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"Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In

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ABSTRACT

Shareholder and public dissatisfaction with executive compensation has led to calls for an annual shareholder advisory vote on a firm's compensation practices and policies, so-called "say on pay." Proposed federal legislation would mandate "say on pay" generally for US public companies. This paper assesses the case for such a mandatory federal rule in light of the UK experience with a similar regime adopted in 2002. The best argument for a mandatory rule is that it would destabilize pay practices that have produced excessive compensation and that would not yield to firm-by-firm pressure. This has not been the UK experience; pay continues to increase. The most serious concern is the likely evolution of a "best compensation practices" regime which would embed normatively-opinionated practices that would ill-suit many firms. There is some evidence of a UK evolution in that direction. This problem might be more pronounced in the US because US shareholders are even more likely than their UK counterparts to delegate judgments over compensation practices to a small number of proxy advisors who themselves will be economizing on analysis. The paper argues instead for a federally provided shareholder opt-in right to a "say on pay" regime, which would change the present reliance on precatory proposals in the issuer proxy which are in turn subject to the power delegated to shareholders under state law. Secondarily, the paper argues that any mandatory regime should be limited to the 500 the largest public companies by public market float and not cover the other 13,500 firms that make public disclosure. Compensation practices at key financial firms present a distinct set of safety and soundness issues because of potential systemic risk from a failure of such firms. These risks should be separately addressed.

INTRODUCTION

The collapse last year of major financial institutions run by extraordinarily well-paid executives has brought intense focus to executive compensation, but the issue always seems on the public agenda. At a recent Columbia conference a *Fortune* editor displayed a 50 year span of

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magazine covers featuring sky-high executive compensation stories. "Excessive" CEO pay led to tax law changes in the early 1990s. Large stock option payoffs and mega-grants made for splashy news stories in the late 1990s. Golden parachute payouts to fired CEOs made for lurid headlines in the 2000s. Hedge fund managers, whose billion dollar annual paychecks dwarfed the typical CEO package, preened in the heady 2004-07 period. By the mid-2000s the changing ratio in the compensation level of CEO versus line-worker from 20-1 in the 1950s to 350-1 came to have traction in the political realm as well as the boardroom. The *coup de main* has been the financial services meltdown before the ink has dried on enormous bonus checks.[1]

Some corporate governance reformers are promoting a particular federal legislative approach to reining in executive compensation, a mandatory shareholder advisory vote on the firm's pay practices, so-called "say on pay," modeled on a 2002 UK reform. The House but not the Senate passed such legislation in the 110th Congress. Given the 2008 election results, including then-Senator Obama's co-sponsorship of such legislation in the Senate,[2] and the increased saliency of the compensation issue, some version of "say on pay" enactment seems highly likely.

If the goal is to devise a compensation system that will better link pay and performance, mandatory "say on pay" as currently proposed is a dubious choice. Based on the UK experience, a comparable US regime is likely to lead to a narrow range of approaches to the inherently difficult problem of executive compensation that will then be adopted across the 14,000 US firms subject to SEC proxy regulation. This narrow range, close to a "one size fits all," is highly likely because the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs. Custom-tailored evaluation is costly; monitoring for adherence to "guidelines" or "best practices" is cheap. Given our recent experience with stock options, which were vigorously promoted by institutional investors in the 1990s as a shareholder-alignment mechanism, we would be well to avoid another rush to economy-wide adoption of a particular normative conception of executive compensation.

Moreover, the flawed performance of the small number of credit rating agencies in evaluating novel financial instruments should make us cautious in producing a regime that could well lead to a "gatekeeper" role for the small number of proxy advisors in an inherently complicated area. The most important proxy advisor, Risk Metrics, already faces conflict issues in both advising and rating firms on corporate governance that will be greatly magnified when it begins to rate firms on their compensation plans. As we have learned in the case of accounting firms (see Enron) and credit rating agencies (see mortgage-backed securities), there are inherent risks to the combination of consulting and rating. Changes to corporate governance that might result from proxy advisory firm pressure matters mostly at the margin. Changes to executive compensation could be very important indeed.

Instead of a mandatory rule, I would propose federal legislative provision of the shareholder right to decide whether a public firm should opt in to an advisory shareholder vote regime. Under current federal and state law, access to the issuer proxy for such a proposal is subject to shifting SEC attitudes on shareholder proxy access and different state law regimes on the scope of shareholder versus board prerogative. An opt-in federal "say on pay" regime would clarify shareholder power without imposing a mandatory regime that would ill-suit many firms. The opt-in regime would invite governance activists to focus on firms with the most questionable

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[1] See, e.g., Louise Story, *On Wall Street, Bonuses, Not Profits, Were Real*, N.Y.TIMES (Dec. 18, 2008)
[2] H.R. 1257 (110th Cong, 1st Sess.); Sen. 1181 (110th Cong, 1st Sess.).

practices. A successful campaign would be observed by similar firms and ramify in a potent way.

If some sort of mandatory rule is politically irresistible, I would recommend application only to the very largest firms, perhaps the top 500 by market capitalization. At smaller firms, the level, form and structure of executive compensation; the composition and role of the board; the role of founders and family, and the nature of shareholdings will vary considerably from the large firm patterns that figure in the corporate governance reform narrative. Indeed limiting the scope of a mandatory rule follows the UK model, which applies only to domestic firms listed on the "main market" of the London Stock Exchange, not the alternative AIM market, which is typically chosen by smaller issuers.

In thinking about executive compensation it is useful to make a number of distinctions. First, what is the animating reason of compensation reform: is it in service of "pay for performance" or is it because of general unease with high absolute compensation irrespective of performance? This will be explored in some detail below. Second, what is the substance of compensation reform: are there specific pay practices that seem particularly troublesome, for example, large severance payments to senior executives who are dismissed because of performance-related shortfalls – "pay for failure?" The UK experience suggests that these could be separately addressed. Third, what is the appropriate scope of a shareholder advisory vote: should it be mandatory across all firms; mandatory across a subset of the largest firms, optional at others; or a protected shareholder option at all firms? Fourth, do pay practices in specific subsectors – liquidity providers in the financial sector, for example – present systemic concerns that require evaluation for "safety and soundness" by a financial services regulator in addition to whatever review shareholders may chose?

Part I of this paper generally engages the executive compensation issue, in particular why a "one size fits all" approach may not be best. Part II addresses the UK experience, including the likely result in the US of a similar rule. Part III addresses the universal mandatory rule and its opt-in alternatives, explaining why a federal rule to protect shareholder opt-in may be necessary. Part IV concludes.

I. EXECUTIVE COMPENSATION: SOME GENERAL CONCERNS

A. *Is "Pay for Performance" the Objective?*

The contemporary executive compensation debate has two strands. One is the "pay for performance" strand, which accepts high executive pay if commensurate with performance, but which argues over whether management has in fact extracted compensation far beyond a performance-based measure. The other is the "social responsibility" strand, which focuses on the social demoralization and economic justice concerns that high levels of CEO compensation may raise. "Pay *without* performance" may be especially demoralizing on this view, but "performance" would be an insufficient basis for current levels of executive compensation, in part because the firm's performance is the result of a team's effort in an environment created by stakeholders. A major reform focus in both debates, however, has been corporate governance, namely the role of the board and possibly the shareholders in evaluating and constraining executive compensation. Because the two strands are fundamentally inconsistent, a "corporate governance" solution cannot satisfy both. "Pay for performance" proponents look to independent directors and empowered shareholders to enforce arms-length bargaining with managers over performance terms. "Social justice" proponents look to the same directors and shareholders to restore a sense of balance and fairness in compensation levels.

The inconsistency in the two strands is reminiscent of the tensions behind the initial burst of corporate governance reform energy in the 1970s, which focused on the composition of the board, specifically the case for independent directors. The analogous strands were reflected by advocacy for a "monitoring board," principally in service of shareholder interests, versus a "stakeholder board," which would balance the interests of shareholders against other important stakeholders. The "shareholder value" position triumphed because of critical changes in the 1980s: the rise of hostile takeover bids which were necessarily geared to the shareholders, and the increasing equity ownership positions of institutional investors, who were, as a matter of fiduciary law, concerned to maximize the value of their investments. Thus independent directors -- the major corporate governance innovation of the period – came to see their principal role as serving shareholders, not other constituencies.[3] In the current debate over executive compensation, the balance of forces within the corporation today is, if anything, more tilted in the shareholder direction than in the 1970s, when critical corporate objectives seemed up for grabs. Institutional shareholders own even more stock; shareholder activism has spread beyond transactions in control. The conventional application of the mechanisms of corporate governance are therefore likely to strongly favor "pay for performance"-based compensation.[4]

It could well be that social responsibility proponents of "say on pay" are not counting on corporate governance *per se*. The appeal of mandatory legislation is that the shock of greater shareholder consultation rights across the full range of firm might well destabilize an equilibrium of accretions to executive compensation that otherwise would be hard to prune and reset. Shareholder contention about pay could also help sustain the issue's saliency in the political and legislative realm, which itself may be a restraining force on public corporation compensation practices. Sustained high saliency could also spur tax code changes that have implications for executive compensation. For example, marginal tax rates have, historically, had a large effect on executive compensation.[5] The point remains, however, that in implementing a "say on pay" regime, we should expect boards and shareholders to emphasize pay-for-performance considerations that under some circumstances could produce payoffs that will register as "very high" on the social seismograph.

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

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

[3] *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).
[4] Note that if high levels of CEO compensation lead to own-firm employee demoralization, that becomes a "pay for performance" issue because it directly affects the profitability of the firm. This is why CEO compensation in a firm facing financial distress becomes such a fraught problem.
[5] *See* Carola Frydman & Raven Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005* (July 6, 2007), FEDS Working Paper No. 2007-35, *available at* SSRN: http://ssrn.com/abstract=972399.

is to align managerial and shareholder interests in light of embedded legal rules that favor managers.

