

# The Regulation of Executive Compensation: An Agency Perspective

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## Abstract

According to the agency theory, directors or managers of corporations do not bear all the consequences of their decisions as they do not own all the shares of a corporation. From that perspective, it is necessary to establish various types of market and contractual mechanisms to motivate or monitor the agents so that they will better align their interests with those of the shareholders. Among the mechanisms, executive compensation is a very important means to achieve this objective. The article discusses the regulation of executive compensation by tax law and the law of disclosure in the U.S. Judged by the efficiency criterion, discussion of the amount of compensation is meaningless and any attempt to provide a legislative, administrative or judicial standard is counterproductive. The emphasis of regulation should be focused on how to strengthen the correlation between executive compensation and corporate performance. Comparatively speaking, the disclosure regulation is more conducive to a market economy and beneficial to the improvement of the capital market. To implement in China an executive compensation system, which ties executive compensation with corporate performance, the law must facilitate the methods of financing such compensation *ex ante* while severely penalizing insider trading, market manipulation, and exploitation of minority shareholders *ex post*.

## I. Introduction

From an agency perspective, directors and managers who do not own all the shares of the company they serve do not bear all the consequences of their decisions. In order to better align the interest of shareholders and the interest of directors and managers, agency theorists consider it necessary to establish market and contractual mechanisms to motivate and discipline directors and managers.<sup>1</sup> Among the various incentive and monitoring mechanisms, executive compensation is a very important means to motivate and discipline senior managers. Due to the fact that the bankruptcy and takeover markets are inefficient and have very little effect in China, executive compensation is of particular importance. In fact, reform of the state-owned enterprises (SOEs) in China began with the contract responsibility system, which emphasized the incentive effects on senior managers.

Although the executive compensation system is very important, the establishment of an efficient system is challenging. Not only are the contributions and efforts of managers difficult to quantify, their decisions affecting the performance of the firm cannot always be accurately assessed. Under this circumstance, the executive compensation system must rely upon proxies such as corporate profit or share price to assess the performance of senior managers. It goes without saying that these proxies will be influenced by factors which are not under the control of senior managers. Because of this reason, comments on the amount or level of executive compensation

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<sup>1</sup> M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 *The Journal of Financial Economics* 305 (1976).

differ considerably. Magazines such as *Forbes*,<sup>2</sup> *The Economist*,<sup>3</sup> and *Global and Mail*<sup>4</sup> all contain articles suggesting that senior managers receive too much. On the other hand, some economists believe that these executives deserve every nickel they receive.<sup>5</sup> In the United States and Canada, popular opinion, the demand of shareholders, and the relevant special interest groups have more or less influenced the regulation of executive compensation. Section II of this article briefly describes the historical development of executive compensation and the restrictions imposed upon executive pay in China. Section III analyses tax restrictions and their effects on executive compensation in the United States. Section IV discusses the disclosure of executive compensation and the impact of such a disclosure system, and further analyzes the correlation between executive pay and firm performance. Section V discusses policy implications of the regulation of executive compensation for China. Conclusions follow in Section VI.

## II. The Development of and Restrictions on Executive Compensation in China

Before the economic reform programme initiated in 1978, the employee remuneration in Chinese enterprises was frequently influenced by leftist ideologies. For instance, during the “Great Leap Forward” period from 1958 to 1961, income distribution based on employee performance and bonus systems were seriously affected.<sup>6</sup> Although income distribution based on employee performance and incentive wages were gradually reaffirmed after 1961,<sup>7</sup> the Cultural Revolution from 1966 to 1976 once again negatively affected the incentive pay system.<sup>8</sup> In general, the differences between the remuneration of executives and the wages of other employees was not significant from 1950 to 1978.

After the economic reform programme in 1978, bonus and other incentive plans for employees were gradually readopted.<sup>9</sup> As bonuses and other incentives in the past were not closely related to the economic performance of the enterprises, the incentive policy was changed in 1979. Starting from that year, the amount of bonus had to be allocated from retained profits in order to increase the correlation between the bonuses and economic performance of the enterprise.<sup>10</sup> In 1981, the State Council stipulated that only those enterprises which were able to comply with the economic criteria on quality, quantity, profit, and supply specified by the State could allocate and distribute bonuses.<sup>11</sup> Furthermore, the total annual amount of the bonus for employees could not be greater than the equivalent of an employee’s three-month standard wage.<sup>12</sup> Later in 1984, the ceiling on bonuses was removed by the State Council. However, bonuses exceeding a specified amount were subject to a bonus

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<sup>2</sup> C. Loomis, “The Madness of Executive Compensation,” (12 July 1982) at 42.

<sup>3</sup> “Fat Cats and Their Cream,” *The Economist* (22 July 1995) at 19.

<sup>4</sup> P. Cook, “When the Boss Gets Paid Too Much,” *The Globe and Mail* (28 September 1995) at B2.

<sup>5</sup> K. Murphy, “Top Executives Are Worth Every Nickel They Get,” *Harvard Business Review* 125 (March-April 1986); M. Jensen and K. Murphy, “Performance Pay and Top-Management Incentives,” Vol. 98, No. 2, *The Journal of Political Economy* 225 (1990).

