

M&A Commentary

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“Say on Pay” Shareholder Advisory Votes on Executive Compensation: The New Frontier of Corporate Governance Activism

Highlights

- The 2008 proxy season “hot button” is almost certain to be shareholder proposals under Rule 14a-8 calling for an annual advisory shareholder vote on executive pay, so-called “Say on Pay.”
- “Say on Pay” was a very popular proposal in the 2007 proxy season and received very strong investor support, particularly considering this was its first full “season” on the ballot. If the usual trends for corporate governance shareholder proposals hold true, “Say on Pay” resolutions could carry at many companies this year.
- There are no easily available mechanisms to exclude “Say on Pay” proposals under the exclusion provisions of Rule 14a-8. Nor are there any “show stopper” arguments for boards against “Say on Pay.” It is politically and emotionally appealing, it attracts very positive press, it tugs at all of the populist chords and, most important, it has been strongly supported by Institutional Shareholder Services (ISS) (currently a part of RiskMetrics Group) and the other proxy advisory firms.
- Many companies will be lucky and not receive a “Say on Pay” proposal in 2008. Many of the others who are not so lucky will find a way to postpone implementation of “Say on Pay” for a year or perhaps two. But given the strong national trend in favor of corporate governance activism and the obvious popular appeal of “Say on Pay,” momentum is building toward a pervasive “Say on Pay” regime for US public companies.
- The advent of “Say on Pay” for a company means, as a practical matter, that its executive pay policies and procedures will have to meet ISS guidelines on executive compensation or suffer a very strong risk of ISS recommending that shareholders vote “No on Pay.” Such a negative vote, if not addressed promptly by modifying executive compensation to fit ISS guidelines, will almost certainly lead to an ISS withhold vote recommendation against the compensation committee and perhaps the entire board.
- The only clearly visible alternative to accepting ISS guidelines on executive compensation would be for the board to negotiate exceptions with ISS based on particular facts and circumstances or with investors voting enough shares to overcome an ISS recommendation to vote “No on Pay.”
- If our analysis proves out, the principal wild card will be how tough ISS guidelines on “Say on Pay” turn out to be. If ISS gives compensation committees sufficient room to fashion pay packages that committees and their compensation consultants find tolerable, “Say on Pay” will probably turn out to be a modest, but important, reform focused on curbing the egregious executive compensation programs.
- If, however, ISS adopts a stringent “regulatory” stance and tries to micro-manage executive compensation, “Say on Pay” will be very troublesome to boards and executives, to say the least.

Question: What is “Say on Pay” and where did it come from?

Answer: “Say on Pay” is the catchy nickname for a board policy calling for an annual shareholder advisory vote on a company’s executive pay policies and practices. The concept originated in the United Kingdom (UK) in the early 2000s and was made mandatory for London Stock Exchange listed companies by an amendment to the Companies Act in 2002.¹ Mandatory shareholder advisory votes on executive compensation have since been legislatively adopted in Australia and Sweden. “Say on Pay” has also been implemented in the Netherlands and Norway in the form of a binding annual “vote of confidence” on executive compensation.

In 2006, the American Federation of State, County and Municipal Employees (“AFSCME”) sponsored several shareholder proposals under SEC Rule 14a-8 calling on boards to adopt a policy providing an annual advisory vote on executive compensation.² The proposals received very strong support and emerged in 2007 as a major initiative of corporate governance activists, with over 60 proposals for “Say on Pay” being reported.³ “Say on Pay” proposals averaged about 40 percent favorable votes in 2007 and passed at four S&P 1500 companies (Verizon, Blockbuster, Motorola and Ingersoll Rand).⁴ There were also greater than 45 percent favorable votes at a number of other notable companies, including The Bank of New York, Merck, Occidental Petroleum and Apple.⁵

Question: What are the prospects for the 2008 proxy season?

Answer: All the indications are that “Say on Pay” proposals will be more pervasive in the 2008 proxy season. They combine extremely attractive elements.