Three examples illustrate the dilemma. Example one: the firm has not done well in the preceding period, but the board does not want to fire the CEO, either because it believes that the CEO has made *ex ante* correct strategic choices that worked out poorly because of unpredictable economic shocks or because all things considered, the board believes the CEO is the leader most likely to lead the firm out of its present straits. The current environment of rapidly escalating oil prices and an abrupt turn in credit markets provides many examples of CEO decisions that might plausibly fit into this category. Assume that the CEO's stock options (or other long-term incentive arrangements) are now significantly underwater. To reprice the options (anathematized in the corporate governance literature) or to issue new options with a different strike price could be readily characterized as "rewarding failure," inconsistent with the first goal. Yet to leave the situation unchanged may poorly incentivize the CEO for the next period, or even worse, to leave the CEO with incentives to swing for the fences since the upside/downside payoffs are so asymmetric.[6]

Example two: the firm has done extremely well; indeed, the CEO has been a star performer over a significant period, to the point where the CEO now owns a meaningful percentage of the firm's equity. What should be the shape of the CEO contract for the next period? From a "rewards" perspective, the compensation package should continue to include hefty stock-related compensation and bonus opportunities consistent with the value-creation that the board hopes the CEO will continue to deliver. But from an "incentives" perspective, why should the board give the CEO more than a token? The largest part of the CEO's personal wealth is tied up in the firm's stock.[7] On that dimension, the CEO is already well-incented to increase shareholder value. Would the CEO start shirking or otherwise make bad decisions with his or her personal wealth on the line just because the pay is less? Would he or she quit, putting the firm in the hands of someone who the CEO probably believes will do a less good job?[8] The polar case merely illustrates the more general claim: that "rewards" objectives and "incentives" objectives would not necessarily produce the same compensation contract, and that the optimal CEO contract for a particular firm could well vary in CEO wealth accumulation.[9] This means that direct comparison of compensation packages across firms is much noisier and potentially misleading about board performance.

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

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

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

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

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

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

Example three: One area of great concern to many governance activists and critics has been the "golden parachute," a special payment to the CEO triggered by a change in control or, commonly, termination without cause. Here a little history is in order. Golden parachutes arose in response to the hostile takeover movement of the 1980s. There are two ways to tell the story. On the bright side, golden parachutes compensated target managers, who typically faced displacement after such a takeover, for the loss of what an economist would call firm specific human capital investments. But why should a laid-off CEO receive such compensation, and so generous, when a laid-off rank and file worker – also having made firm specific human capital investments, often of equal or greater value relative to net worth – usually does not?

That brings us to the dark side. The courts, Delaware most importantly, and many state legislatures gave managers what might be called a takeover-resistance endowment – that is, the right to fight a hostile takeover using corporate resources, including the power to "just say no."[10] One way to solve this dilemma is to structure compensation to align managerial and shareholder incentives in the face of a hostile bid – that's the polite way to describe the resulting golden parachute arrangement. So if the CEO receives approximately three times salary and bonus and the accelerated vesting of a large stock option grant to boot, the chance to become truly rich in a takeover solves the problem of mangers fighting off hostile bidders. But the devil is in the detail and the triggers for these "chutes" were crafted for more broadly than the core case of the takeover where the CEO loses his or her job. Most notably, the "chutes" broadened into a general severance arrangement that covered not only takeover situations, but virtually any case of termination without cause.[11] This then had led to nightmare cases of $100 million-plus payouts, not "pay for performance," not the CEO getting a share of the upside when the firm is

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

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

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

sold at a premium, but "pay for failure" so egregious that even a Chief Executive who has awarded the Medal of Freedom despite failure felt obliged to take notice.[12]

Conditional on the initial grant of the takeover-resistance endowment, the golden parachute may have been a locally efficient response. It is a familiar Coasean observation that the assignment of a legal entitlement does not necessarily interfere with attaining efficient outcomes (though wealth may be redistributed). The golden parachute payment can be seen as shareholder buyback of the resistance endowment so as to permit value-increasing transactions to occur. But changes in the corporate governance environment that have reduced CEO power over the board[13] and that have otherwise empowered shareholder activists[14] have reduced the value of the takeover-resistance endowment. We should expect to see significant changes in golden parachute arrangements, which will separate out compensatory features from hold-up features. But a simple "pay for performance" metric may not tell us how well a board is accomplishing this transition, given the "loss avoidance" and "endowment" effects that make downward renegotiation difficult.

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

Moreover, when we say "pay for performance," what performance are we trying to reward and incentivize? Presumably stock price gains are of the greatest interest to shareholders, but measuring "profits" also has its appeal, because bottom line results may be less susceptible to stock market fashion (though more vulnerable to accounting conventions). "Profits" also seems associated with a hard measure, like more cash in the bank or funds available for dividends. Yet current profits reflect past investments; how to reward and incent the firm's

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

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

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

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

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

development of valuable real options?[15] Stock price measures may imperfectly measure the value of such investments, particularly given that the firm may resist disclosure to hold onto competitive rents. As the firm becomes more granular in its performance objectives, success and compensation becomes harder to measure and monitor.

Another complexity is the timeframe over which to measure performance. Presumably senior executives should be incented to promote increasing returns over time. Stock-related compensation that vests over time and that includes retention requirements provides such incentives. But a year-by-year metering of performance also seems appropriate, which may be easiest to provide via a cash bonus. In both cases some form of "clawback" seems useful to protect shareholders against managers' ability to create the appearance of performance or to provide coinsurance against apparently profitable strategies that fail when evaluated over a longer timeframe. Some "clawback" occurs spontaneously with retained stock-related compensation, which will decline in value if performance expectations are not realized. The terms of clawback will necessarily be controversial. It is easiest to insist on in the case of bad faith. For example, Sarbanes Oxley (section 304) imposes a clawback of bonus or incentive payouts (including profits on equity sales) received by the CEO or chief financial officer in the event of misconduct that leads to an accounting restatement.[16] In many operational settings, however, the difference between bad faith and mistaken judgment may be hard to observe. The "coinsurance" rationale – the sharing of bad outcomes -- sounds appealing in theory but may be difficult to apply (and, on the principle that risk-sharing is costly, may lead to increases in the notional amount of executive compensation). It seems appealing in the context of complicated trading strategies that may earn profits in one year only to crater the next. But how generalizable is it in non-financial sectors, in which performance reversals more commonly result from exogenous factors rather than flaws in a trading model. What to do now about the bonus to the airline managers who in 2007 brilliantly executed a longterm hedge against the escalation of oil prices? To say that clawback necessarily improves longterm performance may be premature, as demonstrated by significant losses in the Harvard endowment despite a sophisticated clawback scheme already in place. The utility and implementation of a clawback scheme is inherently a sector-specific, firm-specific, even strategy-specific judgment.

Of course, even after "performance" has been defined and measured, there remains this question: how much pay for how much performance? We gave up on the idea of a "just price" a long time ago, relying instead on markets to set prices. But the "market price" for a CEO is hardly self-defining, since the market for senior managerial services has no posted prices (hence

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

[16] The practical effect of the SOX clawback provision has been extraordinarily limited, because of courts' refusal to imply a private right of action either by shareholders suing derivatively or the company suing directly, the SEC's limited success in obtaining clawbacks (in only two occasions since 2002), and a restrictive statutory approach that limits clawback to occasions of personal misconduct by either the CEO or CFO. See Rachel E. Schwartz, The *Clawback Provisions of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. L. 1,2-5 (200*0.

the hunt for comparators). Executive compensation at any particular firm seems inevitably the result of a bargaining process between the CEO and someone empowered to act for the firm. Thus recent reform efforts have been principally process-focused and have been particularly geared toward process reform for the large public firm without a controlling shareholder.

C. ***Boards and Shareholders***

The consensus view in the US has been that the board of directors needs to serve as the shareholders' agent in negotiating CEO compensation. As with many other reforms in corporate governance, the standard move is to strengthen board independence, both generally and with respect to this particular function. This has meant tightening standards of director independence and attempting through a series of process reforms to imbue boards with a self-conception of independence.[17] On the functional dimension, stock exchange listing rules now mandate a special board committee, a compensation committee composed exclusively of independent directors, to focus specifically on the CEO compensation question.[18] This committee is empowered to hire outside experts. As part of the SEC's 2006 CD&A regulation, the compensation committee is required to prepare a "Compensation Committee Report" over the name of each member that discloses whether the compensation committee "reviewed and discussed the [CD&A] with management … and recommended … that the [CD&A] be included in the … annual report,"[19] in effect, an ownership statement by the compensation committee.

One of the major current issues is the extent to which this ostensibly independent committee has been captured by its advisors, the compensation consultants either generally or specifically. That is, does the fact that compensation consultants are often part of diversified human relations service providers hired by managements instill a CEO-favoring tilt to compensation consultant work? This raises the question of inherent bias in the compensation consultant industry as presently structured. Or is same-firm work by the compensation consultant (meaning, human relations work for the firm in addition to compensation work for the board) a specific (and limited) source of independence-undermining bias, as commonly hypothesized with accounting firms? Or do compensation consultants have a "style," that is, a reputation for pay packages of a particular mix of compensation elements and level, so that boards pick consultants after a basic decision on the compensation approach? As part of its 2006 CD&A regulations, the SEC required public firms to disclose the role of compensation consultants in the executive compensation-setting process, and quite interesting data is beginning to emerge on these questions.[20]

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[17] For a fuller account, see Gordon, *Independent Directors*, *supra* note 1, at 1490-99.
[18] *Id*., at 1490-93.
[19] Regulation S-K, Item 407(e)(5), 17 CFR §229.407(e)(5).
[20] Alexandra Higgins, *The Effect of Compensation Consultants* (report by The Corporate Library) (Oct. 2007); U.S. H. R. Comm. On Oversight and Govt. Reform (Majority Staff), *Executive Pay: Conflicts of Interest Among Compensation Consultants* (Dec. 2007); Kevin Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants* (WP June 2008), available on SSRN at http://ssrn.com/abstract=114899; Christopher S. Armstrong et al, *Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels (*WP June 2008), available on SSRN at http://ssrn.com/abstract=1145548; Brian Cadman et al, *The Role and Effect of Compensation Consultants on CEO Pay* (WP March 2008), available on SSRN at http://ssrn.com/abstract=1103682; Martin J. Conyon, *Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom* (WP May 2008), available on SSRN at http://ssrn.com/abstract=1106729.

