Selective "Say-on-Pay" the Best Remedy

By Edward Labaton and Ethan Wohl

"Say-on-Pay" looks like it's here to stay. Resolutions urging that executive compensation plans be subject to a non-binding shareholder vote are now a leading corporate governance agenda item, and legislation calling for such votes passed the House of Representatives last year by a wide margin. Both presidential candidates endorsed the concept.

Say-on-Pay is not, however, the clear boon to shareholders that it may appear to be, because routine shareholder votes on pay risk becoming a rubber stamp that lets directors avoid accountability. Shareholders would be better served by more focused voting rights that allow them to put compensation to a vote only when they perceive abuse.

The idea of a shareholder vote on pay appears to have originated across the pond, with enactment of regulations in the United Kingdom in 2002. Companies were required to issue a "remuneration report" and allow shareholders an advisory vote. While approval has generally been routine, shareholders have occasionally used their power to disapprove pay, notably at GlaxoSmithKline in 2003.

In the United States, Say-on-Pay first appeared in 2006, when the American Federation of State, County and Municipal Employees (AFSCME) spearheaded resolutions at a handful of firms. In 2007, a number of other institutional investors took up the cause, sponsoring resolutions at nearly 50 firms, garnering an average 42.5 percent vote and winning a majority at eight firms, according to proxy advisory firm RiskMetrics. New governance initiatives normally take time to build support, so this was an impressive result for a second-year resolution.

In 2008, say-on-pay was introduced at more than 80 firms, and after some notable early failures at financial services firms, where large losses and generous severance should have provided fertile ground, support ticked upwards, with an average 42 percent vote at more than 50 companies and ten majority votes as of late September, according to RiskMetrics.

Reacting to the Say-on-Pay resolutions that received majority votes in 2007, boards of directors have now approved non-binding annual shareholder votes at several companies, including AFLAC, Verizon, and Blockbuster. In the first recorded vote on compensation, shareholders at AFLAC approved the company's plan overwhelmingly, with 93 percent voting in favor and just 2.5 percent opposed.

In Washington, bills mandating Say-on-Pay have been introduced for the past several years by Representative Barney Frank of Massachusetts. Until 2007, these efforts were just the pet project of an outspoken member of the minority. With the change in control of Congress, however, Frank became the Financial Services Committee chairman, and his bill – the Shareholder Vote on Executive Compensation Act – passed the full House by a vote of 269 to 134. The Senate has not acted on its companion bill. The prime Senate sponsor, however, was Barack Obama.

While Say-on-Pay is an activist, regulatory initiative, it enjoys substantial bipartisan support, as reflected by the lopsided vote in the House last year. To the chagrin of the laissez-faire wing of his party, John McCain has come out forcefully in favor of Say-on-Pay, stating that under reforms he would propose, "all aspects of a CEO's pay, including any severance arrangements, must be approved by shareholders."

THE "SAY-ON EQUITY" PRECEDENT

Curiously, coverage of Say-on-Pay generally fails to recognize that shareholders already vote on the central elements of executive pay: stock options and other equity-based compensation.

Under listing rules promulgated by the New York Stock Exchange and Nasdaq, companies on both exchanges have been required to submit equity compensation plans to a shareholder vote since 2003. Voting on equity-based pay plans has been widespread since the mid-1990's, following enactment of Section 162(m) of the Internal Revenue Code, which provided favorable tax treatment for equity compensation plans that received shareholder approval.

While Section 162(m) was intended to constrain executive pay growth, it has been widely recognized as a total failure, and the plans – intentionally presented in very general terms to maximize board and management flexibility – are approved by shareholders as a matter of course.

The experience with the shareholder say-on-equity compensation should serve as a caution to Say-on-Pay advocates. First, companies will limit meaningful oversight by keeping the terms of plans general and withholding the detail needed to fully assess them. Second, institutional shareholder staff and proxy advisors have limited resources and little inclination to battle management on a regular basis, so routine votes on pay get only the barest scrutiny.

There is no substitute for an independent board, with a deep knowledge of the company and its industry and the advice of qualified consultants, negotiating compensation at arm's length.

The way current proposals would operate is clear enough. Companies would be required, through their annual proxies, to present shareholders with the opportunity to vote for or against the executive compensation plan presented by the company pursuant to SEC disclosure rules. The shareholder vote would be advisory only, although Representative Frank has suggested that if boards fail to heed shareholder advice, the vote might be made binding.

