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Keith L. Johnson & Daniel Summerfield

Shareholder Say on Pay

Keith L Johnson and Daniel Summerfield shed light on some possible areas of confusion in the US debate about Say on Pay based on their experience of how it works in practice in the UK

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Shareholder Say

Keith L Johnson and **Daniel Summerfield** shed light on some possible areas of confusion in the US debate about Say on Pay based on their experience of how it works in practice in the UK.

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

A recent study published by the Millstein Center for Corporate Governance and Performance at the Yale School of Management (*Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable*, Stephen M Davis) cited a number of benefits arising from shareholder Say on Pay in Britain. They include an increase in the quantity and quality of dialogue between directors and institutional investors; greater attention to executive compensation on the part of boards and institutional investors; moderation in the rate of increase in executive compensation; and dramatically increased use of incentive compensation. A 2007 Harvard paper (*Solving the Executive Compensation Problem Through Shareholder Votes? Evidence from the UK*, Fabrizio Ferri and David Maber) also found that Say on Pay in Britain lowered CEO compensation when companies had negative operating performance.

In the US, shareholder resolutions asking companies to adopt Say on Pay have been supported by 42 – 43 per cent of shareholders over both of the last two proxy seasons. A 2007 survey done by the CFA Institute found that 76 per cent of Chartered Financial Analysts support Say on Pay (*Advisory Pay Vote Gets Boost From Investment Professionals' Group Survey*, CFA Institute).

The Corporate Library reports that 46 Say on Pay shareholder resolutions received more than 40 per cent support this year, accounting for 70 per cent of those that went to a vote (and up from 60 per cent in 2007). Ten companies got majority votes on the resolutions, up from eight in 2007, and ten companies have announced that they will actually give shareholders an advisory vote.

It is now widely accepted that the structure of compensation programmes at financial services companies played a role in causing the current market crisis. With

President-elect Obama supporting enactment of Say on Pay and legislation to create Say on Pay shareholder rights having passed the House of Representatives on a bipartisan 269 to 134 vote in April 2007 the chances that a Say on Pay law will be enacted by the new Congress appear high.

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

1. Should success be evaluated narrowly or with a broad systemic focus?

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

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

- Most proponents do not claim that Say on Pay is THE answer that will resolve our problems relating to executive compensation. Rather, Say on Pay is viewed as only one important step within the context of various systemic factors that influence compensation decisions and boardroom practices. It is a necessary but not solely sufficient tool.
- Few people expect that fundamental misalignments in executive compensation, which have developed over

on Pay

decades, will realistically be resolved in a year or two. We believe a longer time frame is appropriate, especially given the number of systemic factors that have contributed to creation of the 'pay without performance' culture that has taken root so firmly.

- The global nature of our economy precludes consideration of executive compensation issues in individual markets, like the UK or Australia, without taking into consideration how those markets are influenced by practices in the US. Proponents believe that significant positive change in other markets is unlikely to occur until executive compensation issues are addressed in the US.

2. Does Say on Pay transfer power to shareholders or empower directors?

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

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

3. Can shareholders move toward company-specific analyses?

Opponents of Say on Pay see it as likely to result in a 'tick the box' response from shareholders that fails to

recognise unique needs of individual companies. They are also concerned that proxy voting advisers will not put the necessary resources into evaluating executive compensation in a company-by-company context.

These concerns highlight the systemic nature of executive compensation problems. Just as more effort should be expected from directors, shareholders will need to devote greater resources to building or acquiring expertise on executive compensation issues. Without additional resources it is unlikely that investors will be able to meet the increased workload of consultations and more in-depth analyses that will arise if and when 'Say on Pay' is introduced. One potential solution is for a group of investors to appoint a specialist remuneration consultant to work on their behalf. The specialist would be able to assist with company and sector analyses to ensure incentives are appropriate for individual companies and are linked to strategic objectives and value drivers.

4. Is the US so different that shareholders and boards need not speak?

The US has had less experience than many other markets with direct communication between shareholders and directors. Directors have been isolated from the owners of their companies and this has fostered a lack of mutual respect and understanding, and that carries enormous risks for both sides. Adoption of the majority vote standard has put the wheels of change in motion.

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

Opponents of Say on Pay see roadblocks to better shareholder-director communication in the US. Although improved communication has been one of the results of Say on Pay in other markets, there has been a perception that it just cannot be done here. However, some US companies have already developed mechanisms to facilitate communication with shareholders. For example, Pfizer's board met with its largest shareholders. Other companies have held conference calls with shareholders or organised shareholder advisory groups. (*Talking Governance: Board-Shareholder Communications on*

Shareholder Say on Pay continued

Executive Compensation, Stephen Davis and Stephen Alogna, Policy Briefing No. 2, Millstein Center for Corporate Governance and Performance, Yale School of Management) Some treat the proxy as an important communication tool rather than merely using it as a legal compliance document.

