SAY ON PAY VERSUS MANDATORY VOTES ON PAY

WHY EXISTING SHAREHOLDER ENGAGEMENT MECHANISMS ARE MORE EFFECTIVE THAN A MANDATORY SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION

March 15, 2008

c08-16

Center On Executive Compensation

1100 THIRTEENTH STREET | SUITE 850
WASHINGTON DC 20005
202.408.8181 | FAX 202.789.0064 | WWW.EXECCOMP.ORG

Table of Contents

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

Introduction

Over the past two years, shareholder activists, union pension funds and certain institutional investors in the U.S. have sought an annual shareholder vote on executive compensation as a means to limit senior executive pay. The vote would be nonbinding, taking the form of a shareholder resolution proposed annually by management on the company's executive compensation disclosures. This initiative, dubbed "Say on Pay," is proceeding on two separate, but parallel, tracks.

- Proponents have sought enactment of the "Shareholder Vote on Executive Compensation Act," H.R. 1257/S. 1181, sponsored by Congressman Barney Frank (D-MA) and Senator Barack Obama (D-IL), that would mandate an annual vote on executive compensation and a separate vote on any golden parachute payment as part of a merger or change in control. The bill passed the House 269-134 in 2007, but has not yet been considered in the Senate.
- Proponents filed over 60 shareholder resolutions asking companies to adopt a shareholder vote in 2007. Over 40 of the resolutions went to a vote, receiving shareholder support averaging slightly more than 40 percent. In 2008, proponents have announced that they will file similar resolutions with over 90 companies.

The Center on Executive Compensation supports the ability of shareholders to have a say on pay through the many tools they already have at their disposal, including shareholder resolutions. However, the Center strongly disagrees with requiring, by legislative fiat, a mandatory annual vote on executive compensation for each publicly traded company, regardless of the company's pay practices. Contrary to proponents' claims, a mandated annual vote would:

- <u>Eliminate the ability of companies and shareholders to negotiate mutually agreeable solutions to the annual pay resolution</u>. Even though shareholders often withdraw their resolutions after an alternative agreement is reached with the company, the legislation does not allow for such a result. Roughly one-third of all resolutions seeking an annual shareholder vote on pay were withdrawn in 2007, as were nearly one-third of *all* resolutions offered by shareholders, causing the leading proponent of say on pay and the largest proxy advisory firm to describe 2007 as "the year of [company] engagement."
- <u>Enhance the clout of the proxy advisory services.</u> Proxy advisory services conduct research and often vote the proxies on the shareholders' behalf. Because many institutional investors will not have the time to evaluate the executive compensation policies of over 12,000 publicly held companies, they will defer to the services' recommendations. Even though advocates say the purpose of the vote is to increase the company's dialogue with shareholders, in reality it will increase the dialogue between the company and the proxy services whose views may or may not be aligned with the views of the company's shareholders.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

- Create the potential for institutional investors to abdicate their fiduciary duties to vote on shareholder vote proposals. On the flip side, the increase in proxy votes on executive compensation is likely to cause institutional investors to rely heavily or exclusively on the analyses provided by proxy advisory services. This will create many questions as to whether institutional investors would be discharging their fiduciary duty to carefully review the votes on pay for those whose money they oversee.
- Likely result in less company specific pay. The experience in the UK has not conclusively shown that pay will decrease under a mandatory shareholder vote. Instead, a mandated vote is likely to cause companies to seek to adopt pay models favored by the activist institutional investors, regardless of whether those models support company strategy.

The following paper explains the available means of communication with companies and directors on executive compensation and the negative consequences that are likely to flow from a legislated shareholder vote on executive compensation.

- **Part I** explores existing and very effective mechanisms shareholders have for communicating with companies;
- **Part II** explains how these mechanisms have helped bring about substantial changes in corporate governance and executive compensation;
- **Part III** describes why the current balance in corporate governance between the board and shareholders serves all stakeholders well;
- **Part IV** describes the negative effects of mandating a shareholder vote for all companies and explains that the experience of such a vote in the United Kingdom has not been as successful as commonly thought; and
- **Part V** summarizes the compensation principles the Center believes that boards should consider imbedding into their compensation programs and processes and that shareholders should consider in evaluating compensation.

The paper concludes that the costs of a mandatory vote on executive compensation for all publicly held companies far outweigh the potential benefits and that increased disclosure, improved corporate governance practices, and existing mechanisms of communication will better serve the best interests of shareholders and all interested stakeholders.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

I. Shareholders Have and Regularly Use Existing Say on Pay Mechanisms to Express Their Views on Executive Pay

The proponents of a legislated shareholder vote argue that the vote is needed to establish an ongoing mechanism for providing feedback on executive compensation to directors and companies. This argument ignores the existing and highly effective means shareholders currently use to communicate their views.

