ESSAY

"SAY ON PAY": CAUTIONARY NOTES ON THE U.K. EXPERIENCE AND THE CASE FOR SHAREHOLDER OPT-IN

JEFFREY N. GORDON*

Shareholder and public dissatisfaction with executive compensation has led to calls for an annual shareholder advisory vote on firms' compensation practices and policies, so-called "say on pay." Proposed federal legislation would mandate "say on pay" generally for U.S. public companies. This Article assesses the case for such a mandatory federal rule in light of the U.K. 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 U.K. 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 U.K. evolution in that direction. This problem might be more pronounced in the U.S. because shareholders are even more likely than their U.K. counterparts to delegate judgments over compensation practices to a small number of proxy advisors who themselves will be economizing on analysis. The Article 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 Article argues that any mandatory regime should be limited to the 500 largest public companies by public market float and should not cover the more than 12,000 firms subject to SEC oversight. 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 concerns should be addressed separately.

I. 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 to be on the public agenda. At a recent Columbia conference, a *Fortune* editor displayed a fifty-year span of magazine covers featuring sky-high executive compensation stories. "Excessive" CEO pay[1] led to tax law changes in the early 1990s.[2] Large stock option

* Alfred W. Bressler Professor of Law, Columbia Law School; Fellow, European Corporate Governance Institute. B.A., Yale University, 1971; J.D., Harvard Law School, 1975. I am grateful to Brian Cheffins, Fabrizio Ferri, Jesse Fried, Robert Jackson, Gary Lutin, Eric Nowak, Mark Roe, Randall Thomas, and discussants at the Shareholders Forum for discussion and insightful comments on an earlier draft. I am also grateful for the candor of certain parties in the financial services industry.

[1] *See* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991) (focusing on executive compensation).

payoffs and mega-grants made for splashy news stories in the late 1990s.[3] Golden parachute payouts to fired CEOs generated lurid headlines in the 2000s.[4] Hedge fund managers, whose billion dollar annual paychecks dwarfed the typical CEO package, preened in the heady 2004–07 period.[5] By the mid-2000s the changing ratio in the compensation level of CEO versus line-worker—from 20-1 in the 1950s to a purported approximate of 350-1 today—created controversy in the political realm as well as the boardroom.[6] This furor was only aggravated by the financial services meltdown that came before the ink had dried on enormous bonus checks.[7]

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 U.K. reform. The House, but not the Senate, passed such legislation in the 110th Congress.[8] In light of the 2008 election

---

[2] Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469–71 (1993) (codified at I.R.C. § 162(m) (2006)).

[3] *See, e.g.*, Adam Bryant, *Earning It: Flying High on the Option Express*, N.Y. Times, Apr. 5, 1998, § 3, at 1 (reporting on large stock option grants in 1997). *See also* Geoffrey Colvin, *The Great CEO Pay Heist*, Fortune, June 25, 2001, at 64 (describing "megagrants").

[4] *See, e.g.*, 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; Eric Dash, *An Ousted Chief's Going-Away Pay Is Seen by Many as Typically Excessive*, N.Y. Times, Jan 4, 2007, at C4 (reporting, with accompanying graphic, on Robert L. Nardelli's $210 million exit package from Home Depot and comparable severance for Hank McKinnell, $213 million (Pfizer, 2006); Jay S. Sidhu, $44 million (Sovereign Bank, 2006); Philip J. Purcell, $95 million (Morgan Stanley, 2005); and Tom Freston, $85 million (Viacom, 2006)); Jenny Anderson, *Chiefs' Pay Under Fire at Capitol*, N.Y. Times, Mar. 8, 2008, at C1 (reporting allegations that Charles O. Prince III (Citigroup), E. Stanley O'Neal (Merrill Lynch), and Angelo Mozilo (Countrywide Financial) have "reaped lavish compensation" despite firms' economic distress).

[5] *See, e.g.*, Landon Thomas, Jr., *More Rumors About His Party Than His Deals*, N.Y. Times, Jan. 27, 2007, at C1 (reporting on the 60th birthday party of the co-founder of a leading private equity and hedge fund); *see generally Top 25 Highest-Earning Hedge Fund Managers*, Alpha, Apr. 2009, http://www.iimagazine.com/Alpha/Article.aspx?ArticleID=2165638 (*Alpha* magazine's annual list of most highly compensated hedge fund managers, produced on the basis of self-supplied information).

[6] Inst. for Policy Studies & United for a Fair Econ., Executive Excess 2008 3, 21 (2008) (based on a ratio of average compensation of the CEOs in the S&P 500 (from an Associated Press survey) to the average annual income of a production worker paid hourly (from Bureau of Labor Statistics reports)).

[7] *See* Louise Story, *On Wall Street, Bonuses, Not Profits, Were Real*, N.Y. Times, Dec. 18, 2008, at A1. The furor overflowed upon press reports of large bonuses and retention payments made by the unit of AIG responsible for the misguided derivatives positions that necessitated $180 million in emergency government support. Within days of the first reports, the House of Representatives overwhelmingly voted for a bill that would impose a ninety-percent excise tax on almost all bonuses handed out by financial sector recipients of significant emergency government support. H.R. 1586, 111th Cong. (2009) (covering recipients of more than $5 billion in support). *See generally* Greg Hitt & Aaron Lucchetti, *House Passes Bonus Tax Bill*, Wall St. J., Mar. 20, 2009, at A1.

[8] H.R. 1257, 110th Cong. (2007) (sponsored by Rep. Barney Frank (D-Mass.)). *See also* H.R. Rep. No. 110-88 (2007); *Empowering Shareholders on Executive Compensation: Hearing on H.R. 1257, The Shareholder Vote on Executive Compensation Act Before the H. Comm. on Financial Servs.*, 110th Cong. (2007) [hereinafter *Hearing on The Shareholder Vote on Executive Compensation Act*].

results, then-Senator Barack Obama's sponsorship of the unsuccessful Senate-side companion bill,[9] as well the increased saliency of the compensation issue, adoption of some sort of "say on pay" requirement seems highly likely. Indeed, the economic stimulus legislation enacted in February 2009 required "say on pay" for firms receiving emergency federal support,[10] an estimated 300 firms, mostly in the financial sector.[11] The SEC made this requirement effective with the 2009 proxy season,[12] and firms and activist investors are hastily devising responses.[13] Ironically, the stringent compensation limits previously imposed on recipients of emergency support[14] may undercut the value of this partial and temporary mandatory "say on pay" regime as an experimental test of a more general system.

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 U.K. experience, a comparable U.S. 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 10,000 U.S. firms that are likely to be covered.[15] 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-

---

[9] S. 1181, 110th Cong. (2007).

[10] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (2009) (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3765, 3776–77 (2008)).

[11] *See* Posting of Ted Allen to Risk & Governance Blog, http://blog.riskmetrics.com/index.html (Mar. 6, 2009) (citing government estimates of 280 firms). *See also* Phred Dvorak, *Hundreds of Firms Must Grant 'Say on Pay'*, WALL ST. J. ONLINE, Feb. 26, 2009, http://online.wsj.com/article/SB123569317570788185.html (approximately 400 firms).

[12] *See* SEC, DIV. OF CORPORATE FIN., COMPLIANCE AND DISCLOSURE INTERPRETATIONS: AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 (2009), http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm (following views of Sen. Christopher Dodd (D-Conn.), sponsor of the particular provision).

[13] A valuable resource to follow these developments is the Shareholder Forum, The Shareholder Forum for Reconsidering "Say on Pay", http://www.shareholderforum.com/sop/ (last visited Apr. 9, 2009).

[14] For recipients of significant emergency assistance, the level of deductible cash and bonus for an executive was reduced from from $1 million to $500,000 (see Sec. 302, Div. A of Pub. L. 110-343, the Emergency Economic Stabilization Act of 2008 ("ESSA"), amending I.R.C. § 162(m)(5)), and are subject to Treasury restrictions on excessive risk-taking and golden parachutes and that require "clawbacks" of payments affected by accounting restatements. ESSA, Sec. 111(b), implemented in 30 C.F.R. part 30 (2009). The 2009 legislation limits bonuses and similar payments to one-third of compensation, payable only in restricted stock that cannot fully vest until the institution repays the government assistance. *See* Emergency Economic Stabilization Act § 111(b)(3)(D) (amended by American Recovery and Reinvestment Act § 7001).

[15] *See infra* note 98 for the 10,000 firms estimate.

alignment mechanism,[16] we should avoid another rush to widespread 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 a small number of proxy advisors in an inherently complicated area.[17] The most important proxy advisor, RiskMetrics, already faces conflict issues in its dual role of both advising and rating firms on corporate governance[18] 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 (e.g., Arthur Andersen in the Enron scandal) and credit rating agencies in valuing mortgage-backed securities, there are inherent risks to the combination of consulting and rating functions.[19] Changes to corporate governance that might result from proxy advisory firm pressure have mostly marginal effects. Changes to executive compensation could be very important indeed.

