mangan, Magnan 2012). Beyond everything, the board is still the one who has the final decision in pay practices, especially in countries where Say-on-Pay is non-binding; therefore the true power of Say-on-Pay lies in the board of directors and management team (Cai, Walkling 2011). This fact is a positive side when the board really wants to act on the firm's best interests. Otherwise Say-on-Pay may lead to second faulty consequence: the board tries to provide shareholders with biased information or with valid information but in an unclear way. As a result, Say-on-Pay unintentionally clears the way for suboptimal pay to be legitimate (Mangan, Magnan 2012). Nevertheless, it is believed that there are mechanisms to fix those problems, such as independent audits and reaction of voters who vote against the compensation packages (Becker et al. 1998; Bratton 1998; Craig et al. 2006 as cited in Mangan, Magnan 2012).

For Switzerland, where Say-on-Pay is binding, one of the main reason argumentations that Economiesuisse and other Thomas Minder's opponent is the proposal may aggravate the country's friendly image under investors' eyes and big companies' headquarters might move away from Switzerland (Willsher, Inman 2013). Opposing this argumentation, Mr. Minder claimed that in the contrary, thanks to the new regulation, Switzerland would be even more attractive to investors since he believed that investors always prefer to have more control over companies that they hold shares. And clearly, binding Say-on-Pay hands more control to shareholders. "Investors put their money where they have the most to say, and that will clearly then be Switzerland," said Mr. Minder (Minder 2013).

4.2. Bankers' bonuses cap

4.2.1. Advantages

The biggest goal that bonus cap is expected to achieve is to curb excessive-risk taking. As mentioned, excessive risk-taking is believed to play a crucial role in bringing about the financial crisis. This event is not only a disaster to the banking sector but also to the world economy. Limiting the amount of bonus that bankers get paid may help to limit the unnecessary risk that they take as well (Debate 2009). In addition, curbing bankers' bonuses also makes it fairer to taxpayers, the sole party who had to shoulder the consequences of the crisis, according to José Manuel Barroso, president of the European Commission (Scott, Kanter 2013). Moreover, the high bonuses tradition has led to an overall high expectation when paydays are around the corner. This fact makes it difficult for banks to cut down numbers on paychecks. So banks have no choice but firing people during hard time, which results in boom and bust cycles. Instead of that, now they can cut down compensation and blame the regulation for forcing them doing that (Guerrera 2013). Rob Cotton, chief executive of global information assurance company NCC Group believes that while uncapped bonuses for some particular bankers do not serve this goal employees should unite together. He also convinces that employees should feel part of the firms and capped bonuses are a way for them to share the difficulties during hard economic time (Cotton, Kinnersley 2013).

4.2.2. Disadvantages

Probably, the consequence that is brought up most frequently in capped compensation debate is possible talents exodus. It has been warned that capped bankers' bonuses may trigger star bankers leave banks for other types of organizations such as private-equity

groups, hedge funds or insurance companies (Guerrera 2013; Jones 2013). Although it is admitted that this trend is real, the question should be asked is how significant it is taking into account the cloudy situation of the whole financial sector (Guerrera 2013). Furthermore, as mentioned, since the regulation is applied for all EU-headquartered banks, there may be chances that talents will move to higher-paid positions in American and Asian banks, according to Mr. Kinnersley – managing director of executive search firm Twenty Recruitment Group (Cotton, Kinnersley 2013). As a result, European-based banks might be in jeopardy in the sense of talents attraction.