These mechanisms range from transmitting letters to corporate secretaries or investor relations executives to speaking at annual meetings and filing shareholder resolutions. By all accounts, the use of these mechanisms has increased dramatically in recent years. Unlike a shareholder vote which is a referendum on executive pay generally, these approaches allow shareholders to have a say on pay by targeting the specific aspects of compensation that cause them concern. In addition, over the past year, companies have increased their outreach to shareholders and provided greater mechanisms for feedback. This responsiveness led proxy governance service RiskMetrics/ISS Governance Services to dub 2007 "the year of engagement."

These channels of communication have been made even more effective as a result of the SEC's new executive compensation disclosure rules that give shareholders more information on a number of aspects of executive compensation that have not previously been disclosed. The disclosures being made under these rules give shareholders a much better understanding of the rationale for a company's compensation programs and how they fit with overall business strategy.

A. Existing Means of Directly Expressing Shareholder Views to Directors Are More Effective Than a Shareholder Vote

Shareholders have several existing means of communicating their views on pay to directors that allow shareholders to identify with precision the nature of their concern with executive compensation. Companies listed on the New York Stock Exchange are required to give shareholders a mechanism of communicating with non-management directors,[1] and such approaches have become standard practice for most large companies. There are varying degrees of other actions shareholders can take, and they all are effective in providing a say on pay regarding their concerns and encouraging company action. These include letters to the Corporate Secretary, asking questions at the annual meeting, and submitting shareholder proposals.

Letters to the Corporate Secretary or the Investor Relations Executive

Shareholders can raise questions and concerns through official communications with the company by submitting a letter to the Corporate Secretary or Investor Relations executive. These inquiries are routed to the appropriate officials on the board or in the company for timely reply. Such letters can and do result in a dialogue or meetings where the issue cannot be resolved through correspondence. Many large companies provide for investor input on their websites to expedite the process, as well as channels for communication with independent directors. In addition, recently proposed SEC changes

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

providing for electronic shareholder communications forums, such as company-sponsored investor websites, will likely increase the use of such official channels.[2]

Questions at the Annual Shareholders Meeting

The prevailing practice is for companies to provide an opportunity for shareholders to ask questions regarding the company's operations at the annual meeting. Shareholders frequently ask the board questions about executive compensation, and the resulting exchange is often reported in the business and popular press. Boards and management pay close attention to issues shareholders raise during the public question portion of such meetings. If at all possible, shareholder questions are answered ahead of time in order to ensure that the company is appropriately responsive to shareholders.

Shareholder Proposals

Shareholders already have the ability to file nonbinding shareholder proposals on the rigor of specific aspects of executive compensation, and they are using this avenue frequently and with success. In the 2008 proxy season, shareholders have addressed a wide variety of pay issues through resolutions including equity compensation, performance-based pay, severance plans and policies, and limitations on change-in-control payments. Companies take these submissions very seriously and typically discuss the proposal with the proponent at length before it is included in proxy statements. As discussed below, companies are increasing their discussions with shareholders, and in many cases, shareholders withdraw proposals after a mutually agreeable settlement is reached with the company.

In sum, existing approaches enable shareholders to address specific concerns about pay in a flexible manner, instead of passing vague judgment on the entire executive compensation program, as a mandatory shareholder vote on pay would do. In conjunction with more open company communications, these approaches are extremely effective at conveying shareholders' concerns and engaging companies on those matters.

B. Companies Are Expanding Their Communications With Shareholders

In addition to the means of communication already in place summarized above, companies continue to expand their communications with shareholders. Some are creating special shareholder websites, others are holding regular shareholder forums and still others are creating ongoing mechanisms of feedback with the company, the board of directors, or the compensation committee.[3] Others are simply engaging more frequently and in greater depth with shareholders through the means described above.

Nowhere is this expanded communication more evident than in the data from the 2007 proxy season, in which 309 shareholder proposals out of 1,145 were withdrawn after negotiations between the shareholders and the company.[4] This compares with just 189 shareholder proposals withdrawn out of 947 offered in 2006.[5] According to ISS Governance Services, in 2007, shareholders withdrew over 20 percent of all pay for performance resolutions, over 50 percent of majority voting proposals, and roughly one third of proposals requesting a nonbinding shareholder vote.[6]

The willingness of companies to discuss the issues raised by shareholders in their proposals led Richard Ferlauto, Director of Corporate Governance and Pension

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

Investment at AFSCME, the leading proponent of a mandated vote on pay, to declare at the end of 2007: "There's been an unprecedented level of engagement between companies and shareholders [this year]. Engagement is now part of the landscape."[7] It also led ISS to declare 2007 "the Year of Engagement."[8]

If shareholders did not have effective means of communicating their views on pay with boards, it is highly unlikely that the 2007 proxy season would have received such glowing reviews from those typically so critical of pay. Moreover, the flexibility inherent in the shareholder proposal approach allows for negotiation and creative solutions to investors' concerns. By contrast, under mandatory shareholder vote legislation, the company would be required to propose a resolution annually for a shareholder vote, and the resolution could not be withdrawn even if all the issues that gave rise to the resolution were resolved prior to the vote. The current system, in contrast, allows for flexible, creative responses to shareholder concerns, and companies are expanding their communications with shareholders as a result.