Instead of a mandatory rule, this Article proposes federal legislative provision of a 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[20] and different state law regimes on the scope of shareholder versus board prerogative.[21] 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 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, this Article would recommend application only to the very largest firms, perhaps the top

---

[16] *See, e.g.*, James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 766 (1995) (noting institutional focus has not been on level of executive compensation but on aligning "pay and performance"); CalPERS, Why Corporate Governance Today? (Aug. 14, 1995).

[17] *See, e.g.*, Joshua Coval et al., *The Economics of Structured Finannce*, 23 J. ECON. PERSP. 3 (2009) (flawed assumptions behind ratings); U.K. Financial Services Authority, The Turner Review: A Regulatory Response to the Global Banking Crisis 76–78 (March 2009) (comparing default rates of corporate bonds and structured finance instruments).

[18] *See infra* text accompanying notes 111-114.

[19] See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1236–39 (2002) (accountants' provision of both audit and various consulting services); *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. (2007) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Law School) (credit rating agencies' provision of both rating and consulting services on obtaining high ratings).

[20] *See, e.g.*, Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121 (2d Cir. 2006) (discussing shifting SEC attitudes relating to proxy access for shareholder proposals that may affect director elections).

[21] *See, e.g.*, CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008) (discussing different Delaware judicial attitudes on shareholder versus director balance).

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 U.K. model, which applies only to domestic firms listed on the "main market" of the London Stock Exchange, not the less conventional Alternative Investment Market ("AIM") market, which is typically chosen by smaller issuers.

Finally, this Article notes the importance of separating out the issue of executive compensation in financial sector firms, the saliency of which is distorting the present debate. Compensation design in financial firms can have systemic effects that are beyond the scope of typical corporate governance concerns. This Article makes a specific proposal for a form of compensation review that would push firms toward compensation structures that force risk-creating employees to internalize that risk. Whether the firm achieves this objective is ultimately a matter for its systemic risk regulator, not the shareholders, who may, on a firm-by-firm basis, be quite content with aggressive risk-taking fostered by high-powered incentives.

In thinking about executive compensation it is useful to make a number of distinctions. First, what is the animating reason for 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—what might be termed "pay for failure?" The U.K. 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 by a financial services regulator in addition to whatever review shareholders may choose?

Part II of this Article generally engages the executive compensation issue, in particular why a "one size fits all" approach may not be best. Part III addresses the U.K. experience, including the likely result in the United States of a similar rule. Among other things, Part III discusses the limited empirical evidence on the effects of the U.K. rule, and its possible efficiency consequences, including the entrenchment of cash-based forms of incentive compensation. Part IV addresses the universal mandatory rule and its opt-in alternatives, explaining why a federal rule to protect shareholder opt-in may be necessary. Part V addresses particular compensation concerns for financial firms. Part VI concludes.

II. 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.[22] 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.[23] "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 a 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 need 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 towards shareholders and the increasing equity ownership positions of institutional investors, who were, as a matter of fiduciary law, concerned only with maximizing 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,

---

[22] *See, e.g.*, Lucian A. Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004).

[23] For strong statements from this perspective, see Working Group on Extreme Inequality, http://extremeinequality.org (last visited Apr. 11, 2009). *See also Hearing on The Shareholder Vote on Executive Compensation Act*, *supra* note 8, at 112 (statement of Richard Ferlauto, Director of Pension and Benefit Policy, American Federation of State, County and Municipal Employees) ("This type of inequity may eventually tear at the fabric of our society.").

not other constituencies.[24] 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.[25]

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 firms might well destabilize patterns of 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.[26] 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 which will register as "very high" on the social seismograph.

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

But a focus on "pay for performance" as the lodestar of compensation practice hardly produces straightforward solutions in the real world or 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 is to align managerial and shareholder interests in light of embedded legal rules that favor managers.

---

[24] *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) [hereinafter Gordon, *Independent Directors*].

[25] 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.

[26] *See* Carola Frydman & Raven Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005* 10–11 (Nat'l Bureau of Econ. Research, Working Paper No. W14145, 2008), *available at* http://ssrn.com/abstract=1152686.

Three examples illustrate the dilemma. 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. Unexpected changes in oil prices or an abrupt turn in credit markets could produce poor results even though managerial decisions were sound when made. Assume that the CEO's stock options, or other long-term incentive arrangements, are now significantly underwater. To re-price 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, leave the CEO with incentives for excessive risk-taking since the upside/downside payoffs are so asymmetric.[27]

In a second example, 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 already tied up in the firm's stock.[28] On that dimension, the CEO is already well-incentivized 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 the CEO probably believes will do a worse job?[29] The polar case merely illustrates the more general claim: "rewards" objectives and "incentives" objectives would not necessarily produce the same compensation contract, and the optimal CEO contract for a particular firm could well vary in CEO wealth accumulation.[30] This means that a comparison of compensation

---

[27] This is one reason why there is apparently little correlation between the value of stock option grants and realized performance. *See* Fabrizio Ferri & David Maber, *Say on Pay Vote and CEO Compensation: Evidence from the U.K.* 14 (AAA 2009 Mgmt. Accounting Section, Meeting Paper, 2008), *available* at http://ssrn.com/abstract=1169446.

[28] 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.

[29] 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 to compete for the CEO's services that will simply replace the accumulated original firm equity with new firm equity.

[30] 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

packages across firms can be noisy and potentially misleading about board performance.

Awareness of reward/incentive 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, it does not include the critical variable from an incentives perspective: the sensitivity of CEO wealth to changes in firm performance.[31] 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.

Finally, in the third example, the CEO departs because of a change in control (as through a merger) or termination without cause. At many firms this will trigger a "golden parachute," a severance payment to the CEO of significant size. Golden parachutes arose in response to the hostile takeover movement of the 1980s. There are two ways to analyze their emergence. 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 generous compensation 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's most importantly, and many state legislatures gave managers a takeover-resistance endowment—that is, the right to fight a hostile takeover using corporate resources, including the power to "just say no."[32] One way to solve this dilemma is to structure compensation to align managerial and shareholder

---

CEO age. *See* Rebel A. Cole & Hamid Mehran, *What Do We Know About Executive Compensation at Privately Held Firms?* 2, 4 (Fed. Reserve Bank of N.Y., Staff Report No. 314, 2008), *available at* http://ssrn.com/abstract=1156089.

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

[31] *See* 17 C.F.R. § 229.402 (calling for tabular disclosure of current year compensation, including equity grants, and outstanding option grants from prior years, but not aggregating ownership positions or requiring disclosure of current share ownership).

[32] *See, e.g.*, Paramount Commc'ns v. Time Inc., 571 A.2d 1140 (Del. 1989); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995); N. Y. Bus. Corp. § 717(b); Pa. Consol. Stats. Ann. 15-1715.

incentives in the face of a hostile bid, which is the polite way to describe the resulting golden parachute arrangement. So if the CEO receives a typical payment of 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 managers 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.[33] This then 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 sold at a premium, but "pay for failure" so egregious as to attract negative notice from a business-friendly Chief Executive[34]

It is a familiar Coasean observation that the assignment of a legal entitlement does not necessarily interfere with attaining efficient outcomes, although 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[35] and otherwise have empowered shareholder activists[36] have reduced the value of the takeover-resistance endowment.

---

[33] 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 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 and how often failed business decisions were *ex ante* wrong.

[34] Speaking before an audience of financial leaders in New York City on January 31, 2007, President George W. 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.

President George W. Bush, State of the Economy Address (Jan. 31, 2007), *available at* http://georgewbush-whitehouse.archives.gov/news/releases/2007/01/20070131-1.html.

[35] *See* Gordon, *Independent Directors*, *supra* note 24, at 1468, 1470, 1520–23, 1531–33, 1539–40.

[36] 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, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). *See generally* Henry Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden Ownership*, 79 S. Cal. L. Rev. 811 (2006).

We should therefore expect to see significant changes in golden parachute arrangements, which will separate out compensatory features from hold-up features and better tailor severance agreements to avoid the "pay for failure" scenario. 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.[37] Senior managers will be reluctant to give up beneficial contract terms they may have taken for granted.

These three examples illustrate the more general point that "pay for performance" is a complex phenomenon, not an easily measurable output variable, and that the 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 complementary nature 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 of performance incentives 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 the expected time frame for performance delivery. An "impatient" board may have to offer more generous compensation terms.

