Exploring the Legal Regulation of Executive Remuneration

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Abstract. This paper analyses how the main components of executive compensation have changed in recent decades and the disadvantages of option incentives. It will then analyse the effectiveness or limitations of each of the legal instruments that have been implemented to alleviate the situation and how public and political interventions have been carried out in the specific context of China, and the tools other than the law of the public authorities.

Keywords: FTSE · Executive compensation · out of control · public and political intervention

1 Introduction

In recent years, the growth of the market economy has facilitated the expansion of numerous businesses, the emergence of new markets, the hiring of more workers, and the implementation of more sophisticated management techniques. The problems associated with this trend are essential. The compensation of company executives has increased dramatically over the past few decades, encompassing a wide variety of components such as options, shares, and bonuses, which, if out of control, can be detrimental to the growth of the company and the maintenance of social justice. Currently, executive compensation is a global issue.A comparison between annual organisational pay rankings in the FTSE 100 Index and corporate performance demonstrates that executive pay is excessively high and pervasive [1] and that an out-of-control situation has developed. Giving its CEO stock options and stock awards has caused Xiaomi to spend more than it earns. This situation, which has created a significant income gap in society, must be controlled if the company or the market economy are to flourish. This paper will examine the evolution of the primary components of executive compensation over the past few decades and the drawbacks of option incentives. It will then analyze the efficacy the effectiveness or limitations of each of the legal instruments that have been implemented to alleviate the situation and how public and political interventions have been carried out in the specific context of China, and the tools other than the law that have been utilized by public authorities.

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2 Literature Review

In the majority of corporate compensation systems, the income of executives is typically accompanied by a component such as an option bonus, where the executive's pay is converted from cash to options, thereby creating a significant income gap between them and the average employee or worker. This situation could have inspired executives to be more committed to running the company and generating revenue, thereby enhancing shareholder interests. However, the apparent win-win outcome is not as ideal as it appears [2]. Additionally, when options become a fixed guarantee that executives will take their jobs seriously and contribute to the growth of the company or create benefits for shareholders, the majority of the benefits from options are retained by the executives, while only a small portion is distributed to other executives or regular employees, resulting in significant income disparities within the company. This form of executive compensation has spiraled out of control as a result of options, primarily in the form of enormous option transaction costs borne by corporate interests and a vast income gap between executives and other employees [3].

This is a typical example of presenting executive compensation results that primarily consist of options. After Xiaomi, a well-known Chinese technology company, released its first earnings report for its initial public offering, a series of astounding figures emerged: Due to the $9.9 billion equity incentive given to Lei Jun, the CEO of Xiaomi, the company's operating profit plummeted by $7.6 billion. In the early stages of a company's development, the exercise price of equity is typically low, resulting in high option costs, and options tied to executive salaries have become the "standard treatment" in many industries. This has resulted in high option transaction costs and a massive gap between the earnings of executives and regular employees, which has had a negative impact on the development of the business, with out-of-control executive pay being reflected in one-time equity awards, giving rise to Xiaomi's financial losses.

Long considered a model of corporate development, UK business analysts are dissatisfied with the current level of executive pay in many UK companies, indicating that the current status of pay control is problematic, primarily due to an apparent disconnect between corporate performance and executive pay. This is a disturbing viewpoint and fact in the context of business development as a whole [4]. In recent years, there has been discontent with the level of executive pay in the United Kingdom, and the outcomes of such pay management have been unsatisfactory. The UK government's analysis comparing the annual salary ranking of CEOs in the FTSE 100 Index to the yearly change in the FTSE 100 Corporate Performance Index reveals an apparent discrepancy that serves as an example of this issue's prevalence [1].

The results of the UK business analysts' analysis of pay management in the majority of companies, or the focus of the UK government's discussion from the FTSE 100, indicate that executive pay is excessively high and difficult to regulate. However, the ability of the majority of executives to generate profits for their companies is grossly out of proportion to their high salaries. Such compensation control is incompatible with the path of corporate development. Because there is a strong correlation between executive compensation and company profitability, it would be incorrect to conclude that executives will seek to generate revenue for their own gain. Short-term profitability can result in substantial compensation for executives. They will no longer prioritize the company's long-term trajectory, as these factors have no significant impact on their compensation. The relevant data from the FTSE 100 indicate that high-earning CEOs and poorer annual performance are the outcomes.

Globally, executive remuneration is a complex corporate governance issue, and previous research suggests that executive remuneration levels have become excessive in many regions. There are several reasons why it is challenging to control. In terms of the most fundamental concept of pay, however, the calculation of the average worker's salary is typically based on a variable that is easily calculable, such as the number of hours worked or the amount of work completed. However, executive performance is highly autonomous and subjective, and there is no standard method for measuring it. Furthermore, managers determine the salaries of regular employees. Still, executives are at a higher level than payroll managers, and the majority of company shareholders believe that executives share the same goals as they do, such as the company's share price and project earnings. This is how executive compensation is determined and measured [5]. An increase in executive compensation can be interpreted as an incentive for executives to work as hard as possible to increase shareholder value and company profits.

Neither the issue of option transaction costs caused by the fact that executive compensation is frequently tied to option incentives nor the issue of significant income disparities between employees caused by the addition of large earnings incentives to executive income is conducive to the long-term growth of the company or the preservation of the principle of maximizing shareholder interest. In the cases of the FTSE 100 and Xiaomi Technologies, executive overpayments have likely become a pervasive and somewhat out-of-control issue. To maintain the company's regular operation and growth, it is necessary to take legal or other measures to rein in the out-of-control situation of executive compensation.

The climate of out-of-control executive remuneration has spawned a number of legal and non-legal attempts to address the problem, each with advantages and disadvantages; therefore, the issue may require consideration of multiple approaches in addition to legal instruments.

