<u>Shareholder Say on Pay – Ten Points of Confusion</u>[1]

By Keith L. Johnson & Daniel Summerfield[2]

Introduction

Advisory shareholder votes on executive compensation ("Say on Pay") have become a standard part of corporate governance in many developed countries. For example, Australia and Britain require companies to annually put their compensation disclosures to a non-binding shareholder vote. Some countries, like the Netherlands and Germany, provide for a binding vote on executive compensation plans.[3]

A recent study published by the Millstein Center for Corporate Governance and Performance at the Yale School of Management cited a number of benefits from shareholder Say on Pay in Britain.[4] They include an increase in the quantity and quality of dialogue between directors and institutional investors; greater attention to executive compensation on the part of boards and institutional investors; moderation in the rate of increase in executive compensation; and dramatically increased use of incentive compensation. A 2007 Harvard paper also found that Say on Pay in Britain lowered CEO compensation when companies had negative operating performance.[5]

In the United States, shareholder resolutions asking companies to adopt Say on Pay have been supported by 42 – 43 percent of shareholders over both of the last two proxy seasons.[6] A 2007 survey done by the CFA Institute found that 76 percent of Chartered Financial Analysts support Say on Pay.[7]

The Corporate Library reports that 46 Say on Pay shareholder resolutions received more than 40 percent support this year, accounting for 70 percent of those that went to a vote (and up from 60 percent in 2007).[8] Ten companies got majority votes on the resolutions,

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[1] A prior version of this article was prepared for the Shareholder Forum Program on Reconsidering "Say on Pay" Proposals, which was held on October 14, 2008 at the Columbia School of Journalism. See http://www.shareholderforum.com/sop/index.htm.

[2] Keith L. Johnson is Program Director of the International Corporate Governance Initiative at the University of Wisconsin Law School and a Member of the Network for Sustainable Financial Markets Coordinating Team. Mr. Johnson was formerly Chief Legal Officer at the State of Wisconsin Investment Board, the 10th largest public pension fund in the United States. Dr. Daniel Summerfield is Co-Head of Responsible Investment at Universities Superannuation Scheme, the second largest pension fund in Britain. He previously served as Head of Corporate Governance at the UK Institute of Directors.

[3] For a description of shareholder rights on executive compensation in Europe, see *In Europe, CEO Pay Gets Complicated*, Neil Baker, Compliance Week, May 20, 2008.

[4] Davis, Stephen M., *Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable*, Millstein Center for Corporate Governance and Performance, Policy Briefing No. 1 (2007).

[5] Fabrizio Ferri and David Maber, *Solving the Executive Compensation Problem Through Shareholder Votes? Evidence from the U.K.*, November 2007.

[6] Reed Waltona, *"Say on Pay" Gets Ninth Majority*, Risk & Governance Weekly, RiskMetrics Group, June 20, 2005.

[7] *Advisory Pay Vote Gets Boost From Investment Professionals' Group Survey*, CFA Institute, March 30, 2007.

[8] Damion Rallis, *Analyst Alert – Say on Pay 2008*, The Corporate Library, July 22, 2008.

up from eight in 2007, and ten companies have announced that they will actually give shareholders an advisory vote.[9]

It is now widely accepted that the structure of compensation programs at financial services companies played a role in causing the current market crisis. With both major party Presidential candidates supporting enactment of Say on Pay and legislation to create Say on Pay shareholder rights having passed the House of Representatives on a bipartisan 269 to 134 vote in April 2007, the chances that a Say on Pay law will be enacted by the new Congress appear high.

However, the debate is not over, and confusion about Say on Pay persists. We are familiar with implementation of Say on Pay in Britain and offer the following to help separate fact from fiction on how it would work in the United States. Our intent is to shed additional light on the debate by identifying areas where people on opposite sides seem to talk past each other.