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). The term "profits" also seems to be associated with a hard measure, like more cash in the bank or funds available for dividends. Yet current profits reflect past investments; how should the company reward and incentivize the firm's development of valuable real options?[38] 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

---

[37] The two phenomena mean that having something and having to give it up engenders more resistance than being refused in the first instance.

[38] "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 the immediate 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 generally 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).

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 incentivized 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, section 304 of the Sarbanes-Oxley Act of 2002 ("SOX") imposes a clawback of bonus or incentive payouts, including profits on equity sales received by the CEO or chief financial officer ("CFO") in the event of misconduct that leads to an accounting restatement.[39] 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).

A "clawback" 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 the flaws in a trading model? What to do now about the bonus previously paid to the airline managers who, in 2007, brilliantly executed a long-term hedge against the escalation of oil prices?[40] To say that clawback necessarily improves long-term performance may be premature, as demonstrated by significant losses in Harvard University's endowment despite having had a sophisticated clawback scheme already in place.[41] The utility and implementation of a

[39] SOX, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002) (codified at 15 U.S.C. § 7243(a) (2006)). The practical effect of the SOX clawback provision has been extraordinarily limited because of courts' refusals 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 (on only two occasions since 2002), and a restrictive statutory approach that limits clawback to occasions of personal misconduct by either the CEO or chief financial officer. *See* Rachael E. Schwartz, *The Clawback Provisions of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 Bus. Law. 1, 2–5 (2008).

[40] *See* Jeff Bailey, *An Airline Shrugs at Oil Prices*, N.Y. Times, Nov. 29, 2007, at C1 (describing Southwest's then comparative advantage from oil price hedging).

[41] The current estimate is at least a thirty percent loss. *See* Athena Y. Jiang & June Q. Wu, *Payout To Fall By Eight Percent*, Harv. Crimson, Mar. 19, 2009, *available at* http://www.thecrimson.com/article.aspx?ref=527263; Peter Zhu, *Alumni Urge Lower Pay For HMC*,

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 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 executive compensation reform efforts have been principally process-focused and have been particularly geared toward process reform for the large public firm without a controlling shareholder who could keep managerial compensation in check.

In short, "pay for performance" is a standard idea but its expression across firms and individual CEOs seems to require custom tailoring. The complexity of the objective leads to complicated relational contracts that require human agency to shape and monitor. In the case of the large public firm with dispersed shareholders, this has meant the board.

C. Boards and Shareholders

In negotiating CEO compensation, the consensus view in the United States has been that the board of directors needs to serve as the shareholders' agent. As with many other reforms in corporate governance, the standard move has been to strengthen board independence from senior management, 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.[42] 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.[43] If compensation consultants are retained, this committee should have "sole authority" over that engagement.[44] 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

---

HARV. CRIMSON, Jan. 29, 2009, *available at* http://www.thecrimson.com/article.aspx?ref=526219 (noting clawbacks). The clawbacks have been a long-time feature of Harvard endowment management. *See* Jeffrey N. Gordon, *Executive Compensation: If There is a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675, 679 (2005) [hereinafter Gordon, *CD&A*].

[42] *See* Gordon, *Independent Directors*, *supra* note 24, at 1490–99.

[43] *See id.* at 1490–93. *See* NYSE Listed Company Manual 303A.05.

[44] *See id.*, Commentary (describing elements of compensation committee charter).

[CD&A] be included in the . . . annual report"[45]—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 the compensation consultants. 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 (e.g., 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?[46] Or do compensation consultants have a "style" or reputation for pay packages of a particular mix of compensation elements and levels, 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.[47]

---

[45] SEC Regulation S-K, 17 C.F.R. § 229.407 (2008).

[46] Section 201 of SOX, codified as Section 10A-3(g) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j-1(g), h, forbids most non-audit services performed "contemporaneously with the audit," and requires audit committee prior approval for any remaining non-audit service, including tax accounting. But the statute does not prohibit the audit firm from performing such non-audit services where it does not contemporaneously perform the audit. In this way SOX seems to assume that a firm's effort to sell non-audit services to firm A will not bias the independence of its audit services for firm B even though a reputation for audit "toughness" might offend firm A's management.

[47] *See* ALEXANDRA HIGGINS, CORPORATE LIBRARY, THE EFFECT OF COMPENSATION CONSULTANTS (2007); MAJORITY STAFF OF H. COMM. ON OVERSIGHT AND GOV'T REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS (Comm. Print 2007); Christopher S. Armstrong et al., *Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels* (Rock Ctr. for Corporate Governance, Working Paper No. 15, 2008), *available at* http://ssrn.com/abstract=1145548; Brian D. Cadman et al., The Incentives of Compensation Consultants and CEO Pay (Feb. 1, 2009) (unpublished manuscript, *available at* http://ssrn.com/abstract=1103682); Martin J. Conyon, Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom (May 2008) (unpublished manuscript, *available at* http://ssrn.com/abstract=1106729); Kevin Murphy & Tatiana Sandino, Executive Pay and "Independent" Compensation Consultants (June 20, 2008) (unpublished manuscript, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148991).

In using these empirical studies it is important to appreciate their methodological limitations. The House Committee Print, the boldest in its suggestion of firm-specific conflict, relies on basic quantitative descriptions of the differences between firms that do and 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. 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.

The most salient current issue 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 buttress boards’ independence-in-fact by making them more accountable.[48] 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, granular shareholder role, one that unbundles executive compensation from other elements of board decision-making.

One way to categorize the possible shareholder role in compensation-setting is with respect to four binary choices: (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 U.S. 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.”[49] Yet U.S. 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.”[50] 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.

III. 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 prac-

[48] Fabrizio Ferri suggested to me this way of formulating the issue.
[49] Gordon, *CD&A*, *supra* note 41, at 698–99.
[50] *Id.*

tices through the existing means of public and private response.[51] These include media reactions, private shareholder interventions with management 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,[52] most notably because of general shareholder debility in corporate governance, which argues 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 other senior managers, not to mention other members of the management team and line employees.[53] The sense of out-of-control compensation has been heightened both by enormous payouts to unsuccessful CEOs at a time of economic unease[54] and by the option back-dating scandal,[55] which suggested widespread overreaching by already well-paid senior managers.

In the search for remedies, governance activists, already inspired by the U.K. model of greater shareholder governance rights, looked to the United Kingdom'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.[56] After the Democratic takeover of

---

[51] *See, e.g.*, Christopher Cox, Chairman, SEC, Address to the New York Financial Writers Association (June 6, 2006), *available at* http://sec.gov/news/speech/2006/spch060806cc.htm.

[52] *See, e.g.*, John E. Core et al., *The Power of the Pen and Executive Compensation*, 88 J. FIN. ECON. 1 (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.").

[53] *See* Lucian A. Bebchuk et al., *CEO Centrality* (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 601, 2008), *available at* http://ssrn.com/abstract=1030107.

[54] *See* examples cited *supra* note 4.

[55] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. 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); 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, at A1. The back-dating persisted even after the adoption of SOX, which imposed internal controls standards that should have ended it. *See* Jesse M. Fried, *Options Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 856 (2008).

[56] *See infra* notes 58–59. The U.K. 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* Companies Act of 1985, 2002, sched. 7A (Eng.). Second, it required an advisory shareholder vote on the Report. *Id.* § 241A. The Report must provide particularized disclosure for senior executives of the various sources of compensation as well as an explanatory statement of 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

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.[57] The legislation died in the Senate. With the compensation provisions of the February 2009 Economic Stimulus package, "say on pay" has already entered the agenda of the new Congress.[58]

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.[59] The activists soon formed a working group to pursue "say on pay" and tried to find common ground with firms that regarded themselves as corporate governance progressives.[60] For the 2007 proxy season, activists led by the American Federation of State, Country and Municipal Employees ("AFSCME") and Walden Asset Management, the social investor, put forward approximately sixty precatory proposals.[61] The proposals generated average support of forty-two percent and passed at eight firms, including Verizon, Blockbuster, Motorola, and Ingersoll-Rand.[62] Two of the firms, Verizon and Blockbuster, adopted annual "say on pay" bylaw provisions.

Anticipation grew that sentiment for these proposals would snowball.[63] 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 seventy, and the level of shareholder support has remained at the same level, approximately forty-two percent.[64] Majority support was attained at ten firms, in-

---

shareholder vote is mandatory for every public company, "[n]o entitlement of a person to remuneration is made conditional on the resolution [required by this section] being passed . . . ." *Id.* § 241A(8). *See also* Directors' Remuneration Report Regulations 2002, 2002, S.I. 2002/1986, explanatory ¶ 1 (U.K.); GEOFFERY MORSE, ET AL., PALMER'S COMPANY LAW ¶ 8.207.3. The DRR requirement has been reenacted in sections 420–22, 439, 447, and 454(3) of the Companies Act of 2006. The detailed regulations are now found in the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations, 2008, S.I. 2008/410, sch. 8 (U.K.). *See generally*, L.C.B. GOWER & PAUL L. DAVIES, THE PRINCIPLES OF MODERN COMPANY LAW §§ 14–16 to 14–17, 14–22 to 14–23 (8th ed. 2008).