The use of legal means to regulate and control executive compensation is one approach that can be taken. The introduction of pertinent legal provisions can help restrict or direct the situation. Nonetheless, due to the development of the market economy, public power control cannot be the ideal solution for preventing executive compensation from spiraling out of control. Several studies are focusing on a US tax code bill, The Omnibus Budget Reconciliation Act of 1993 (OBRA93). The Act was used by President Bill Clinton to fulfill a promise made after the 1992 election in the United States, when both candidates and the public were dissatisfied with the excessive pay of corporate executives in recent decades, and the provision prohibited corporate income tax deductions for corporate executives who qualified as CEOs with more than one million dollars in compensation. Jensen and Murphy (1990) focus on the effect of political pressure or strong regulation on executive pay performance, with executives in regulated firms being paid significantly less, all else being equal, and then longer tenure and increased pay as political pressure decreases and shareholding gradually shifts to private ownership [6].

There is a role for legal action to preventing executive pay from spiraling out of control, including not only through the enactment of legislation to encourage companies to control executive pay, but also political factors or regulatory intervention [6]. However, this strategy is not flawless. First, as stated previously, the gradual privatization of a company reduces political pressure and regulation and increases the tenure and compensation of executives, so the limitations of this strategy can be partially justified. On a company's annual tax return, the portion related to executive remuneration must be minuscule; the measure does not completely limit excessive executive remuneration because executives are exempt from having performance-based income. I believe that such legislation does not achieve the original intent and that controlling executive remuneration is for the company's long-term development. For instance, if the first five executives in a company earn more than $1 million per year, many of them will opt for high salaries with deferred benefits or phased benefits [7].

To have a significant impact, the legal approach to executive remuneration control may require a particular context, and the law's role is not limited to restricting or limiting excessive executive remuneration. Legislative measures to adjust and control a company's structure and underlying operating model may be able to alter the situation in which executive compensation is out of control. Switching the study area from the previously mentioned Western economic environments such as the United Kingdom and the United States to the specific economic climate of China, it is surprising to discover that many Chinese executives' compensation is not linked to options and stock dividends, nor do they have the option incentives that are prevalent in the West. In the context of the world's largest economy with daily trading of trillions of dollars, many Chinese firms do not view share price or shareholder interest as a long-term objective of corporate growth. Political factors have a significant impact on China's unique market economy, and many companies are still publicly or state-owned, so performance pay will likely not be the primary method of calculating the income of Chinese executives but will be calculated similarly to that of ordinary employees [8]. Obviously, as executives who have worked harder for the company, their compensation will be greater than that of regular employees, both in terms of material compensation (cash, housing incentives, exclusive transportation, etc.) and political status (increased political status).

In China, the executive compensation system is influenced by the political and economic climate. China's different economic environment from the West has resulted in the absence of the same tradition of linking share options to executive remuneration as in countries such as the United Kingdom, where state control and political intervention have radically altered the basic structure of many Chinese companies and where widespread tolerance of centralisation has resulted in such a corporate system gaining control over executive remuneration. In addition, the state has enacted pertinent corporate governance regulations and compensation systems to safeguard this model [5]. Legal authorities on executive compensation are adequate, but insufficient to be effective in this particular economic and political context. They are not universally applicable in all nations or regions. However, the study's reference value cannot be entirely discounted; it is an attempt to use public power or legal means to regulate executive compensation, and it has had some success in certain areas.

There should be alternatives to controlling executive compensation through public power or the law. Returning to the phenomenon of excessive executive pay, the change in the composition of executive pay from the mid-20th century to the present century is a clear indication of this. In the middle of the 20th century, 99 percent of executive income in large U.S. companies consisted of cash salaries and bonuses. In the last decade of this century, however, this number has dropped to approximately 60%. In spite of increases in overall compensation, executives' incomes have been multiplied by equity incentives and pay-for-performance systems [9]. As mentioned previously, the purpose of these initiatives was to motivate executives to do more for the company's benefit, to increase the share price, and to generate profits for shareholders. However, a number of studies published between 2003 and 2007 indicate that equity incentives are largely ineffective in boosting corporate profits [10].

Increasing the autonomy of the board of directors in the regulation of compensation, having a small number of independent directors form a compensation committee to regulate executive compensation, or having an external compensation consultant assist the board in regulation are all ways to control excessive executive compensation [11]. Overall, there are ways to control executive compensation that are internal to the market economy, as opposed to using public or legal means, so that the market economy can solve its own problems.

3 Conclusion

One thing that can be determined from the previous conclusions is that the role of the law in controlling this situation is not perfect, and remuneration committees and external remuneration consultants are also methods of controlling the case outside of the authority of the state. This paper concludes that, in addition to legal intervention, there are other ways to address the out-of-control situation of executive remuneration, both within the company and in the marketplace. There are a variety of ways to collaborate to solve the problem. This paper identifies one of the leading causes of excessive executive remuneration: the high proportion of options and share gains in executive remuneration. It then analyzes data from Xiaomi and the FTSE 100 and concludes that excessive executive remuneration hinders the long-term growth of the company. In discussing solutions, this paper mentions the use of legal instruments in a market economy, public regulation in a specific political and economic context, and the use of control and law in addition to legal instruments. It is evident from the process and feedback regarding the use of these instruments that different approaches have different benefits and drawbacks and that there is no perfect solution to the problem. To solve the problem of excessive executive remuneration, future research may be able to explore additional working directions, such as employee unions, the public, public opinion, etc.; after all, the issue of executive remuneration is not just an issue of corporate governance; it affects the group of executives themselves, as well as other company employees and the public at large, necessitating the use of a combination of instruments and measures.

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