Concerns about Regulation Fair Disclosure as a roadblock to shareholder-director communications have proven to be unnecessary. Many boards have resolved previous concerns about Reg FD by working with independent legal counsel to establish appropriate ground rules for shareholder-director communication. For example, director adoption of a 'listen only' mode during meetings or development of a process to promptly supplement public disclosures when needed are easy solutions to legal concerns. As Stephen Davis and Stephen Alogna say in their paper mentioned above 'There is no insurmountable legal obstacle to boards and shareholders engaging in constructive dialogue on governance matters, including executive pay policies.'

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

5. Are proxy voting results reliable or should we ignore them?

Recently, opponents of Say on Pay have cited a survey done for the Center on Executive Compensation of 20 of the largest investors that found only 25 per cent of large institutional investors support Say on Pay (*Executive Compensation from the Perspective of the Largest Institutional Investors*, Kevin Hallock). Proponents of Say on Pay found the survey to be disingenuous. It was narrowly targeted to primarily poll institutional investors that have recognised conflicts of interests associated with the marketing of their services to corporate executives. Few people were surprised to learn that large institutional investors with conflicts of interest were more reticent to support Say on Pay than shareholders generally.

Had the largest 20 institutional investors without commercial conflicts of interest been surveyed, we suspect the level of support for Say on Pay would have been much higher. We already know that 42 – 43 per cent of shareholders support Say on Pay from voting results on resolutions over the last two years. From the CFA Institute survey, we also know that 76 per cent of investment industry professionals support Say on Pay. What the largest and most conflicted few institutional investors might think about Say on Pay tells us more about how conflicts influence their judgment than it says about shareholder support for the concept.

The fact is that nearly half of voting shareholders have consistently supported Say on Pay. Given market events of the past few months, we expect the level of support to grow.

6. Will shareholders destroy value or force boards to preserve it?

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

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

7. Do shareholders need a rifle when they already have a cannon?

Opponents of Say on Pay argue that shareholders can already vote against directors to protest executive compensation practices. For proponents, this fails to recognise that companies have widely adopted the majority vote standard for director elections. Protest votes

against candidates could result in capable directors failing to be elected. Many shareholders would prefer to send a message before acting to remove a director who adds value to the board. An advisory vote allows shareholders to target the issue instead of the individual.

8. Could boards understand shareholders if directors listened to them?

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

9. Will Say on Pay result in loss of good CEOs or better succession planning?

One of the most dreaded outcomes of Say on Pay is loss of executive talent to private companies or to public companies with more reasonable shareholders. However, let's review some basic facts:

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

Given that 25 per cent of companies in the S&P 500 report having no emergency succession plan for the CEO and half allow the current CEO to lead the CEO succession planning

process, it is no wonder that boards are afraid of losing CEOs. One of the side benefits of Say on Pay would be greater board attention to succession planning.

10. What do we fear most: Excessive compensation or pay without performance?

What should be the main focus of Say on Pay? Is excessive compensation the villain, or should boards and shareholders focus on pay for performance, without concern for the absolute size of compensation awards?

Excessive compensation has been found to be associated with increased exposure to risk of corporate fraud and what has been called 'CEO centrality risk'. (*Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter*, Shane A Johnson, Harley E Ryan and Yisong S Tian – available at <http://ssrn.com/abstract=395960>.) When the payoff is large enough, CEOs are willing to run higher risks than they would for a more modest reward. Accordingly, some Say on Pay proponents view reduction of CEO compensation levels as the more important goal. They fear the impact that growing income disparity and risks associated with the 'imperial CEO' will have on investment returns, the markets and society.

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

CEO Centrality by Bebchuck, Cremers and Peyer (John M Olin Center for Law, Economics and Business Discussion Paper No. 601), provides a discussion of the risks associated with overpaying the CEO. Among other things, they found greater pay differentials between CEOs and other members of senior management to be associated with lower company accounting profitability and increased likelihood of rewarding CEOs for luck from the effects of positive industry-wide shocks. In addition, aggregate compensation paid to company executives (rather than accruing to the benefit of shareholders) increased from five per cent of company earnings in 1993 to about ten per cent in 2003.

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

A previous version of this article was prepared for the Shareholder Forum Programme on Reconsidering 'Say on Pay' Proposals, which was held on 14 October 2008 at the Columbia School of Journalism. See <http://www.shareholderforum.com/sop/index.htm>.

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