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"Say on Pay": Cautionary Notes on the UK Experience and the Case for Muddling Through

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I. INTRODUCTION AND OVERVIEW

Executive compensation seems always on the public agenda. At a 2003 Columbia Law School conference that debated the newly-published ***Pay without Performance*** by Lucian Bebchuk and Jesse Fried, an editor of *Fortune* magazine showed a series of magazine covers beginning with the early 1950s to illustrate the persistent fascination with the pay of the chief executive of large public companies. "Excessive" CEO pay led to tax law changes in the early 1990s. Large stock option payoffs and mega-grants made for especially vivid magazine cover stories in the late 1990s. Golden parachute payouts to fired CEOs made for lurid headlines in the 2000s. The changing ratio in the compensation level of CEO versus line-worker from 20-1 in the 1950s to 350-1 today has taken on traction in the political realm as well as the boardroom. Add to the uneasy contemporary mix the preening of hedge fund managers, whose billion dollar annual paychecks dwarf the typical CEO package.

Thus there are really two strands in the contemporary executive compensation debate. One is the "pay for performance" strand, which accepts that managers should be paid commensurate with performance, but which focuses on management's purported ability to extract compensation beyond an arm's-length bargaining outcome. The other is the "social responsibility" strand, which focuses on the social demoralization and economic justice concerns that high levels of CEO compensation may raise. "Pay without performance" may be especially demoralizing on this view, but "performance" would be an insufficient basis for current levels of executive compensation, in part because the firm's performance is the result of a team's effort in an environment created by stakeholders. A major reform focus in both debates, however, has been corporate governance, namely the role of the board and possibly the shareholders in evaluating and constraining executive compensation.

The fundamental inconsistency in the two strands is reminiscent of the tensions behind the initial burst of corporate governance reform energy in the 1970s, which focused on the composition of the board, specifically the case for independent directors. The analogous strands were reflected by advocacy for a "monitoring board," principally in service of shareholder interests, versus a "stakeholder board," which would balance the interests of shareholders against other important stakeholders. The "shareholder value" position triumphed because of critical changes in the 1980s: the rise of hostile takeover bids which were necessarily geared to the shareholders, and the increasing equity ownership positions of institutional investors, who were,

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as a matter of fiduciary law, concerned to maximize the value of their investments. Thus independent directors -- the major corporate governance innovation of the period – came to see their principal role as serving shareholders, not other constituencies.[1]

In the current debate over executive compensation, the balance of forces within the corporation today is, if anything, more tilted in the shareholder direction than in the 1970s, when critical corporate objectives seemed up for grabs. Institutional shareholders own even more stock; shareholder activism has spread beyond transactions in control. The social responsibility strand in the debate is likely to have far more influence in the political and legislative realm than in corporate governance reform. For example, marginal tax rates have, historically, had a large effect on executive compensation.[2] This is not to rule out a feedback loop between the political traction of the executive compensation debate and subsequent public corporation practice, only that boards and shareholders are likely, in the end, to give much greater emphasis to pay-for-performance considerations.[3]

A. *The Complexity of "Pay for Performance": Why We Leave It to the Board*

But focusing on "pay for performance" as the lodestar of compensation practice hardly produces straightforward solutions in the real world or even provides an easy metric to determine which corporate boards have most faithfully adhered to that precept. Among other reasons, this is because executive compensation must serve four goals that are not in stable relationship with one another. The first goal is to provide a reward for successful prior service; the second is to provide incentives for future service; the third is retain and attract managerial talent; the fourth is to align managerial and shareholder interests in light of embedded legal rules that favor managers.

Three examples illustrate the dilemma. Example one: the firm has not done well in the preceding period, but the board does not want to fire the CEO, either because it believes that the CEO has made *ex ante* correct strategic choices that worked out poorly because of unpredictable economic shocks or because all things considered, the board believes the CEO is the leader most likely to lead the firm out of its present straits. The current environment of rapidly escalating oil prices and an abrupt turn in credit markets provides many examples of CEO decisions that might plausibly fit into this category. Assume that the CEO's stock options (or other long-term incentive arrangements) are now significantly underwater. To reprice the options (anathematized in the corporate governance literature) or to issue new options with a different strike price could be readily characterized as "rewarding failure," inconsistent with the first goal. Yet to leave the situation unchanged may poorly incentivize the CEO for the next period, or even worse, to leave the CEO with incentives to swing for the fences since the upside/downside payoffs are so asymmetric.[4]

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[1] *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

[2] *See* Carola Frydman & Raven Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005* (July 6, 2007), FEDS Working Paper No. 2007-35, *available at* SSRN: http://ssrn.com/abstract=972399.

[3] Note that if high levels of CEO compensation lead to own-firm employee demoralization, that becomes a "pay for performance" issue because it directly affects the profitability of the firm. This is why CEO compensation in a firm facing financial distress becomes such a fraught problem.

[4] This is one reason why there is apparently little correlation between the value of stock option grants and performance. *See* Fabrizio Ferri & David Maber, *Say on Pay Vote and CEO Compensation: Evidence from the UK* (June 2008), available on SSRN at http://ssrn.com/abstract=1169446, at 14 (citing sources).

Example two: the firm has done extremely well; indeed, the CEO has been a star performer over a significant period, to the point where the CEO now owns a meaningful percentage of the firm's equity. What should be the shape of the CEO contract for the next period? From a "rewards" perspective, the compensation package should continue to include hefty stock-related compensation and bonus opportunities consistent with the value-creation that the board hopes the CEO will continue to deliver. But from an "incentives" perspective, why should the board give the CEO more than a token? The largest part of the CEO's personal wealth is tied up in the firm's stock.[5] The CEO is already well-incented to increase shareholder value. Would the CEO start shirking or otherwise make bad decisions with his or her personal wealth on the line just because the pay is less? Would he or she quit, putting the firm in the hands of someone who the CEO probably believes will do a less good job?[6] The polar case merely illustrates the more general claim: that "rewards" objectives and "incentives" objectives would not necessarily produce the same compensation contract, and that the optimal CEO contract for a particular firm could well vary in CEO wealth accumulation.[7] This means that direct comparison of compensation packages across firms is much noisier and potentially misleading about board performance.

Awareness of rewards/incentives differences has already begun to percolate among professional executive compensation observers. For example, some have begun to complain that the SEC's newly revamped annual compensation disclosure, Compensation Discussion and Analysis (CD&A), does not include sufficient disclosure of the CEO's accumulated ownership position, in particular, what is taken to be the critical variable (from an incentives perspective): the sensitivity of CEO wealth to changes in firm performance. Disclosure of the annual compensation package – what the firm is paying out on an annual basis to its CEO – incompletely informs investors about the CEO's performance incentives. But this is not simply a disclosure point, because the accumulation of ownership changes the optimal rewards/incentives mix. The board's role is not to benchmark compensation to some industry measure (though that may be relevant) but to tailor compensation to its actual CEO.

Example three: One area of great concern to many governance activists and critics has been the "golden parachute," a special payment to the CEO triggered by a change in control or, commonly, termination without cause. Here a little history is in order. Golden parachutes arose in response to the hostile takeover movement of the 1980s. There are two ways to tell the story. On the bright side, golden parachutes compensated target managers, who typically faced displacement after such a takeover, for the loss of what an economist would call firm specific human capital investments. But why should a laid-off CEO receive such compensation, and so

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[5] This of course assumes that the CEO has not been able to unwind his or her equity exposure through stock dispositions or hedging transactions, itself a complicated matter for the board to monitor.