<sup>6</sup> Yan Zhongqin, ed., *Employee Wages, Benefits and Social Insurance in Contemporary China* (Beijing: China Social Sciences Publishing House, 1987) at 75-79.

<sup>7</sup> *Ibid.*, at 80-83.

<sup>8</sup> *Ibid.*, at 91-93.

<sup>9</sup> *Ibid.*, at 106-07.

<sup>10</sup> *Ibid.*, at 112.

<sup>11</sup> *Ibid.*, 108.

<sup>12</sup> *Ibid.*

tax.<sup>13</sup> Enterprises were also allowed to carry out wage reforms to motivate the employees. The method of linking wages and bonuses with the economic performance of enterprises considerably enhanced the morale of employees. The successful outcome of incentive remuneration led to the decision of the State Council in 1985 to provide greater freedom to enterprises so that the wages of enterprises might float within a proportional range according to the economic performance of the enterprise.<sup>14</sup> In the same year, the State Council also decided to de-link the wage system of enterprise employees with that of public servants in governmental institutions, universities, and hospitals.<sup>15</sup> These two significant changes not only reduced the importance of governmental control on the wages of employees in enterprises but also increased the role of the labour market. During that period, however, the difference between the remuneration of executives and employees was not very great. There were no separate legal provisions on the remuneration of executives and thus the directions in this area were neither specific nor clear.

In 1986, the State Council promulgated *Several Provisions Concerning the Deepening of Enterprise Reform and Strengthening of Enterprise Vitality (Several Provisions)*.<sup>16</sup> The *Several Provisions* permitted enterprises owned by all the people to provide the factory director or the general manager with remuneration one to three times the average wage of employees or higher.<sup>17</sup> In 1988, the State Council issued the *Provisional Regulation on the Leasing Operation of Small Enterprises Owned by all the People (Provisional Regulation)*.<sup>18</sup> This *Provisional Regulation* allows for the remuneration of the operator of a local enterprise to be up to five times the average wage (including bonus) of the employees of the enterprise.<sup>19</sup> While these administrative measures of the State Council provided enterprises with greater room to increase the difference in remuneration between executives and ordinary employees, restrictions on executive compensation still remained.

In 1994, an experiment was carried out in Shenzhen so that the system of annual remuneration might be applied to the chairperson of the board of directors and/or the general manager.<sup>20</sup> The annual remuneration system for general managers in SOEs became standardized in Shenzhen in 1996. According to article 22 of the *Provisional Measures on the Work of Company Managers in the City of Shenzhen (Provisional Measures)*,<sup>21</sup> the annual remuneration of the general manager shall consist of basic annual remuneration, performance annual remuneration, and bonus annual remuneration.<sup>22</sup> The basic annual remuneration depends upon factors including the amount of assets of the company, the realized amount of profit, the amount of tax paid, the sales volume, and/or the foreign exchange earned. Specific classification is made by the State Asset Administration Office of that city. The performance annual remuneration has two components: 40% of the performance annual remuneration is based on the growth rate of the net asset and the other 60% is based on the growth rate of the realized profit. The annual bonus remuneration is linked with the requirement

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<sup>13</sup> Ibid., 109.

<sup>14</sup> Ibid., 116-17.

<sup>15</sup> Ibid., 116.

<sup>16</sup> <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>17</sup> Ibid., article 3.

<sup>18</sup> <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>19</sup> Ibid., article 33.

<sup>20</sup> Gao Shusheng, *20 Years of Income Distribution System Reform in China* (Zhongzhou: Zhongzhou Ancient Book Publishing House, 1998) at 118.

<sup>21</sup> <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>22</sup> Ibid.

that the growth rate of the company based on the above factors exceeds that of the industrial average. Bonuses can be in the form of cash, in kind, or in share dividend.<sup>23</sup>

The Ministry of Labour and Social Security extended the annual remuneration system to other parts of the country in 1997.<sup>24</sup> The main purposes of adopting the annual remuneration system in China include the separation of executive compensation with the remuneration of other employees; linking executive compensation with the level of difficulty inherent in enterprise management and firm performance; and the enhancement of transparency of executive compensation.<sup>25</sup> Although one of the purposes of the annual remuneration system is to increase the correlation between executive compensation and the performance of their firm, the current basic annual remuneration of corporate executives is still highly constrained within a few times the average annual wages of ordinary employees. In addition the annual performance remuneration of corporate executives is not allowed to exceed the basic annual remuneration. With China moving further towards a market economy, it is necessary to examine whether the restrictions on corporate executives are conducive to firm performance. To analyze this issue, I will discuss the experience and lessons drawn from the regulation of executive compensation through tax law or alternatively through the law on disclosure of executive compensation in other countries.