C. Expanded Compensation Disclosure Will Enhance Shareholders' Use of Existing Communication Channels

The SEC's recent comprehensive changes to its executive compensation disclosure requirements will enhance shareholders' understanding of executive compensation programs and facilitate their ability to take full advantage of the existing means of engagement. The changes will provide more information and clearer explanations of how companies pay their top executives and the general rationale behind the board's compensation decisions. This will give shareholders more information to determine how closely pay is linked with results. The Center supports full, fair and understandable disclosure and believes that the SEC's rules are an important step to improving shareholder comprehension of pay practices.

CD&A Gives More and Useful Information

One of the SEC's most important changes involved replacing the Compensation Committee Report with a Compensation Discussion and Analysis ("CD&A") that sets forth the "how" and "why" of the company's pay program. The CD&A covers the company's pay philosophy, general descriptions of how incentive programs work and how compensation is linked to business strategy.[9] Unlike the compensation committee report, its predecessor document, the CD&A must be signed by the CEO and the CFO, and is considered "filed" with the SEC.[10] Failure to disclose material terms of the compensation program can lead to SEC enforcement and even personal liability.

The new rules also provide a total compensation number to give shareholders an idea of the potential future value of the executives' total compensation, including salary, annual bonus, long-term incentives, additional pension amounts, and perquisites. The rules require companies to provide retirement plan tables that show the annual increase in the executives' benefits under the plans, the executives' contributions where applicable, as well as the expected annual payments at retirement. The rules also require companies to report total severance, change-in-control, and other separation commitments, thus giving shareholders a much better sense of the total compensation picture.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

Existing Mechanisms Cited in Rejecting a Shareholder Vote in Canada

Although some shareholder activists and institutional investors claim that improved disclosure and existing communication mechanisms are not sufficient, it has been cited as a primary reason for not seeking mandated votes on executive compensation by institutional investors in other countries. For example, the Canadian Coalition for Good Corporate Governance, the group representing Canada's major institutional investors, declined to seek a mandated shareholder vote in 2008 or provide universal support for shareholder proposals on the subject. In its policy position announcing its decision, the Coalition stated:

> The CCGG is prepared to devote its resources to constructive engagement with boards and Compensation Committees of Canadian issuers to explain the shareholder perspective on compensation practices and disclosure.[11]

The coalition likewise indicated that its members should monitor the companies they invest in and "be prepared to intervene where necessary."[12] Incidentally, the Coalition's decision was made in anticipation of new executive compensation disclosure rules that have since been proposed by the government.[13]

In sum, the SEC's disclosure rules give shareholders an unprecedented amount of information to evaluate company pay programs and whether pay and performance are linked. Based on that information, shareholders can and do utilize the communications tools discussed above to seek clarification or changes in a specific practice or practices. A general vote on the overall executive compensation program and the company's disclosures is much less specific and thus ineffective.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

II. Shareholder Say on Pay Mechanisms Are Working

A key test for whether a mandated shareholder vote is necessary is whether the existing means of shareholder communication are working. Without question, the existing means are. Changes that boards have implemented in recent years have made directors more accountable for their decisions on executive compensation and aligned pay more closely with company results. The changes include—

- strengthening of corporate governance standards and approaches;
- greater use of independent outside advisors;
- increased scrutiny over pay packages; and
- boards holding CEOs more accountable for company performance.

In light of these changes, boards are more vigilant about adopting best compensation and governance practices while fulfilling their responsibility for managing the company in the interest of all shareholders.

A. Boards Have Become More Independent and Responsive

The substantial strengthening of corporate governance practices over the past five years is clear evidence that shareholder communication is working. In part due to stock exchange listing requirements and in part due to best practices, boards have increased the number of independent directors such that 85 percent of large company boards are now composed of directors over 80 percent of whom are independent.[14] This trend toward predominantly independent boards is increasing, and it is now common to find the CEO as the only member of management on many boards.

Changes to the rules for companies listed on the New York Stock Exchange now require that compensation committees be comprised exclusively of independent directors, and the practice has become standard for most companies.[15] Overall, compensation committees have adopted a more rigorous approach to evaluating and approving executive pay practices, including the development of a charter as well as more frequent and longer committee meetings. These changes help ensure that the committees fully and carefully evaluate executive pay packages.

Further, the vast majority of compensation committees today retain their own independent advisors to assist them in their analysis of executive pay matters. This analysis includes careful benchmarking of peer group pay levels and practices which now must be disclosed in the proxy. Many compensation committees are now using “tally sheets” to ensure they have a full understanding of the executive’s total compensation package before it is finalized.

The independence of the board and compensation committee is underscored by the increase in the use of “executive sessions,” deliberations in which all members of management, including those who are also directors, such as the CEO, are excused from the room. This is a further indication of the independence of compensation committees in their deliberations on pay.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

More companies have also adopted majority voting requirements for election of directors to the board, in which directors must be elected by a majority of votes cast. This contrasts with the system of plurality voting in which, in uncontested elections, a director could theoretically be elected with just one vote. The Business Roundtable reports that 82 percent of its members now have majority voting rules,[16] and the trend is spreading quickly, especially among large companies. This strengthens the role of the shareholders in the most important decision they make, namely selecting the directors that represent them.