[6] The example implicitly includes some lock-in of the CEO's stock ownership position in the immediate post-retirement period and some limit on the CEO's ability to find another firm that to compete for the CEO's services will simply replace the accumulated original firm equity with new firm equity.

[7] This intuition is behind some of the noticeable elements in executive compensation at private firms, particularly the inverse relationship of compensation to CEO ownership and to CEO age. *See* Rebel A. Cole & Hamid Mehran, *What Do We Know About Executive Compensation at Privately Held Firms?* (July 6, 2008), FRB of New York Staff Report No. 314, *available at* SSRN: http://ssrn.com/abstract=1156089.

For a development of the idea of a CEO's "wealth leverage," see Stephen F. O'Byrne & S. David Young, *Top Management Incentives and Corporate Performance*, 17 J. APP. CORP. FIN. 105 (Fall 2005); id., *Why Executive Pay is Failing,* 84 HARV. BUS. REV. 28 (June 2006) . For an evaluation of CEO wealth sensitivities in the US, see John E. Core et al., *Is US CEO Compensation Broken*? 17 J. APP. CORP. FIN. 97 (Fall 2005).

generous, when a laid-off rank and file worker – also having made firm specific human capital investments, often of equal or greater value relative to net worth – usually does not?

That brings us to the dark side. The courts, Delaware most importantly, gave managers what might be called a takeover-resistance endowment – that is, the right to fight a hostile takeover using corporate resources, including the power to "just say no."[8] One way to solve this dilemma is to structure compensation to align managerial and shareholder incentives in the face of a hostile bid – that's the polite way to describe the resulting golden parachute arrangement. So if the CEO receives approximately three times salary and bonus and the accelerated vesting of a large stock option grant to boot, the chance to become truly rich in a takeover solves the problem of mangers fighting off hostile bidders. But the devil is in the detail and the triggers for these "chutes" were crafted for more broadly than the core case of the takeover where the CEO loses his or her job. Most notably, the "chutes" broadened into a general severance arrangement that covered not only takeover situations, but virtually any case of termination without cause.[9] This then had led to nightmare cases of $100 million-plus payouts, not "pay for performance," not the CEO getting a share of the upside when the firm is sold at a premium, but "pay for failure" so egregious that even a Chief Executive who has awarded the Medal of Freedom despite failure felt obliged to take notice.[10]

Conditional on the initial grant of the takeover-resistance endowment, the golden parachute may have been a locally efficient response. It is a familiar Coasean observation that the assignment of a legal entitlement does not necessarily interfere with attaining efficient outcomes (though wealth may be redistributed). The golden parachute payment can be seen as shareholder buyback of the resistance endowment so as to permit value-increasing transactions to occur. But changes in the corporate governance environment that have reduced CEO power over the board[11] and that have otherwise empowered shareholder activists[12] have reduced the value of

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[8] *See* Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

[9] Of course, firing a CEO is arguably just a lower cost way to achieve the result of a significant fraction of hostile deals which seek gains in the replacement of inefficient managers. The CEO's loss of human capital in such a case is equivalent to the actual takeover. The only difference is in the CEO's resistance right, which in the firing case comes from managerial control over the proxy machinery that has been a source of the CEO's ability to stack the board with allies. The corporate governance changes that have undercut the CEO's ability to dominate the board selection process are parallel to other changes in the corporate control markets that have reduced the anti-takeover endowment.

Some would defend large severance payments as providing insurance to encourage CEO risk-taking, particularly given the reality that even an *ex ante* correct decision that turns out badly may well result in CEO turnover. The question is how large a payout is appropriate. The acceleration of unvested stock-related compensation seems hard to justify even a generous reading of that rationale. Moreover, many failed business decisions were *ex ante* wrong. "Clawbacks" are rarely invoked for failure short of fraud.

[10] Speaking before an audience of financial leaders in New York City on January 31, 2007, President Bush said:

> "Government should not decide the compensation for America's corporate executives, but the salaries and bonuses of CEOs should be based on their success at improving their companies and bringing value to their shareholders. America's corporate boardrooms must step up to their responsibilities. You need to pay attention to the executive compensation packages that you approve. You need to show the world that American businesses are a model of transparency and good corporate governance."

"State of the Economy" address, Jan. 31, 2007, *available at* www.whitehouse.gov (major speeches)..
Among the recipients of the Medal of Freedom from President Bush have been Paul Bremer, head of Reconstruction and Humanitarian Assistance and the Coalition Provisional Authority in post-invasion Iraq, 2003-04; Tommy R. Franks, leader of American military forces in the invasion of Iraq and the post-invasion aftermath; and George Tenet, director of the CIA in 1997-2004.

[11] Gordon, *The Rise of Independent Directors, supra* note 1, at 1468, 1470, 1520-23, 1531-33, 1539-40.

the takeover-resistance endowment. We should expect to see significant changes in golden parachute arrangements, which will separate out compensatory features from hold-up features. But a simple "pay for performance" metric may not tell us how well a board is accomplishing this transition, given the "loss avoidance" and "endowment" effects that make downward renegotiation difficult.

These three examples just illustrate the more general point that "pay for performance" is an objective rather than an easily measureable output variable and that the effort to attempt to reduce it to a simple output may lead boards (and the evaluators of boards) astray. Much additional complexity arises from the substitutability and the complementarity of the many different instruments in executive compensation. Restricted stock, for example, which can be seen as a combination of cash plus an option, substitutes for each separate element, but the blending of such elements is complementary. A different combination of elements from even a standardized menu may produce quite different effects. The ultimate CEO performance incentive is threat of termination or non-renewal, which means that managers may value identical compensation packages differently across firms depending on comparative "performance delivery patience."

Moreover, when we say "pay for performance," what performance are we trying to reward and incentivize? Presumably stock price gains are of the greatest interest to shareholders, but measuring "profits" also has its appeal, because bottom line results may be less susceptible to stock market fashion (though more vulnerable to accounting conventions). "Profits" also seems associated with a hard measure, like more cash in the bank or funds available for dividends. Yet current profits reflect past investments; how to reward and incent the firm's development of valuable real options?[13] Stock price measures may imperfectly measure the value of such investments, particularly given that the firm may resist disclosure to hold onto competitive rents. As the firm becomes more granular in its performance objectives, success and compensation becomes harder to measure and monitor.

Of course, even after "performance" has been defined and measured, there remains this question: how much pay for how much performance? We gave up on the idea of a "just price" a long time ago, relying instead on markets to set prices. But the "market price" for a CEO is hardly self-defining, since the market for senior managerial services has no posted prices (hence the hunt for comparators). Executive compensation at any particular firm seems inevitably the result of a bargaining process between the CEO and someone empowered to act for the firm. Thus recent reform efforts have been principally process-focused and have been particularly geared toward process reform for the large public firm without a controlling shareholder.

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[12] An example is the use of equity swaps to accumulate significant economic ownership and "virtual" voting positions that do not trigger a poison pill. *See, e.g.,* CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP, 2008 U.S. Dist. LEXIS 46039 (S.D.N.Y. June 11, 2008), appeal pending.