As introduced, one way to get around the capped bonuses regulation is to enlarge the base salaries. Financial Conduct Authority chief Martin Wheatley alerted that the base salaries can even get doubled in order to offset the loss bonuses (Treanor 2013b). It is warned that this method will impact negatively on banks' ability to keep fixed cost at a low level, which will be shouldered by the customers and hard to adjust during economic slump since banks have to pay their employees more before dismissing them (Cotton, Kinnersley 2013; Frac 2013; Macalister 2013). Moreover, once the base salaries are paid, there is almost no mechanism to take it back, like clawback for bonuses. Therefore according to Mr. Wheatley, the regulation to cap bonuses might even make it more challenging to penalize bankers when something turns out to be rotten (Treanor 2013b). Although it is observed that not so much clawing back payments have been taken place, it is still better than absolutely nothing in base salaries cases (Sunderland 2013). Paul Hodgson – Forbes Contributor – strongly doubted that the bonuses cap would work from the lesson in US: When bonuses were limited up to one third of the base salaries according to ARRA, the bases salaries went sky-high. For instance, at Goldman Sachs, base salaries for CEOs soared from \$600,000 to \$2,000,000 and at Wells Fargo, CEO John Stumpf received base salary of \$5,600,000 – a more-than-six-fold increase compared to the previous paycheck (Hodgson 2013).

As said earlier, one extreme method to avoid the regulation is to move employees abroad by relocating banks' headquarters, for instance. This movement will result in a heavy and painful aftermath to European countries' economies due to the fact that government will not be able to collect tax from those banks anymore (Cotton, Kinnersley 2013).

4.3. Salary cap

The case of Deutsche Bank capping its co-CEOs salaries in 2013 may be one of the very few examples of executives' salaries cap – if there are any other cases (Stevens 2013). To be specified, Deutsche Bank's co-chief executives Jürgen Fitschen and Anshuman Jain are likely to have their base salaries in 2013 limited at €2.3 million this year together with their bonuses limited at €7.55 million for each person (Chase 2013). Without salary cap, it is estimated that their bonuses may reach to €9.35 million provided that Deutsche Bank attains all their set targets this year under their management (Wilson, Schäfer 2013). So each of Deutsche Bank's executives will receive maximum a capped compensation of €9.85 million in 2013, which is still twice as much as what they made in 2012. According to the compensation report in Deutsche Bank's financial report 2012, the two executives earned €4.8 million last year.¹⁴ The number €9.85 million is just slightly below the “double-digit millions” number that Werner Wenning, a Deutsche Bank supervisory board member, suggested to be a reasonable pay (Wilson, Schäfer 2013; Wilson 2012).

4.3.1. Advantages

Capping executive's remuneration is a part of Deutsche Bank's “recalibration”, along with enhancing the bank's capital position, restructuring its business model and so on. Deutsche Bank is the “Germany's flagship lender” in the effort to ameliorate banks' image concerning executive compensation issue (Schäfer, Wilson 2012). Although the salary curb might be only a “window dressing” tactic, this response can be a positive signal to the shareholders and the investors amid the anger and suspicion of tax payers in general toward banks after the crisis.

4.3.2. Disadvantages

Once again, the possibility of talent exodus is usually mentioned when talking about the consequence of curb European salaries. For instance, Time Magazine's London correspondent Michael Schuman said that limiting executive pay might result in European “brain drain” when top-quality experts choose to work in the rest of the world instead of

¹⁴ Deutsche Bank, *Annual Report 2012*, available at https://www.deutsche-bank.de/ir/en/download/Deutsche_Bank_Annual_Report_2012_entire.pdf (checked on October 1, 2013)

Europe (Chase 2013). In addition, the specific numbers that are used as the ceiling of executive corporate salaries seem baffling to be defined since many elements have to be taken into account; such as each country's economies, banking sector's financial health, general standard of living and so on. Provided that there are more regulations capping salaries of executives, public may still be outraged if the salary cap for them are way excessive in comparison with paycheck of an average citizen.