[57] *See supra* notes 8.

[58] *See supra* notes 9–12.

[59] *See* Kristin Gribben, *Divisions Grow Within Say-on-Pay Movement*, AGENDA, July 7, 2008, http://www.shareholderforum.com/sop/Library/20080707_Agenda.htm.

[60] *See* Stephen Taub, *Working Group Eyes "Say on Pay*," CFO.COM, Feb 8, 2007, http://www.cfo.com/article.cfm/8686940?f; L. Reed Walton, RiskMetrics Group, *Will Other Firms Follow Aflac?*, Feb. 23, 2007, http://blog.riskmetrics.com/2007/02/000886print.html.

[61] *See* Erin White & Aaron O. Patrick, *Shareholders Push for Vote on Executive Pay*, WALL ST. J., Feb. 26, 2007, at B1.

[62] *See* RISKMETRICS GROUP, 2007 POSTSEASON REPORT 5 (2007).

[63] *See* George Anders, '*Say on Pay' Gets a Push, But Will Boards Listen?*, WALL ST. J., Feb. 27, 2008, at A2.

[64] *See* Posting of Carol Bowie to Risk & Governance Blog, http://blog.riskmetrics.com/2008/08/another_majority_vote_for_say.html (Aug. 25, 2008); Posting of L. Reed Walton to

cluding Alaska Air, PG&E, Lexmark, Motorola (again), and Apple (presumably because of its stock option backdating involvement). Interestingly, support for "say on pay" slipped among shareholders at financial firms from percentages in the forties to percentages in the thirties.[65] Proponents had thought that massive losses would occasion shareholder outrage, especially in light of large payouts to departing CEOs at Merrill Lynch and Citigroup. One possible explanation is that investors were nervous about disrupting governance at a time of stress and were 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 determine 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."[66] 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 U.K. experience of invariable shareholder approval, and believe a vote is not a stern enough rebuke compared to the alternative of voting against retention of compensation committee members.[67] Others are wary of what they foresee as dependence on proxy advisory firms for voting guidance.

Because of the slow pace of adoptions of "say on pay" provisions over the last two years, proponents have put their hopes on mandatory adoption by federal legislation.

B. Legislated "Say on Pay" in the U.K.

So what of the U.K. experience? The relevant questions include: (1) How successful has it been in the U.K. in reining-in excessive compensation?; (2) Are there other effects that might be positive or negative?; (3)How would that experience translate to the U.S. setting?; and (4) In particular, how does a U.K.-like rule compare with firm opt-in through shareholder-proposed bylaw amendments?

Risk & Governance Blog, http://blog.riskmetrics.com/2008/05/us_midseason_reviewsubmitted_b_1.html (May 23, 2008).

[65] *See* 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, at C1.

[66] *See* Gribben, *supra* note 59. For a specific example, see PETER C. CLAPMAN, NEXT STEPS? BE CAREFUL, DIRECTORS & BOARDS, ANNUAL REPORT 2008, at 6 (retired head of corporate governance program at TIAA-CREF expressing skepticism on mandatory "say on pay" because 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.").

[67] *See* RISKMETRICS GROUP, *supra* note 62, at 1012 (detailing significant "withhold votes" at seventeen firms over compensation issues); Claudia H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, N.Y. TIMES, Apr. 6, 2008, at BU9.

The facts of the U.K. 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 United Kingdom'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, U.K. 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, however, also some empirical evidence that the "pay for performance" sensitivity of U.K. 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.

1. History of the U.K. Legislation

The U.K. adoption of a shareholder advisory vote on executive compensation had its roots in a particularly U.K. story of compensation "outrage."[68] 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'

---

[68] This account of the adoption of the U.K. regime draws from BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION (Oxford Univ. Press 1997); 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) (Rickford was the former project director of the U.K. Company Law Review of the Department of Trade and Industry and a member of European Commission's High Level Group on Company Law); 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); 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); Jonathan Rickford, *Fundamentals, Developments and Trends in British Company Law—Some Wider Reflections (Second Part)*, 2 EUR. CORP. & FIN. L. REV. 63 (2005).

Remuneration, which produced the "Greenbury Code" in 1995.[69] 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 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. 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 vast majority of firms complied with the compensation disclosure mandate.

The "New Labour" government that took power in 1997 began a review of various elements of the U.K. corporate governance system in light of a growing international consensus that good governance added a competitive economic edge. The procedural changes of the Greenbury Code had limited substantive effect. Thus, escalating U.K. CEO pay, post-tech bubble golden parachutes for dismissed CEOs, and survey data that less than five percent of firms had brought compensation policy questions to a shareholder vote[70] led to the 2002 amendment of the U.K. Companies Act to require both a somewhat more detailed disclosure regime than under the London Stock Exchange's 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 United Kingdom) stock price performance graph and the board's compensation rationale.

2. *Aftermath of the UK Legislation*

What has been the effect on U.K. compensation of the shareholder advisory vote? The new regime likely 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

---

[69] Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury (1995), *available at* http://www.econsense.org/_CSR_INFO_POOL/_CORP_GOVERNANCE/images/greenbury_report.pdf.

[70] *See* PricewaterhouseCoopers, Monitoring of Corporate Aspects of Directors' Remuneration (1999), available at http://www.berr.gov.uk/files/file13428.pdf (report to the U.K. Department of Trade and Industry).

rejection of the remuneration committee’s report.[71] During that year there were press accounts of shareholder interventions into the remuneration policy of perhaps a dozen large firms.[72]

In subsequent years, observers have noted four visible effects of the regime shift.[73] First, consultation has increased between firms and large shareholders, or at least with the leading institutional investor groups[74] and with the proxy services firms, RREV and IVIS.[75] 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—with all but GlaxoSmithKline’s involving small firms. Deloitte has reported that only ten percent of a large sample of firms received a negative vote of twenty percent or more over this period. Nevertheless, in recent years, the proxy services firms have recommended negative votes in ten to fifteen percent of cases, principally involving smaller firms. 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 such firms make changes to accommodate shareholder views.[76]

Third, the leading associations of institutional investors, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF), have extended their compensation influence through the fashioning of compensation guidelines that provide a set of yellow and red lines.[77] These guidelines build on the “best practices” for executive pay that are

---

[71] *See* Gautum Naik, *Glaxo Holders Reject CEO’s Compensation Package*, WALL ST. J., May 20, 2003, at D8; 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 U.K. 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.

[72] *See* Rickford, *supra* note 68; Ferrarini & Moloney, *supra* note 68, at 295–97.

[73] This draws generally from Stephen Davis, *Does ‘Say on Pay’ Work? Lessons on Making CEO Compensation Accountable* (Millstein Ctr. for Corp. Governance & Performance, Policy Briefing No. 1, 2007), which cites relevant sources. *See also* Fabrizio Ferri & David Maber, Say on Pay Vote and CEO Compensation Evidence from the U.K., App. I (unpublished paper, dated March 2009, on file with author) (particular instances).

[74] *See* Joanna L. Ossinger, *Regarding CEO Pay, Why Are the British So Different?*, WALL ST. J., Apr. 10, 2006, at R6 (200 firms annually consult with ABI).

[75] RREV (for “Research, Recommendation, Electronic Voting”) is owned by ISS in affiliation with the National Association of Pension Funds. IVIS (for “Institutional Voting Information Service”) is owned by ABI.

[76] *See* Ferri & Maber, *supra* note 27 (finding an increase in performance sensitivity of CEO compensation in firms receiving higher negative vote); Kym Sheehan, Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the U.K. and Preliminary Results from Australia (Mar. 18, 2007) (unpublished manuscript, *available at* http://ssrn.com/abstract=974965) (analyzing results for 2003, 2004, and 2005 votes).

[77] *See* ASS’N OF BRITISH INSURERS & NAT’L ASS’N OF PENSION FUNDS, BEST PRACTICE ON EXECUTIVE CONTRACTS AND SEVERANCE—A JOINT STATEMENT (2002) (reissued annually as part of ASS’N OF BRITISH INSURERS, PRINCIPLES AND GUIDELINES ON REMUNERATION, available at http://www.ivis.co.uk/ExecutiveRemuneration.aspx).

built into the Combined Code.[78] The consultations often arise with respect to changes in a firm's "approved" compensation practices ("approved" because they passed muster the prior year) or practices that trench on the guidelines. Indeed, whether the guidelines are being complied with often becomes the basis for the shareholder vote.