[13] "Real options" refer to business opportunities that become more or less valuable depending upon future states of the world. For example, a pilot plant in an area of technological uncertainty creates a "real option" for a major commercial rollout, whose exercise (or abandonment) is conditional upon the arrival of new information about the technology's feasibility. So the return on the investment in the pilot plant includes not only expected profits on its output but also the value of the embedded real option associated with the investment. For accounts of how "real options" theory should figure in business decision making, see, for example, RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 597–615 (8th ed 2006); AVINASH K. DIXIT & ROBERT S. PINDYCK, INVESTMENT UNDER UNCERTAINTY (1994); Timothy A. Luehrman, *Strategy as a Portfolio of Real Options*, 76 HARV. BUS. REV. 89 (1998).

B. *Boards and Shareholders*

The consensus view in the US is that the board of directors needs to serve as the shareholders' agent in negotiating CEO compensation. As with many other reforms in corporate governance, the standard move is to strengthen board independence, both generally and with respect to this particular function. This has meant tightening standards of director independence and attempting through a series of process reforms to imbue boards with a self-conception of independence.[14] On the functional dimension, stock exchange listing rules now mandate a special board committee, a compensation committee composed exclusively of independent directors, to focus specifically on the CEO compensation question.[15] This committee is empowered to hire outside experts. As part of the SEC's 2006 CD&A regulation, the compensation committee is required to prepare a "Compensation Committee Report" over the name of each member that discloses whether the compensation committee "reviewed and discussed the [CD&A] with management … and recommended … that the [CD&A] be included in the … annual report,"[16] in effect, an ownership statement.

One of the major current issues is the extent to which this ostensibly independent committee has been captured by its advisors, the compensation consultants either generally or specifically. That is, does the fact that compensation consultants are often part of diversified human relations service providers hired by managements instill a CEO-favoring tilt to compensation consultant work? This raises the question of inherent bias in the compensation consultant industry as presently structured. Or is same-firm work by the compensation consultant (meaning, human relations work for the firm in addition to compensation work for the board) a specific (and limited) source of independence-undermining bias, as commonly hypothesized with accounting firms? Or do compensation consultants have a "style," that is, a reputation for pay packages of a particular mix of compensation elements and level, so that boards pick consultants after a basic decision on the compensation approach? As part of its 2006 CD&A regulations, the SEC required public firms to disclose the role of compensation consultants in the executive compensation-setting process, and quite interesting data is beginning to emerge on these questions.[17]

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[14] For a fuller account, see Gordon, *Independent Directors*, *supra* note 1, at 1490-99.

[15] *Id*., at 1490-93.

[16] Regulation S-K, Item 407(e)(5), 17 CFR §229.407(e)(5).

[17] Alexandra Higgins, *The Effect of Compensation Consultants* (report by The Corporate Library) (Oct. 2007); U.S. H. R. Comm. On Oversight and Govt. Reform (Majority Staff), *Executive Pay: Conflicts of Interest Among Compensation Consultants* (Dec. 2007); Kevin Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants* (WP June 2008), available on SSRN at http://ssrn.com/abstract=114899; Christopher S. Armstrong et al, *Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels* (WP June 2008), available on SSRN at http://ssrn.com/abstract=1145548; Brian Cadman et al, *The Role and Effect of Compensation Consultants on CEO Pay* (WP March 2008), available on SSRN at http://ssrn.com/abstract=1103682; Martin J. Conyon, *Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom* (WP May 2008), available on SSRN at http://ssrn.com/abstract=1106729.

In using the empirical studies it's important to appreciate their methodological limitations. The House Report, the boldest in its suggestion of firm-specific conflict, relies on basic quantitative descriptions of the differences between firms that do/do not use compensation consultants, without assessing the statistical significance of these differences and without taking into account standard control variables. More sophisticated papers by financial economists necessarily rely on one year's disclosure data and thus the effects they observe are all "cross-sectional." Policy makers customarily will be interested in the dynamic effects of disclosure generally and for specific firms. For sure, policy decisions are often taken without the benefit of authoritative empirical studies, but apart from seeking more

Another current issue, even more salient, is the extent to which shareholders should be involved in the pay-setting process. For most proponents of a shareholder role, the objective is not to substitute the shareholders' business judgment for the board's, but rather to heighten the board's independence-in-fact given subsequent shareholder response. Alternatively, we can frame the shareholder role in compensation-setting (and corporate governance more generally) in terms of terms of accountability.[18] First, strengthen the board's independence, then strengthen the board's internal process, finally, strengthen the board's accountability to shareholders. Of course, the annual election of directors provides a recurrent shareholder check on board action, an annual accountability moment. Additional disclosure of compensation information per the 2006 CD&A regulations now provides shareholders even more information to assess board performance on this critical element of corporate governance. Proponents of shareholder influence in compensation-setting argue, however, that replacing directors or even targeting compensation committee members through a "just vote no" campaign is costly and cumbersome and therefore not a credible constraint on the board. They support a more specific shareholder role, one that unbundles executive compensation from other elements of board decision-making, more granular accountability.

One way to categorize the shareholder role in compensation-setting is with respect to a 2x2x2x2 matrix that sets up shareholder consultation choices between (1) "before" versus "after," (2) "binding" versus "advisory," (3) "general" versus "specific" compensation plans, and (4) "mandatory" versus "firm-optional." So, for example, the present US system requires (via stock exchange listing rule) shareholder approval of stock option plans, meaning consultation must occur "before" implementation, the consultation is "binding," and consultation is "mandatory." Yet US shareholders have no role in the specific implementation of stock option plans, that is, the decision to make specific grants to particular officers, so this consultation right is "general." Presumably the basis for the distinction is the sense that shareholders should have approval rights over establishment of a compensation plan that may dilute shareholder interests but that approval of specific grants (as with other compensation elements) would interfere with the board's role in setting (and tailoring) compensation. Current proponents of a larger shareholder role call for a shareholder advisory vote on both general and specific compensation plans, so-called "say on pay." In terms of the matrix, this means an "after" consultation that is "advisory" with respect to "general" and "specific" plans (bundled into a single vote). Some proponents think "say on pay" should be "mandatory," meaning shareholders at all firms should have the right; others that the principle should be adopted on a firm-by-firm basis, meaning "optional."

This chapter addresses the "say on pay" question, in particular recent federal legislative proposals modeled on UK legislation adopted in 2002 that makes shareholder consultation "mandatory." The advantage to mandatory legislation is that the shock of greater shareholder consultation rights across the full range of firm could well destabilize an equilibrium of accretions to executive compensation that otherwise would be hard to prune and reset. The disadvantage is the likely evolution of a "best compensation practices" regime that would ill-suit many firms. The cookbook and normatively opinionated nature of compensation "best practices" that are emerging in the UK seems a cautionary tale. In the US setting, the consequences might be even more concerning, as the energized shareholder actors have even less

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disclosure, it might well be wise to see how the compensation consultant industry practice unfolds, particularly given the complementary effects of shareholder voice.

[18] Fabrizio Ferri suggested this way of formulating the issue.

basis for independent business judgment than their UK counterparts and thus may well delegate these judgments to a small number of specialized advisors.