B. Governance Changes Have Led to Greater CEO Accountability and More Performance-Based Pay

The procedural and independence changes that boards have implemented have led to greater scrutiny of CEO performance. Where performance lags, boards are much quicker to seek a replacement. In the past decade, the average tenure of CEOs has fallen from 8 years to 4.5 years.[17] In addition, annual turnover of CEOs globally has increased 59 percent.[18] Over the same period, the number of CEOs dismissed by boards has increased four-fold. A 2007 Booz Allen report noted that Boards are "now removing chief executives more frequently because of concerns over poor current performance or if they expect future underperformance."[19] This not only reflects changes in good governance, but expectations of performance from the largest shareholders as well.

Meanwhile, there is strong evidence that executive compensation is more closely linked with results. A recent Watson Wyatt report shows that overall there is a strong relationship between realizable total direct compensation and company performance.[20] The report states that CEOs of companies with high total shareholder return earned a median increase of 13.1 percent in total direct compensation, while those with low total shareholder return experienced a 3.4 percent *decrease*.[21] Research from Professors Steven Kaplan and Josh Rauh of the University of Chicago Graduate School of Business is consistent with this finding. Specifically, they found:

> Firms with CEOs in the top decile of actual pay earned stock returns that were 90% greater than those of other firms in their industries over the previous 5 years. Firms with CEOs in the bottom decile of actual pay underperformed their industries by almost 40% in the previous 5 years. The results are qualitatively similar if we look at performance over the previous three years or previous year. There can be absolutely no doubt that the typical CEO in the U.S. is paid for performance.[22]

In addition, a greater share of compensation is concentrated in performance-based equity vehicles rather than pure stock options. Performance-based vehicles vest based on achievement of performance goals measured over a period of time, and many pay out in stock, which is likewise aligned with shareholders' interests. According to one recent survey, the value of the CEO pay package comprised of stock options has dropped from 76 percent in 2002 to 53 percent in 2007.[23] Meanwhile, the value of performance awards in the CEO package has increased from 8 percent in 2002 to 28 percent in 2007.[24] In addition, the share of Fortune 250 companies with stock ownership policies, which help align the interests of executives and shareholders, increased from 73.9 percent to 80.1

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

percent.[25] While no single method of equity compensation will fit every company, the increase in variety of different types of long-term incentive vehicles used by different companies demonstrates the move toward company-specific and performance-based pay.

In sum, the existing mechanisms have been successful in creating changes in governance and compensation. However, like all governance changes, the independence of boards and their compensation committees takes time to become fully effective, as does the greater focus on performance-based compensation. The Center On Executive Compensation believes that the changes being made by publicly traded companies to further reduce non-performance-oriented pay practices must be given time to work through the system.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

III. The Division of Duties Between Boards of Directors and Shareholders Should Be Maintained for the Benefit of the Shareholders

Mandating a shareholder vote on executive compensation would make substantial undesirable changes to our system of corporate governance, and for that reason, the current balance of duties between shareholders and directors should be maintained. Even though a mandatory shareholder vote would be nonbinding, the effects would undermine the authority of the board because it would be obliged to act in response to a majority vote against a resolution. Further, mandating a vote on pay would trivialize the careful development of compensation packages, which requires the exercise of substantial board judgment on a number of elements, including confidential details of corporate strategy, compensation levels, succession planning, and evaluation of the strengths and weaknesses of individual executives. In contrast, shareholders have different perspectives on issues such as executive compensation and, unlike boards, they do not have fiduciary responsibilities to the other shareholders. For these reasons, a mandated shareholder vote should be rejected, the board should retain responsibility for setting strategy and closely related issues such as setting executive compensation, and shareholders should retain the ultimate authority over directors.

A. Boards of Directors and Shareholders Have Different Roles and Responsibilities Under Our Corporate Governance System

A hallmark of the U.S. system of corporate governance is that boards manage companies on behalf of the shareholders. In turn, the shareholders are responsible for electing directors and for approving major corporate changes and certain programs or transactions that typically directly affect shareholders. In a corporation, boards act on behalf of shareholders, and they address the many complexities of running a large enterprise, including confidential information that cannot be divulged to shareholders. Executive compensation, which is a natural extension of the company's strategy, is one of those complex issues. Overall, this system has worked very well, as evidenced by the long-term growth and returns it has created for shareholders, and it should be maintained in its current form.

The philosophy behind a mandated annual shareholder vote is that shareholders should approve the compensation for the corporation's leaders. While that may sound attractive on its face, the prospect of turning the corporation into an entity run by shareholder referendum is fraught with negative unintended consequences.

B. Shareholders Have Varied Interests

The primary argument against a shareholder referendum is that while shareholders have an interest in maximizing the value of the corporation, it is clear that different shareholders have different perspectives on what that value is. Some shareholders have a short time horizon while others may be long-term investors. Some shareholders seek out risk in hope of large return, while others may be risk-averse. Some may seek to promote social change through internal or external policies adopted by the corporation. Others may seek a combination of these or other objectives. It is these diverse interests that

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

make the concept of corporate democracy as envisioned by the proponents of mandated shareholder vote largely unworkable.