### III. Tax Restrictions on Executive Compensation

In the United States and the United Kingdom, the high growth rate of the amount of executive compensation is an undisputed fact. An investigation in the United Kingdom showed that the actual average salary and bonus of the executives in the surveyed companies increased 149% during 13 years in the 1980s and 1990s.<sup>26</sup> A survey in the United States in 1990 also revealed that the average compensation of CEOs was 35 times of that of manufacturing employees, while this ratio was 15 times in Japan and 20 times in Europe respectively.<sup>27</sup> Although the increase of remuneration of manufacturing employees between 1980 and 1989 was less than 15%, the growth rate of compensation of CEOs was more than 150%.<sup>28</sup> For example, in 1993, the total compensation to the CEO of Water Disney Company reached US\$200 million.<sup>29</sup>

Both the populists and shareholders in the United States have strong reactions to the high amount of executive compensation. Most populist criticisms of executive compensation focus on the level of pay rather than on the relationship between CEO pay and firm performance while shareholder criticisms of COE pay have centered on the lack of meaningful rewards for superior performance and strict penalties for failure.<sup>30</sup> Opinions of the populists and shareholders on higher levels of executive pay

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<sup>23</sup> Ibid., article 23.

<sup>24</sup> Main Objectives and Policy Measures of Enterprise Wage Administration During the Ninth Five Year Period, available on line at <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>25</sup> Ibid., Part V.

<sup>26</sup> M. Conyon et al., "Taking Care of Business: Executive Compensation in the United Kingdom," 105 *The Economic Journal* 701, 707 (May 1995).

<sup>27</sup> J. Nelson-Horchler, "The Pay Revolt Brews," *Industrial Work* (18 June 1990) at 28, 30.

<sup>28</sup> "Punters or Proprietors: A Survey of Capitalism," *The Economist* (5 May 1990) at 64, 73.

<sup>29</sup> G. Crystal, "CEO Compensation: The Case of Michael Eisner," in F. Foulkes ed., *Executive Compensation: A Strategic Guide for the 1990s* (Boston: Harvard Business School Press, 1991) at 353.

<sup>30</sup> K. Murphy, "Politics, Economics, and Executive Compensation," 63 *University of Cincinnati Law Review* 713, 715 (1995).

received responses of a political nature in the Congress. It is obvious that simultaneously satisfying the concerns of popular groups and shareholders is impossible. As will be discussed further, satisfying shareholders by increasing pay-performance sensitivities implies higher levels of pay; while yielding to populist pressures to restrict pay level results in lower incentives and firm value. The tax regulation of executive compensation in the United States in 1994 clearly reflects this dilemma.

The Omnibus Budget Reconciliation Act of 1993 (OBRA) added section 162(m) to the Internal Revenue Code. Section 162(m) limits the corporate tax deduction for compensation paid to the CEO and the next four highest-paid executive officers to US\$ one million each.<sup>31</sup> Performance-based pay, however, may be exempted from this tax deduction limit. Qualification for this exemption requires, inter alia, approval by shareholders in advance to link executive compensation to specific and objective performance targets formulated by a compensation committee composed solely of outside directors and ex post certification of performance by the compensation committee.<sup>32</sup>

After section 162(m) became effective, people carried out follow-up studies to examine the effects of this provision. The result of one research reveals it is impossible to deal with both the concern of populists and the concern of shareholders adequately through legislation. Section 162(m) not only fails to restrict the amount of executive compensation but also accelerates the increase of the amount of executive compensation. There are two explanations. First, some companies ignore the legislative restrictions in tax law and continue to pay more than US\$ one million as annual salary to executives. A survey of 91 firms showed that one-third of the companies are not concerned with the negative impact of section 162(m) and continue to provide executives with an annual compensation beyond the US\$ one million limitation.<sup>33</sup> Second, section 162(m) and the exemptions led some firms near the US\$ one million cap to restrain their salary increases, and perhaps to increase the performance components of their pay packages.<sup>34</sup> An investigation in 1996 revealed that while the salary and bonus of corporate executives only increased by 7%, the value of the options they received increased by 27.9%.<sup>35</sup> According to the figures of the Internal Revenue Service, section 162(m) did not result in a decrease in executive compensation. Quite the contrary, executive pay actually rose 29 % faster in the first year after the law took effect.<sup>36</sup>

Although the tax reform has led firms to use more stock options and have, to a certain degree, increased the correlation between executive pay and firm performance, it is very difficult to satisfy both the demands of shareholders and populists. Responding to the demand of shareholders means the enhancement of the correlation between executive compensation and firm performance. Whether to use incentive bonuses or to use stock options to strengthen the correlation between executive compensation and firm performance will result in a greater amount of pay. First, in

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<sup>31</sup> 26 U. S. C. 162(m)(1), 1994.

<sup>32</sup> 26 U.S.C. 162(m)(14)(c), (1994).

<sup>33</sup> J. Luben, "Firms Forfeit Tax Break to Pay Top Brass US\$ 1 Million – Plus," Wall Street Journal (21 April 1994) at B1.

<sup>34</sup> N. Rose and C. Wolfram, "Has the Million – Dollar Cap Affect CEO Pay," 90(2) The American Economic Review (Papers and Proceedings) 197, 201 (2000).

<sup>35</sup> J. Dobzynski, "New Road to Riches Is Paved with Options," New York Times (30 March 1997) at 1.