If "pay for performance" is the ultimate objective of compensation activism, it could be that the jury-rigged version of shareholder consultation that is evolving in the US, firm-by-firm consideration of "say on pay" proposals and firm-specific threats to target compensation committee board members through "withhold vote" campaigns, is the best way to muddle forward. From the public/social responsibility perspective, this form of muddling-through[19] may be insufficient because it will probably result in compensation that is still "too much."[20] Resetting the basic equilibrium may be highly valued, and a system-wide rule may offer a greater chance for that outcome. But if the master problem is on the social responsibility dimension, how likely is that a corporate governance-based solution will lead to a better outcome than a general tax policy change?

II. SHAREHOLDER CONSULTATION AND "SAY ON PAY"

A major goal of the SEC's 2006 adoption of a CD&A requirement was to stimulate shareholder reaction to the firm's executive compensation practices through the existing means of public and private response. These include media reactions, private shareholder interventions with managements and directors, precatory resolutions, and "withhold vote" campaigns against compensation committee directors. Some have argued that these mechanisms are insufficient to check potential compensation excess,[21] most notably because of general shareholder debility in corporate governance, and have pushed for an explicit shareholder role in the compensation-setting process. This push is partly fueled by what has been revealed through CD&A disclosure, particularly pension and deferred-compensation benefits whose bottom-line dimensions may have startled even experienced directors. Some have been especially concerned by compensation inequities, including the large disparities between CEO compensation and even other C-level managers, not to say other members of the management team and line-employees.[22] The sense of out-of-control compensation has been heightened both by enormous payouts to unsuccessful CEOs at a time of economic unease[23] and by the option back-dating scandal,[24] which suggested widespread overreaching by already well-paid senior managers.

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[19] *See* Charles A. Lindblom, *The Science of Muddling Through*, 19 PUB. ADMIN. REV. 79 (1959).

[20] *See* Jeffrey N. Gordon, *Executive Compensation: If There Is a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. LAW 675 (2005) (reaction to pay-for-performance compensation for Harvard Endowment managers).

[21] *See, e.g.*, John E. Core et al., *The Power of the Pen and Executive Compensation*, J. FIN. ECON. (forthcoming 2008) (finding that press coverage focuses on firms with higher excess compensation ("sophistication") and greater executive stock option exercise ("sensationalism") but also finding "little evidence that firms respond to negative press coverage by decreasing excess CEO compensation or increasing CEO turnover").

[22] Lucian Bebchuk et al., *CEO Centrality*, Harvard Law & Econ. Discussion Paper No. 601 (May 2008), *available on SSRN at* http://ssrn.com/abstract=1030107

[23] Dismissed CEOs of Pfizer and Home Depot, for example, received severance packages in the $200 million range. *See* Ylan Q. Mui, *Seeing Red Over a Golden Parachute Home Depot's CEO Resigns, and His Hefty Payout Raises Ire*, WASH. POST (Jan. 4, 2007), at D1; Ellen Simon, *Pfizer's McKinnell to Get $180M Package*, Assoc. Press (Dec. 21, 2006), on *Washington Post* website (accessed July 20, 2008).

[24] Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MNGMNT SCI. 802 (2005); Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271(2007) (web-posted in 2006); Mark Maremont, *Authorities Probe Improper Backdating of Options: Practice Allows Executives to Bolster Their Stock Gains; A Highly Beneficial Pattern*, WALL ST. J., Nov. 11, 2005 (p. A 1). The back-dating persisted even after the adoption of the Sarbanes-Oxley legislation, which imposed internal controls

In the search for remedies, governance activists, already inspired by the UK model of greater shareholder governance rights, looked to the UK's 2002 adoption of a mandatory shareholder vote on a firm's annual "Directors Remuneration Report," in effect an advisory vote on the firm's executive compensation practices since rejection of the report did not invalidate a compensation agreement.[25] After the Democratic takeover of the Congress in the November 2006 midterm elections, Cong. Barney Frank, the new chair of the House Committee on Financial Services, and Sen. Barack Obama sponsored a similar bills calling for a mandatory annual shareholder advisory vote on executive compensation.[26] The House passed the legislation on April 20, 2007, but it was not taken up by the Senate. In the course of his presidential campaign, Sen. John McCain has embraced the "say on pay" cause.[27] After the 2008 elections, it seems likely that the legislative push will be renewed.

A. *Self-Help "Say on Pay" in the US*

In the meantime governance activists have employed the shareholder proposal route to put precatory say-on-pay resolutions before shareholders. The issue apparently caught fire at a meeting of governance activists and professionals in December 2006.[28] For the 2007 proxy season, activists led by the American Federation of State, Country and Municipal Workers (AFSCME) and Walden Asset Management, the social investor, put forward approximately 60 proposals.[29] The proposals generated average support of 42% and passed at seven firms, including Verizon, Blockbuster, Motorola, and Ingersoll-Rand.[30] Two of the firms, Verizon and Blockbuster, adopted annual "say on pay" bylaw provisions.

Anticipation grew that sentiment for these proposals would snowball.[31] Aflac voluntarily adopted "say on pay"; so did RiskMetrics, the keeper of corporate governance scorecards, and H&R Block, trying to make amends after an unfortunate foray into mortgage lending led to a successful shareholder insurgency. But 2008 was not the banner year that proponents had expected. Although tallies are not yet complete for the 2008 proxy season, the number of proposals grew only moderately, to 70, and the level of support has remained at the same level,

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standards that should have ended it. The backdating persisted even after the adoption of the Sarbanes-Oxley legislation, which imposed internal controls standards that should have ended it. *See* Jesse Fried, *Options Backdating and Its Implications*, 65 WASH. & LEE L. REV. (forthcoming 2008).

[25] The UK legislation did two things. First it expanded disclosure of executive compensation beyond the requirements of the London Stock Exchange Listing Rule 12.43A(c), requiring a Directors Remuneration Report. *See* Schedule 7A of the Companies Act of 1985, effective Aug. 1, 2002. Second, it required an advisory shareholder vote on the Report. *Id*. § 241A. The Report must provide particularized disclosure for senior executive of the various sources of compensation as well as an explanatory statement by the company's compensation policy (including the company's comparative performance). The Report must be signed by Remuneration Committee members and its quantitative elements must be audited. Although a shareholder vote is mandatory for every public company, "No entitlement of a person to remuneration is made conditional on the resolution [required by this section] being passed . . . ." *Id*. § 241A.(8). *See* Directors' Remuneration Report Reg. 2002/1986 Explanatory Para. 1 [UK Stat. Inst. 2002/1986]; PALMER'S COMPANY LAW FROM SWEET & MAXWELL ¶ 8.207.3

[26] H.R. 1257 (110th Cong, 1st Sess.); Sen. 1181 (110th Cong, 1st Sess.).

[27] NEWSWEEK, *McCain Seeks Shareholders' Say on Pay*, (June 10, 2008), available at htttp://www.businessweek.com/bwdaily/dnflash/content/jun2008/db20080610_480485.htm?chan=top+news_top+news+index_news+%2B+analysis.

[28] Kristin Gribben, *Divisions Grow within Say-on-Pay Movement*, AGENDA, July 7,

[29] Erin White & Aaron O. Patrick, *Shareholders Push for Vote on Executive Pay*, WALL ST. J. (Feb. 26, 2007), p.B1.

[30] RiskMetrics, Group, 2007 POSTSEASON REPORT (Oct. 2007), at 8.