The issue of day is the extent to which shareholders should be involved in the pay-setting process. For most proponents of a shareholder role, the objective is not to substitute the shareholders' business judgment for the board's, but rather to heighten the board's independence-in-fact given subsequent shareholder response. Alternatively, we can frame the shareholder role in compensation-setting (and corporate governance more generally) in terms of terms of accountability.[21] First, strengthen the board's independence, then strengthen the board's internal process, finally, strengthen the board's accountability to shareholders. Of course, the annual election of directors provides a recurrent shareholder check on board action, an annual accountability moment. Additional disclosure of compensation information per the 2006 CD&A regulations now provides shareholders even more information to assess board performance on this critical element of corporate governance. Proponents of more direct shareholder influence in compensation-setting argue, however, that replacing directors or even targeting compensation committee members through a "just vote no" campaign is costly and cumbersome and therefore not a credible constraint on the board. They support a more specific shareholder role, one that unbundles executive compensation from other elements of board decision-making, more granular accountability.

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

II. SHAREHOLDER CONSULTATION AND "SAY ON PAY"

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

A major goal of the SEC's 2006 adoption of a CD&A requirement was to stimulate shareholder reaction to the firm's executive compensation practices through the existing means

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

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

of public and private response. These include media reactions, private shareholder interventions with managements and directors, precatory resolutions, and "withhold vote" campaigns against compensation committee directors. Some have argued that these mechanisms are insufficient to check potential compensation excess,[22] most notably because of general shareholder debility in corporate governance, and have pushed for an explicit shareholder role in the compensation-setting process. This push is partly fueled by what has been revealed through CD&A disclosure, particularly pension and deferred-compensation benefits whose bottom-line dimensions may have startled even experienced directors. Some have been especially concerned by compensation inequities, including the large disparities between CEO compensation and even other C-level managers, not to say other members of the management team and line-employees.[23] The sense of out-of-control compensation has been heightened both by enormous payouts to unsuccessful CEOs at a time of economic unease[24] and by the option back-dating scandal,[25] which suggested widespread overreaching by already well-paid senior managers.

In the search for remedies, governance activists, already inspired by the UK model of greater shareholder governance rights, looked to the UK's 2002 adoption of a mandatory shareholder vote on a firm's annual "Directors Remuneration Report," in effect an advisory vote on the firm's executive compensation practices since rejection of the report did not invalidate a compensation agreement.[26] After the Democratic takeover of the Congress in the November 2006 midterm elections, the House of Representatives passed a bill calling for a mandatory annual shareholder advisory vote on executive compensation.[27] The legislation died in the

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

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

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

[25] Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MNGMNT SCI. 802 (2005); Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271(2007) (web-posted in 2006); Mark Maremont, *Authorities Probe Improper Backdating of Options: Practice Allows Executives to Bolster Their Stock Gains; A Highly Beneficial Pattern*, WALL ST. J., Nov. 11, 2005 (p. A 1). The back-dating persisted even after the adoption of the Sarbanes-Oxley legislation, which imposed internal controls standards that should have ended it. The backdating persisted even after the adoption of the Sarbanes-Oxley legislation, which imposed internal controls standards that should have ended it. *See* Jesse Fried, *Options Backdating and Its Implications*, 65 WASH. & LEE L. REV. (forthcoming 2008).

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

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

Senate. Representative Barney Frank, chair of the House Committee on Financial Services, has already announced his intention to put "say on pay" on the agenda of the new Congress.

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

Anticipation grew that sentiment for these proposals would snowball.[31] Aflac voluntarily adopted "say on pay"; so did RiskMetrics, the keeper of corporate governance scorecards, and H&R Block, trying to make amends after an unfortunate foray into mortgage lending led to a successful shareholder insurgency. But 2008 was not the banner year that proponents had expected. The number of proposals grew only moderately, to 70, and the level of support has remained at the same level, approximately 42%.[32] Majority support was attained at ten firms, including Alaska Air, PG&E, Lexmark, Motorola (again), and Apple (presumably because of its stock option backdating involvement). Interestingly, support for "say on pay" slipped at financial firms from the 40s% level to the 30s%.[33] Proponents had thought that massive losses would occasion shareholder outrage, especially in light of large payouts to departing CEOs at Merrill Lynch and Citigroup. Apparently investors were nervous about disrupting governance at a time of stress and concerned about retention of highly compensated employees in an industry with great job mobility. Indeed, the hesitation to press for "say on pay" in the financial services industry may show the complexity of trying to figure out what counts as good performance and how to devise an appropriate pay-for-performance scheme.

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

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

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

[30] RiskMetrics, Group, 2007 POSTSEASON REPORT (Oct. 16, 2007), at 5.

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

[32] Carol Bowie,Another Majority Vote for "Say on Pay," RISKMETRICS RISK & GOVERNANCE BLOG (Aug. 25, 2008); L. Reed Walton, *U.S. Midseason Review*, RISKMETRICS RISK & GOVERNANCE BLOG (May 23, 2008).

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

[34] Kristin Gribben, *supra* note 28. For a specific example, see Peter C. Clapman, *Next Steps? Be Careful What You Wish For* BOARDS & DIRECTORS 6, 48 (July 2008) (retired head of corporate governance program at TIAA-CREF expressing skepticism on mandatory "say on pay" since, among other things, "a shareholder right to say on pay already exists, since the option of withholding votes from compensation committee members is not only available but is being widely exercised").

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

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

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

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

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

The UK adoption of a shareholder advisory vote on executive compensation had its roots in a particularly UK story of compensation "outrage."[36] One of the hallmarks of the Thatcher government in the 1980s was the privatization of many utilities, including the gas, water, electricity, and telecommunications monopolies. The salaries of the senior officers skyrocketed for doing allegedly the same job, and not necessarily better. At the same time, executive compensation in other industry sectors also escalated, dissonantly coinciding with an increase in high profile employee layoffs and other retrenchment. The public reaction in the mid-1990s to "fat cats" (so-labeled in the press) threatened to undermine the spirit behind unleashing the private sector and perhaps to lead to government regulation of compensation. Such intervention was headed off by an industry-sponsored Study Group on Directors' Remuneration, which produced the "Greenbury Code" in 1995.[37] This code had two important elements: first, a call on boards to establish a remuneration committee of independent directors to set executive compensation and second, the disclosure of significantly more detailed compensation

[36] This follows Jonathan Rickford, *Do Good Governance Recommendations Change the Rules for the Board of Directors?, in* CAPITAL MARKETS AND COMPANY LAW (Klaus J. Hopt & Eddy Wyrmeersch eds., 2003); Jonathan Rickford, *Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections (Second Part)*, 2 EUR. CORP. & FIN. L. REV. 63 (2005) (Rickford was the former project director of the UK Company Law Review of the Department of Trade and Industry and a member of European Commission's High Level Group on Company Law); Guido Ferrarini & Niamh Moloney, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, 1 EUR. CORP. & FIN. L. REV. 251 (2004); Brian R. Cheffins, COMPANY LAW: THEORY, STRUCTURE AND OPERATION (1997); Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have Say Over Executive Pay?: Learning from the US Experience*, 1 J. CORP. L. STUD. 277 (2001).

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

information and policies through an audited remuneration report. Key elements of the Greenbury Code were quickly added to the London Stock Exchange's Listing Rules and, in 1998, were included without substantial change as part of the Combined Code on Corporate Governance produced by the Hampel Committee. In general the Combined Code required listed firms to "comply or explain [non-compliance]" with Code provisions. The vast majority of firms complied with the compensation disclosure mandate. In addition to such disclosure, boards were also obliged to annually "consider" and "minute" their consideration of whether to seek shareholder approval of the firm's remuneration polices, especially in the case of significant changes or controversial elements.

The "New Labour" government that took power in 1997 began a review of various elements of the UK corporate governance system in light of a growing international consensus that good governance added a competitive economic edge. Escalating UK CEO pay, post-tech bubble payouts to dismissed CEOs, and survey data that less than five percent of firms had brought compensation policy questions to shareholder vote[38] led to the 2002 amendment of the UK Companies Act to require both a somewhat more detailed disclosure regime than under the Listing Rules and to require a shareholder advisory vote on a newly-fashioned Directors Remuneration Report (DRR). The DRR was to supply not only more granular compensation information but also a novel (for the UK) stock price performance graph and the board's compensation rationale.

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

In subsequent years, observers have noted four visible effects of the regime shift.[41] First, consultation has increased between firms and large shareholders, or at least with the leading institutional investor groups[42] and with the proxy services firms, RREV and IVIS.[43] The communications range from the perfunctory to the serious. Second, rejections of remuneration reports have been rare, only eight over the six year history of the new regime, all but GlaxoSmithKline involving small firms. Deloitte has reported that over the period only 10 percent of a large sample of firms received a negative vote of 20% or more. Nevertheless, in

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

[39] Gautum Naik, *Glaxo Holders Reject CEO's Compensation Package*, WALL. ST. J., May 20, 2003, at D8, *available at* 2003 WL-WSJ 3968195; Heather Timmons, *Glaxo Shareholders Revolt Against Pay Plan for Chief*, N.Y. TIMES, May 20, 2003, at W1. The vote was narrow, 50.72% to 49.28%. Two large institutional investors voting against the report were Isis Asset Management, a UK money manager with nearly $100 billion in assets, and CalPERS, a U.S. public pension fund with more than $150 billion in assets that is a notable proponent of corporate governance reform worldwide.