Recent research has given us a glimpse as to how certain shareholders – many of which are proponents of the say on pay legislation – use proxy voting to further their social and individual objectives. A 2007 study by Ashwini Agrawal of the University of Chicago Graduate School of Business found that labor union pension funds voted against the company's directors more frequently when their union or union federation was engaged in a labor dispute or union organization drive with a company. After the dispute or the federation affiliation ended, the funds went back to supporting the company's directors.[26] Aside from casting doubt on whether these funds were properly discharging their fiduciary duty to their participants, it also demonstrates how proxy issues are used to send a message or obtain leverage on other issues.

An annual vote on executive compensation could easily misused to promote social, political, and other agendas of parochial interest. Moreover, shareholders do not have the same responsibilities or obligations the board has, and thus it does not follow that they should have identical management rights as the board, which is what a mandated shareholder vote would provide.

C. The Board Acts in the Interests of All Shareholders

In contrast to shareholders who act in their self-interest, boards under our corporate governance system have a fiduciary duty to manage the company on behalf of all shareholders. Directors can be held responsible for bad faith or exercising poor judgment, and in some cases these actions can result in personal liability. Thus, board decisions are based on an independent assessment of the interests and well-being of the company as a whole that is already attuned to the needs of various stakeholders. The role of balancing competing shareholder interests and sustaining corporate success properly rests with the board as it sets corporate strategy.

Hiring, incenting and retaining CEOs and other senior executives is a key element of the board's duty to set corporate strategy. The skills and approach of these essential managers must match the specific culture and strategy of the company. The determination of proper pay levels and the structure of the executives' pay programs are integral to aligning their interests with the company's strategy. The board engages in rigorous performance evaluation, succession planning and shifts in executive responsibilities to retain the best performers who match the company's needs. Shareholders are not equipped to carry out these tasks, and the information required to discharge them often must remain confidential to preserve the company's competitive advantage in the marketplace. Divulging the information would reduce the company's returns, and thus returns to the shareholders. Yet, under any version of the shareholder vote, shareholders are required to vote on the adequacy of the compensation program even though they do not and cannot have the complete picture on which the board made its decision.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

In addition, the impact of a mandatory shareholder vote would change the dynamics between boards and shareholders from a dialogue to a negotiation on pay in advance of the vote. This would divert the attention of the compensation committee and senior management from running the business to meet with advocacy groups and their lobbyists to secure a favorable vote. This is hardly a productive use of the board's and management's time which should be focused on running the business and enhancing shareholder value. Having shareholders provide their views through existing and developing mechanisms is a much more effective and efficient approach that benefits the company and all shareholders.

D. Shareholders Have Ultimate Authority Over Directors

Shareholders will continue to play an essential role in the corporate governance process, without a mandated vote on pay. Shareholders retain the ultimate authority to elect directors and vote on significant corporate transactions and other issues such as stock programs that have a direct impact on their ownership stake. Even though many shareholders state they prefer not to campaign against directors, the advent of majority voting has given them significant leverage, and in 2007, there were still "vote no" campaigns against directors at 18 S&P 500 companies.[27] Thus, if shareholders believe that the directors are not managing the company in their best interests, they can vote out existing directors.

In sum, shareholders and boards each have important roles under our system of corporate governance. A mandated shareholder vote would insert shareholders into confidential areas of board decision making closely aligned with corporate strategy. It would divert the time and resources of corporate leadership to annual lobbying over pay issues. Unlike our political system which constantly pits competing views against one another, our system of corporate governance is designed so that boards operate consensually to resolve differences and maximize value for all shareholders. Shareholders retain the ultimate authority over directors by being able to vote them out of office. A mandated shareholder vote on pay should be rejected so that this effective and balanced system of corporate governance can continue to produce benefits for all stakeholders.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

IV. With Effective Shareholder Say on Pay Mechanisms In Place and Working, Mandatory Shareholder Vote Legislation Is Not Necessary and, If Adopted, Would Have Negative, Unintended Consequences

When examined closely, a mandated shareholder vote would have significant negative consequences for shareholders. These include making executive compensation packages less company specific and more formulaic, increasing the power of proxy advisory services, and creating the potential to allow institutional investors to abdicate their fiduciary duties. In addition, although proponents claim that a mandated shareholder vote would work in the United States exactly as it has in the UK, the U.S. and UK systems of corporate governance are considerably different. And even if they were extremely similar, the UK's experience with the shareholder vote is hardly the magic fix that the proponents claim, as it has failed to reduce pay.

A. Mandated Shareholder Votes Would Have Profound Negative Effects on Pay to the Detriment of Shareholders

Compensation that is aligned with performance by definition is specific to the company in question. Even though certain industries and types of companies may pay similarly, each has slightly different products and markets, as well as different strengths and weaknesses and different leadership. By tailoring short and long-term incentives to business strategy, boards more directly align executives' interests with those of the company and its shareholders.