<sup>36</sup> D. Johnston, "Executive Pay Increases at a Much Faster Rate Than Corporate Revenues and Profits," New York Times (2 September 1997) at D4.

the process of moving from fixed salary to performance-based pay, managers require a higher amount of compensation for the greater risks assumed.<sup>37</sup> Compared with stock options, salaries are relatively stable. The welfare effects from the exercise of stock options may be affected by external factors not related to the efforts of managers. To overcome this potential problem, companies normally have to provide a greater value in stock options. It is generally not acceptable for managers to receive an expected US\$100 in stock options in exchange for a reduction of US\$100 in their salary.

Second, the reason why the greater use of performance-based stock options increases the amount of executive compensation is because companies routinely but erroneously perceive options as relatively low-cost ways to deliver compensation.<sup>38</sup> From the perspective of senior managers, the standard option pricing models are not appropriate for valuing options held by undiversified, risk-averse employees who cannot freely sell the options or hedge their risks.<sup>39</sup> From the perspective of companies, options are perceived as inexpensive because they can be granted without any cash outlay and without incurring an accounting charge.<sup>40</sup> Further, when options are exercised, the accounting income is left unchanged, but the taxable income is reduced under US accounting and tax rules.<sup>41</sup>

Third, the reason why stock options will result in an increase of the amount of executive compensation is because of the endowment effect.<sup>42</sup> Economic theories normally assume that there is no fundamental difference between a foregone gain (opportunity cost) and an out-of-pocket loss. Experimental economists have, however, demonstrated that people view opportunity costs as less important than out-of-pocket costs. The bias toward retaining what one possesses has been called the “endowment effect.”<sup>43</sup> Applying the endowment effect to executive compensation, a scholar has reached a conclusion that the endowment effect may result in a bargain whereby the executive retains his salary, but is granted an additional variable pay package.<sup>44</sup>

The above discussion shows that satisfying the demand of shareholders requires performance based variable pay. The result of using variable pay, the perceived cost of stock options, and the endowment effect all tend to increase the amount of executive compensation. This is, however, not a desired outcome for the populists. On the other hand, yielding to the pressure of populists to reduce the amount of executive compensation requires restrictions on the amount of executive compensation. Restrictions on the amount of executive compensation are likely to result in a welfare loss on the part of shareholders. The discussion also reveals that the legislative endeavor of using tax law to restrict the amount of executive pay is likely to fail. In a market economy, what is a reasonable amount of executive pay shall be determined

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<sup>37</sup> Murphy, *supra* note 30, at 739.

<sup>38</sup> K. Murphy, “Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options,” 69 *University of Chicago Law Review* 847, 858 (2002).

<sup>39</sup> *Ibid.*, at 858-59.

<sup>40</sup> *Ibid.*, at 859.

<sup>41</sup> *Ibid.*, at 859-60.

<sup>42</sup> J. Knetsch, “The Endowment Effect and Evidence of Nonreversible Indifference Curves,” 79 *The American Economic Review* 1277 (1989).

<sup>43</sup> *Ibid.*; see also J. Knetsch and J. Sinden, “Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value,” 99 *Quarterly Journal of Economics* 507 (1984).

<sup>44</sup> E. Iacobucci, “The Effects of Disclosure on Executive Compensation,” 48 *University of Toronto Law Journal* 489, 508-10 (1998).

by market conditions. There does not exist any ideal legislative, administrative or judicial criterion on how much executives should be paid.

#### IV. Legislative Requirement of Disclosure of Executive Pay

The populist criticisms of executive pay and shareholders concerns over the method of executive pay in the 1990s also led to the expansion of the scope of or the adoption of disclosure of executive pay in North America in the 1990s. Despite the fact that US regulators have required disclosure of executive compensation for over 50 years, the United States has by far the world's highest-paid executives.<sup>45</sup> Obviously people need to reconsider the role of disclosure of executive pay. Two questions naturally emerge. The first question is whether the disclosure of executive pay improves the method of executive remuneration in responding to shareholders demand for the production of greater wealth. The second question is whether the disclosure of executive pay serves the purpose of controlling the amount of executive compensation demanded by the populists. After discussing the content of disclosure of executive pay, Part A and Part B of this section will deal with each of the two questions above.

In 1992, the Securities Exchange Commission (SEC) further enlarged the scope of disclosure of information on corporate executive compensation.<sup>46</sup> Among other things, the new rules require companies to produce the following: (i) a table summarizing the major components of compensation received by the CEO and other highly paid executives over the past three years; (ii) tables describing option grants, option holdings, and option exercises in greater detail; (iii) a chart showing the company's stock-price performance relative to the performance of the market and the company's "peer group" over the prior five fiscal years, and (iv) a report of the compensation committee describing the company's compensation philosophy.

##### A. The Function of Pay Disclosure on the Relation between Pay and Firm Performance

The system of disclosing executive compensation has played a very active role in increasing the correlation between executive pay and firm performance. In the first place, disclosure has a desirable effect in lowering the costs of shareholders monitoring executive compensation.<sup>47</sup> In companies where shares are widely dispersed, small investors do not have incentives to monitor the activities of the management. The passive participation of small investors in corporate governance is understandable. Participation in corporate governance requires time and information and the cost of time and acquiring the necessary information will be borne by the active monitoring shareholders. The benefits deriving from active monitoring by these active shareholders must be shared with other shareholders. Being unable to fully capture all the benefits of monitoring the management by active shareholders results in reduced incentives for small investors to monitor, and also leads to the free rider problem. Although the disclosure of executive compensation does not affect the positive externalities, it may have significantly reduced the private costs of monitoring compensation. This is true because it may have been very difficult for an

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<sup>45</sup> "Paying the Public Pipers," The [Toronto] Global and Mail (2 April 1996) at A18.