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

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

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

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

recent years, the proxy services firms have recommended negative votes in 10-15% of cases, principally involving smaller firms. Presumably most firms shape their compensation policies to avoid negative shareholder votes. There is also some evidence that firms receiving a significant negative vote in one year receive a much higher positive vote in the subsequent year, suggesting that most firms accommodate to shareholder views.[44] Third, the leading associations of institutional investors, the ABI and the NAPF, have extended their compensation influence through the fashioning of compensation guidelines that provide a set of yellow and red lines.[45] These guidelines build on the "best practices" for executive pay built into the Combined Code.[46] The consultations often arise with respect to changes in a firm's "approved" compensation practices (because it passed muster the prior year) or practices that trench on the guidelines. Indeed, compliance or not with the guidelines often becomes the basis for the shareholder vote. Fourth, long-term CEO employment agreements, which in the UK setting gave rise to highly salient episodes of "pay for failure," seem to have ratcheted down. GlaxoSmithKline was such a case. Indeed, the most dramatic changes have occurred in this area. Almost no large UK firms now enter into senior manager contracts of more than one year or provide for accelerated options upon a change in control, thus putting to an end the UK version of the golden parachute.[47] This change, however, could have partly resulted from the Government's initiation of a consultative process that raised the threat of legislation on termination payments, a threat made credible by legislation of the DRR regime.[48]

When it comes to looking at the effect of the new regime on actual pay, the results are much murkier. UK CEO salaries and bonus payouts increased at a double digit rate in recent years.[49] The value of long term incentive plans is harder to meter, but the growth rate is similar, indeed, higher than in the US,[50] though UK observers have noted a tightening of performance triggers to vesting of particular benefits. The most thorough empirical analysis, albeit through

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

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

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

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

[48] *See* DEPARTMENT OF TRADE & INDUSTRY, REWARDS FOR FAILURE: DIRECTORS' REMUNERATION – CONTRACTS, PERFORMANCE AND SEVERANCE (Consultation, June 2003). Moreover, the ratcheting-back of "pay for failure" began with the Greenbury best practice guidelines in this area, which had reduced the typical three year managerial term to one year by 2002. Further impetus in this direction was provided by a report of the Company Law Review Steering Group, see note 36 *supra*, suggesting standard one year terms. *See* Steve Thompson, *The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK*, 13 CORP. GOV. 19, 22, 23 (2005) (suggesting that investors pushed to limit contract terms to one year, which generally produced relatively small savings, because shorter terms "facilitate[ed] the ousting of under-performing executives").

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

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

2005 only, is Ferri & Maber (2008),[51] which analyzes UK compensation trends before and after adopting of the DRR regime. Using standard controls for documented influences on CEO compensation (such as firm size), they report a number of important findings. First, the overall growth rate of CEO pay is unchanged; there is no one-time downward revision or a moderation in the trend. Second, they do nonetheless find greater pay-performance sensitivity in certain categories of firms: firms with a "controversial" compensation history, namely those with high levels of shareholder dissent in the first year of the shareholder advisory vote and those with "excess" pay in the pre-DRR period (firms in the top 20% of CEO pay after controlling for standard pay determinants). These, by hypothesis, are the firms where compensation is least tied to performance, and where a regime that brings shareholder focus to bear may have its strongest effect.

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

Although Ferri & Maber's results are suggestive, only a literature, not any single empirical paper, can securely ground a conclusion about the positive effects of the DRR regime. Among the elements in their work that counsel against over-enthusiasm on its finding of firms' greater responsiveness to pay-for-performance demands are factors that suggest the possibility of efficiency losses. For example, the demonstrated increased pay-performance sensitivity is generally with respect to losses, not gains (although they test both). In other words, after the DRR regime, pay is more likely to go down if performance declines, but there is no evidence of the reverse. This, of course, is consistent with avoiding pay for failure, certainly a major theme, if not the preoccupation, of the reform impulse behind the DRR. Similarly, the performance indicator that is associated with greater sensitivity is return on assets (ROA), an accounting measure, rather than stock price performance.[52] Putting aside the matter of shareholder preference, stock prices measure expectations of future earnings, which relate to new investment. Possible message of the new regime: "Don't overcompensate the 'failed' CEO; focus on today's safely measurable earnings, not tomorrow's." If that is the result of a shareholder advisory vote, it seems an odd way to build a system that relies on entrepreneurial energy and the risk of failure.[53]

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

[52] More technically, total shareholder return, which includes dividends and stock repurchases.

[53] A more positive interpretation might be that since the UK compensation scheme is generally tilted to cash payouts rather than stock-related compensation, 65% to 35%, pay-to-ROA performance is the right, or at least more important, sensitivity measure. Then the concern becomes the guidelines that lock in a normatively controversial tilt against stock-related compensation. It is still a consequence of the regime as a whole. An alternative interpretation offered by Eric Nowak is that since pay-performance sensitivity with respect to stock price performance is not degraded from the prior regime, the greater sensitivity to ROA measures is of some benefit, suggesting some restraint against pay on failure. Erick Nowak, "Say on Pay": Some Preliminary Statements from a European Financial Economist's View," Nov. 28, 2008 (unpublished mss on file with author). This seems an odd argument, especially in the absence of a claim that the UK compensation system has a desirable level of stock price performance sensitivity. If it would be normatively desirable to have more such sensitivity, then a costly regulatory system that achieves some other (possible) goal but not that one may not be best.

An additional point is a possible "size effect" in Ferri & Maber's results, meaning that independent of performance, the DRR regime may have had a negative effect on CEO compensation at the largest firms. Since pay generally increases in size, this suggests that the DRR may have produced a decrease in the rate of compensation growth where pay was on average the highest and where high pay was most visible. This may serve perfectly fine social objectives, but it does not fit the "pay for performance" objectives of the DRR.[54]

A more technical factor that may confound the Ferri & Maber result is that the DRR regime consisted of two elements: extensive mandatory disclosure of executive compensation particulars, including the board's reasoning process in the award of compensation, and the shareholder advisory vote. As the authors observe, many compensation elements were already mandatorily disclosed via the London Stock Exchange's Listing Rule 12.43(c), though the report requires significantly more detail, particularly on long-term incentive plans and severance. Contemporary market participants, though they appreciated the improved disclosure, seemed to think that the new advisory vote was a more significant change than the improved disclosure. A 2004 Deloitte survey of leading institutional investors on the impact of the new DRR regime, commissioned by the Department of Trade and Industry, reported that 70% regarded the shareholder vote as having "very significant impact" whereas only 26% regarded the detailed disclosure of compensation particulars as having comparable significance, even though nearly 90% regarded the remuneration report as providing better understanding of compensation.[55] Thus Ferri & Maber seem safe in attributing most of the effect to the shareholder empowerment elements of the scheme.

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

1. Side Effects of the UK system

The efficiency effects of the UK system are potentially a matter of concern. As noted above, the only available empirical evidence shows pay-performance responsiveness tied to a current earnings measure, not a stock-based measure. Beyond that, the workings of the system seem ill-suited for a dynamic environment. For example, immediately upon adoption of the DRR regime, the ABI and the NAPF adopted "best practices" of compensation guidance. Because of the dominance of those two actors, whose institution investor members own nearly 30% of the shares of large UK public firms, the annual shareholder vote is often a test of "comply or explain" with those guidelines. Indeed, an alternative approach, in which shareholders would annually evaluate firm compensation practices in light of the firm's performance and prospects as a whole, would be very costly.[56] The tendency for firms to "herd" in their compensation practices is very strong: Follow the guidelines, stay in the middle of the pack and avoid change from a prior year, when the firm received a favorable vote. Yet what is the normative basis for giving authoritative weight to the guidelines, whose conventional wisdom has not itself been tested for performance-inducing effect?

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

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

[56] *See* Kristin Gribben, *U.K. Investors Warn U.S. About Say on Pay,* AGENDA (Nov. 12, 2007) (citing experience of UK fund managers, who nevertheless want to retain the advisory vote).

For example, the current ABI guidelines contain elaborate prescriptions for the issuance of stock options and other sorts of stock-related compensation, including a requirement of "performance based vesting" based on "challenging and stretching financial performance" (not just a high exercise price) that applies not only to shares from an initial grant, but also shares from a bonus grant, meaning that an option (or share) grant will not necessarily ever be in the money.[57] To a non-professional eye, this reads simply like a prejudice against stock-based compensation, and the expression of a preference for a UK-style of compensation that traditionally has been tilted toward cash salary and bonus. Indeed, this is consistent with the Ferri & Maber evidence that shows pay-performance responsiveness to earnings-based measures that commonly are used in bonus awards, not stock-based measures geared toward stock-related compensation. The guidelines may be "correct" in their outcome in particular instances of compensation form, but it is hard to believe that they will persistently produce a result similar to arms' length bargaining, if that is the ultimate comparator. More concerning, the implementation of the guidelines may transmit a particular form of compensation practice across an entire economy.

Moreover, a recent empirical study of UK compensation practices suggests that the favored form of stock-related compensation, performance-vested stock options, produces more earnings management than plain vanilla stock options more commonly used in the US.[58] This may be particularly important in a compensation system that tilts to earnings-based measures of performance.

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

2. Translation of the UK Experience to the US

Possible "side-effects" do not necessarily negative the value of the shareholder advisory vote in the UK. But it could be that many of its benefits are bundled with an overall corporate governance system that gives shareholders considerably more power than in the US, so that a "transplant" of "say on pay" alone would trade differently in the US. Corporate governance in this sense is a function of ownership and legal rules. UK ownership is characterized by what might be called "concentrated institutional ownership," meaning that although UK firm are "Berle-Means" firms without controlling owners, the shares are held first, by institutions rather than retail investors, and second, that these institutions are "concentrated" rather than "dispersed."[59] As noted above, the dominant UK institutional investors have been insurers and private industry pension funds. They share a common address, the City of London, and common

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[57] ABI, EXECUTIVE REMUNERATION – ABI GUIDELINES ON POLICIES AND PRACTICES §§ 4.1., 4.6, 4.12 5.7 (2006).