[31] George Anders, '*Say on Pay Gets a Push, But Will Boards Listen?*, WALL St. J. (Feb. 27, 2008).

approximately 43%.[32] Majority support was attained at six firms, including Alaska Air, PG&E, Lexmark, Motorola (again), and Apple (presumably because of its stock option backdating involvement). Interestingly, support for "say on pay" slipped at financial firms from the 40s% level to the 30s%.[33] Proponents had thought that massive losses would occasion shareholder outrage, especially in light of large payouts to departing CEOs at Merrill Lynch and Citigroup. Apparently investors were nervous about disrupting governance at a time of stress and concerned about retention of highly compensated employees in an industry with great job mobility. Indeed, the hesitation to press for "say on pay" in the financial services industry may show the complexity of trying to figure out what counts as good performance and how to devise an appropriate pay-for-performance scheme.

It appears that more traditional investors and even some governance professionals are rethinking the matter of an annual "say on pay."[34] Some think that an annual vote will be divisive and will disrupt shareholder-board communications. Others think such a vote will provide cover for the board and the compensation committee, pointing to the UK experience of invariable shareholder approval, and is not a stern enough rebuke compared to the alternative of voting against retention of compensation committee members.[35] Others are wary of what they foresee as dependence on proxy advisory firms for voting guidance.

Because of the slow slog – adoptions of "say on pay" provisions by only 8 firms over two years – proponents have put their hopes on mandatory adoption by federal legislation.

B. *Legislated "Say-on-Pay" in the UK*

So what of the UK experience? The relevant questions include: How successful has it been in the UK in reining-in excessive compensation? Are there other effects that might be positive or negative? How would that experience translate to the US setting? In particular, how does a UK-like rule compare with firm opt-in through shareholder-proposed bylaw amendments?

The stylized facts of the UK experience appear to be these: Shareholders invariably approve the Directors Remuneration Report, with perhaps eight turndowns across thousands of votes over a six year experience. This level of shareholder approval reflects (at least in part) board behavior that flows from direct and indirect shareholder influence. Such influence comes principally from "best practice" compensation guidelines issued by the two largest shareholder groups, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) and further elaborated in the UK's Combined Code of Corporate Governance. Shareholder influence also comes, less commonly, from occasional firm-level shareholder consultation. In terms of direct effects on pay, UK executive compensation has continued to increase, significantly, in both the fixed and variable components. It may be that some "performance" pay elements are more tightly geared to actual performance. There is also some empirical evidence that the pay-for-performance sensitivity of UK compensation increased after adoption of the advisory vote, particularly for firms that paid "excess compensation" or otherwise had controversial pay practices in the pre-adoption period.

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[32] L. Reed Walton, *U.S. Midseason Review*, RISKMETRICS RISK & GOVERNANCE BLOG (May 23, 2008).

[33] Tom McGinty, *Say-on-Pay Doesn't Play on Wall Street: Fewer Investors Back Plans to Weight in Executive Compensation*, WALL ST. J. (May 22, 2008).

[34] Kristin Gribben, *supra* note 28.

[35] Claudi H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, N.Y.TIMES (Ap. 6, 2008). See RiskMetrics Group, *supra* note 30, at 10-12 (detailing significant "withhold votes" at 17 firms over compensation issues).

The UK adoption of a shareholder advisory vote on executive compensation had its roots in a particularly UK story of compensation "outrage."[36] One of the hallmarks of the Thatcher government in the 1980s was the privatization of many utilities, including the gas, water, electricity, and telecommunications monopolies. The salaries of the senior officers skyrocketed for doing allegedly the same job, and, in the case of all but British Telecom, not very well. The public reaction to such "fat cats" (so-labeled in the press) threatened to undermine privatization itself. In 1995 a Study Group on Directors' Remuneration produced the "Greenbury Code"[37] which called on boards to establish a remuneration committee of independent directors to set executive compensation and for disclosure of an audited remuneration report. Subsequent corporate governance reform consolidation by the Hempel Committee in 1998 produced the Combined Code on Corporate Governance. The Combined Code was attached to the London Stock Exchange Listing Rules, which obliged firms to "comply or explain [non-compliance]" with Code provisions. In addition to remuneration report disclosure, boards were obliged to annually "consider" and "minute" their consideration of whether to seek shareholder approval of the firm's remuneration polices, especially in the case of significant changes or controversial elements.

The "New Labor" government that took power in 1997 began a review of various elements of the UK corporate governance system in light of a growing international consensus that good governance added a competitive economic edge. Escalating UK CEO pay, post-tech bubble payouts to dismissed CEOs, and survey data that less than five percent of firms had brought compensation policy questions to shareholder vote[38] led to amendment of the UK Companies Act to require both a somewhat more detailed disclosure regime than under the Listing Rules and to require a shareholder advisory vote on a newly-fashioned Directors Remuneration Report (DRR). The DRR was to supply not only audited compensation information but also a novel (for the UK) stock price performance graph and the board's compensation rationale.

What has been the effect on UK compensation of the shareholder advisory vote? It seems fair to say that the new regime brought about a much higher level of shareholder engagement with the pay-setting process. In the initial year there was a flurry of high visibility activity, most famously in the case of GlaxoSmithKline, in which a large golden parachute (estimated by shareholders at $35 million) for the CEO triggered a shareholder revolt that led to rejection of the remuneration committee's report.[39] During that year there were press accounts of shareholder interventions into the remuneration policy of perhaps a dozen large firms.[40]

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[36] This follows Jonathan Rickford, *Do Good Governance Recommendations Change the Rules for the Board of Directors?, in* CAPITAL MARKETS AND COMPANY LAW (Klaus J. Hopt & Eddy Wyrmeersch eds., 2003); Jonathan Rickford, *Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections (Second Part)*, 2 EUR. CORP. & FIN. L. REV. 63 (2005) (Rickford was the former project director of the UK Company Law Review of the Department of Trade and Industry and a member of European Commission's High Level Group on Company Law); Guido Ferrarini & Niamh Moloney, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, 1 EUR. CORP. & FIN. L. REV. 251 (2004).

[37] Named after its chairman Sir Richard Greenbury (then chairman of Marks and Spencer, the retailer).

[38] *See* PRICEWATERHOUSECOOPERS, MONITORING CORPORATE ASPECTS OF DIRECTORS' REMUNERATION 1999 (Report to the Department of Trade and Industry).

[39] Gautum Naik, *Glaxo Holders Reject CEO's Compensation Package*, WALL. ST. J., May 20, 2003, at D8, *available at* 2003 WL-WSJ 3968195; Heather Timmons, *Glaxo Shareholders Revolt Against Pay Plan for Chief*, N.Y. TIMES, May 20, 2003, at W1. The vote was narrow, 50.72% to 49.28%. Two large institutional investors voting against the report were Isis Asset Management, a UK money manager with nearly $100 billion in assets, and CalPERS, a U.S.