<sup>46</sup> Executive Compensation Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48, 126 Regulation S – K, 17 C.F.R. paras. 228, 229, 240, 249 (21 October 1992).

<sup>47</sup> Iacobucci, *supra* note 44, at 499-500.

investor to find out the composition of executive pay packages prior to mandatory disclosure. With mandatory disclosure, it is much easier to discover the composition of executive pay packages. Under the mandatory disclosure system both in the United States and in Canada, the information disclosed by companies must show the performance of the company and the strategy and reasons of adopting different compensation methods. Other things being equal, the lower the monitoring cost, the greater the benefits from monitoring by shareholders. Another reason why disclosure of executive compensation increases the benefits of monitoring is the lower cost of evaluating the pay packages as disclosure rules require companies to explain their compensation strategy and to provide comparative tables showing the firm's financial performance.<sup>48</sup>

Second, mandatory disclosure rules facilitate shareholder activism and increase monitoring reputation. In the United States, the SEC in 1992 revised the proposals on executive compensation.<sup>49</sup> Disclosure has not only lowered the cost of monitoring executive pay but also made it easier for activist shareholders to publicize their monitoring activities. Both aspects have positive effects on institutional investors. Institutional investors account for more than two thirds of the investment in Canada in the 1990s.<sup>50</sup> As relatively large shareholders, institutional investors are able to obtain a higher proportion of monitoring gains. Diversification of investment by institutional investors through portfolios will also result in positive externalities of their monitoring activities. Proposals on compensation packages by institutional investors will deter unjustifiable executive pay packages of the same company in the future. Furthermore, the good reputation and credible threat of active monitoring of executive pay by institutional investors may deter the adoption of executive pay packages by other companies which do not have shareholder's best interests in mind.<sup>51</sup> Examples of active monitoring of executive pay by institutional investors include the California Pension Fund, CalPERS. CalPERS has scrutinized and demanded changes to compensation schemes in a number of firms.<sup>52</sup>

Third, disclosure of the executive pay policy may be important in requiring the compensation committee to explicitly formulate a compensation strategy. Under a disclosure regime, the compensation committee is forced to justify its choice of a particular pay package.<sup>53</sup> Viewed from the standpoint of shareholders, only those compensation packages which will bring more wealth to the company will receive their support. Empirical studies in Canada have shown that mandatory disclosure of executive pay strengthens the correlation between executive compensation and firm performance.<sup>54</sup>

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<sup>48</sup> Ibid., at 498.

<sup>49</sup> See K. Salwen, "The People's Proxy: Shareholder Proposals on Pay Must be Aired, SEC to Tell 10 Firms," *Wall Street Journal* (13 February 1992) at A1.

<sup>50</sup> J. MacIntosh, "Institutional Shareholders and Corporate Governance in Canada," 26 *Canadian Business Law Journal* 145, 150 (1996).

<sup>51</sup> D. Kreps, "A Course in Microeconomic Theory (London: Harvester Wheatsheat, 1990).

<sup>52</sup> L. Barris, "The Overcompensation Problem: A Collective Approach to Controlling Executive Pay," 68 *Indiana Law Journal* 59 (1992).

<sup>53</sup> Iacobucci, *supra* note 44, at 500.

<sup>54</sup> H. Harts, "Does Canada Have a Problem with Executive Compensation," in E. Iacobucci, ed., *Value for Money: Executive Compensation in the 1990s* (Toronto: C.D. Howe Institute, 1996) 59 at 60-61; X. Zhou, "Essays on Executive Compensation and Managerial Incentives (Doctoral Thesis, University of Toronto, 1997) at 27.



Kevin Murphy, a renowned scholar in financial economics, summarizes the 1992 reform on the disclosure of executive pay as follows:<sup>55</sup>

Overall, the new SEC rules make it much easier for shareholders to quantify and distinguish between the level of pay and the pay-performance relation and have helped to focus attention on stock-price appreciation as the preeminent measure of corporate performance. These changes facilitate better monitoring of compensation committees and boards of directors in general, which in turn leads to the design of more effective compensation policies. Perhaps more importantly, the compensation committee report requirement and the other SEC initiatives have dramatically increased the visibility and the accountability of compensation committees as the architects of top-management compensation plans. Because the scrutiny on compensation committees emanates from political sectors as well as shareholders, it is not a foregone conclusion that the increased scrutiny will lead to more effective compensation policies....