[58] Yu Flora Kuang, Performance-vested Stock Options and Earnings Management, 35 J. Bus Fin. & Acctg. 1049 (2008).

[59] This and much of the succeeding discussion draws from John Armour & Jeffrey N. Gordon, *The Berle-Means Firm of the 21st Century*, preliminary working paper, Jan. 2009, on file with author.

objectives, long-term holdings producing steady dividends and gains. Over a 40 year period they have gained considerable experience in collaborative efforts to engage their investee firms on business and governance matters.[60]

Part of the reason they are paid attention to is a legal regime that empowers shareholders to a much greater extent than in the U.S. For example, shareholders can remove directors or amend the articles. Ten percent of the shareholders of a public company can call a special meeting.[61] The board may not interfere with shareholder choice in a takeover bid. Through the exercise of preemptive rights, shareholders can constrain the firm's access to equity capital markets. Yet it is the coordination possibilities of the UK form of concentrated institutional ownership that has transformed these statutory rights into governance power. Thus the benefits of shareholder advisory voting in the UK need to be assessed against that backdrop. The dialogue about compensation may be genuinely informative in a two-sided sense and may inject leeway that is not immediately apparent. In the course of the compensation talk, the conversation may turn to performance more generally, including the performance of the CEO or perhaps consultation about business plans.

The U.S. statutory system empowers shareholders less, granting the board greater autonomy but taking greater pains to bolster its independence. The fraction of independent directors in the U.S. is considerably higher; the requirements of "independence" are stricter; the compensation committee is entirely independent. By comparison, UK Combined Code currently permits the Chairman (if formerly an "independent") to sit on the remuneration committee. But an equally important difference is in ownership structure. Even as recently as 1980, most US firms had a dispersed retail ownership base. Dramatic increases in institutionalization began in the 1980s but the form of ownership was "dispersed institutional ownership," meaning the institutions were very different in investment objectives, anticipated holding periods, and geographic location.[62] That diversity has increased over time. Moreover, U.S. securities regulation has placed various barriers to coordination among institutional investors that increase its cost and legal risk. Among other things, close coordination may trigger special disclosure requirements that in turn entail liability risk for the institutions and their control persons.[63]

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[60] The ground under the UK model is shifting rapidly, as Armour and Gordon, *supra* note 59, discuss. A decade ago, yearend 1997, UK pension funds and insurers owned approximately 46 percent of the equity of the largest 200 UK companies; at yearend 2006 (the last year surveyed), such ownership had declined to approximately 27 percent. The slack has been picked up by foreign investors, particularly institutional investors, increasing their UK equity ownership from 28 percent to 40 percent over the period, and other financial institutions, like investment banks and hedge funds, increasing their equity ownership from approximately one percent to almost 10 percent. See UK Office for National Statistics, Share Ownership: A Report on Ownership of UK Shares of at 31st December 2006, available at www.statistics.gov.uk/downloads/theme_economy/Share_Ownership_2006.pdf. Prof. Cheffins explains the decline in UK insurance company and pension fund ownership as resulting from regulatory and accounting changes that have pushed such investors to a closer matching of asset and liability duration and cash-flows. See Brian R. Cheffins, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 387-92 (2009). This altered ownership landscape may change the workings of the UK model in its country of origin.

[61] See Companies Act of 2006, sec. 303(3).

[62] See Henrik Cronqvist & Rudiger Fahlenbrach, Large Shareholders and Corporate Policies (forthcoming 2009 Rev. Fin. Stud., available at http://ssrn.com/abstract=891188 (finding that "large shareholders differ in their approaches to corporate investment and growth, their appetites for financial leverage, and their attitudes towards CEO pay").

[63] See Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475 (2008) (discussing requirements under sections 13(d) and 14(a) of the 1934 Securities and Exchange Act).

So how would a "say on pay" regime work in the United States? There are many more firms in the United States, not just the S&P 1500 versus the FTSE 350, but more than 14,000 US firms that are subject to proxy regulation under the 1934 Securities Exchange Act[64] versus less than 1100 UK firms subject to "say on pay."[65] Stock market capitalization is more concentrated in the UK: the market cap of only 82 firms cumulates to approximately 85 percent of the total; 202 firms, 95 percent of the total.[66] In the US, by comparison, the S&P 500 cumulates to approximately 75 percent of market capitalization; the S&P 1500, 85 percent.[67] There are also many more institutional investors in the US,[68] but a very limited practice of institutional consultation and much less coordinated consultation. The most active institutional investors have been public pension funds and union pension funds, which act from shareholder value economic motives for sure but which may have other motives as well. Hedge funds have recently joined the ranks of shareholder activism, but they are looked at warily, not just by boards but also by other institutions, whose managers cannot benefit from "2 and 20" compensation schemes.

Only a relative handful of the large public pension funds have independent corporate governance expertise to guide their share voting, and even the largest and most experienced of these, CalPERS and TIAA-CREF, depend on guidelines that they fashion with only limited company-specific accommodation. Most of the rest simply delegate most of the substantive decisionmaking in the governance area to a proxy services firm, in particular Institutional Shareholder Services (ISS), now part of RiskMetrics.[69]

Like ABI and NAPF, ISS will establish guidelines on compensation; indeed, such guidelines already exist. As in the UK, firms that do not want to stir trouble will herd. Or firms with alternative ideas will engage ISS in negotiation – but the numbers of firms and the time for serious engagement could easily make the situation untenable. The propensity of many U.S. institutional investors to delegate such decisions could well give power to a handful of proxy service firms to make substantively very important decisions with potentially economy-wide ramifications. Indeed, the economy-wide embrace of stock options in the 1990s resulted in part from institutional investor pressure on firms to adopt this "best practice" way to enhance

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[64] The Disclosure data base provides information on 12,000 public filers. The SEC, in its ill-fated 2003 proposal to open the issuer proxy to shareholder nomination of directors identified 14,484 companies that filed periodic reports and proposed to apply the issuer proxy access rule to 3,159 companies that had at least $75 million in public common shareholder float. See Proposed Rule: Security Holder Director Nominations, SEC Rel. No. 34-48626, TAN 70 (Oct. 17, 2003).

[65] See London Stock Exchange, Main Market Statistics, Table 8 (Dec. 2008) (1080 "listed companies"). The UK Director Remuneration Report requirements apply only to companies on the "official list," see UK Companies Act of 2006, §§ 420(1) (DRR applies to "quoted companies"); 382(2) (defining "quoted companies" in terms of "official list"); UK Financial Services and Markets Act of 2000 § 74 ("official list" is maintained by "competent authority," now the Financial Services Authority acting as the UK Listing Authority). Application for an "official listing" is now made to the UK Listing Authority simultaneously with an application to the London Stock Exchange Main Market. See London Stock Exchange, A Guide to the Main Market 14 (2007).

[66] London Stock Exchange, Main Market Statistics, Table 8 (Dec. 2008).

[67] Standard & Poor's, S&P 500 Factsheet (Dec. 2008) (75%); S&P MidCap 400 Factsheet (Dec. 2008)(7%); S&P SmallCap 600 Factsheet (Dec. 2008) (3%).

[68] The leading proxy advisor for US firms, ISS (now a division of Risk Metrics Group) claims over 1700 institutional clients. Robert Daines et al, Rating the Ratings: How Good Are Commercial Governance Ratings?, W.P. Sept. 2008, available at http://ssrn.com/abstract=1152093.

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

managerial incentives.[70] Then-favored accounting treatment established "plain vanilla" options as the "best practice" implementation.[71] In other words, much of what we now regret was the result of prior standardized practice that guidelines epitomize.[72] It is clear that legislated "say on pay" in the U.S. is one way to catch and stop the bad-behaving outliers. But there are costs and risks that cannot be ignored.

Moreover, the power that could well accrue to a small number of proxy advisors cannot be ignored, particularly in light of the conflicts of interest already beginning to emerge in the industry. Risk Metrics both rates firms on its proprietary corporate governance index and, through a purportedly separate arm, provides proxy voting advice. It charges firms for consulting services on how to improve corporate governance scores. A recent empirical paper that is generally skeptical about the predictive value commercial corporate governance ratings asserts that the index produced by ISS "exhibits virtually no predictive ability."[73] In a mandatory "say on pay" world in the U.S., it is easy to imagine that a single party could create guidelines, establish "rating systems" for good compensation, consult with firms on how to improve their compensation ratings in light of their particular circumstance (counting on management's and the compensation committee's great sensitivity to bring in business), and then, behind a "chinese wall," "on a separate floor," provide proxy voting advice to shareholders.

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

Moreover, there would be no "big bang" in the U.S. As discussed above, U.S. shareholder activists have focused on executive compensation for some time, through both the shareholder proposal machinery and withhold vote campaigns for offending compensation committee directors. The one area in which US law favors shareholders relative to the UK is with respect to the making of shareholder proposals, usually precatory.[74] Majority voting for directors rules that have been adopted by a majority of U.S. public firms only add to the potency of withhold vote campaigns. Ironically such activity in the U.S. over the same period as the DRR

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

[71] The newly adopted tax law change that addressed executive compensation also pushed in the direction of plain vanilla options. See note 75 *infra*.

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

[73] Robert Daines et al, Rating the Ratings: How Good Are Commercial Governance Ratings?, W.P. Sept. 2008, available at http://ssrn.com/abstract=1152093; see also Sanjai Bhagat, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008).

[74] Rule 14a-8 under the US 1934 Securities and Exchange Act, 17 CFR § 240.14a-8(b) provides access to the issuer proxy to a small shareholder (owning the lesser of $2000 in market value or 1%). By contrast, Section 376 of the UK 1985 Companies Act 1985 imposes a 5% share ownership threshold.

regime may well have produced a one-time downward revision lacking in the UK, according the Ferri & Maber's data.[75]

3. Executive Compensation as a Hard Problem

Even putting aside agency cost considerations (which are considerable), devising an effective executive compensation scheme is hard. Private equity firms have a solution – very high levels of stock-related compensation that pays off only upon a successful exit from the going private transaction. Success results in very large payoff, but a fired private equity CEO typically loses unvested options and restricted stock (rather than obtaining acceleration through a U.S.-style golden parachute). Severance is typically limited to the equivalent of one or two years' salary, but of course the salary base is much smaller because of the concentration on incentive-based pay.[76] For such high-powered incentives to work well, a high-powered governance structure is also required.