As already said, Deutsche Bank's salary cap is established as the bank's own will and not due to any legislation. Copp (2011) argued that capping directors' remuneration brought more disadvantages than advantages. Although his argumentations concern influence of the cap towards all industries, some of them are still valid when talking about financial sector particularly. Copp (2011) reasoned that limiting directors' compensation might discourage merger activity since it does not make too much sense for directors to pursue mergers and acquisitions chances and end up managing a bigger, more complex corporate without being paid more. In the long run, banks in countries in which capped salaries are obligated might lose their competitiveness. Beside, a salary cap might distort the structure of board of directors as firms might come up with new positions for the board so that those members will not be covered by the regulation, such as consultants. Efficient corporate governance would consequently break down. Moreover, once the legislation is introduced, there might be campaigns which aim to lower the cap or extend the coverage of the cap, which are likely to make further damage. Yet the most considerable argumentation that Copp (2011) put on the table was a remuneration cap legislation could prevent free market from operating. Due to the pay cap, if a manager has reached the compensation limit, he will have no motivation to move to another firm which needs his ability more and pay him more than his current one. That manger also does not take advantage of his talent and earn more money. This is a 'lose-lose' situation.

IV. Conclusion

When the world economy got tough due to the financial crisis started in 2007, executives' compensation in all industries all over the world were questioned heavily by the public. As a result, regulators have been enhancing legislation in order to bring executives' compensation to its right place. Say-on-Pay is probably a typical example of this effort as an approach to give shareholders more power in setting top managers' remuneration by offering them a chance to say if they are agree or disagree with the pay packages that board of director proposed. However, since Say-on-Pay is non-binding, except in Switzerland, the effectiveness of Say-on-Pay is still dependent on the management and boards of directors in each firm. Nevertheless, Say-on-Pay seems not to be enough for public's dissatisfaction towards compensation level employees working in financial sector. This reaction is straightforward to understand considering the fact that some banks paid their executives and got government bailout to survive instead of going bankrupt like firms in other industries. Hence there have been regulations which focus on regulating executives' pay practices in financial industry and the Financial Stability Board Compensation Principles is only one of many examples. Generally speaking, these legislations focuses on limiting excessive risk-taking (such as by recommendations about restructuring compensation package) as well as enhancing corporate governance (such as recommending independent compensation committee).

Yet perhaps the lengthy texts in those above legislations still have many loopholes for banks to get around. Therefore a harsher method is to come up with a number specifying the maximum compensation that a banker can earn and force banks to follow. This idea might base on an assumption that it is more difficult to get around numbers than to get around texts. Two of the very first illustrations in this case is the EU's bonus cap for bankers and the voluntary salary cap established by Deutsche Bank for its two CEOs. About the former case, although it is obvious to see that the regulation still has obvious flaws for banks to take advantage of, in the long run there is likelihood that people will be able to tell which one is better: a non-capped salary system or a capped salary one because unlike EU, U.S. seems to be not so interested in capping bankers' remuneration.

In regards of the question stated in the beginning of this work: “Should there be a salary cap for top managers in financial sector?” the author suggests that the salary cap might not be exactly the solution to the problems that we are facing in financial industry around the world: moral hazard, excessive risk-taking, over-rewarded short-term profits and so on. A salary cap might lead to talents exodus when talent people leave for other industry and prevent free market from operating seamlessly. An alternative solution could be regulating executive pay more strictly so that they do not seem to be a method of “window dressing” like it has been. Executive compensation practice so far might make some people associate with Lernaean Hydra, a monster in Greek mythology which grows two heads more replacing every head it is cut off. The problem with regulations on executive pay up to this point is they still have loopholes and do not base on holistic view. The case of EU’s banker bonus cap and the intention of banks to increase base salary might be a recent and typical example. In addition, regulations should make sure that rewards are tied to long-term growth and utilize clawback bonuses, deferred compensation and the like. But the most important point might be how serious authority will act to make sure that bankers get what they deserve. People working in financial industry might deserve to get big paycheck if they abide regulations and aim for long-term growth of the whole economy. But if it turned out that they violate legislations, punishment would be severe as well. And so far there are not so many countries do the same thing, let alone more serious than what Iceland has been doing to some of its bankers, who indirectly pushed Iceland to the financial crisis during 2008 to 2011.

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