## B. The Impact of Disclosure on the Amount of Compensation

There are four reasons to explain why the disclosure of executive pay will lead to higher amounts of executive compensation. First, under the disclosure regime on corporate executive compensation after the reform in North America, more companies have adopted performance based pay. As discussed in Section III, performance based variable pay is more likely to lead to an increase in the total amount of executive compensation. Where there is a divergence of interest between the management and shareholders and managers have great discretion, the company needs to give executives more performance based variable pay in order to provide incentives for managers to produce more wealth for the company. Compared with the old pay regime where executive remuneration is not based on firm performance, performance based variable pay allows managers to receive part of the wealth they helped create, resulting in higher pay from successful management of the company. Under the old regime, there is no close relationship between executive remuneration and firm performance. Executive remuneration under such a regime may be a zero-sum game.<sup>56</sup> Higher pay for managers means less profit for shareholders. Under the regime where executive remuneration is closely linked with firm performance, however, executive compensation is more likely a positive-sum game. The performance based variable pay to executives is proportionally related to the growth of total wealth of the company. From an efficiency perspective, the negative reaction from the public against an increase in the amount of executive compensation is not reasonable.

Second, under the performance based pay regime, executive pay is positively connected with firm performance. The firm's performance, however, is not perfectly associated with managers' performance as it is difficult to separate the contribution of managers from other factors. Under these circumstances, the managers bear the risk of external factors that could negatively influence the firm's performance.<sup>57</sup> Other things being equal, risk-averse managers prefer a fixed salary to receiving the same amount in expected variable pay. For risk-averse managers, an increase in the expected amount of the variable pay must be higher than the reduction in the amount

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<sup>55</sup> Murphy, *supra* note 30, at 737.

<sup>56</sup> Iacobucci, *supra* note 44, at 505.

<sup>57</sup> B. Holmstrom, "Moral Hazard and Observability," 10 *Rand Journal of Economics* 74 (1979).

of fixed salary for managers to accept performance based variable pay.<sup>58</sup> To the extent that disclosure increases the positive correlation between executive remuneration and firm performance, managerial risk aversion and bargaining will result in higher levels of expected pay.<sup>59</sup> Moreover, the human capital of managers is normally firm specific and cannot be perfectly diversified. Performance based pay generally requires, that managers take on more risky projects with higher expected payoff in order to receive a greater proportion of executive pay. The risk of higher probability of bankruptcy of the firm in undertaking riskier projects also requires greater pay to manager.

Third, mandatory disclosure of executive compensation necessarily requires the adoption of variable executive pay by companies; this indicates the close link between executive compensation with firm performance. Performance based pay for executives are widely practiced by way of adoption of stock options.<sup>60</sup> The discussion in Section III shows that both companies and employee managers tend to undervalue the cost of stock options.<sup>61</sup> The undervaluation of stock options results in the award of greater value of stock options as opposed to the economic cost of stock options. The result is a higher amount of total executive compensation.

Fourth, the endowment effect discussed in the previous section is also likely to have an indirect effect on the amount of executive compensation. Mandatory disclosure of executive pay reduces the cost of shareholder monitoring and generates pressure on the compensation committee or the board of directors to adopt performance based variable pay. The endowment effect suggests, however, that executive compensation from fixed salary to performance based variable pay may not be able to replace a certain amount of salary with the same expected amount of variable pay. From a distributive perspective, this may sound slightly negative. On the other hand, judged by the efficiency criterion, a higher amount of executive compensation under a regime of pay sensitive to performance is not negative as the higher amount of executive compensation means a greater net corporate wealth. In that sense, there is no need to worry about the higher amount of executive compensation.

## V. The Regulation of Executive Compensation and Policy Implications for China

Although China has moved more towards a market economy, the transition is not complete. During the transitional phase of the economy in China, the method of executive compensation is still adversely affected by the mentality of the old economic planning regime. Currently, there is significant tension between the market oriented efficiency perspective and the egalitarian values. In that sense, the intellectual debate as well as the reforms on executive compensation is highly political. This section will first discuss the empirical evidence related to executive compensation in Chinese listed companies and then discuss the regulation of executive compensation.

A survey of 78 listed companies in China in 1997 revealed that there was virtually no correlation between the annual compensation of corporate executives and firm

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<sup>58</sup> C. Milkovich and B. Rabin, "Executive Compensation and Firm Performance: Research Questions and Answers," in F. Foulks, ed., *Executive Compensation: A Strategic Guide for the 1990s* (Boston: Harvard Business School Press, 1991) at 81.

<sup>59</sup> Iacobucci, *supra* note 44, at 506.

<sup>60</sup> Conyon, *supra* note 26, at 706.

<sup>61</sup> Murphy, *supra* note 38, at 858 and 867.

performance.<sup>62</sup> Another empirical study done in 2000 confirmed that there did not exist any connection between executive compensation and firm performance amongst listed companies.<sup>63</sup> Although the steps of reform taken by state-owned enterprises are slow, the trend of reforming the methods of corporate executive compensation is promising. Several studies indicate that a positive correlation between executive compensation and firm performance is emerging. A study in 2002 showed that there was in fact a positive relationship between executive compensation and firm performance in Chinese listed companies.<sup>64</sup> Another survey of executive compensation in 381 listed companies reveals that there is a positive link between the proportion of share holding of the most influential director and firm performance.<sup>65</sup> This study also discovered that there is a further negative impact upon firm performance if the most influential director (the general manager or the chairperson of the board of directors) does not receive pay from the listed company.<sup>66</sup>