So why isn't the private equity model an exemplar for public company practices? One possible answer is that it may be too demanding, both on the executives who bear enormous firm-specific risk, and on the governance structure, which requires directors who are knowledgeable about the business, deeply engaged, and willing to resist management pushback against close monitoring. For example, a recent paper by Leslie & Oyer observes that compensation patterns in reverse leverage buyouts begin to revert to the public company norm within one year of the going public transaction.[77] "Executive ownership drops quickly and substantially right after the IPO… to levels similar to public firms."[78] Salary levels take a little longer to reach the comparable public firm norm, three or four years. Private equity owners presumably have every incentive to maximize the value of their shares in the exit IPO and bear the cost of compensation structures, so it is hard to believe that they would knowingly install a suboptimal regime.

III. ALTERNATIVES TO MANDATORY UNIVERSAL "SAY ON PAY"

So we need public firms and we need compensation mechanisms that reward, provide incentives, and are political sustainable -- in short, that serve a number of social ends. It is tempting to contest the wisdom of near-term federal legislative change, on the view that the current U.S. compensation reform project is headed in the right direction, that prior legislative intervention has been fraught with unintended consequences,[79] and that particular problem areas, such as compensation in the financial services area, need scrutiny through a "safety and

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[75] Ferri & Maber, *supra* note 4, at 56,Table 7 Panel A. This apparent finding may have resulted from exchange rate fluctuations, see Table 7, Panel B, so must be taken cautiously.
[76] *See* David Carney, *Deliver and You Get Paid*, THE DEAL, June 1, 2007.
[77] Philip Leslie & Paul Oyer, *Managerial Incentives and Strategic Change: Evidence from Private Equity* (draft, March 2008) (manuscript on file with Jeffrey N. Gordon).
[78] *Id*. at 16-17.).
[79] he early 1990s effort at addressing "excessive" executive compensation through section 162(m) of the Internal Revenue Code is widely regarded as a failure. In setting a $1 million threshold, it probably increased the level of executive compensation at many firms. In exempting performance-based pay, it encouraged the rush to stock options. And in limiting the form of stock options that would count as performance-based, it encouraged the use of plain vanilla options rather than options that subtracted out market or sector effects. See generally Gregg Polsky, *Controlling Executive Compensation through the Tax Code*, 64 Wash & Lee L. Rev. 877 (2007).

soundness" lens, not the customary viewpoint of corporate governance. The reform project's tools include two potent weapons: first, firm-specific "say on pay" campaigns that can be targeted against compensation miscreants and that can have useful demonstration effects for many other firms,[80] and second, targeted "just vote no" campaigns against compensation committee members that can have similar, perhaps even more powerful, firm-specific and demonstration effects.[81] These efforts could be augmented by concerted efforts by institutional investors, other governance groups, and the securities analyst community to develop a set of compensation "good practices," akin to the Greenbury Code, that could provide a focal point for engagement. Such measures will become even more effective as institutional investors gain more experiences in coordinated activity and as stock market ownership becomes even more institutionalized. From a pay-for-performance perspective, this kind of "muddling-through"[82] might actually dominate the alternatives.

Nevertheless some expansion of shareholder rights in the executive compensation area has a legislative momentum that responds to the political moment, and an advisory vote is far from the greatest possible intervention. In my view the negative side effects would be reduced by modifications to the mandatory, universal version of "say on pay" that is under consideration. First, "say on pay" should be made optional based on a clearly defined and protected shareholder opt-in right that does not depend upon shifting winds at the SEC or, more significantly, different state corporate laws. Second, if optional "say on pay" is rejected, then any mandatory version should be limited to the largest firms, where compensation concerns are likely to be the greatest and where parties' behavior under the rule can most easily be observed. The theory behind both of these alternatives is that shareholder attention focused on the pay practices of a smaller number of firms is a better way to restrain excessive or abusive compensation packages while limiting the risks of formulaic approaches that would ill-suit many firms. Moreover, each alternative tests in a different way the usefulness of "say on pay" as a governance device without committing to a system-wide approach.

A. *Shareholder Opt-into "Say on Pay"*

Shareholder opt-in empowers shareholders to target those firms whose pay practices (or the board's justification of them) raise the most serious questions. It would signal both the shareholders' expectation of significant engagement by the board and the shareholders'

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[80] Recent evidence on board responsiveness to shareholder proposals has been somewhat encouraging. See Yonca Ertimu et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals* (WP April 2008), available on SSRN at http://ssrn.com/abstract=816264 (greater board responsiveness to recent "majority vote" shareholder proposals than prior proposals). Fabrizio Ferri & Tatiana Sandino, *The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing* Harv. Busn. Sch. W.P. No. 08-022 (Sept.2007) (finding that shareholder proposals in 2003, 2004 on stock option expensing affected probability of subsequent decision to expense, the effect increasing in the degree on shareholder support, and with spillovers to other firms).

[81] *See* Diane Del Guercio et al, *Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'?* J. FIN ECON. (forthcoming 2008), available on SSRN at http://ssrn.com/abstract=575242 (positive effects from "just vote no" campaigns"); Jie Cai et al, Electing Directors (WP March 2008), available on SSRN at http://ssrn.com/abstract=1101924) (lower votes for directors is correlated with subsequent reductions in excess compensation). For an argument generally in favor of election-based approaches, see Leo E. Strine, Jr., *Breaking The Corporate Governance Logjam In Washington: Some Constructive Thoughts On A Responsible Path Forward*, 63 BUS. L. 1079 (2008).

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

willingness to engage over executive compensation issues, at least at the outset.[83] A shareholder opt-in right could be the principle objective of "say on pay" legislation, since the current federal and state pattern significantly constraints shareholder initiative in this area.

The current framework provides two potential routes for adoption of "say on pay" at a particular firm. First, a qualifying shareholder can use the shareholder access to the issuer proxy currently provided under the SEC's proxy rules[84] to propose shareholder adoption of a precatory resolution requesting the board to provide shareholders with an annual advisory vote on executive compensation. This "precatory route" means that a proposal approved by the requisite shareholder majority still requires board action, which is not necessarily forthcoming. Second, a shareholder can use the same proxy access machinery to propose shareholder adoption of a bylaw that would require such a shareholder advisory vote, the "bylaw route."

Shareholder access to the issuer proxy statement is a construct of the SEC's proxy rules, in particular the shareholder initiative rule. Over its 66 year history, such shareholder access has become an embedded element of the US corporate governance model, although its terms have been significantly amended and reinterpreted over the period.[85] For executive compensation, two limitations have been particular flashpoints: the excludability of a proposal that "deals with a matter relating to the company's ordinary business operations,"[86] or that "is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."[87] Since a significant reinterpretation of "ordinary course of business" in 1992, the SEC staff, though its "no-action" process, has developed a series of interpretations that seem to have fashioned a safe harbor for "say on pay" proposals. The 1992 reinterpretation distinguished between proposals that relate to "general employee compensation matters" (excludible) and "only senior executive and director compensation" (not excludible).[88] More recently, as executive compensation has become a more frequent subject, the staff has followed a pattern that seems to distinguish between specific compensation formulas (often excludible) and a shareholder advisory vote (generally not excludible).[89] A 2007 AT&T no-action letter clearly articulated the non-excludability of a "say on pay" resolution,[90] although the company's sharp challenge seems somewhat in tension with a recent remarks by a senior official that "the staff decided some time ago that so-called 'say on pay' proposals generally could not be excluded as relating to ordinary business."[91]

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[83] Shareholders should also be able to choose a time-limited opt-in as well as an indefinite opt-in to permit greater calibration.

[84] This route is provided by Rule 14a-8 promulgated under the 1934 Securities Exchange Act.

[85] See generally 4 Louis Loss & Joel Seligman, SECURITIES REGULATION 1916-83 (3d ed. 1990); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 98-99(1988); Jeffrey N. Gordon, P*roxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475 (2008) .

[86] Rule 14a-8(i)(7).

[87] Rule 14a-8(i)(1).

[88] SEC Corporation Finance Staff Legal Bulletin 14A (Shareholder Proposals) (July 12, 2002), available at http://sec.gov/interps/legal/cfslb14a.htm#P32_3865.

[89] The no-action letters relating to specific formulas are canvassed in Marc H. Folladori, *Shareholder Proposals* (Jan. 2008) , available on Westlaw, 1641 PLI/Corp. 81.

[90] *AT&T Inc*., 2007 SEC No-Act. Lexis 196 (Feb. 16, 2007). See also *Sara Lee Corp.*, 2006 SEC No-Act. Lexis 610 (Sept. 11, 2006) .

[91] John W. White, Director, Division of Corporation Finance, *Corporation Finance in 2008 – A Year of Progress* (Aug. 11, 2008), available at http://www.sec.gov/news/speech/2008/spch081108jww.htm.