1. **Should Success be Evaluated Narrowly or with a Broad Systemic Focus?** Can Say on Pay deliver as advertised? Should the question be evaluated over one or two years by looking at whether compensation levels have dropped and pay has been aligned with company performance in countries where it has been adopted? Conversely, is it more appropriate to look longer-term at effects that Say on Pay has had on the quality of corporate governance, in addition to its impact on compensation practices over a five- to ten-year time period?

   Opponents of Say on Pay stress that executive compensation has continued to rise in markets where it is practiced and that pay has not been aligned with compensation. However, we believe opponents miss the point by narrowly defining their inquiry. Proponents tend to focus more broadly on the systemic context within which executive compensation decisions are made. For example:

   - Most proponents do not claim that Say on Pay is THE answer that will resolve our problems relating to executive compensation. Rather, Say on Pay is viewed as only <u>one important step</u> within the context of various systemic factors that influence compensation decisions and boardroom practices. It is a necessary but not sufficient tool.

   - Few people expect that fundamental misalignments in executive compensation, which have developed over decades, will realistically be resolved in a year or two. We believe a <u>longer time frame is appropriate</u>, especially given the number of systemic factors that have contributed to creation of the pay without performance culture that has taken root so firmly.

   - The global nature of our economy precludes consideration of executive compensation issues in individual markets, like the UK or Australia, without

[9] Subodh Mishra, *Bailout Bill to Curb Some Elements of Pay*, RiskMetrics Group Risk & Governance Blog, September 29, 2008. http://blog.riskmetrics.com/2008/09/bailout_bill_to_curb_some_elem.html.

taking into consideration how those markets are influenced by practices in the United States. Proponents believe that significant positive <u>change in other markets is unlikely to occur until executive compensation issues are addressed in the United States</u>.

2. **Does Say on Pay Transfer Power to Shareholders or Empower Directors?** While opponents fear that a shareholder advisory vote would move influence over executive compensation to shareholders, <u>proponents see Say on Pay as an effort to empower directors</u>. It is merely a way to provide directors with additional information on how the marketplace views a company's remuneration practices. Say on Pay leaves boards with full control over executive compensation while giving them increased support for a display of backbone when needed!

   One thing is clear, Say on Pay does ask more of directors. It will <u>require boards to focus additional attention on compensation decisions and on explaining company practices to investors</u>. While that might be an annoyance, it would be healthy for corporate governance. Proponents see executive compensation decisions and pay plan structuring as among a board's most important tasks. We strongly support this view and see the current market crisis as an illustration of the risks that result from getting compensation wrong. Muddling through is no longer an option if we want to reclaim the decade worth of shareholder returns that disappeared over the last few months.

3. **Can Shareholders Move Toward Company-Specific Analyses?** Opponents of Say on Pay see it as likely to result in a 'tick the box' response from shareholders that fails to recognize unique needs of individual companies. They are also concerned that proxy voting advisors will not put the necessary resources into evaluating executive compensation in a company-by-company context.

   These concerns highlight the systemic nature of executive compensation problems. Just as more effort should be expected from directors, <u>shareholders will need to devote greater resources to building or acquiring expertise on executive compensation issues</u>. However, institutional investors are not likely to do this unless directors and other stakeholders (e.g., regulators) undertake a concerted effort to push shareholders in that direction. Companies could play a key role in improving health of the overall corporate governance system by demanding that beneficial shareholders (the ultimate owner stakeholders) play their governance role effectively. The current market crisis illustrates the consequences of shareholders and boards falling asleep at the tiller.

4. **Is the United States so Different that Shareholder and Boards Need Not Speak?** The United States has had less experience than many other markets with direct communication between shareholders and directors. Directors have been isolated from the owners of their companies in the United States. This has fostered a lack of mutual respect and understanding, and that carries enormous risks for both sides. Adoption of the majority vote standard has put the wheels of change in motion.

There is little chance that boards can return to the 'good old days' when directors had little reason to interact with shareholders on a regular basis.