A mandated shareholder vote would undermine this approach. Even though it is nonbinding, a majority vote against a compensation package would force boards to respond by changing the executive compensation program. Compensation committees use their judgment and the advice of the committee's independent advisor(s) to structure a compensation program that best fits the company's strategy, competitive environment and internal culture. Thus, changes to the program would result in a compensation program that is less than optimally based on the committee's judgment and would undermine the board's authority.

Even in the absence of a negative vote, a mandatory annual vote is likely to cause compensation committees to be focused on ensuring that the company will receive a majority vote in favor of the annual pay resolution and tailor their pay programs to achieve this goal. The experience in the UK has not conclusively shown that compensation committees will continue to adopt carefully tailored programs specific to their own situations in order to motivate specific behaviors leading to achievement of specific corporate objectives. Instead, there is evidence that some may seek to implement what shareholders have ratified at other companies. Adoption of "cookie cutter" pay packages is neither in the company's nor the shareholders' best interests.

Further, the sheer volume of annual shareholder votes – one at each publicly held company annually – would put significantly more power in the hands of the proxy advisory services.[28] These businesses evaluate proxy proposals, issue recommendations and even vote the proxies of institutional investors. The reality is that pay matters are complex, and most institutional investors do not have the resources to conduct a detailed

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

analysis of thousands of company pay packages annually. As a result, the vote on pay movement will concentrate power and decision making in the hands of the advisory services. Companies can be expected to conform their pay packages to the recommendations made by the services because, in many cases, the institutional investors will have neither the time nor the resources to conduct their own analysis. In other words, even though advocates say the purpose of the vote is to increase the company's dialogue with shareholders, in reality it will increase the dialogue between the company and the proxy services whose views may or may not be aligned with the views of the company's shareholders.

There is an indication that the proxy advisory services view mandating votes on pay this as a significant business opportunity for them. For example, in the wake of the policy adopted by the largest institutional investors in Canada rejecting support for mandatory vote resolutions in 2007, the Canadian arm of ISS Governance services put out a report urging shareholders to support shareholder vote proposals in 2008 anyway. Although the report gives lip service to the concerns echoed by the largest investors – that shareholders need to wait until disclosure rules are changed – ISS indicated that by supporting the resolutions this year, shareholders will have a chance to vote on them next year.[29] Of course, in that case, institutional investors would likely rely on the recommendations of services such as ISS, which often supports such votes.

A related issue is how a shareholder vote would affect institutional investors' fiduciary duty to vote their shares to maximize the value of their investments. Because the shareholder vote on executive compensation is on the entire pay package, it is difficult to tell what impact a vote for or against the pay package will have on the investment.

Behind the scenes, some institutional investors have expressed concern about this conundrum. While the vote itself is nonbinding, directors would be obliged to make some adjustment in the event of a majority vote against a pay package. However, the true impact of a vote on institutional investors' holdings will often not be clear. Conceivably, a vote in favor of a pay package could be considered improper if the pay was not aligned with performance. Likewise, a vote against a pay package that was properly aligned could be viewed as causing the company to spend unnecessary resources to revamp their pay programs. Given that institutional investor proxy votes are now disclosed, and activists routinely analyze how institutional investors voted, this could result in greater scrutiny on these votes and consequences for the management of the fund.

B. Comparisons With the UK Are Misplaced

Proponents of a mandated annual shareholder vote trumpet the fact that the UK has had such a vote since 2003 and that it has benefitted shareholders tremendously. However, what often is not discussed are the vast differences in corporate governance structures between the U.S. and the UK, as well as the overall lack of success the shareholder vote has had in constraining pay.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

The structure of corporate governance is substantially different in the UK than in the U.S. There are no mandatory standards for independent directors for UK companies. In fact they have a much larger percentage of in-company directors, 38 percent, compared to less than 20 percent for large American firms.[30] Members of management who are company directors can participate on compensation committees in the UK,[31] but management is prohibited from participating on such committees in the U.S. by stock exchange rules. In the UK, court action against the board may be barred after a board decision is put to a shareholder vote. Also, legal action is much more constrained in the UK since the loser must pay the winner's litigation expenses. In the U.S., litigation is not foreclosed just because there is a shareholder vote on an issue, and in the U.S. the parties bear their own costs.

In addition, roughly 30 percent of the shares in UK corporations are held by just two large shareholders, the Association of British Insurers and the National Association of Pension Funds. If these two investors "approve" of the company's pay program, most other investors follow. There is no such concentration of share ownership in the U.S.. Hence, it might be appropriate in the UK for corporations to meet with such large shareholders to develop consensus on executive pay. However, it would be prohibitive to extend this system to the much larger number of shareholders in the U.S.[32]

Studies of the UK experience with a mandatory shareholder vote have indicated that it has increased communication between British companies and the two large shareholders.[33] Since the U.S. does not have a similar corporate governance system, this "success" does not really translate. However, the mandated shareholder vote in the UK has not slowed the increase in executive pay, which is the implied objective for U.S. legislation. This may well have to do with the competition for executive talent in the global market, the merging of executive pay practices globally, and increased stock returns since the recovery from the 2000-2002 recession. Incidentally, these factors drive executive pay in the U.S. market as well.