Another potential pitfall for "say on pay" precatory proposals is the objection that compensation is the kind of management oversight decision delegated to the board under state corporate law and thus not a "proper subject" for shareholder action. As in most contexts, the SEC staff has relied on the precatory nature of the proposals -- that a proposal "requests" or "recommends" or "suggests" board action -- in refusing no-action requests for exclusion on this or similar grounds.[92] In any event, after the submission of dozens of "say on pay" proposals in 2007 and 2008, it seems almost certainly the case that, at least in the near term, the SEC will allow proxy access for such proposals. Of course, in response to a different political mood, the SEC remains free to change its interpretation or rewrite the shareholder initiative rule.[93] Moreover, the proposals are precatory, meaning that even after an approving shareholder vote, their efficacy depends upon the board's acceptance and implementation. Thus far, not all firms have followed through with the shareholders' "recommendation." A pattern of resistance could take hold, either through outright refusal or narrowing the scope of the advisory vote, though at least some sophisticated counselors believe that such a course risks a withhold vote campaign against the compensation committee or the entire board at the next annual meeting.[94]

The bylaw route has the advantage of being self-executing. Adopted by shareholders as a change to the internal governance processes of the firm, a by-law does not depend upon board acquiescence. Putting to one side the technical challenges in drafting a bylaw that is sufficiently prescriptive to constrain a possibly resistant board, the major impediment is whether such a shareholder initiative is consistent with state law. A proposal is excludible if the firm can successfully argue that a shareholder-adopted bylaw would trench on the firm's "ordinary business" or would "cause the company to violate state law"[95] by turning over to shareholders matters within the scope of the board's managerial prerogative and fiduciary responsibility.

The potential reach of shareholder-adopted by-laws has been controversial. In Delaware, there is a "recursive loop"[96] in the interaction of section 109(b), which permits bylaws to "contain any provision, not inconsistent with law … relating to the business of the corporation [and] the conduct of its affairs…" and section 141(a), which prescribes that a corporation's "business and affairs … shall be managed by or under the direction of a board of directions, except as may be otherwise be provided in this chapter…"[97] The Delaware Supreme Court

[92] Rule 14a-8(i)(1) Note. For its 2007 no-action request, AT&T argued that "say on pay" would cause the company to violate state law, excludible under Rule 14a-8(i)(2), because it "would prevent the board from exercising its fiduciary duty to determine what matters should be submitted to the shareholders at an annual meeting . The no-action letter said the argument was insufficiently weighty "to meet [AT&T's] burden of establishing that the proposal would violate applicable law."

[93] See, e.g., Am. Fed'n of State, County & Mun. Employees (AFSCME) v. Am. Int'l Group, Inc., 462 F.3d 121, 130 n.9, 131. (2d Cir. 2006).

[94] See e.g., Latham & Watkins, *Say on Pay" Shareholder Advisory Votes on Executive Compensation: The New Frontier of Corporate Governance Activism* (Nov 2007), available at http://www.lw.com/upload/pubContent/_pdf/pub2039_1.pdf.

[95] Rule 14a-8(i)(1),(2).

[96] See Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Approved Bylaw Amendments,"* 19 CARD. L. REV. 511, 546-49 (1997).

[97] Del. Gen. Corp. L. §§ 109(b), 141(a). Although the Revised Model Business Corporation Act initially seems to avoid this circularity, by not conditioning the board's exercise of managerial authority on other law, see §§ 2.06 (bylaw definitions) and 8.01(b) (board prerogative), the circularity may reemerge in provisions that seem to allocate certain corporate power to shareholders that seems to imply a carve-out for limits on board power otherwise stated in law. See §§3.02(3) (corporate power to amend bylaws); 8.01(b) (apparently exclusive grant to board to exercise all corporate powers); 10.20(a) (shareholder power to amend bylaws); 10.20(b) (shareholder power to constraint

recently cut through the tangle in *CA, Inc. v. AFSCME Employees Pension Plan*[98] by declaring the directors' preeminence (section 141(a) wins) and thus presumptively invalidating any bylaw that trenches on the board's managerial prerogatives. Shareholders may propose bylaws that are "procedural, process-oriented,"[99] not ones that "mandate how the board should decide specific substantive business decisions."[100] How this "process"/"substance" distinction plays out in the context of "say on pay" will determine the usefulness of the bylaw route in pursuing shareholder opt-in.

In *CA*, the proposed bylaw would have required the board to reimburse a winning proxy contestant for expenses incurred in a "short slate" campaign (less than half the board). The case arose because in responding to CA's no-action request, the SEC used a new Delaware constitutional amendment that permits referral of such matters to the Delaware Supreme Court. The question was whether the proposal was a "proper subject for action by shareholders as a matter of Delaware law"[101] and whether the proposal, "if adopted, [would] cause [the corporation] to violate any Delaware law."[102] The Delaware Supreme Court held that the proposal was a proper subject, even though it addressed the payout of corporate funds, because it "has both the intent and the effect of regulating the process for electing directors."[103] The Court seems strongly influenced by the context in which the bylaw would operate, the core shareholder interest in the election of directors. The Court took a different view on the proposal's lawfulness: Because the payout was mandatory, it precluded the board "from fully discharging their fiduciary duties to the corporation and its shareholders"[104] and thus violated Delaware law.

The *CA* case injects uncertainty into whether shareholders of Delaware corporations can pursue the bylaw route to "say on pay." To be sure, such a bylaw aims only at an advisory vote, thus wanting to be a bylaw "that establishes or regulates a process for substantive director decision-making," not one "that mandates the decision itself."[105] Nevertheless the subject of the initiative, executive compensation, is at the core of the board's managerial function and one goal of the bylaw is to enhance shareholder influence over pay. Unlike in director elections, however, shareholders have no obvious role in setting executive compensation. As with other business decision (undoing a poison pill, for example), the preexisting Delaware default is that shareholders should focus on replacing the board.[106] The power that shareholders now have in the compensation area derives from the voting requirements of stock exchange listing rules[107] and the Internal Revenue Code.[108] The Delaware courts have previously indicated that such

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board's amendment of shareholder-adopted bylaw). These provisions cannot be harmonized without an implicit carve-out.

[98] 953 A.2d 227 (Del. 2008).
[99] 953 A.2d at 235.
[100] 953 A.2d at 234-35.
[101] 953 A.2d at 231 (tracking Rule 14-a(8)(i)(1).
[102] Id. (tracking Rule 14a-8(i)(2).
[103] 953 A.2d at 236.
[104] 953 A.2d at 238 (footnote omitted).
[105] 953 A.2d at 235.
[106] See Unitrin, Inc. v. Am Gen. Corp., 651 A.2d 1361 (Del. 1995).
[107] Section 303A.08 of the NYSE listing standards (and the parallel NASDAQ rule) requires a shareholder vote on the creation of "equity-compensation plans and material revisions thereto."
[108] Section 162(m) of the Internal Revenue Code requires shareholder approval of a stock option plan that would be regarded as "performance-based" and so outside the $1 million deductibility cap on executive compensation.

external grants of shareholder power do not create a protectable Delaware interest.[109] Moreover, the "say on pay" bylaw would require the board to put an advisory resolution on executive compensation before the shareholders every year. Does this denial of discretion prevent the directors from "fully discharging their fiduciary duties?" It is not just that the SEC might exclude a "say on pay" bylaw from an issuer proxy, but that such a bylaw might be invalidated by a reviewing state court.

Finally, when the public eye veers away from this current crisis, Delaware (or some other state) may well adopt some management-protective law that puts executive compensation off limits for shareholder engagement. So might be predicted by the "race to the bottom" theorists about corporate law's evolution.

Thus a useful role for federal legislation is to establish shareholders' right to opt into a "say on pay" regime. The bill passed by the House in the 110th Congress usefully describes the nature of that regime;[110] the legislation could be readily modified to establish that such an opt-in right is exercisable through a shareholder vote pursuant to procedures specified by the SEC for qualifying shareholders to propose an opt-in via issuer proxy access.[111]

B. *Narrowing the Range of Covered Firms Subject to a Mandatory Regime*

An alternative approach is to enact a mandatory "say on pay" regime for some but not all firms, based on a size measure like the stock market float of non-affiliated shareholders. Indeed, the UK precedent supports such a limitation. Only firms listed on the LSE's Main Market (now 1080 firms) are subject to "say on pay," not the generally smaller firms that trade on the AIM (now 1546 firms).[112] In general a strategy that focuses on the largest firms is likely to improve the benefit/cost payoff of a mandatory rule. Three factors account for this. First, the monitoring and shareholder engagement costs of "say on pay" do not vary greatly in firm size but the payoff

[109] Paramount Communications v. Time Warner, Inc., 1989 WL 79880 (Del.Ch.. 1989) (at TAN 18), aff'd 571 A.2d 1140, (1990) (restructuring of a transaction to avoid the shareholder vote that would have been required under the NYSE listing rules did not call for greater scrutiny because shareholder vote did not arise under Delaware law).

[110] See HR 1257. The revised legislation should omit the provision calling for a separate vote on a golden parachute in connection with an acquisition. Ordinarily the golden parachute of a senior officer would have been previously been subject to an advisory vote or would be more accurately characterized as a retention arrangement paid by the acquirer, which generally would not be offered to a failed senior manager. "Pay for failure" is not well addressed by such provision.

[111] There are many important technical details to a shareholder opt-in regime. For example, what should be the required vote? Should shareholders also be able to opt-out? In my preliminary view, the required vote should be the vote the firm usually requires for non-extraordinary shareholder action, typically a majority of those voting "yes" or "no," but in no event should the required voted exceed an affirmative majority of the outstanding common stock, to avoid the risk of "shark repellant" supermajority charter amendments. I also preliminarily think that shareholders should have the right to opt-in for a fixed period and to opt out after a minimum of three years experience with a "say on pay" regime. In any event, the measure should also provide that any opt-out vote must be subject to the same voting rule as the opt-in vote. It seems to me that a view that shareholders should have the right to opt-out of the regime after a testing period implies that both opt-in and opt-out decisions should be subject to a majority vote of the relevant quorum.