Opponents of Say on Pay see roadblocks to better shareholder-director communication in the United States. Although improved communication has been one of the results of Say on Pay in other markets,[10] there has been a perception that it just cannot be done here. However, some United States companies have already developed mechanisms to facilitate communication with shareholders. For example, Pfizer's board met with its largest shareholders. Other companies have held conference calls with shareholders or organized shareholder advisory groups. [11] Some treat the proxy as an important communication tool rather than merely using its as a legal compliance document.

Concerns about Regulation Fair Disclosure as a roadblock to shareholder-director communications have proven to be unnecessary. Many boards have resolved previous concerns about Reg FD by working with independent legal counsel to establish appropriate ground rules for shareholder-director communication. For example, director adoption of a "listen only" mode during meetings or development of a process to promptly supplement public disclosures when needed are easy solutions to legal concerns.[12]

Ultimately, Say on Pay supporters find it odd that boards would not want to receive information on how their executive compensation practices are perceived in the marketplace. Lack of interest in shareholder dialogue should raise questions about whether resistance is a symptom of a dysfunctional board.

5. **Are Proxy Voting Results Reliable or Should We Ignore Them?** Recently, opponents of Say on Pay have cited a survey done for the Center on Executive Compensation of 20 of the largest investors that found only 25 percent of large institutional investors support Say on Pay.[13] Proponents of Say on Pay found the survey to be disingenuous. It was narrowly targeted to primarily poll institutional investors that have recognized conflicts of interests associated with the marketing their services to corporate executives. Few people were surprised to learn that large institutional investors with conflicts of interest were more reticent to support Say on Pay than shareholders generally.

[10] See the Millstein Center Policy Briefing No. 1, cited in footnote 4, above.

[11] Stephen Davis and Stephen Alogna, *Talking Governance: Board-Shareholder Communications on Executive Compensation,* Policy Briefing No. 2, Millstein Center for Corporate Governance and Performance, Yale School of Management (2008).

[12] "There is no insurmountable legal obstacle to boards and shareholders engaging in constructive dialogue on governance matters, including executive pay policies." Millstein Center Policy Briefing No. 2, cited in footnote 11.

[13] Hallock, Kevin, *Executive Compensation from the Perspective of the Largest Institutional Investors,* Center on Executive Compensation, September 10, 2008.

We already know that 42 – 43 percent of shareholders support Say on Pay from voting results on resolutions over the last two years.[14] From the CFA Institute survey, we also know that 76 percent of investment industry professionals support Say on Pay.[15] What the largest and most conflicted few institutional investors might think about Say on Pay tells us more about how conflicts influence their judgment than it says about shareholder support for the concept.[16] The fact is that nearly half of voting shareholders have consistently supported Say on Pay. Given market events of the past few months, we expect the level of support to grow.

6. **Will Shareholders Destroy Value or Force Boards to Preserve It?** One of the arguments against Say on Pay has been that short-term activists might use it as an offensive tool in hostile takeovers or control contests, to the detriment of long-term owners. However, we think this concern misses the point. Companies can prevent misuse of Say on Pay by adopting good pay practices and effectively communicating with shareholders about pay issues. Say on Pay offers an opportunity for companies with a viable long-term strategy to tie compensation to that strategy and sell it to the marketplace.

   Proponents also point out that Say on Pay would give a voice to all shareholders, not just the noisy short-term activists. The fact is that Say on Pay could be used by savvy boards as a counterbalance to pressure from short-term activists.

7. **Do Shareholders Need a Rifle When they Already have a Cannon?** Opponents of Say on Pay argue that shareholders can already vote against directors to protest executive compensation practices. For proponents, this fails to recognize that companies have widely adopted the majority vote standard for director elections. Protest votes against candidates could result in capable directors failing to be elected. Many shareholders would prefer to send a message before acting to remove a director who adds value to the board. An advisory vote allows shareholders to target the issue instead of the individual.