Moreover, even the proponents note that the volume of pay votes has made it difficult to keep up with the analysis required to take a reasoned position on pay. As noted by one paper on the UK system funded by proponents of a mandated U.S. vote:

> Funds have experienced mixed success in facing challenges posed by the introduction of advisory votes. Some funds responded by relying almost entirely on outsourced agents, the proxy advisory services, to conduct such analysis and consultation.[34]

In addition, the report notes that the reliance on proxy advisory services has increased markedly and not to the benefit of shareholders:

> Investment funds in Britain expect proxy service providers to vet remuneration plans with companies and to engage in dialogue with boards in search of improvements before plans are finalized. Other funds use service providers merely for guidance in voting. Either way, market concerns center on two questions: First, whether too many investors

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

> follow service provider voting advice automatically and, second, whether such providers apply a "one-size-fits-all" framework instead of evaluating compensation plans according to a company's specific circumstances.[35]

Given the size of the U.S. investment market relative to the UK, these concerns would be amplified many times over. Taken to its logical conclusion, it is possible that the proxy advisory services would effective control the vote over executive compensation plans.

In sum, the negative effects on U.S. pay packages, combined with the substantial differences between the U.S. and UK systems, weigh against the adoption of a mandated shareholder vote on pay in the U.S.. These effects deserve careful consideration before legislation is adopted.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

V. What Boards Should Strive For in Developing Executive Compensation Programs

The Center On Executive Compensation believes that the negative consequences of a mandated shareholder vote on executive compensation far outweigh the benefits. The Center also believes that the existing mechanisms shareholders have to communicate with directors are more effective than a vote and, based on the results of the 2007 proxy season, lead to more mutually satisfactory results for shareholders and companies.

Below, the Center details the principles that it believes compensation committees should consider when constructing their compensation programs and that shareholders should look for in annual compensation disclosures. These principles are generally consistent with those of several large institutional investors, such as TIAA-CREF.

- **Companies' Executive Compensation Programs Should Be Aligned With the Best Interests of the Company's Shareholders and Other Stakeholders**

At bottom, the push for a shareholder vote is to ensure that pay is appropriately linked to results and a significant share of total compensation is at risk. Alignment means that the pay program supports the business strategy by recruiting, retaining and developing the necessary leadership talent and aligning executives and shareholders' interests.

- **Companies' Executive Compensation Programs Should Be Fully Compliant With Applicable Laws and Regulations**

A fundamental difference between companies with the best compensation practices and those that are more at risk of generating adverse media, shareholder and regulatory attention is the adoption of a compliance orientation throughout the organization. Shareholders should review whether the company has a culture of compliance and whether it takes quick and decisive steps to address lapses when they occur.

- **Companies' Executive Compensation Programs Should Be Independently Informed and Approved**

Executive compensation programs should be reviewed by the board's independent compensation committee, and the committee should apply sound corporate governance practices in the pay development process. When compensation committees use outside advisors, they should retain independent advisors to assist it in structuring pay programs. The committee should undergo regular self-evaluation, and also consider having periodic outside reviews of the company's compensation program conducted by an external advisor not currently affiliated with the company or the compensation committee. These steps help keep the committee from becoming too inwardly focused on the company's own programs and that the compensation committee considers new ideas for maximizing shareholder value.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

- **Companies' Executive Compensation Programs Should be Appropriately Customized to their Respective Cultures, Values, Industries and Strategies**

Pay programs that are carefully tailored to the company link pay with performance more effectively. In their review of pay programs, compensation committees should determine whether the company's incentive programs are customized and that compensation levels appear appropriate relative to competitors, in light of the company's objectives.

- **Companies' Executive Compensation Programs Should Be Transparent and Accessible**

The Center believes that companies should disclose and explain their executive compensation arrangements in a clear, concise and understandable manner that facilitates a full understanding of the rationale for and levels of all aspects of executive compensation. In addition, the company should make its shareholder communications processes clear and accessible to shareholders.

- **Companies' Executive Compensation Programs Should Be Fair and Reasonable to the Company's Shareholders and Executives as a Whole**

In the final analysis, executive compensation arrangements as a whole should be objectively fair and reasonable first to the company, and second to internal and external stakeholders. This should be a final "litmus test" for the compensation committee which involves reviewing executive compensation arrangements from multiple angles after they are structured each year.

In sum, these principles provide a good benchmark which can help the compensation committee determine whether company pay programs will provide reasonable shareholder returns and appropriate compensation amounts. By acknowledging these questions and potential shareholder action, the Center On Executive Compensation seeks to foster constructive engagement between companies and shareholders on specific pay issues where appropriate, rather than accepting a vague and undefined vote on the entire pay disclosure. Where shareholders disagree, they have the ability to engage companies through existing channels.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

Conclusion

The Center On Executive Compensation opposes a legislated shareholder vote on executive compensation for two principal reasons—existing mechanisms for communication are more effective, and the negative consequences of such a mandated vote far outweigh its benefits. Above all, such a vote will undermine the authority of boards and result in cookie-cutter pay packages that are not in shareholders' best interests. Even the largest proponent of a mandated shareholder vote, AFSCME, admits that the existing mechanisms have resulted in unprecedented engagement with shareholders. The largest shareholders in Canada have rejected a mandatory vote there for similar reasons.