[112] This is because the AIM firms are not on the "official list" and thus not subject to the DRR requirements, see *supra* note 65, nor the LSE Listing Rules. Technically AIM is not an "exchange," but an "exchanged regulated market," which permits this distinction under the applicable EU directives. See AIM Frequently Asked Questions, http://www.londonstockexchange.com/NR/exeres/147CB65C-2EC8-4F8C-B29F-92D96C352362.htm (last visited Jan. 17, 2009). Although the median AIM firm market capitalization is approximately £10 million, more than 75 firms have a market capitalization greater than £100 million. See London Stock Exchange, Main Market Statistics, Table 8 (Dec. 2008).

does. This has important efficiency implications at the firm level and systemically. Almost all public firms engage in tax-related executive compensation planning and stock-based compensation (a major advantage in going public) that requires considerable focus to understand properly. Yet from a social perspective, "getting it right" matters more for larger firms, both because of putative performance-based effects of better compensation practices and on the social responsibility dimension. Since compensation generally varies in firm size, it is large firm compensation that has been most salient. As noted above, potentially 14,000 firms are subject to the SEC proxy regulations; more than 3000 are presumed to have market capitalization over $75 million. The poor benefit/cost ratio from close scrutiny of particular compensation practices at the vast majority of these firms is a major driver to standardized guidelines and "one size fits all." Limiting mandatory "say on pay" to the largest firms, where the benefits from particularized scrutiny and engagement will be greatest, will reduce this systemic risk.

Second, smaller public firms may present governance challenges different from larger firms, including in executive compensation. For example, the strong contemporary reformist push towards boards that consist almost exclusively of independent directors may be costly for smaller firms. The governance failures at large firms have played a large role in the reform narrative, and enhancing the monitoring role of directors has been a major focus of reformist energy. Yet in smaller firms, directors provide "resources" in addition to (or in substitution for) monitoring, such as access to sources of finance, business partners, specialized skills, and general business expertise.[113] Thus the stock exchange and SOX board-related mandates have affected larger and smaller firms differently, with perhaps negative effects for smaller firms.[114] Similarly the level, form and structure of executive compensation, the composition and role of the board, the role of founders and family, and the nature of shareholdings will vary considerably depending on firm size. Monitoring issues would expectedly be different; smaller firms are more exposed to capital markets and the market in managerial services. Shareholder opt-in to say on pay is an effective way to avoid the mismatch of this particular mechanism to the different situation of smaller firms.

Third, the risks of "off label" use of "say on pay" are probably highest in small firms because a smaller market capitalization both eases block acquisition and lowers the public visibility that may constrain certain activist behavior. It is naïve to think that in the US context "say on pay" will be used exclusively by long term shareholders concerned about CEOs who may extract excessive compensation. Instead, in at least some instances, the vote will serve as a low cost "no confidence" measure on management's strategy and the board's oversight. The compensation nexus will be that if performance is lacking, the basic compensation problem is that the CEO is still on the payroll. A blockholder who could credibly promote an embarrassing vote on a "say on pay" resolution will gain significant bargaining power with the incumbents to pursue strategies that may not necessarily serve the interests or goals of all other shareholders. It is not to be excessively critical of this form of shareholder empowerment to concede its existence; it may be a good thing to give activists another tool. The question is what are the checks and constraints. In the UK, these checks have historically arisen from a pattern of repeat interactions among a relatively small number of institutional investors of similar longterm payoff

[113] This perspective is emphasized in the management science literature.

[114] See, e.g., M. Babajide Wintoki, *Corporate Boards and Regulation: The Effect of the Sarbanes–Oxley Act and the Exchange Listing Requirements on Firm Value*, 13 J. CORP. FIN 229 (2007); James S. Linck et al, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors* (forthcoming Rev. Fin. Stud. 2008).

horizons concentrated geographically in the City of London.[115] In other words, goals behavior can be observed, and reputations gain or lost.

Whether or not this pattern will persist in the UK is an open question,[116] but it has never existed in the US. For example, small firms have been disproportionately the target of activist hedge funds, because a medium-sized hedge fund can acquire a significant stake in a small firm while remaining diversified.[117] Given the uncertain long term effects of hedge fund activism and other good governance concerns, it seems wise to give shareholders of the most exposed firms the right to choose whether to make this additional activist tool available rather than to impose "say on pay" through a mandatory rule whose main target, truly, are the largest firms.

What would be a reasonable size threshold for the imposition of mandatory "say on pay," with an opt-in rule for other public firms? One conventional test might be the largest 500 reporting companies by market capitalization, net of shares beneficially owned by insiders and affiliates. Market capitalization would be determined as of yearend of the year that preceded the relevant annual meeting (so, December 31, 2008 for the 2010 annual meeting), and once a firm qualified, it would remain subject to the mandatory regime.[118]

C. *The Special Case of Financial Firms*

The spectacle of enormous compensation packages received in recent years by senior officers of financial firms that soon thereafter collapsed or survived only through an unprecedented government bailout has added new energy to the "say on pay" push. Yet "say on pay" is hardly the tool for this problem and it would be a mistake to adopt "say on pay" because of outrage over excessive compensation paid by financial firms. For these firms, specifically liquidity-providing firms whose failure would create significant systemic risks, reform should take a different direction, one that evaluates safety and soundness concerns created by particular compensation structures.[119]

The compensation structure for senior executives in many Wall Street firms was in many respects quite focused on "pay for performance." Firms were generating record level profits. Star traders received $10 million-plus bonuses because senior executive thought the alternative was to lose them to other Wall Street firms or the hedge funds, where payouts could reach even higher. Although senior executives received quite large cash bonuses, they also took a significant fraction of their compensation in own company stock. Employees owned more than

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115 See, e.g., Bernard Black and John C. Coffee, *Hail Britannia? : Institutional Investor Behavior Under Limited Regulation,* . 92 MICH. L. REV. 1997 (1994).

116 See generally John Armour and Jeffrey N. Gordon, The Berle-Means Corporation of the 21st Century , *supra* note 59. Indeed, a major new project of corporate governance reform is to deal with a worldwide pattern of increased ownership by increasingly diverse and geographically dispersed institutional investors, an ownership pattern that confounds the assumptions of both the US (retail) and the UK (concentrated institutional) systems.

117 For recent articles on the "size effect" and "performance effect" of activist hedge funds, see Alon Brav et al, *Hedge Fund Activism, Corporate Governance, and Firm Performance,* 63 J. FIN. 1729 (2008); Id., *The Returns , to Hedge Fund Activism***,** 64 FIN ANAL J. 45 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors,* J. FIN. (forthcoming 2009).

118 The SEC would need to work out various details, such as the applicability of "say on pay" to firm that dipped below the threshold and then made an acquisition through a reverse merger with a firm that never qualified.

119 Indeed, this seems to be the approach embraced by recent proposals of the Group of Thirty, chaired by Paul Volcker. See Group of Thirty, Financial Reform: A Framework for Financial Stability 12 (Jan. 15, 2009).

25% of the stock in Lehman Brothers and Bear Stearns.[120] The gold ring for senior AIG executives was participation in a lucrative restricted stock plan that could not be disposed of until retirement.

Wall Street firms were built on high-powered incentives. In the midst of the financial crisis, a blogpost blamed excessive risk-taking by hedge funds in light of their "2 and 20" compensation structure.[121] The response was that the compensation structure for investment bankers was "0 and 50," meaning that the bankers took home 50 percent of trading profits and fees, not a mere 20 percent. But shareholders were doing exceedingly well too. Over the January 2003-January 2007 period, indices of financial stocks doubled, an 18 percent annualized return.[122] There is no reason to believe that shareholders of financial services firms would have utilized "say on pay" to reject compensation packages that the board would have told them was essential to retain the talent that generated these profits.

Whatever the firm level risk associated with these compensation structures, the most significant policy issue was the systemic risk that these particular high-powered incentives created for firms whose failure would ramify throughout the financial system as a whole. In other words, much like improvident lending or failure to maintain sufficient capital, particular compensation structures may so threaten the safety and soundness of financial firms so as to call for a different sort of oversight. "Say on pay" is a procedural approach that relies on the self-interest of shareholders to enhance the board's bargaining power over senior officer compensation. On a firm by firm basis, shareholders are unlikely to internalize systemic risk. Thus for a crucial set of liquidity-providing firms that are above a certain size, compensation may require a regulatory review on the safety and soundness dimension.

IV. CONCLUSION

Executive compensation reform is difficult because devising a compensation structure that satisfies company-specific and officer-specific rewards and incentives objectives is difficult. It becomes doubly difficult because there are important social concerns tied up in this area of private decision-making. Beginning with the collapse of the dot.com bubble in 2000, governance activists have devised new tools to address excessive or misaligned compensation, including better accounting (the expensing of stock options), better disclosure (the SEC's augmented disclosure regime), and more board accountability (withhold vote campaigns). The saliency of high levels of executive compensation, especially "pay for failure," have made an additional tool, "say on pay" modeled on the UK example, seem like an attractive reform. The evidence suggests that "say on pay" has some downsides even in the UK, which would exacerbated by a simple transplant into the US. In particular the annual vote requirement is likely to result in a narrow range of compensation "best practices" that will be adopted throughout the economy. This creates efficiency concerns for individual firms and systemic concerns as the incentive effects of these particular compensation schemes unfold. Thus I have proposed that federal "say on pay" legislation should, for now, be limited to provision of a shareholder opt-in right to a "say on pay" regime at publicly-traded firms. Activists can focus on

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[120] Randall Smith et al, *The Lehman Stock Slide Hits Home: Employees Face $10 Billion in Losses,* WALL ST. J. Sept. 12, 2008.
[121] Meaning, fees of two percent of assets under management and 20 percent of profits.
[122] This was the performance of the Fidelity Financial Services sector fund.

firms where compensation looks to be a particular problem, and those experiences will provide useful information for other firms. This is a significant step.

If some sort of mandatory "say on pay" regime is nevertheless the legislatively preferred choice, then I would recommend that mandatory application be limited to the largest firms (something like the largest 500 firms by public market float) rather than to the full range of public firms, approximately 14,000. Compensation concerns have arisen particularly at the largest firms, and smaller firms present a different set of governance and compensation issues that would be particularly ill-served by narrowed set of compensation best practices.

Finally, the terms of the debate should not be distracted by the possible tie-in between compensation practices at financial firms and the credit bubble and meltdown. Compensation practices of significant liquidity-providing institutions are a safety and soundness issue, not principally a corporate governance issue.