- “Say on Pay” proposals cater to the strong emotional reactions of investors, commentators, the press and politicians of all stripes to the widely publicized “excessive” pay practices of the last several years, such as a \$2 million birthday bash for a CEO’s wife, compensation packages in the hundreds of millions of dollars for executives who have been fired for poor performance, and large cash and stock compensation awards to executive teams at a time when company performance and stock prices are underperforming or worse.
- For many, “Say on Pay” embodies the current economic and political issues surrounding the widely perceived pay inequalities of US capitalism and the asserted growing gap between the “rich” and the “middle class.”
- Moving from the political aspects of the debate, proponents characterize “Say on Pay” as a principled example of shareholder democracy, as well as a responsible means for creating meaningful board accountability. They also tout the proposal as an exercise in “restraint,” since they explicitly provide for an advisory, non-binding vote—far better advocates say than voting down members of the compensation committee for their failures to control executive pay excesses.
- Supporters of “Say on Pay” also point to the UK experience, in particular, as validating their arguments for the wisdom and desirability of advisory votes on executive compensation. They cite the UK model as demonstrating the practicality of the advisory vote concept and also point to a wide array of favorable testimonials from large UK investors and investor representatives celebrating the cooperative spirit the advisory vote regime has fostered between the investor community and company boards.
- Finally, the relative success of “Say on Pay” proposals in the 2007 proxy season makes them a corporate governance winner. Like everyone else, corporate governance activists like winners, whatever the actual merits.

Question: What is the dark side of “Say on Pay?”

- **Answer:** First, of course, is that an annual advisory vote of shareholders on any matter is novel as a corporate governance mechanism. Like precatory (non-binding) votes under Rule 14a-8, the concept is not recognized as a matter of state statutory law, and it’s very uncommon, if not unknown, in the United States. This, standing alone, will quite probably produce qualms at the board and management level of any company.
 - Moreover, an advisory vote on executive compensation is the antithesis of a vote on
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“home, mother and apple pie.” There is no more contentious and emotional issue in corporate governance today than executive pay policies and practices—not poison pills, not staggered boards, not majority voting and not shareholder access to the company proxy material. Nor is there a topic on which reasonable people (let alone, unreasonable people) can so easily disagree at every level from the highest issues of policy to the lowliest issues of implementation detail.

- Compensation policy and practice is, moreover, potentially the most adversarial issue between management and the board. It is at the very heart of not one, but three, very critical conflicts:
 - First is the tension a board faces between paying managers what they are truly worth and in a manner that incentivizes them to expend their utmost to create shareholder value and not paying managers more than they are truly worth or in a way that distorts their incentives.
 - Second is the tension between an adversarial view of the board’s role (aggressively supervising management and holding them accountable in a meaningful sense for their performance) and a collegial model of board-management relations (working together with management in a constructive environment as “partners”).
 - Third and perhaps most fundamental, is the tension between today’s commonly held notions of corporate governance and shareholder democracy, which emphasizes the board’s and management’s direct accountability to shareholders as the “owners” of the enterprise, and a more traditional governance model, which looks to the board and management working together and exercising independent judgment as to what is best for the corporation and its shareholders.

As a result of these tensions, a board and its compensation committee can all too easily be trapped in a “no win” position of needing to please its two key constituencies—shareholders and management—at the same time. While this risk is inherent in the compensation process, any dynamic that adds to the tension or shifts leverage from one constituency to another should be examined carefully and dispassionately.

Question: What are the practical implications of “Say on Pay?”

Answer: The down-side of “Say on Pay” doesn’t stop with the conceptual issues we have outlined. Perhaps its most challenging aspect is that not only is it perennial, but it also is likely to result in a significant transfer of leverage on all aspects of executive pay from the board and compensation committee to corporate governance activists and proxy advisory firms, principally ISS.

- After one disastrous episode in which GlaxoSmithKline lost its first advisory vote on compensation, the near universal practice in the UK has been for the board to assess and resolve any investor dissatisfaction with executive compensation through private discussions with representatives of investors in advance of setting compensation for the forthcoming year. The avowed intention and result of this consultative practice is to ensure that the next year’s compensation policies address significant investor concerns and thus win a positive advisory vote.⁶
 - This consultative process, which seems to be viewed benignly by UK boards, would not easily translate to the United States. First, unlike the UK, there are not one or two large umbrella organizations that can speak for a predominant part of the investment community. Rather we have a far larger and more diverse universe of investors. Even if the larger institutional investors in a given company were willing to participate in a consultative process, they often would be too numerous to fit into a conference room and a meeting in a large auditorium does not seem conducive to constructive dialog.
 - The Council of Institutional Investors might claim the mantle of spokesperson for institutional investors, but it is likely to be perceived by many, if not most, boards as a surrogate for state and local pension plans and unions. This group of investors and the Council are widely perceived as having a thinly disguised political and social agenda, especially when it comes to executive pay. The Council therefore will lack credibility as a neutral intermediary for the larger community of equity investors.
 - This leaves ISS and its smaller rival proxy advisory firms as the only parties that can claim to be neutral and to speak on behalf of a broad cross-section of investors in any
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particular company. Moreover, whatever one's views of the desirability of investing ISS with the mantle of investor representation, ISS' dominant role in the outcome of any proxy vote (conventionally estimated to be on average 30-50 percent determinative at any given company and probably growing in influence), as a practical matter, makes ISS a necessary party to any dialog between the board and investors regarding executive pay. Put another way, even if a compensation committee or board satisfied several of its largest shareholders on its executive pay profile through consultative dialog, would it be comfortable going to a vote on "Say on Pay" without also getting a "green light" from ISS?