Fourth, long-term CEO employment agreements, which in the U.K. setting gave rise to highly salient episodes of "pay for failure," such as the case of GlaxoSmithKline, seem to have become less common. The most dramatic changes have occurred in this area. Almost no large U.K. 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 U.K. version of the golden parachute.[79] 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 the creation of the DRR regime.[80]

The results, however, are much murkier in regards to the effects of the new regime on actual pay. U.K. CEO salaries and bonus payouts have increased at a double-digit rate in recent years.[81] The value of long-term incentive plans is more difficult to measure, but the growth rate is actually higher than that of the United States,[82] though U.K. observers have noted a tightening of performance triggers to vesting of particular benefits.

The most thorough empirical analysis, albeit through 2005 only, is Fabrizio Ferri and David Maber's *Say on Pay Vote and CEO Compensation: Evidence from the U.K.*,[83] which analyzes U.K. 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 has

---

[78] *See* Fin. Reporting Council, Combined Code on Corporate Governance 13–15 (2008) (prior Code versions issued in 1998, 2003, and 2006).

[79] *See* Deloitte, Report on the Impact of the Directors' Remuneration Report Regulations: A Report for the Department of Trade and Industry 6, 19–20 (2004).

[80] *See* Dep't of Trade & Indus., Rewards for Failure: Directors' Remuneration—Contracts, Performance and Severance (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* Rickford, *supra* note 68, suggesting standard one-year terms. *See also* Steve Thompson, *The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK*, 13 Corp. Governance 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.").

[81] *See* RREV, Executive Remuneration: Trends in Executive Remuneration 2006 (2007); Ferri & Maber, *supra* note 27, at 49.

[82] Ferri & Maber, *supra* note 27, at 49 and the author's own calculations. This is merely a continuation of the narrowing of the compensation gap between U.S. and U.K. CEOs. *See* Martin J. Conyon et al., How High Is U.S. CEO Pay? A Comparison with U.K. CEO Pay (June 2006) (unpublished manuscript, *available at* http://ssrn.com/abstract=907469).

[83] Ferri & Maber, *supra* note 27.

not changed; 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: 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 twenty percent 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 enhances shareholder voice may have its strongest effect.

To counter the suggestion that contemporaneous U.K. governance changes, but not the DRR regime, drove the greater pay-performance sensitivity, Ferri and Maber ran tests with firms listed on AIM. They found that 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 ran comparable tests on a sample of U.S. firms, which show no comparable change in pay-performance sensitivity over the period.

Although Ferri and Maber's results are suggestive, elements in their work indicate a possibility that firms' greater responsiveness to pay-for-performance demands have been accompanied by efficiency losses.[84] For example, the demonstrated increased pay-performance sensitivity is generally with respect to losses, not gains (although Ferri and Maber tested for 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 attuned to present earnings, rather than total shareholder return, which includes dividends and stock repurchases as well as stock price performance. Putting aside the matter of shareholder preference, stock prices measure expectations of future earnings, which relate to new investment. The possible message of the new regime would be, "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.[85]

---

[84] Of course, although Ferri and 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.

[85] A more positive interpretation might be that since the U.K. compensation scheme is generally tilted towards approximately sixty-five percent cash payouts and twenty-five percent stock-related compensation (the remainder is pension related and "other"), pay-to-ROA performance is the more important sensitivity measure. *See* Ferri & Maber, *supra* note 73, at tbl. 1 panel B. Then the concern becomes that the guidelines reinforce the system's bias against stock-related compensation. It is still a consequence of the regime as a whole.

Additionally, the DRR regime may have had a negative effect on CEO compensation at the largest firms independent of performance. Since pay generally increases with the size of the firm, 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.[86]

A more technical factor that may confound the Ferri and Maber result is that the DRR regime consisted of two elements: (1) extensive mandatory disclosure of executive compensation particulars, including the board's reasoning process in the award of compensation; and (2) the shareholder advisory vote. As the authors observe, many compensation elements were already mandated to be 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. This was shown by a 2004 Deloitte survey of leading institutional investors on the impact of the new DRR regime, commissioned by the Department of Trade and Industry, which reported that seventy percent of the institutional respondents regarded the shareholder vote as having "very significant impact," whereas only twenty-six percent regarded the detailed disclosure of compensation particulars as having comparable significance, even though nearly ninety percent regarded the remuneration report as providing better understanding of compensation.[87] Thus, Ferri and Maber seem safe in attributing most of the effects they observe to the shareholder empowerment elements of the scheme.

An alternative interpretation offered by Eric Nowak is that since pay-performance sensitivity with respect to stock price performance is not lessened by the prior regime, the greater sensitivity to ROA measures is of some benefit, suggesting some additional restraint against pay on failure. *See* Erick Nowak, "Say on Pay": Some Preliminary Statements from a European Financial Economist's View (Nov. 28, 2008) (unpublished manuscript, on file with author). This seems an odd argument, especially in the absence of a claim that the U.K. 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.

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

[87] DELOITTE, supra note 79, at 34 tbl. 10. The Report used a 1–5 intensity scale. On a broader definition of significance that adds the "4s" and the "5s," the gap between the vote and the disclosure is less pronounced: ninety-two percent versus seventy-four percent.

C. Lessons from the United Kingdom for the United States in "Say on Pay"

1. Side Effects of the U.K. System

The efficiency effects of the U.K. 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 U.K. 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 institutional investor members own nearly thirty percent of the shares of large U.K. public firms,[88] the annual shareholder vote is often a test of "comply or explain" with those guidelines. Indeed, an alternative approach, in which shareholders would evaluate annually rate firm compensation practices in light of the firm's performance and prospects as a whole, would be very costly.[89] 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, which have not been tested for performance-inducing effect?

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 to shares from a bonus grant, meaning that an option (or share) grant will not necessarily ever be in the money.[90] To a non-professional eye, this reads simply like a prejudice against stock-based compensation and the expression of a preference for a U.K.-style of compensation, traditionally tilted toward cash salary

---

[88] OFF. FOR NAT'L STAT. (U.K), SHARE OWNERSHIP: A REPORT ON OWNERSHIP OF UK SHARES AS OF 31ST DECEMBER 2006, at 9 tbl.A (2007) [hereinafter SHARE OWNERSHIP], *available at* http://www.statistics.gov.uk/downloads/theme_economy/Share_Ownership_2006.pdf, (over 2002–2006 period, total ownership of insurers and pension funds declined from approximately 35 percent to approximately 27 percent).

[89] *See* Kristin Gribben, *U.K. Investors Warn U.S. About Say on Pay,* AGENDA (Money Media, New York, N.Y.), Nov. 12, 2007, at 1, 8. (citing experience of U.K. fund managers, who recognize increased time and workload for the board, but who nevertheless want to retain the advisory vote).

[90] *See* ASS'N OF BRITISH INSURERS, EXECUTIVE REMUNERATION—ABI GUIDELINES ON POLICIES AND PRACTICES §§ 4.1, 4.6, 4.12, 5.7 (2008), http://www.ivis.co.uk/ExecutiveRemuneration.aspx. An option that is "out of the money" gives the holder the right to buy shares at greater than the current market price and thus would not be exercised. The result may be to give managers greater risk-taking incentives. *See supra* note 27 and accompanying text.

and bonus.[91] Indeed, this is consistent with the Ferri and 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 arm's length bargaining, if that is the ultimate basis for comparison. It is an even greater concern that the implementation of the guidelines may establish a standardized form of compensation practice across an entire economy.

Moreover, a recent empirical study of U.K. 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 United States.[92] 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, 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, since compensation changes may have unpredictable effects. In light of the generally greater shareholder power in the United Kingdom, however, it does 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 U.K. Experience to the United States*

Possible "side effects" do not necessarily negate the value of the shareholder advisory vote in the United Kingdom. However, if many of its benefits are bundled with an overall corporate governance system that gives shareholders considerably more power than in the United States, a "transplant" of "say on pay" alone would operate differently in the United States.

---

[91] Compare the 65 percent to 25 percent ratio of cash to equity-based compensation in the United Kingdom, *see* Ferri & Maber, *supra* note 73, at tbl. 1.B., with nearly the reverse ratio in the United States, ranging from one estimate of 34 percent cash versus 66 percent options, *see* Brian Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. Corp. Fin. 21, 23 Fig. 1 (2003), to another of 34 percent cash versus 50 percent options. *See* Michael Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them*, 31 Fig. 3 (Eur. Corp. Governance Inst. Working Paper Series in Fin., Working Paper No. 44/2004, 2004) (author averaging of 2001-2002 figures provided in Fig. 3).