In subsequent years, observers have noted four visible effects of the regime shift.[41] First, consultation has increased between firms and large shareholders, or at least with the leading institutional investor groups[42] and with the proxy services firms, RREV and IVIS.[43] The communications range from the perfunctory to the serious. Second, rejections of remuneration reports have been rare, only eight over the six year history of the new regime, all but GlaxoSmithKline involving small firms. Deloitte has reported that over the period only 10 percent of a large sample of firms received a negative vote of 20% or more. Nevertheless, in recent years, the proxy services firms have recommended negative votes in 10-15% of cases, principally involving smaller firms. Presumably most firms shape their compensation policies to avoid negative shareholder votes. There is also some evidence that firms receiving a significant negative vote in one year receive a much higher positive vote in the subsequent year, suggesting that most firms accommodate to shareholder views.[44] Third, the leading associations of institutional investors, the ABI and the NAPF, have extended their compensation influence through the fashioning of compensation guidelines that provide a set of yellow and red lines.[45] These guidelines build on the "best practices" for executive pay built into the Combined Code.[46] The consultations often arise with respect to changes in a firm's "approved" compensation practices (because it passed muster the prior year) or practices that trench on the guidelines. Indeed, compliance or not with the guidelines often becomes the basis for the shareholder vote. Fourth, long-term CEO employment agreements, which in the UK setting gave rise to highly salient episodes of "pay for failure," seem to have ratcheted down. GlaxoSmithKline was such a case. Indeed, the most dramatic changes have occurred in this area. Almost no large UK firms now enter into senior manager contracts of more than one year or provide for accelerated options upon a change in control, thus putting to an end the UK version of the golden parachute.[47] This change, however, could have partly resulted from the Government's initiation of a consultative process that raised the threat of legislation on termination payments, a threat made credible by legislation of the DRR regime.[48]

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public pension fund with more than $150 billion in assets that is a notable proponent of corporate governance reform worldwide.

[40] *See* Rickford, *supra* note 36; Ferrarin & Moloney, *supra* note 36, at 295-297.

[41] This draws generally from Stephen Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, Policy Briefing No. 1 [Draft] (2007), which cites relevant sources.

[42] Joanna L. Ossinger, *Regarding CEO Pay, Why Are the British So Different?*, WALL ST. J., Apr. 10, 2006. (200 firms annually consulting with ABI).

[43] RREV is owned by ISS in affiliation with the National Association of Pension Funds. IVIS is owned by the Association of British Insurers.

[44] *See* Kym Sheehan, *Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia* (March 18, 2007), *available at* SSRN: http://ssrn.com/abstract=974965 (analyzing results for 2003, 2004, 2005 votes); Ferri & Maber, *supra* note 4 (finding increase in performance sensitivity of CEO compensation in firms receiving higher negative vote).

[45] *See* Association of British Insurers & National Association of Pension Funds, *Best Practice on Executive Contracts and Severance – a Joint Statement*, initially issued in December 2002 and then reissued annually as part of ABI, *Principles and Guidelines on Remuneration*. The most recent version of the ABI's *Principles and Guidelines* (2007) is carried on the IVIS website, http://www.ivis.co.uk/ExecutiveRemuneration.aspx.

[46] *See* FINANCIAL REPORTING COUNCIL, COMBINED CODE ON CORPORATE GOVERNANCE, PART B (Rev. June 2008) (prior Code versions issued in 1998, 2003, and 2006).

[47] *See* DELOITTE, REPORT ON THE IMPACT OF THE DIRECTORS' REMUNERATION REPORT REGULATIONS 6, 19-20 (Nov. 2004) (Report to the Department of Trade and Industry).

[48] *See* DEPARTMENT OF TRADE & INDUSTRY, REWARDS FOR FAILURE: DIRECTORS' REMUNERATION – CONTRACTS, PERFORMANCE AND SEVERANCE (Consultation, June 2003). Moreover, the ratcheting-back of "pay for failure"

When it comes to looking at the effect of the new regime on actual pay, the results are much murkier. UK CEO salaries and bonus payouts increased at a double digit rate in recent years.[49] The value of long term incentive plans is harder to meter, but the growth rate is similar, indeed, higher than in the US,[50] though UK observers have noted a tightening of performance triggers to vesting of particular benefits. The most thorough empirical analysis, albeit through 2005 only, is Ferri & Maber (2008),[51] which analyzes UK compensation trends before and after adopting of the DRR regime. Using standard controls for documented influences on CEO compensation (such as firm size), they report a number of important findings. First, the overall growth rate of CEO pay is unchanged; there is no one-time downward revision or a moderation in the trend. Second, they do nonetheless find greater pay-performance sensitivity in certain categories of firms: firms with a "controversial" compensation history, namely those with high levels of shareholder dissent in the first year of the shareholder advisory vote and those with "excess" pay in the pre-DRR period (firms in the top 20% of CEO pay after controlling for standard pay determinants). These, by hypothesis, are the firms where compensation is least tied to performance, and where a regime that brings shareholder focus to bear may have its strongest effect.

To counter the suggestion that contemporaneous UK governance changes, but not the DRR regime, drove the greater pay-performance sensitivity, they run tests with firms listed on AIM (the Alternative Investment Market). They find AIM firms did not experience a comparable increase in pay-performance sensitivity. Similarly, to test the possibility that worldwide governance or competitive factors were the driver, they run comparable tests on a sample of US firms, which show no comparable change in pay-performance sensitivity over the period.

Although Ferri & Maber's results are suggestive, only a literature, not any single empirical paper, can securely ground a conclusion about the positive effects of the DRR regime. Among the elements in their work that counsel against over-enthusiasm on its finding of firms' greater responsiveness to pay-for-performance demands are factors that suggest the possibility of efficiency losses. For example, the demonstrated increased pay-performance sensitivity is generally with respect to losses, not gains (although they test both). In other words, after the DRR regime, pay is more likely to go down if performance declines, but there is no evidence of the reverse. This, of course, is consistent with avoiding pay for failure, certainly a major theme, if not the preoccupation, of the reform impulse behind the DRR. Similarly, the performance indicator that is associated with greater sensitivity is return on assets (ROA), an accounting measure, rather than stock price performance. Putting aside the matter of shareholder preference, stock prices measure expectations of future earnings, which relate to new investment. Possible message of the new regime: "Don't overcompensate the 'failed' CEO; focus on today's safely

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began with the Greenbury best practice guidelines in this area, which had reduced the typical three year managerial term to one year by 2002. *See* Steve Thompson, *The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK*, 13 CORP. GOV. 19, 22, 23 (2005) (suggesting that investors pushed to limit contract terms to one year, which generally produced relatively small savings, because shorter terms "facilitate[ed] the ousting of under-performing executives").

[49] *See, e.g.*, RREV EXECUTIVE REMUNERATION: TRENDS IN EXECUTIVE REMUNERATION 2006 (2007); Ferri & Maber, *supra* note 4, at 49,Table 1, Panel A.

[50] *Id.*, Table 1 (and author's own calculations). This is merely a continuation of the narrowing of the compensation gap between U.S. and UK CEOs. *See* Martin J. Conyon et al., *How High Is US CEO Pay? A Comparison with UK CEO Pay* (WP June 2006), available on SSRN at http://ssrn.com/abstract=907469.