Question: How will ISS deal with "Say on Pay?"

Answer: The upshot of our analysis is that adoption by a company, voluntary or otherwise, of an annual "Say on Pay" advisory vote will be tantamount to making ISS an on-going, full fledged partner of the compensation committee in the determination of executive pay policies and amounts. The critical question is what sort of "partnership."

- It is highly unlikely that the UK consultative process focusing on face-to-face dialog can be carried over to the United States. We have far too many companies, ISS has far too little resources and the implementation expenses would be far too high to make such a process practical in this country.
- Rather, it is probable that ISS will exercise its leverage by promulgation of guidelines for executive compensation for purposes of "Say on Pay" voting. Whether these guidelines are adopted wholesale from ISS' existing voting policies on compensation or are a modification of these policies, given ISS' historical behavior they are likely to be relatively detailed and prescriptive in nature.
- In this context, a board that believes it needs an exception from ISS guidelines will likely seek an audience from ISS, which would mimic the UK consultative practice. The difference would be that ISS would decide whether and with which board it was willing to consult, rather than accepting an impossible obligation to consult with all comers.
- A possible alternative to seeking an exception directly from ISS would be for a board to seek an exception from enough of its larger institutional holders to give it comfort that it can avoid a negative advisory vote if ISS refuses to move off its stated rules. Such an alternative would seem most feasible for very large companies with active and successful investor relations programs and supportive large investors.
- Boards and compensation committees seeking leeway may also resort to avoidance tactics, resulting in pay practices that meet the letter of the ISS guidelines but not what ISS deems to be the spirit. This reaction to an ISS prescriptive rule-based regime, however, is likely only to produce more detailed and dense regulation.
- An alternative, and far happier, ISS response to "Say on Pay" would be for ISS to forego detailed prescriptive rules by crafting a "principles" based set of guidelines that provide room for particular solutions and experimentations on a company-by-company basis. Whether this course of action is in the cards remains to be seen.

Question: Can "Say on Pay" be avoided?

Answer: It seems safe to predict that most US public companies will not view "Say on Pay" as benignly as UK companies seem to view their annual compensation discussions with representatives of their investors. The question, then, is what should a company do?

- First, of course, is to do nothing to stimulate a "Say on Pay" proposal. Not every company will receive a "Say on Pay" proposal, even if they become the leading category of shareholder proposals in 2008 and following years. After all, the corporate governance activist campaign for redemption of poison pills is well into its second decade, but a large number of companies with pills have never received a shareholder redemption proposal.
 - If a company receives a "Say on Pay" proposal, its board (management, for obvious reasons, would not be a felicitous choice to lead the negotiation) should seriously consider entering into a dialog with the sponsoring shareholder to see if there is an acceptable compromise short of placing the proposal on the agenda for the next annual meeting. For example, it might be possible to convince the sponsor that an informal annual consultation process between the compensation committee and, say,
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the top four or five institutional holders would be a more constructive approach than a proxy battle over a more formal “Say on Pay” proposal. An informal *ad hoc* working group consisting of representatives of several corporate governance activists, proxy advisory firms and large public companies is studying the “Say on Pay” issue. It might well come out with other alternatives to a formal “Say on Pay” policy acceptable to a wide range of investors and proxy advisory firms.