[92] Yu Flora Kuang, *Performance-Vested Stock Options and Earnings Management*, 35 J. Bus. Fin. & Acct. 1049 (2008). "Earnings management" refers to a form of accounting manipulation that consists of slowing or advancing the recognition of revenue or costs to attain specific earnings objectives. A compensation system tilted to the achievement of specific earnings targets may particularly invite such behavior.

Corporate governance in this sense is a function of ownership structure as well as law on the books. U.K. ownership is characterized by a "concentrated institutional ownership." This means, firstly, that U.K. firms are held by institutional investors, not retail investors, and secondly, that the institutions are "concentrated" rather than "dispersed."[93] As noted above, the dominant U.K. institutional investors have been insurers and private industry pension funds. They share a common address, the City of London, and common objectives, long-term holdings producing steady dividends and gains. Over a forty-year period they have gained considerable experience in collaborative efforts to engage their investee firms on business and governance matters.[94]

Part of the reason institutional investors capture firms' attention is a legal regime that empowers shareholders to a much greater extent than in the United States. For example, shareholders can remove directors or amend the articles of incorporation. Ten percent of the shareholders of a public company can call a special meeting.[95] 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 U.K. form of concentrated institutional ownership that has transformed these statutory rights into governance power. Thus, the benefits of shareholder advisory voting in the United Kingdom must be assessed against the backdrop of coordinated institutional practice. In British companies, 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 correspondingly taking greater pains to bolster its independence. The fraction of independent directors in the United States

---

[93] This and much of the succeeding discussion draws from John Armour & Jeffrey N. Gordon, The Berle-Means Firm of the 21st Century (Jan. 2009) (unpublished manuscript, on file with author).

[94] The ground under the U.K. model is shifting rapidly, as Armour & Gordon, *supra* note 93, discuss. At year-end 1997, U.K. pension funds and insurers owned approximately forty-six percent of the equity of the largest 200 U.K. companies; at year-end 2006 (the last year surveyed), such ownership had declined to approximately twenty-seven percent. Foreign investors, particularly institutional investors, have picked up the slack, increasing their U.K. equity ownership from twenty-eight percent to forty percent over the period, and so have other financial institutions, like investment banks and hedge funds, increasing their equity ownership from approximately one percent to almost ten percent. *See* Share ownership, *supra* note 88, at 9 tbl. A (2007). Professor Brian R. Cheffins explains the decline in U.K. 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 (Oxford Univ. Press 2008). This altered ownership landscape may change the workings of the U.K. model in its country of origin.

[95] *See* Companies Act, 2006, c. 46, § 303 (Eng.).

is considerably higher, the requirements of "independence" are stricter, and the compensation committee is entirely independent. By comparison, the U.K. Combined Code currently permits the Chairman (if formerly an "independent") to sit on the remuneration committee. An equally important difference lies in ownership structure. Even as recently as 1980, most U.S. firms had a dispersed retail ownership base. Dramatic increases in institutionalization began in the 1980s, but the form of ownership was dispersed institutional ownership, in which institutions differed significantly in investment objectives, anticipated holding periods, and geographic locations.[96] That diversity has increased over time, as new sorts of institutional investors, hedge funds, for example, have entered the fray, and as locations like Greenwich (hedge funds); Boston, Baltimore and Denver (Mutual funds); and London (U.K. institutional investors) have become important centers of institutional decisionmaking. Moreover, U.S. securities regulation places 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.[97]

How would a "say on pay" regime work in the United States? Many more firms would be covered in the United States than the United Kingdom—approximately 10,000 in the United States (under the current legislative proposal),[98] as opposed to fewer than 1100 firms in the United

---

[96] *See* Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, R. Fin. Stud. (forthcoming) (manuscript at 3, *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.").

[97] *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) [hereinafter, Gordon, *Proxy Contests*].

[98] The House "Say on Pay" bill, H.R. 1257, 110th Cong. (1st Sess. 2007), would have amended section 16 of the 1934 Securities and Exchange Act, which applies to companies required to register under section 12 thereof. Rule 12(b) requires registration of all issuers who trade on a "national exchange," Rule 12g-1 requires registration of all other issuers with more than $10 million in assets and 500 shareholders. These criteria appear to include at least all U.S. issuers listed on the NYSE (which recently acquired the American Stock Exchange), NASDAQ, and the OTC Bulletin Board ("OTCBB"). Recent inspection of the relevant websites produces 3800 (NYSE), 2900 (NASDAQ), 3500 (OTCBB), or a total of 10,200. The SEC's 2009 budget request says that the Commission "oversees" more than 12,000 public companies. *See* SEC, FY 2009 Congressional Justification in Brief 7 (2008), *available at* www.sec.gov/about/secfy09congbudgjust.pdf. By contrast, the House Financial Services Committee Report accompanying H.R. 1257, citing "government sources," said that "about 6,000" public companies would be subject to say on pay. H.R. Rep. 110-88, at 17 (2007). The House estimate appears to be too low.

For "Say on Pay" legislation that covered all public companies, the number would be significantly higher, perhaps as many as 14,000 firms. The Disclosure database 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 3159 companies that had at least $75

Kingdom.[99] Stock market capitalization is also more concentrated in the United Kingdom: the market capitalization of only eighty-two firms cumulates to approximately eighty-five percent of the total; the largest 202 firms account for ninety-five percent of the total.[100] In the United States, by comparison, the S&P 500 comprises approximately seventy-five percent of market capitalization and the S&P 1500 accounts for eighty-five percent.[101] There are also many more institutional investors in the United States, but institutional consultation is more limited and much less coordinated than the United Kingdom. The most active institutional investors have historically been public pension funds and union pension funds, which may have other motives in addition to shareholder-value economic considerations. Hedge funds have recently joined the ranks of shareholder activism,[102] but boards look at them warily, as do other institutions whose managers cannot benefit from "two and twenty" compensation schemes[103] and therefore do not have the same incentives to make short-term profits that hedge fund managers do.[104]

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.[105] Most of the rest simply delegate the bulk of their substantive

---

million in public common shareholder float. Security Holder Director Nominations, 68 Fed. Reg. 60,788 (proposed Oct. 23, 2003).

[99] London Stock Exchange, Market Statistics 13 (2008). U.K. Director Remuneration Report requirements apply only to companies on the "official list." Companies Act, 2006, c. 46, §§ 420(1), 385(2) (Eng.) (only directors of "quoted companies" must prepare a director remuneration report; "quoted companies" are those who have been included on the "official list"); Financial Services and Markets Act, 2000, c. 8, § 74 (Eng.) (official list is maintained by "competent authority," now the Financial Services Authority acting as the U.K. Listing Authority).

[100] *See* London Stock Exchange, *supra* note 99, at 13.

[101] Standard & Poors, S&P 500, at 2 (2008), *available at* http://www2.standardandpoors.com/spf/pdf/index/500factsheet.pdf (S&P 500 accounts for seventy-five percent of market capitalization); Standard & Poors, S&P MidCap 400, at 2 (2008), *available at* http://www2.standardandpoors.com/spf/pdf/index/SP_MidCap_400_Factsheet.pdf (S&P MidCap 400 accounts for seven percent of market capitalization); Standard & Poors, S&P SmallCap 600 2 (2008), *available at* http://www2.standardandpoors.com/spf/pdf/index/SP_SmallCap_600_Factsheet.pdf (S&P SmallCap 600 accounts for three percent of market capitalization).

[102] *See, e.g.*, Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1729 (2008) [hereinafter Brav, *Hedge Fund Activism*].

[103] Meaning, fees of two percent of assets under management and twenty percent of profits.

[104] *See* Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021 (2007) (discussing effect of different compensation schemes on institutional investor behavior).

[105] *See* TIAA-CREF, TIAA-CREF Policy Statement on Corporate Governance (2009), *available at* www.tiaa-cref.org/pubs/pdf/governance_policy.pdf; CalPERS, Global Principles of Accountable Corporate Governance (2009), *available at* http://www.calpers-governance.org/docs-sof/marketinitiatives/2009-04-01-corp-governance-pub20-final-glossy.pdf.

governance decision-making to a proxy services firm, in particular Institutional Shareholder Services (ISS), now part of RiskMetrics.[106]

Like ABI and NAPF, RiskMetrics will establish guidelines on compensation; indeed, such guidelines already exist.[107] As in the United Kingdom, cautious firms will hew to these guidelines in the design and implementation of compensation plans. Although, in theory, firms with alternative ideas could engage RiskMetrics in negotiation, the numbers of firms and the limited time available for serious engagement could easily make that situation improbable. 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 widespread embrace of stock options in the 1990s resulted, in part, from institutional investor pressure on firms to adopt this "best practice" method of enhancing managerial incentives.[108] Then-favored accounting treatment established "plain vanilla" options as the "best practice" implementation.[109] In other words, much of what we now regret was the result of prior standardized practice epitomized by guidelines.[110] It is clear that legislated "say on pay" in the United States is one way to catch and stop misbehaving outliers; but there are costs and risks that must be considered as well.

