

## **An Advisory Vote on Executive Compensation Makes Sense for Both Companies and Shareholders.**

**By John C. Wilcox**

Should shareholders have the right to an advisory vote on executive compensation? What would be the consequences? These questions have become the defining issue of the 2008 proxy season in the U.S.

The predominant tone of the public discourse over advisory votes has been highly confrontational, treating the issue as a struggle for power between companies and shareholders. The unfortunate consequence of this overheated debate has been to obscure the advisory vote's most important benefits – its potential to reduce conflict and promote constructive dialogue between companies and shareholders. An annual advisory vote would likely result in the elimination of most compensation proposals under Rule 14a-8 together with the costs and uncertainties associated with the shareholder proposal process. In addition, over time an annual vote would shift the focus of the compensation debate to individual company practices rather than broad policy issues.

Fortunately, the dialogue at private meetings of companies and institutional investors has been more substantive and nuanced than the public debate. Here is a look behind the scenes at how some shareholders are responding to companies' questions about the advisory vote and the goals of executive compensation disclosure:

1. *Is an advisory vote necessary?* The goal of an advisory vote is to help ensure that directors pay attention to the elements of compensation that matter most to investors: goals, metrics, philosophy and links to performance and business strategy. Shareholders generally agree that they don't have the knowledge or inclination to second-guess how or how much senior executives should be paid at specific companies. They want board compensation committees to handle this responsibility, provided they act responsibly and explain their decisions. Shareholders also agree with companies that compensation standards should be flexible, strategic, clear and not standardized or formulaic. If a company's Compensation Discussion and Analysis (CD&A) makes a convincing case that its compensation program is performance-based and rewards executives for solving business problems and creating long-term value, shareholders will support it even if the amounts paid seem high. Since performance-based compensation implies that exceptional performance deserves exceptional pay, companies should not fear that votes will be consistently negative.
2. *If shareholders are given an advisory vote on compensation, won't they end up micromanaging the company's business?* The advisory vote on compensation is not a "slippery slope." Executive compensation is a one-of-a-kind issue for

which an advisory vote is uniquely suited. Compensation is an annual concern; it involves difficult and sensitive issues; it requires boards to exercise independence, skill and judgment; it is integral to a company's long-term strategy and performance. The importance of compensation is further underscored by the SEC's extensive disclosure requirements, which are substantially more detailed than for other issues in the proxy statement. For all these reasons, compensation opens a window into the boardroom, revealing how directors set priorities and balance competing interests. The advisory vote in turn offers a means for shareholders to provide feedback on how the board is handling these duties. An annual advisory vote has the potential to increase dialogue and provide companies with early warning of shareholder concerns before a crisis develops.

3. *Isn't an advisory vote misleading, since the vote results may not send a clear message?* If compensation programs are appropriately customized, the meaning of an advisory vote will be different at every company. Uncertainty can be dealt with in two ways – (1) companies can survey shareholders directly or provide a web site for their comments; and (2) shareholders can be held to best practice standards that call for diligence in proxy voting, reporting and communication. Responsibility for communicating with shareholders falls squarely on the management and boards of public companies. At the same time, shareholders -- particularly institutional investors governed by fiduciary standards -- should accept full responsibility for their voting decisions and should take advantage of every means available to explain them.
4. *Won't advisory votes weaken boards?* An advisory vote should empower boards, not weaken them. Accountability to shareholders should reinforce directors' independence and strengthen their resolve to deal with compensation strategically. It should reduce directors' reliance on compensation consultants and benchmarks, encourage them to customize their programs and broaden their use of compensation to drive business strategy in addition to attracting and retaining executive talent.
5. *Won't an advisory vote ultimately draw shareholders too deeply into compensation decision-making?* In the U.K. the advisory vote is credited with increasing dialogue between companies and investors, particularly in the early stages of designing compensation plans. U.S. shareholders are less interested in such early-stage engagement, which many would characterize as micromanagement. Instead, they seem willing to defer to the expertise of managers and board compensation committees, while holding them accountable for disclosing, explaining and justifying their decisions. Judgment after-the-fact is standard practice for U.S. shareholders, who tend to take a long-term view and recognize that improvement in compensation practices will take time.
6. *How will proxy advisors handle recommendations on advisory votes?* Proxy advisors' compensation analyses and recommendations have in some cases utilized "black-box" formulas and quantitative factors applied uniformly to companies with little regard for context. Such an approach is not suitable for evaluating customized compensation programs and disclosure. Proxy advisors say they recognize the need to revise their evaluation methodology and are beginning to do so in response to demands from both investors and companies. In

- any case, companies must recognize that they bear primary responsibility for communicating with shareholders when they believe proxy advisors' recommendations are wrong. Such communication campaigns are already commonplace when companies are seeking shareholder votes to approve equity compensation plans.
7. *Isn't a vote against directors more effective than an advisory vote?* Withhold and vote-no campaigns against directors are a blunt instrument that sends a powerful message. Recognizing that a director's independence, experience, skill and conduct inside the boardroom are difficult to assess from outside the boardroom, many shareholders are reluctant to evaluate directors on the basis of a single issue. Accordingly, their policies recommend withhold and against votes for serious cases where there are violations of fiduciary duty, undisclosed conflicts of interest or unethical conduct. Under such guidelines a vote against directors based exclusively on a company's compensation shortcomings would be viewed as an overreaction. Particularly since the adoption of majority voting in director elections, best practice standards call for shareholders to exercise restraint in their votes against directors. The advisory vote avoids a heavy-handed approach and provides a moderate response that focuses on compensation concerns.
  8. *Is legislation or regulation the best way to mandate an advisory vote?* Since shareholders do not favor a one-size-fits-all approach to compensation, they are concerned that regulation could be overly prescriptive or formulaic. As with the adoption of the majority vote standard, private ordering is a preferred alternative to regulation. Companies should consider voluntarily amending their charter or bylaws to provide for advisory votes. However, the window of choice for voluntary action may not be open for long -- bills are pending in Congress to mandate the advisory vote, and the NYSE, whose listing requirements already mandate a binding shareholder vote on equity compensation, could extend the requirement to other forms of executive pay.
  9. *Won't an advisory vote increase companies' vulnerability to activism and other short-term market forces?* An advisory vote ultimately poses the question of trust between companies and their shareholders. Companies are understandably concerned about the diversity of shareholder interests. They are reluctant to give more leverage to aggressive, high-profile investors with short-term financial goals and questionable commitment to the business enterprise. At the same time, responsible, long-term investors rightfully demand a voice in decisions affecting the future of their investment. By definition, an advisory vote is both non-binding and self-limiting. It offers a referendum on compensation, not a forum for activism or change of control. Advisory votes are not designed to encourage opportunistic short-term strategies, but to support basic corporate governance standards that strengthen economic performance, reward appropriate risk-taking, increase director accountability and protect the long-term interests of shareholders.
  10. *Aren't shareholders expecting too much from compensation disclosure and the advisory vote?* Should the CD&A be retrospective or prospective, short-term or long-term, defensive or proactive? These questions are being asked by both companies and shareholders as they deal with the complex legal and technical

requirements imposed by the SEC disclosure rules. While the attention of the SEC staff is focused primarily on issues of materiality in pay decisions for the reporting year, shareholders are equally concerned about the ways in which compensation aligns with business strategy and drives long-term performance. Companies face the admittedly difficult task of both complying with detailed rules and explaining how their decisions serve the long-term interests of owners. The hope is that the SEC and companies will find the right balance of disclosure and narrative that best enables shareholders to evaluate each company's executive compensation program on the merits.

March 24, 2008.