From the perspective of total executive compensation, opinions of economists are largely rational although populist criticisms of executive compensation occasionally appear on the media.<sup>67</sup> The following survey results also affirm the above point. A survey of 89 listed companies, which disclosed executive compensation in 1997, shows that the average annual compensation of the general managers in listed companies was only RMB 38,650.<sup>68</sup> The average annual compensation of senior managers in listed companies in 2002 increased to RMB 157,400. There are, of course, some extreme cases where the executives received RMB 6-7 million in 2002.<sup>69</sup>

The regulation of executive compensation in other countries shows that restrictions on the amount or level of executive compensation either through tax law or by disclosure rules are unlikely to have a positive effect. The discussion of the two previous sections tells us that laws which try to restrict the amount of executive pay are counterproductive. What is a reasonable amount of executive pay should be determined by the managerial market. Any attempt to find an ideal legislative, administrative, or judicial criterion for the purpose of regulating executive pay in a market economy is doomed to fail. If the amount of executive compensation in a company is suspiciously high and there is no correlation between the executive compensation and firm performance of a particular company in a market economy, this is a good indication that there are weaknesses in the corporate governance of that company. A study in the United Kingdom found that there was a negative correlation between the amount of executive pay and the absence of a compensation committee in the surveyed companies.<sup>70</sup> It must be pointed out that demanding a reduction of executive compensation is not necessarily in the interest of shareholders. A study in the United States showed that proposals imposing restrictions on executive pay by

<sup>62</sup> "The Status of CEO Annual Compensation," Shanghai Securities News (18 November 1998).

<sup>63</sup> Wei Gang, "Senior Management Incentives and Performance of Listed Companies," 3 *Jingji Yanjiu* (The Economic Journal of the China Academy of Social Sciences) 32 (2000).

<sup>64</sup> Yin Changlin, "A Study on Executive Incentive Pay and Performance in Listed Companies," 1 *The Economist* (in China) (2004) at 125.

<sup>65</sup> Yu Aihong, "An Empirical Study on the Remuneration of Directors and Firm Performance," 2 *The Northern Economy and Trade* 14 (2000).

<sup>66</sup> *Ibid.*

<sup>67</sup> Lin He, "The Rapid Growth of Executive Compensation: Cautioning Against Treating Listed Companies as Teller Machines," *China Securities Journal* (16 July 2004).

<sup>68</sup> "Remuneration of the General Manager in China's Listed Companies," Shanghai Securities News (18 November 1998).

<sup>69</sup> Liu Jianfeng, "Executive Compensation in China's Listed Companies Increased in 2002," *China Economic Times* (14 May 14 2002).

<sup>70</sup> Conyon, *supra* note 26, at 711.

institutional investors might have a negative effect on the share prices of these companies.<sup>71</sup>

On the other hand, regulation of executive pay emphasizing the increasing correlation between executive pay and firm performance will normally have better results. As discussed in the two previous sections, regulation in the United States on executive pay either through tax law or disclosure rules both promote the positive correlation between executive pay and firm performance. Nevertheless, regulation by using disclosure rules is more conducive to corporate management in a market economy. Disclosure rules have a clear advantage with respect to the promotion of transparency and efficiency of the stock market. Discussion in Section IV has shown that disclosure of executive pay reduces the cost of monitoring the management by shareholders. In addition, disclosure rules enhance the reputation of active shareholder monitoring and create a deterrence effect in the same company as well as in the other companies that the institutional investors have invested in. Finally, disclosure rules promote the accountability of the compensation committee, as a heightened policy of transparency means that directors on the committee have to explain the reasons for the executive pay package.

A mandatory disclosure regime plays a significant role in strengthening the positive correlation between executive pay and firm performance. So long as there are no externalities, the higher the correlation between executive pay and firm performance, the greater the net wealth created by the company. The lessons from the regulation of executive pay in other countries have clear policy implications for China, which is in transition from a planned economy to a market oriented economy. The benefits from mandatory disclosure of executive pay require institutional changes in China.

The requirement of disclosing executive pay in China's listed companies began in 1996. The China Securities Regulatory Commission (CSRC) issued the Notice Concerning the Implementation of Regulating the Disclosure of Information in Listed Companies in 1995 (Notice).<sup>72</sup> The Notice requires listed companies to disclose in their annual report information regarding directors, supervisors, and senior managers' shareholding at the beginning and end of the year, any change of the shareholding, and the annual compensation paid by the company including salary, bonus, benefits, special treatments in the form of cash, in kind or others, and securities.<sup>73</sup> Subsequently, the CSRC issued the Code on Corporate Governance for Listed Companies (Governance Code).<sup>74</sup> Although article 77 of the Governance Code emphasizes the establishment of incentive schemes to link executive compensation with firm and personal performance, the provisions on the disclosure of compensation to directors and senior managers in listed companies are also very brief. Article 72 of the Governance Code stipulates that directors and supervisors shall report to the shareholders at shareholders meetings about the performance of their duties, firm performance, and their remuneration and shall disclose the same to the public. Article 79 of the Governance Code provides that the pay package for senior managers shall be approved by the board of directors, explained to the shareholders, and disclosed to the public. After promulgation of the Governance Code, the CSRC revised its

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<sup>71</sup> R. Romano, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance," 18 *Yale Journal on Regulation* 174 (2000).