Moreover, the power that may 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. RiskMetrics both rates firms on its proprietary corporate governance index and, through a purportedly separate arm, provides proxy voting advice.[111] 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 of commercial

[106] *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, 349–52 (2008). ISS claims over 1700 institutional clients. Robert Daines et al., *Rating the Ratings: How Good Are Commercial Governance Ratings?* 1 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 1, 2008), *available at* http://ssrn.com/abstract =1152093.

[107] *See* RISKMETRICS GROUP, U.S. CORPORATE GOVERNANCE POLICY 2009 UPDATES (2008), *available at* http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdate UnitedStates.pdf.

[108] *See* Gordon, *supra* note 24, at 1529 n.257.

[109] The newly adopted tax law change that addressed executive compensation also pushed in the direction of plain vanilla options. *See infra* note 122.

[110] Only with the adoption of FAS 123R, which provides updated guidance on the valuation of executive stock options under GAAP for years after 2005, can firms freely experiment with alternative stock option forms, such as performance triggers for grant or vesting, possibly using industry indices to measure performance. FIN. ACCT. STANDARDS BD., FINANCIAL ACCOUNTING SERIES: STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (Revised 2004), *available at* http://www.fasb.org/pdf/fas123r.pdf. Yet the concerns about valuation of tailored instruments for accounting purposes may have its own uniformity pressure.

[111] *See* RiskMetrics Group, Business Practices Policy, ISS Governance Services Policies, Procedures and Practices Regarding Potential Conflicts of Interest, http://www.riskmetrics .com/practices#conflicts (last visited Apr. 11, 2009).

corporate governance ratings asserts that the index produced by RiskMetrics "exhibits virtually no predictive validity."[112] In a mandatory "say on pay" world in the United States, it is easy to imagine that a single entity could create guidelines, establish rating systems for good compensation, consult with firms on how to improve their compensation ratings in light of their particular circumstances, and then, behind purported ethical and physical barriers, provide proxy voting advice to shareholders.[113] Alternatively, such entities could follow RiskMetrics, which says it minimizes potential conflicts of interest "[b]y applying our voting policies consistently across proxy proposals and by issuing vote recommendations strictly according to policy[.]"[114] That is, the very effort to avoid criticism over its multiple roles may lead a multi-service proxy advisor towards "one size fits all" rather than firm-specific compensation tailoring.

The major advantage of mandatory "say on pay" legislation is the powerful shock it might deliver to the executive compensation structure, destabilizing the present equilibrium. This is similar to what happened in the United Kingdom: adoption of the DRR regime suddenly roused the U.K. institutions into taking a very significant role in reviewing and challenging compensation practices, a 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 toward a more U.S.-style, stock-based incentive compensation appears to have reversed. Yet, even in the United Kingdom, 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 United States. As discussed above, U.S. shareholder activists have already focused on executive compensation for some time, both through the shareholder proposal machinery and through withhold-vote campaigns for offending compensation committee directors.[115] The one area in which U.S. law favors shareholders relative to the United Kingdom is with respect to making shareholder proposals, usually precatory.[116] Rules requiring majority-voting for directors that have been adopted by a majority of U.S. public firms only add to the potency of withhold-vote campaigns.[117] Ironically, such activity in the

[112] Robert Daines et al., *supra* note 106, at 4. RiskMetrics is now the owner of ISS.

[113] *See* Sanjai Bhagat, *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803, 1807 n.7 (2008).

[114] *See* RiskMetrics Group, *supra* note 111.

[115] *See supra* note 67, *infra* notes 123–24 and accompanying text.

[116] *See* Rule 14a-8 under the U.S. Securities and Exchange Act, 17 C.F.R. § 240.14a-8(b) (1934), which provides access to the issuer proxy to a small shareholder (owning the lesser of $2000 in market value or one percent). By contrast, section 314(2) of the U.K. 2006 Companies Act imposes a five percent share ownership threshold. Companies Act 2006, c. 46, § 314(2) (Eng.).

[117] *See* Gordon, *Proxy Contests*, *supra* note 97, at 482–83.

United States over the same period as the DRR regime may well have produced a one-time downward revision lacking in the United Kingdom.[118]

3. *Executive Compensation as a Hard Problem*

Even putting aside agency cost considerations, which are considerable, devising an effective executive compensation scheme is difficult. Private equity firms offer as a solution high levels of stock-related compensation that pay 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, and of course the salary base is much smaller because of the preference for incentive-based pay.[119] 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 Philip Leslie and Paul 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.[120] "Executive ownership drops quickly and substantially right after the IPO . . . to levels similar to public firms."[121] Salary levels take slightly longer, roughly three or four years, to reach the comparable public firm norm. 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.

IV. Alternatives to Mandatory Universal "Say on Pay"

We need public firms and we need compensation mechanisms that reward, provide incentives, and are politically sustainable. It is tempting to challenge the wisdom of near-term federal legislative change, on the view

---

[118] Ferri & Maber, *supra* note 27, at 56 tbl.7 panel A. This apparent finding may have resulted from exchange rate fluctuations, *see id.* at tbl.7 panel B, so it must be taken cautiously.

[119] *See* David Carney, *Deliver and You Get Paid*, The Deal, June 1, 2007, http://www.thedeal.com/servlet/ContentServer?pagename=crpDmkr&cid=1183754894399.

[120] Philip Leslie & Paul Oyer, Managerial Incentives and Value Creation: Evidence from Private Equity (Jan. 2009) (unpublished manuscript, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1341889).

[121] *Id.* at 22-23.

that the current U.S. compensation reform project is headed in the right direction; that prior legislative intervention has been fraught with unintended consequences;[122] and that particular problem areas, such as compensation in the financial services area, need scrutiny through a "systemic risk" 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;[123] and second, targeted "just vote no" campaigns against compensation committee members that can have similar, perhaps even more powerful, firm-specific and demonstration effects.[124] 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 experience in coordinated activity and as stock market ownership becomes more institutionalized. From a "pay for performance" perspective, this kind of "muddling-through"[125] 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 broadest possible intervention. As this Article proposes, the negative side effects could be reduced by modi-

---

[122] The early 1990s effort to address "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 actually 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).

[123] Recent evidence on board responsiveness to shareholder proposals has been somewhat encouraging. *See* Yonca Ertimur et al., Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals (Harvard Bus. Sch., Working Paper No. 08-048, 2008), *available at* http://www.hbs.edu/research/pdf/08-048.pdf (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* (Harvard Bus. Sch., Working Paper No. 08-022, 2007) (finding that shareholder proposals in 2003 and 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).

[124] *See, e.g.*, Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'?*, 90 J. FIN. ECON. 84, 85 (2008) (discussing the positive effects of "just vote no" campaigns); Jie Cai et al., *Electing Directors*, J. FIN. (forthcoming, issue number not yet determined), *available at* http://ssrn.com/abstract=1101924) (lower votes for directors is correlated with subsequent reductions in excess compensation). For an argument in favor of election-based approaches, see generally Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. L. 1079 (2007–08).

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

fications 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 the political mood 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-In to "Say on Pay"

Shareholder opt-in empowers shareholders to target those firms whose pay practices (or their boards' justifications for them) raise the most serious questions. It would signal both the shareholders' expectation of significant engagement by the board and their own willingness to engage over executive compensation issues, at least at the outset.[126] Since the current federal and state pattern significantly constrains shareholder initiative in this area, a shareholder opt-in right could be the principle objective of "say on pay" legislation.