- Once a company’s luck runs out in the sense that it cannot find an acceptable compromise in lieu of a “Say on Pay” shareholder proposal, its options become quite limited.
 - There is no question that a “Say on Pay” proposal couched as a non-binding request for the board to implement an annual “Say on Pay” advisory vote can not be excluded under Rule 14a-8. Accordingly, a company that receives a “Say on Pay” shareholder proposal would have limited options, none of them particularly appealing.
 - The most obvious course would be to try to defeat the proposal at the annual meeting. While “Say on Pay” proposals have enjoyed very strong support, only a handful was adopted in 2007. Every indication, however, is that ISS and the other proxy advisory firms will enthusiastically endorse “Say on Pay” proposals for 2008, and other institutional investors are increasingly enamored of the concept. This suggests that the proposals will enjoy stronger investor support this proxy season. Nevertheless, given the alternatives there seems little harm in trying to beat the proposal. Worse comes to worse, the Company can always accede to its shareholders’ wishes a year later.
 - Another approach would be to voluntarily adopt a “Say on Pay” policy and rely on the “substantial implementation” exclusion under Rule 14a-8 to avoid a vote on the shareholder proposal. This would make sense if the shareholder proposal was badly worded and the company saw value in “seizing the pen.” For example, if the proposal called for a vote only on the amount of the CEO’s compensation package, the board might consider it better to enact a policy calling for an advisory vote on the entire CD&A section of the proxy statement. Whether the board’s version would meet the “substantial implementation test” is not free from doubt, but it certainly would be worth a try.
 - A third, and probably the least attractive, option would be to put an alternative proposal on the agenda at the annual meeting that “conflicts” with the shareholder “Say on Pay” proposal and claim exclusion under Rule 14a-8 based on the conflict. The trouble with this alternative is that, at first blush, it is not easy to come up with a proposal that would create a conflict under Rule 14a-8. The only obvious example would be a policy or bylaw that bars advisory votes on executive compensation. While a board could propose such a policy or bylaw for a shareholder vote, the likelihood of passage is virtually nil. This tactic would postpone passage of “Say on Pay” for a year, but most probably at the cost of creating bitterness among corporate governance activists and ISS and attracting a lot of negative press. It is not clear that these negatives outweigh avoidance of “Say on Pay” for a year.

Question: What are the withhold vote implications of “Say on Pay?”

Answer: Viewed in isolation, “Say on Pay” poses many hard issues and few positives, although its supporters would argue that it considerably strengthens the bargaining position of a compensation committee in its dealings with management, particularly when it wants to say “no.” After all, it gives a compensation committee the handy “cover” of being able to attribute its toughening position on pay to investors and the need to get a positive advisory vote.

“Say on Pay,” however, should not be viewed in isolation. It is part of a much bigger context in which the corporate governance activists and proxy advisory firms are playing an increasingly large role in executive compensation policy and practices, as well as many other phases of corporate governance.

One of these other aspects of corporate governance that weighs heavily in the discussion of “Say on Pay” is the growing acceptance of majority voting regimes by public companies in place of the former near universal plurality voting regime. Majority voting gives legal consequence to the withhold vote concept that ISS and its competitors have successfully

honed as the principal disciplinary tool for what are perceived as recalcitrant boards and recalcitrant directors. With majority voting, a nominee's failure to capture a majority of votes moves the consequence from the sphere of embarrassment and moral suasion to the reality of a failure to be elected and/or invocation of a resignation as a director.

Although ISS has not yet finalized its voting policies for 2008, it seems safe to predict that those policies will include withhold vote positions related to "Say on Pay" along the following lines.

- First, failure by a board to implement a "Say on Pay" proposal that has been approved by shareholders at an annual meeting will trigger a withhold vote for the entire board slate at the next meeting. As a practical matter, this means that if shareholders endorse "Say on Pay," directors have little practical choice but to implement it.
- Second, a failure to achieve a majority "Yes on Pay" advisory vote will almost certainly lead to withhold vote recommendations against the entire compensation committee at the next annual meeting, at least unless the compensation committee does a "big time" mea culpa that convinces ISS not to invoke its withhold vote sanction.
- Third, is the risk that ISS may invoke withhold vote recommendations based on more generic reluctance by a board to implement "Say on Pay" in a whole-hearted fashion. For example, if a board were to adopt a bylaw purporting to bar "Say on Pay" advisory resolutions without taking the matter to a shareholder vote, it doesn't seem far-fetched that ISS might respond with a withhold vote recommendation against the board. Similarly, there is a possibility that a compensation committee that tries to negotiate overly aggressive executive compensation at repeated meetings with ISS and/or large investors might over time stimulate a withhold vote campaign.