[51] Ferri & Maber, *supra* note 4.

measurable earnings, not tomorrow's." If that is the result of a shareholder advisory vote, it seems an odd way to build a system that relies on entrepreneurial energy and the risk of failure.[52]

An additional point is a possible "size effect" in Ferri & Maber's results, meaning that independent of performance, the DRR regime may have had a negative effect on CEO compensation at the largest firms. Since pay generally increases in size, this suggests that the DRR may have produced a decrease in the rate of compensation growth where pay was on average the highest and where high pay was most visible. This may serve perfectly fine social objectives, but it does not fit the "pay for performance" objectives of the DRR.[53]

A more technical factor that may confound the Ferri & Maber result is that the DRR regime consisted of two elements: extensive mandatory disclosure of executive compensation particulars, including the board's reasoning process in the award of compensation, and the shareholder advisory vote. As the authors observe, many compensation elements were already mandatorily disclosed via the London Stock Exchange's Listing Rule 12.43(c), though the report requires significantly more detail, particularly on long-term incentive plans and severance. Contemporary market participants, though they appreciated the improved disclosure, seemed to think that the new advisory vote was a more significant change than the improved disclosure. A 2004 Deloitte survey of leading institutional investors on the impact of the new DRR regime, commissioned by the Department of Trade and Industry, reported that 70% regarded the shareholder vote as having "very significant impact" whereas only 26% regarded the detailed disclosure of compensation particulars as having comparable significance, even though nearly 90% regarded the remuneration report as providing better understanding of compensation.[54] Thus Ferri & Maber seem safe in attributing most of the effect to the shareholder empowerment elements of the scheme.

C. *Lessons from the UK for the US in "Say on Pay"*

1. Side Effects of the UK system

The efficiency effects of the UK system are potentially a matter of concern. As noted above, the only available empirical evidence shows pay-performance responsiveness tied to a current earnings measure, not a stock-based measure. Beyond that, the workings of the system seem ill-suited for a dynamic environment. For example, immediately upon adoption of the DRR regime, the ABI and the NAPF adopted "best practices" of compensation guidance. Because of the dominance of those two actors, whose institution investor members own 30% of the shares of large UK public firms, the annual shareholder vote is often a test of "comply or explain" with those guidelines. Indeed, an alternative approach, in which shareholders would annually evaluate firm compensation practices in light of the firm's performance and prospects

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[52] A more positive interpretation might be that since the UK compensation scheme is generally tilted to cash payouts rather than stock-related compensation, 65% to 35%, pay-to-ROA performance is the right, or at least more important, sensitivity measure. Then the concern becomes the guidelines that lock in a normatively controversial tilt against stock-related compensation. It is still a consequence of the regime as a whole.

[53] The "size" effect looks to be separate from the "excess compensation" effect.

[54] DELOITTE, REPORT ON THE IMPACT OF THE DIRECTORS' REMUNERATION REPORT REGULATIONS 34, 27 (2000) (Report to Department of Trade and Industry). The Report used a 1-5 intensity scale. On a broader definition of significance that adds the "4s" and the "5s," the gap is less pronounced: 92 percent vs.74 percent.

as a whole, would be very costly.[55] The tendency for firms to "herd" in their compensation practices is very strong: Follow the guidelines, stay in the middle of the pack and avoid change from a prior year, when the firm received a favorable vote. Yet what is the normative basis for giving authoritative weight to the guidelines, whose conventional wisdom has not itself been tested for performance-inducing effect?

For example, the current ABI guidelines contain elaborate prescriptions for the issuance of stock options and other sorts of stock-related compensation, including a requirement of "performance based vesting" based on "challenging and stretching financial performance" (not just a high exercise price) that applies not only to shares from an initial grant, but also shares from a bonus grant, meaning that an option (or share) grant will not necessarily ever be in the money.[56] To a non-professional eye, this reads simply like a prejudice against stock-based compensation, and the expression of a preference for a UK-style of compensation that traditionally has been tilted toward cash salary and bonus. Indeed, this is consistent with the Ferri & Maber evidence that shows pay-performance responsiveness to earnings-based measures that commonly are used in bonus awards, not stock-based measures geared toward stock-related compensation. The guidelines may be "correct" in their outcome in particular instances of compensation form, but it is hard to believe that they will persistently produce a result similar to arms' length bargaining, if that is the ultimate comparator. More concerning, the implementation of the guidelines may transmit a particular form of compensation practice across an entire economy.

Deviations from the guidelines require, as a practical matter, a consultation with the proxy adviser of one of the institutional groups, either RREV or IVIS. To do otherwise may be to risk a negative recommendation on the advisory vote. There are no studies on the bureaucratic capabilities or expertise of either proxy advisor. The system as a whole seems to tilt toward stasis rather than innovation in compensation practices. Perhaps this is wise. In light of the generally greater shareholder power in the UK, it does, however, seem ironic that the implementation practicalities of "say on pay" may reduce the freedom-in-fact of the shareholders' bargaining agent.

2. Translation of the UK Experience to the US

Possible "side-effects" do not necessarily negative the value of the shareholder advisory vote in the UK. But it could be that many of its benefits are bundled with an overall corporate governance system that gives shareholders considerably more power than in the US, so that a "transplant" of "say on pay" alone would trade differently in the US. Corporate governance in this sense is a function of ownership and legal rules. UK ownership is characterized by what might be called "concentrated institutional ownership," meaning that although UK firm are "Berle-Means" firms without controlling owners, the shares are held first, by institutions rather than retail investors, and second, that these institutions are "concentrated" rather than "dispersed."[57] As noted above, the dominant UK institutional investors have been insurers and private industry pension funds. They share a common address, the City of London, and common

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[55] *See* Kristin Gribben, *U.K. Investors Warn U.S. About Say on Pay,* AGENDA (Nov. 12, 2007) (citing experience of UK fund managers, who nevertheless want to retain the advisory vote).
[56] ABI, EXECUTIVE REMUNERATION – ABI GUIDELINES ON POLICIES AND PRACTICES §§ 4.1., 4.6, 4.12 5.7 (2006).
[57] This and much of the succeeding discussion draws from John Armour & Jeffrey N. Gordon, *The Berle-Means Firm of the 21st Century,* preliminary working paper, Feb. 2008, on file with Jeffrey N. Gordon.

objectives, long-term holdings producing steady dividends and gains. Over a 40 year period they have gained considerable experience in collaborative efforts to engage their investee firms on business and governance matters.

Part of the reason they are paid attention to is a legal regime that empowers shareholders to a much greater extent than in the U.S. For example, shareholders can remove directors or amend the articles. Five percent of the shareholders can call a special meeting. The board may not interfere with shareholder choice in a takeover bid. Through the exercise of preemptive rights, shareholders can constrain the firm's access to equity capital markets. Yet it is the coordination possibilities of the UK form of concentrated institutional ownership that has transformed these statutory rights into governance power. Thus the benefits of shareholder advisory voting in the UK need to be assessed against that backdrop. The dialogue about compensation may be genuinely informative in a two-sided sense and may inject leeway that is not immediately apparent. In the course of the compensation talk, the conversation may turn to performance more generally, including the performance of the CEO or perhaps consultation about business plans.

The U.S. statutory system empowers shareholders less, granting the board greater autonomy but taking greater pains to bolster its independence. The fraction of independent directors in the U.S. is considerably higher; the requirements of "independence" are stricter; the compensation committee is entirely independent. By comparison, UK Combined Code currently permits the Chairman (if formerly an "independent") to sit on the remuneration committee. But an equally important difference is in ownership structure. Even as recently as 1980, most US firms had a dispersed retail ownership base. Dramatic increases in institutionalization began in the 1980s but the form of ownership was "dispersed institutional ownership," meaning the institutions were very different in investment objectives, anticipated holding periods, and geographic location. That diversity has, if anything, increased. Moreover, U.S. securities regulation has placed various barriers to coordination among institutional investors that increase its cost and legal risk.