<sup>72</sup> This Notice is available at <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>73</sup> *Ibid.*, Article 3(2) and 3(3) of Part IV.

<sup>74</sup> This Governance Code appears at Shanghai Securities News (10 January 2002).

disclosure requirements for information in the annual report by listed companies. The provisions require, among other things: the disclosure of decision making process concerning the compensation of directors, supervisors, and senior managers; the basis of determining the compensation; the total annual pay of the directors, supervisors, and senior managers including basic salary; all kinds of bonuses, welfare benefits, housing and other allowances; and the total compensation of the three highest paid directors and the three highest paid senior managers.<sup>75</sup>

An examination of the disclosure requirements of executive compensation in China shows some inadequacies. Future reforms will require amendment of the Governance Code on disclosure and the annual report so that listed companies need to disclose detailed information on the composition of executive pay packages - particularly the disclosure of performance based remuneration in the form of stock options or restricted stocks and their quantities. In addition, the price of shares on the date of granting the stock options, the exercise price of stock options by senior executives, and restrictions on the holding period after the exercise of the stock options shall be disclosed. Moreover, information comparing with other similarly situated companies associated with the appreciation of stock prices and the distribution of dividends shall also be disclosed. Finally, the compensation committee or the board of directors must disclose in detail to the shareholders, the basis or reasonableness of adopting different pay methods or the composition of pay packages and the correlation between executive pay and firm performance. It can be said with reasonable certainty that improvement of the mandatory disclosure regime on executive compensation in China will enhance the efficiency and effectiveness of shareholder monitoring of executive compensation. With the external monitoring mechanisms of bankruptcy and takeover very weak in China, the mechanism of executive compensation is of vital importance.

Although the mechanism of disclosing executive compensation is very important, to strengthen the positive correlation between executive compensation and firm performance requires a move towards the liberalization of corporate finance so that companies can issue shares and options, repurchase shares and the strict enforcement of law against violations of corporate law and securities regulation. While the use of these instruments helps companies enhance the relationship between executive compensation and firm performance, the implementation of such compensation methods requires a liberalized and open stock market. If China wants to carry out reforms to strengthen the correlation between executive compensation and firm performance, it has to improve its corporate law and securities regulation regimes and must strictly enforce such laws. On the other hand, the use of stock options does not fully enable the separation of external factors from the efforts of executives.<sup>76</sup> Viewed from this perspective, the compensation method of using stock options is not perfect. In the real world, we can only compare this performance-based method with other methods that have little or no correlation between executive pay and firm performance. Furthermore, with the legal system in China not yet fully mature, the stock option compensation method is more likely to be abused. Prevention of abuses of stock market requires heavy penalties against insider trading, market manipulation of share

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<sup>75</sup> The Notice of the CSRC Concerning the Amendment of Code 2 on the Content and Format of Information Disclosure by Listed Companies (The Content and Format of Annual Report), article 26, Part 5 of Chapter 2 (22 December 2003), available at <<http://www.chinainfobank.com>>, law database (last visited on 15 May 2005).

<sup>76</sup> R. Ellis, "Equity Derivatives, Executive Compensation, and Agency Costs," 35 Houston Law Review 399, 436 (1998).

prices, and misrepresentation by corporate executives. With corporate scandals erupting in the United States, which boasts a far more established and mature legal system than China, it is highly unrealistic to expect that there will be no abuse or manipulation of share prices by executives in China. The crucial point is that despite the existence of some fraud against small investors, the adoption of performance based pay methods like stock options will result in a faster growth of shareholder wealth and wealth in society compared with the use of other compensation methods which are not sensitive to firm performance. With respect to any resulting distributional issues, other regimes including the tax system are in a much better position than corporate law to address the problem of income disparity.

## VI. Conclusion

This article has dealt with the issue of executive compensation and applied it to the case of China. In the early stages of China's market economy, it is necessary to compare and learn from the experiences of matured economies regarding executive compensation. However, it is also necessary to avoid comparison with performance based executive pay methods in an ideal system. With this in mind, this article has discussed the regulation of the differing levels and methods of executive pay. Efficiency-wise, the regulation of the level of executive compensation is meaningless, any attempt to formulate an ideal legislative, administrative, or judicial criterion on the level of executive compensation is likely to be counterproductive. The emphasis of regulation on executive compensation should be placed upon the correlation between executive compensation and firm performance. Comparatively speaking, the mechanism of disclosure in executive compensation is more conducive to a market economy and beneficial to the further development of the stock market in China. The reform of executive compensation emphasizing the correlation between executive compensation and firm performance makes it necessary for China to liberalize the use of performance based executive pay in corporate law and securities regulation. The flexible use of stock options and other performance based pay methods require heavier penalties on insider trading, market manipulation, and misrepresentation by executives. With the insolvency market and the takeover market too weak to penalize incumbent managers, the reform on executive compensation becomes very important in motivating corporate executives. While there are still distributional concerns in China during its transitional economy phase, the fact that performance-based methods of executive compensation enhances not only the net growth of corporate wealth but of social wealth at large, making it the only irresistible and viable option at present.