As an alternative to a legislated shareholder vote, the Center encourages shareholders to carefully review corporate disclosures and communicate with companies using proven existing means to express their views. Meanwhile, the ongoing and shareholder-friendly changes to compensation and corporate governance will continue to strengthen existing practices that are in shareholders' best interests.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

Endnotes

[1] New York Stock Exchange Listing Standard §303A.03. *See also* 17 C.F.R. § 240.10A-3 (providing a model for implementing the method of contact with external directors).
[2] *See U.S. Securities and Exchange Commission, Electronic Shareholder Forums, Release No 34–57172; 73 Fed. Reg. 4,450* (Jan. 25, 2008).
[3] RiskMetrics/ISS Governance Services, "2007 Postseason Report: A Look at Accountability and Engagement," at 44, *available at* http://www.riskmetrics.com/pdf/2007PostSeasonReportFINAL.pdf [hereinafter, ISS 2007 Year-End Report].
[4] *Id*. at 3. The 1,145 resolutions represented the ones tracked by ISS.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id*.
[9] See, e.g., Securities and Exchange Commission, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A;34-54302A, 71 Fed. Reg. 53157, 53164-65 (Sept. 8, 2006).
[10] *Id*. at 71 Fed. Reg., 53,167.
[11] Canadian Coalition for Good Governance, "CCGG Position on Say on Pay," Dec. 12, 2007, last viewed at http://www.ccgg.ca/media/files/guidelines-and-policies/compensation/CCGG%20position%20on%20say%20on%20pay%2012.12.07.pdf.
[12] *Id*. at 2.
[13] *Id*. *See also*, Peter Brieger, "Regulators Unveil New Disclosure Rules on Executive Pay," Financial Post, Feb. 22, 2008, *last viewed at* http://www.financialpost.com/creditcrunch/story.html?id=327901.
[14] Business Roundtable, Corporate Governance Survey Key Findings, October 2007, http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6E75BF159F949514481138A74FA1851159169FEB5693FB3AE.
[15] New York Stock Exchange Listing Standard §303A.04.
[16] Business Roundtable, Corporate Governance Survey Key Findings, October 2007, *last viewed at* http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6E75BF159F949514481138A74FA1851159169FEB5693FB3AE.
[17] *Id*.
[18] Booz-Allen Hamilton, "The Era of the Inclusive Leader," Summer 2007, at 3.
[19] *Id.* at 4.
[20] Watson Wyatt, "Debunking Executive Compensation Myths," 2007-08, at 3. Total direct compensation is the total of salary, annual bonus and the grant-date value of long-term incentives. *Realizable* total direct compensation is the value of salary actual annual bonus and the realizable value of long-term incentives, including the sum of in-the-money value of stock options, end of period value of restricted stock, and payouts of long-term incentive plans beginning and ending during the same performance period.
[21] *Id.* at 6.
[22] Steven Kaplan, Testimony Before the House Committee on Oversight and Government Reform, ""Empowering Shareholders on Executive Compensation" and H.R. 1257, the "Shareholder Vote on Executive Compensation Act," March 8, 2007, at 4 *last viewed at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htkaplan030807.pdf.
[23] Frederic W. Cook & Co, The 2007 Top 250, October 2007, at 12.
[24] *Id*.
[25] Equilar, 2007 Executive Stock Ownership Guidelines Report, January 2008, at 3.
[26] Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders*, Job Market Paper, Nov. 22, 2007, *available at* http://home.uchicago.edu/~aagrawa1/AGRAWAL_paper.pdf.
[27] ISS 2007 Year-End Report at 3.
[28] Steven M. Davis, Testimony Before the House Committee on Oversight and Government Reform, "Empowering Shareholders on Executive Compensation" and H.R. 1257, the "Shareholder Vote on Executive Compensation Act," March 8, 2007, at 6 *last viewed at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htdavis030807.pdf.
[29] Janet McFarland, "Shareholders Urged to Support Say-on-Pay Proposals," *Globe and Mail*, Feb. 21, 2008.
[30] Spencer Stuart Board Index 2006; Spencer Stuart 2006 UK Board Index.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation

[31] Combined Code, 2006 Edition, at Section 1, A.3, A.3.1.
[32] Amy Knierem and Kelly Crean, Say on Pay Policies: A Global Comparison," Mercer Human Resource Consulting, May 2, 2007, at 9.
[33] Stephen Davis, "Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable," at 10, *last viewed at http://millstein.som.yale.edu/Davis_Say_on_Pay_Policy_Briefing.pdf.*
[34] *Id*. at 12.
[35] *Id*. at 13.

Copyright © 2008 by Center On Executive Compensation
No part of this analysis may be reproduced without permission of Center On Executive Compensation