So how would a "say on pay" regime work in the United States? There are many more firms in the United States (think S&P 1500 versus FTSE 350) and many more institutional investors, but a very limited practice of institutional consultation and much less coordinated consultation. The most active institutional investors have been public pension funds and union pension funds, which act from shareholder value economic motives for sure but which may have other motives as well. Hedge funds have recently joined the ranks of shareholder activism, but they are looked at warily, not just by boards but also by other institutions, whose managers cannot benefit from "2 and 20" compensation schemes.

Only a relative handful of the large public pension funds have independent corporate governance expertise to guide their share voting, and even the largest and most experienced of these, CalPERS and TIAA-CREF, depend on guidelines that they fashion with only limited company-specific accommodation. Most of the rest simply delegate most of the substantive decisionmaking in the governance area to a proxy services firm, in particular Institutional Shareholder Services (ISS), now part of RiskMetrics.[58]

Like ABI and NAPF, ISS will establish guidelines on compensation; indeed, such guidelines already exist. As in the UK, firms that do not want to stir trouble will herd. Or firms with alternative ideas will engage ISS in negotiation – but the numbers of firms and the time for

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[58] *See* Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008).

serious engagement could easily make the situation untenable. The propensity of many U.S. institutional investors to delegate such decisions could well give power to a handful of proxy service firms to make substantively very important decisions with potentially economy-wide ramifications. Indeed, the economy-wide embrace of stock options in the 1990s resulted in part from institutional investor pressure on firms to adopt this "best practice" way to enhance managerial incentives.[59] Then favored accounting treatment established "plain vanilla" options as the "best practice" implementation. In other words, much of what we now regret was the result of prior standardized practice that guidelines epitomize.[60] It is clear that legislated "say on pay" in the U.S. is one way to catch and stop the bad-behaving outliers. But there are costs and risks that cannot be ignored.

The major advantage of mandatory "say on pay" legislation is the powerful shock it might well deliver to the executive compensation structure that would destabilize the present equilibrium. This is some of what happened in the UK. Adoption of the DRR regime suddenly roused the UK institutions into a very significant role in reviewing and challenging compensation practices, kind of "big bang" of compensation engagement. Some dubious practices like long-term contracts and lavish golden parachutes simply disappeared in the new equilibrium. The trend to more U.S-style stock-based incentive compensation appears to have reversed. Yet even in the UK the new equilibrium is not a dramatic change. As Ferri and Maber show, the trend line of compensation increases was not affected.

Moreover, there would be no "big bang" in the U.S. As discussed above, U.S. shareholder activists have focused on executive compensation for some time, through both the shareholder proposal machinery and withhold vote campaigns for offending compensation committee directors.[61] Majority voting for directors rules that have been adopted by a majority of U.S. public firms only add to the potency of such withhold vote campaigns. Ironically such activity in the U.S. over the same period as the DRR regime may well have produced a one-time downward revision lacking in the UK, according the Ferri & Maber's data.[62]

3. Executive Compensation as a Hard Problem

Putting aside agency cost consideration, devising an effective executive compensation scheme is hard. Private equity firms have a solution – very high levels of stock-related compensation that pays off only upon a successful exit from the going private transaction. Success results in very large payoff, but a fired private equity CEO typically loses unvested options and restricted stock (rather than obtaining acceleration through a U.S.-style golden parachute). Severance is typically limited to the equivalent of one or two years' salary, but of

[59] Gordon, *Independent Directors*, *supra* note 1, at 1529 n. 257.

[60] It is only now, with adoption of FAS 123R, that firms may feel free to experiment with alternative stock option forms, such as performance triggers for grant or vesting, possibly using industry indices to measure performance. Yet the concerns about valuation of tailored instruments for accounting purposes may have its own uniformity pressure.

[61] The one area in which US law favors shareholders relative to the UK is with respect to the making of shareholder proposals. Rule 14a-8 under the US 1934 Securities and Exchange Act, 17 CFR § 240.14a-8(b) provides access to the issuer proxy to a small shareholder (owning the lesser of $2000 in market value or 1%). By contrast, Section 376 of the UK 1985 Companies Act 1985 imposes a 5% share ownership threshold.

[62] Ferri & Maber, *supra* note 4, at 56,Table 7 Panel A. This apparent finding may have resulted from exchange rate fluctuations, see Table 7, Panel B, so must be taken cautiously.

course the salary base is much smaller because of the concentration on incentive-based pay.[63] For such high-powered incentives to work well, a high-powered governance structure is also required.

So why isn't the private equity model an exemplar for public company practices? One possible answer is that it may be too demanding, both on the executives who bear enormous firm-specific risk, and on the governance structure, which requires directors who are knowledgeable about the business and deeply engaged. For example, a recent paper by Leslie & Oyer observes that compensation patterns in reverse leverage buyouts begin to revert to the public company norm within one year of the going public transaction.[64] "Executive ownership drops quickly and substantially right after the IPO… to levels similar to public firms."[65] Salary levels take a little longer to reach the comparable public firm norm, three or four years. Private equity owners presumably have every incentive to maximize the value of their shares in the exit IPO and bear the cost of compensation structures, so it is hard to believe that they would knowingly install a suboptimal regime.

III. CONCLUSION: ON MUDDING-THROUGH

So we need public firms and we need compensation mechanisms that reward, provide incentives, and are political sustainable -- in short, that serve a number of social ends. My tentative view is that the current U.S. compensation reform project is headed in the right direction. Firm-specific "say on pay" campaigns can be targeted against compensation miscreants and can have useful demonstration effects for many other firms. Targeted "just vote no" campaigns against compensation committee members can have similar, perhaps even more powerful, effects.[66] These efforts could be augmented by concerted efforts by institutional investors, other governance groups, and the securities analyst community to develop a set of compensation "good practices," akin to the Greenbury Code, that could provide a focal point for engagement. In a 2005 article I said that the regime launched by the SEC's CD&A regulation deserved a five year trial before we undertook significant change.[67] Having looked more closely at the UK "say on pay" regime, I am prepared to reaffirm my prior view. We need more information about the consequences of the UK system. And we need more experience about the possible success of present compensation-reform efforts by shareholder activists at particular firms. If this is not a satisfactory result from a social responsibility perspective, then the tax code would be a better place to look than adjustment with corporate governance.

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[63] *See* David Carney, *Deliver and You Get Paid*, THE DEAL, June 1, 2007.

[64] Philip Leslie & Paul Oyer, *Managerial Incentives and Strategic Change: Evidence from Private Equity* (draft, March 2008) (manuscript on file with Jeffrey N. Gordon).

[65] *Id*. at 16-17.

[66] *See* Diane Del Guercio et al, *Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'?* J. FIN ECON. (forthcoming 2008), available on SSRN at http://ssrn.com/abstract=575242 (positive effects from "just vote no" campaigns"); Jie Cai et al, Electing Directors (WP March 2008), available on SSRN at http://ssrn.com/abstract=1101924) (lower votes for directors is correlated with subsequent reductions in excess compensation). See also Yonca Ertimu et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals* (WP April 2008), available on SSRN at http://ssrn.com/abstract=816264 (greater board responsiveness to recent "majority vote" shareholder proposals than prior proposals).

[67] *See* Gordon, *Executive Compensation*, *supra* note 20, at 701.