Conclusion

Because of the clearly negative implications of a successful "Say on Pay" resolution, boards and compensation committees should focus on avoidance of shareholder proposals on "Say on Pay." Saying this, of course, is easier than doing it.

- One obvious tactic would be to not challenge openly corporate governance activists by adopting aggressive executive pay packages. Executive compensation is, for better or worse, a highly charged emotional arena in which getting lost in the middle of the pack is far better than being at the forefront of "offenders" against institutional investor sentiments about management pay best practices.
- A compensation committee should also look carefully at its internal processes. Reliance on management's compensation consultants is coming under increasing attack from corporate governance activists, for obvious reasons. Compensation committees should consider retaining their own compensation consultants selected by them, not by management.
- A somewhat more proactive but probably desirable approach would be for the compensation committee to review its current executive compensation programs against the current ISS and other proxy advisory firm voting policies with regard to executive compensation and, to the extent feasible, eliminate non-complying aspects of its pay programs.

The purpose of these and similar steps would be to demonstrate in advance of a "Say on Pay" proposal that the compensation committee and board are sensitive to investor sentiment and are actively "responding" to investor views on appropriate executive compensation policies. Hopefully, such an approach will itself forestall any motivation for a "Say on Pay" proposal. If not, it should at the least establish a strong basis for negotiating a livable compromise with the proponent of the proposal.

If a company is unsuccessful in avoiding a "Say on Pay" proposal, its next best line of defense is to fight the proposal. These efforts should focus on an aggressive advocacy campaign with ISS, the other proxy advisory firms and key institutional shareholders. A successful record of having modified executive pay in line with published guidelines and/or otherwise having been responsive to shareholder concerns and curbing abusive executive

compensation practices should stand the company in far better stead in its advocacy than a record of benign neglect or worse.

A loss by a company on a “Say on Pay” shareholder proposal will require its board to focus on the reality that failure to adopt a responsive “Say on Pay” policy will almost certainly lead to an ISS withhold vote recommendation in the following year against the entire board. As a result, the likelihood is that a high percentage of companies that have a “Say on Pay” proposal adopted by shareholders will implement the required advisory vote before the next annual meeting to avoid the risk of a withhold vote campaign against the board. The only meaningful issue is likely to be the precise wording of the board’s version of an advisory vote policy, which in turn is likely to be dictated by ISS policy regarding what it considers to be an acceptable version of a “Say on Pay” policy.

Once a “Say on Pay” advisory vote policy is put in place, it will lead to an annual review of executive pay for compliance with ISS guidelines. In cases where change is required for compliance, some companies will seek to negotiate exceptions with ISS or its large shareholders, but probably with at best marginal results. ISS is not likely to change its *modus operandi* of sticking to its announced policies and guidelines in the emotionally charged arena of executive pay. Many more companies will amend their executive pay to achieve compliance with ISS guidelines rather than press the fight. A few companies may be able successfully to end-run ISS by dealing directly with their key shareholders, a tactic that has sometimes worked in the context of adoption of new executive stock option plans. What is certain, however, is that only a small handful will emulate Don Quixote and take executive compensation packages to an advisory shareholder vote without the support either of ISS or a sufficient number of institutions to make a favorable vote highly probable.

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- ¹ Companies Act, 2006, ch. 46, pt. 15, ch. 9, § 439.
- ² Allan Sloan, *Aflac Looks Smart on Pay*, The Washington Post, May 29, 2007, at D01.
- ³ Allan Sloan, *Aflac Looks Smart on Pay*, The Washington Post, May 29, 2007, at D01.
- ⁴ RiskMetrics Group, *2007 Postseason Report* (Oct. 2007) at 8.
- ⁵ LawyerLinks Advantage, “Say on Pay” Proposals, 2007 Proposals, at http://content.lawyerlinks.com/default.htm#http://content.lawyerlinks.com/sec/Proxy/say_on_pay_proposals.htm#Verizon (last visited Nov. 5, 2007).
- ⁶ See generally, Stephen Davis, *Does ‘Say on Pay’ Work? Lessons on Making CEO Compensation Accountable* (Millstein Ctr. for Corp. Governance and Performance, Policy Briefing No. 1 (drft.), 2007), available at

http://millstein.som.yale.edu/documents/Davis_Say_on_Pay_Policy_Briefing.pdf (last visited Nov. 5, 2007).