8. **Could Boards Understand Shareholders if Directors Listened to Them?** Concerns have been expressed by Say on Pay opponents that shareholders have so many different viewpoints that it would be difficult to know what a negative vote means. However, that presumes boards and shareholders make no attempts to improve communications. In other markets, improved communications between directors and shareholders has been one of the first results of Say on Pay. Advisory votes would encourage boards to regularly interact with and understand the views of company shareholders. While it would place more demands on directors and investor relations staff (as well as institutional investors), better communication would help directors better understand market sentiments and encourage development of stronger boards.

[14] See The Corporate Library Report referenced in footnote 8, above.
[15] See the CFA Institute Survey referenced in footnote 7, above.
[16] Had the largest 20 institutional investors without commercial conflicts of interest been surveyed, I suspect the level of support for Say on Pay would have been much higher.

9. **Will Say on Pay Result in Loss of Good CEOs or Better Succession Planning?** One of the most dreaded outcomes of Say on Pay is loss of executive talent to private companies or to public companies with more reasonable shareholders. However, let's review some basic facts:

- Directors remain in control of the executive compensation process under Say on Pay and retain full authority to do what is necessary to retain needed talent.
- One of the most important board functions (besides setting executive compensation) is retaining, reviewing and knowing when to replace the CEO. Succession planning is part of that. Boards with an effective succession plan will be less likely to incur the risks associated with overcompensating a CEO.[17]

Given that 25 percent of companies in the S&P 500 report having no emergency succession plan for the CEO and half allow the current CEO to lead the CEO succession planning process,[18] it is no wonder that boards are afraid of losing CEOs. <u>One of the side benefits of Say on Pay would be greater board attention to succession planning</u>.

10. **What do We Fear Most: Excessive Compensation or Pay Without Performance?** What should be the main focus of Say on Pay? Is excessive compensation the villain, or should boards and shareholders focus on pay for performance, without concern for the absolute size of compensation awards?

Excessive compensation has been found to be associated with increased exposure to risk of corporate fraud and what has been called "CEO centrality risk".[19] When the payoff is large enough, CEOs are willing to run higher risks than they would for a more modest reward. Accordingly, some Say on Pay proponents view reduction of CEO compensation levels as the more important goal. They fear the impact that growing income disparity and risks associated with the "imperial CEO" will have on investment returns, the markets and society.

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[17] See Bebchuck, Cremers and Peyer, *CEO Centrality*, John M. Olin Center for Law, Economics and Business Discussion Paper No. 601, November 2007 for a discussion of the risks associated with overpaying the CEO. Among other things, they found greater pay differentials between CEOs and other members of senior management to be associated with lower company accounting profitability and increased likelihood of rewarding CEOs for luck from the effects of positive industry-wide shocks. In addition, aggregate compensation paid to company executives (rather than accruing to the benefit of shareholders) increased from five percent of company earnings in 1993 to about ten percent in 2003. See Bebchuck and Grinstein, *The Growth of Executive Pay, Oxford Review of Economic Policy, Vol. 21, pp. 283 – 303, 2005.*

[18] Spencer Stuart, *2007 Board Index.*

[19] Johnson, Shane A., Ryan, Harley E. and Tian, Yisong S., *Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter* (February 29, 2008). Available at http://ssrn.com/abstract=395960. See also Bebchuck, Cremers and Peyer, referenced in footnote 17, above.

Other Say on Pay proponents are more concerned about the lack of compensation alignment with company performance. They argue that shareholders should not be concerned about the amount of remuneration as long as CEOs share the same fate as shareholders.

However, we need look no further than the 2008 market crisis for examples of both overpaid and improperly incentivized executives destroying companies and leading shareholders to ruin while walking away with their own personal fortunes. Although interesting, the debate over emphasis on alignment of interests versus reining in stratospheric levels of executive compensation became largely irrelevant in the third quarter of 2008. <u>Both excessive and misaligned compensation are dangerous</u>. In our view, boards and shareholders should tackle both. Muddling through is no longer a viable option.