Some Say-on-Pay critics have argued that a simple up or down vote would fail to identify the defects perceived by shareholders and would therefore be ambiguous. That argument is not compelling, however, because in any actual situation where a pay package is voted down, the issues that aroused the displeasure of institutional investors and the proxy advisory services will be abundantly clear.

The bigger ambiguity in Say-on-Pay, as with "Say-on-Equity," is whether shareholders know what they are voting on. While the compensation discussion and analysis (CD&A) mandated for 2007 substantially enhanced the earlier disclosure regime, the quality of CD&As varies significantly. By design, even the best compensation reports do not allow shareholders to fully grasp the financial impact of compensation arrangements because key metrics, such as performance targets and peer benchmarks, are treated as competitive information and often are not disclosed.

In addition, the growing complexity of compensation packages, with "portfolios" of options, time and performance-vested restricted stock, stock appreciation rights, restricted stock units and other incentives means that even with full disclosure, pay arrangements are not easy to grasp. The complexity of pay is reflected by a memorable episode in the epic Disney litigation, where a leading compensation expert admitted that he had failed to analyze the payout to former Disney president Michael Ovitz under the early-termination scenario that ultimately occurred.

Shareholders are also ill-equipped to pass on pay because of the deference ordinarily given to board decisions. Normally, shareholders will act only when a governance problem becomes clear and present. At that point, the offending compensation plan will likely be years old and beyond attack. Accordingly, shareholder review of pay will generally take the form of closing the barn door after the horse is long gone.

RUBBER-STAMP RISK

Routine approval of pay plans carries the risk of being more than just ineffective. Setting appropriate pay ultimately depends on board action, and there is no substitute for an independent board, with a deep knowledge of the company and its industry and the advice of qualified consultants, negotiating compensation at arm's length.

Giving ultimate say to shareholders, then, risks harming the quality of compensation by diminishing board authority and providing an "out" through the ratification of board action conferred by shareholder approval. When members of the compensation committee and the full board set and vote on pay, they should know that responsibility for its fairness is theirs alone.

Recognizing the limitations of shareholder action, the problem of excessive executive pay still calls out for a way to let shareholders formally register their disapproval when a board fails in its compensation-setting function. Properly constituted, Say-on-Pay could significantly enhance board accountability by providing some degree of shareholder oversight. The facile response of some Say-on-Pay opponents – that investors who are dissatisfied with a board can always vote it out of office – ignores the significant costs to investors and disruption and detriment to the company of such a major change in leadership. Shareholders need a way of formally expressing displeasure on compensation without electing the nuclear option of board ouster.

The potential value of Say-on-Pay is illustrated by the British experience, and is supported by the market. Research by Stephen Davis at the Millstein Center for Corporate Governance and Performance found that in the United Kingdom, the shareholder vote on pay spurred dialogue between boards and shareholders, increased responsiveness to shareholder concerns, slowed pay growth and improved the linkage between pay and performance. Qualitative analysis by two professors at Harvard Business School also found that the alignment between pay and performance had increased in the U.K. since shareholder votes were instituted.

Finally, the market seems to value Say-on-Pay. According to a study by two researchers at Drexel University, House approval of Say-on-Pay legislation last year caused an uptick in the stock prices of companies with weaker governance, where the say could be particularly valuable.

SELECTIVE SAY

The right remedy, then, would allow shareholders to vote on pay, but would not mandate that such votes be held routinely. Rather, a vote would occur only when requested by a substantial shareholder. Under this regime, governance advocates like AFSCME would have a built-in incentive to be selective in their challenges, since their credibility with larger institutions is crucial for mounting an effective challenge to compensation, as well as action on other governance issues.

At the same time, when pay was challenged, institutional investors and the proxy advisory services would know that the vote was not routine and deserved real scrutiny. This remedy is in keeping with the current right of shareholders to gain access to the company proxy under SEC regulations, but would require new rules to allow both expedited vote requests following issuance of the company proxy (which includes the CD&A) and to govern when companies could contest or exclude such requests.

It is questionable whether Say-on-Pay, by itself, will correct the board failures that have led to the explosive growth in executive pay over the past 25 years. That growth followed the imposition of significant restrictions on derivative lawsuits in the late 1970s. The revival of a viable derivative claim, with suitable limitations to avoid nuisance litigation, may be necessary to adequately address the problem. In any event, a selective Say-on-Pay would give shareholders a needed voice, and it could thereby increase board responsiveness without undermining the norm and expectation of board control and accountability.

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