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 to propose shareholder adoption of a precatory resolution, requesting that board provide shareholders with an annual advisory vote on executive compensation.[127] 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.[128] Over its sixty-six-year history, such shareholder access has become an embedded element of the U.S. corporate governance model, although its terms have been

---

[126] Shareholders should also be able to choose between a time-limited opt-in and an indefinite opt-in to permit greater calibration.
[127] This route is provided by Rule 14a-8 promulgated under the 1934 Securities Exchange Act. 17 C.F.R. § 240.14a-8 (2008).
[128] *Id.*

significantly amended and reinterpreted during that period.[129] For executive compensation, two limitations have been particular flashpoints: proposals that "deal[ ] with a matter relating to the company's ordinary business operations,"[130] or that are "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."[131]

Since a significant reinterpretation of "ordinary course of business" in 1992, the SEC staff, through 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" (excludable) and those that relate to "only senior executive and director compensation" (not excludable).[132] More recently, as executive compensation has become a more frequent subject of shareholder proposals, the staff has followed a pattern that seems to distinguish between specific compensation formulas (often excludable) and a shareholder advisory vote (generally not excludable).[133] A 2007 AT&T no-action letter clearly articulated the non-excludability of a "say on pay" resolution,[134] although the company's sharp challenge seems somewhat in tension with 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."[135]

Another potential objection to "say on pay" precatory proposals is 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," "recommends," or "suggests" board action—in refusing no-action requests for exclusion on this or similar grounds.[136] In any event, after the submission of dozens of "say on pay" proposals in 2007 and 2008, it seems almost certain that, at

---

[129] *See generally* 4 Louis Loss & Joel Seligman, Securities Regulation 1916–83 (3d ed. 1990); Jeffrey N. Gordon, *Proxy Contests*, *supra* note 97, at 478–87; Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 Ga. L. Rev. 97, 98–99 (1988).

[130] 17 C.F.R. § 240.14a-8(i)(7).

[131] 17 C.F.R. § 240.14a-8(i)(1).

[132] SEC Staff Legal Bulletin No. 14A (2002) (emphasis omitted), http://sec.gov/interps/legal/cfslb14a.htm#P32_3865.

[133] The no-action letters relating to specific formulas are canvassed in Marc H. Folladori, *Shareholder Proposals*, *in* 2 Preparation of Annual Disclosure Documents 2008 81 (Practising Law Inst., 2008).

[134] AT&T Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 196 (Feb. 16, 2007); *see also* Sara Lee Corp., SEC No-Action Letter, 2006 SEC No-Act. LEXIS 610 (Sept. 11, 2006).

[135] John W. White, Dir., Div. of Corp. Fin., SEC, Speech by SEC Staff: Corporation Finance in 2008—A Year of Progress (Aug. 11, 2008), *available at* http://www.sec.gov/news/speech/2008/spch081108jww.htm.

[136] *See* 17 C.F.R. § 240.14a-8(i)(1) note (2008). For its 2007 no-action request, AT&T argued that "say on pay" would cause the company to violate state law, and so it was excludable 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." AT&T Inc., SEC No-Action Letter, 2007 SEC No-Act. Lexis 196, at *39 (Feb. 16, 2007). The

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.[137] Moreover, because proposals are precatory, 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 through narrowing the scope of the advisory vote. However, this resistance does have limits: excessive obstinacy risks a withhold vote campaign against the compensation committee or the entire board at the next annual meeting.[138]

In contrast to a precatory vote, 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 bylaw does not depend upon board acquiescence. Putting to one side the challenges in drafting a bylaw that is sufficiently prescriptive to constrain a possibly resistant board, the major question is whether such a shareholder initiative is consistent with state law. A proposal is excludable if the firm can successfully argue that a shareholder-adopted bylaw would encroach on the firm's "ordinary business" or would "cause the company to violate state law" by turning over to shareholders matters within the scope of the board's managerial prerogative and fiduciary responsibility.[139]

The potential reach of shareholder-adopted bylaws has been controversial. In Delaware, there is a "recursive loop"[140] in the interaction of section 109(b) of the General Corporation Law, 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 . . . ."[141] The Delaware Supreme Court recently

---

no-action letter said the argument was insufficiently weighty to meet AT&T's "burden of establishing that the proposal would violate applicable law." *Id.* at *1.

[137] *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).

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

[139] 17 C.F.R. § 240.14a-8(i)(1)–(2).

[140] Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Approved Bylaws: An Essay for Warren Buffett*, 19 Cardozo L. Rev. 511, 546–49 (1997).

[141] Del. Code Ann tit. 8, §§ 109(b), 141(a) (2001). 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* Model Bus. Corp. Act §§ 2.06, 8.01(b) (2007) (dealing with bylaw definitions and board prerogative), the circularity may reemerge in provisions that seem to allocate certain corporate power to shareholders in a way that seems to imply a carve-out for limits on board power otherwise stated in law. *See id.* § 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

cut through the tangle in *CA, Inc. v. AFSCME Employees Pension Plan* by presumptively invalidating any bylaw that treads on the board's managerial prerogatives.[142] Shareholders may propose bylaws that are "procedural, process-oriented,"[143] not ones that "mandate how the board should decide specific substantive business decisions."[144] 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 questions were whether the proposal was a "proper subject for action by shareholders as a matter of Delaware law"[145] and whether the proposal, "if adopted, [would] cause [the corporation] to violate any Delaware law."[146] 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."[147] The court seemed strongly influenced by the context in which the bylaw would operate, namely 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 board members "from fully discharging their fiduciary duties to the corporation and its shareholders" and thus violated Delaware law.[148]

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," and not one "that mandates the decision itself."[149] 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 decisions (e.g., undoing a poison pill), the preexisting Delaware default is that shareholders should focus on replacing the board rather than attempting to di-

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

[142] 953 A.2d 227 (Del. 2008).

[143] *Id.* at 235.

[144] *Id.* at 234–35.

[145] *Id.* at 231 (tracking Rule 14-a(8)(i)(1), 17 C.F.R. § 240.14a-8(i)(1) (2008)).

[146] *Id.* (tracking Rule 14a-8(i)(2), 17 C.F.R. § 240.14a-8(i)(2)).

[147] *Id.* at 236.

[148] *Id.* at 238 (footnote omitted).

[149] *Id.* at 235.

rectly undo the decision.[150] The power that shareholders now have in the compensation area derives from the voting requirements of stock exchange listing rules[151] and the Internal Revenue Code.[152] The Delaware courts have previously indicated that such external grants of shareholder power do not create a protectable Delaware interest.[153] Moreover, a "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. This would be predicted by those who would explain corporate law's evolution as a "race to the bottom."[154]

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;[155] 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.[156]

---

[150] *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

[151] *See* NYSE Euronext, Listed Company Manual § 303A.08 (2004), *available at* http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm_section.html; NASDAQ, Inc., Equity Rules § 4350(i)(1)(A) (2009), *available at* http://nasdaq.cchwallstreet.com/nasdaqtools/platformviewer.asp?selectednode=chp%5f1%5f1%5f4%5f1%5f5%5f9&manual=%2fnasdaq%2fmain%2fnasdaq%2dequityrules%2f (requiring a shareholder vote on the creation of "equity compensation plans and material revision thereto.").

[152] *See* I.R.C. § 162(m) (2006) (requiring 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).

[153] *See* Paramount Commc'ns v. Time Warner, Inc., 1989 WL 79880, at *18 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 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).

[154] *See generally* Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003) (setting out position in the debate).

[155] *See* H.R. 1257, 110th Cong. (1st Sess. 2007). The revised legislation should omit the provision calling for a separate vote on a golden parachute in connection with an acquisition. *See id.* § 2(a)(i)(2)(B). Ordinarily the golden parachute of a senior officer would have been previously subject to an advisory vote or would be characterized more accurately 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.

[156] 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? As this Article suggests, 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 vote exceed an affirmative majority of the outstanding common stock to avoid the risk of "shark repellant" supermajority charter amendments that would make change difficult. Preliminarily, this Article supports shareholders having the right to opt-

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 such as the stock market float of non-affiliated shareholders. Indeed, the U.K. 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).[157] 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 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 the putative performance-based effects of better compensation practices (which will presumably be more noticeable in big firms) 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 10,000 firms are subject to the most probable "say on pay" legislative poposal; only 3000 have market capitalization over $75 million.[158] The poor benefit/cost ratio from close scrutiny of particular compensation practices at the vast majority of these firms is a major driver toward 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 gov-

---

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 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.

[157] *See supra* note 99. This is because the AIM firms are not on the "official list" and thus not subject to the DRR requirements, nor the LSE Listing Rules. AIM Frequently Asked Questions, http://www.londonstockexchange.com/NR/exeres/147CB65C-2EC8-4F8C-B29F-92D96C352362.htm (last visited Jan. 17, 2009) (Technically AIM is not an "exchange," but an "exchanged regulated market," which permits this distinction under the applicable EU directives); London Stock Exchange, Main Market: Market Statistics tbl.8 (2008), *available at* http://www.londonstockexchange.com/en-gb/about/statistics/factsheets/ (follow "December, 2008 PDF file" hyperlink) (although the median AIM firm market capitalization is approximately £10 million, more than seventy-five firms have a market capitalization greater than £100 million).

[158] *See supra* note 98.

ernance 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 as substitution for) monitoring, such as access to sources of finance, business partners, specialized skills, and general business expertise.[159] Thus, the stock exchange and SOX board-related mandates have affected larger and smaller firms differently, with perhaps negative effects for smaller firms.[160] 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 U.S. 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 large shareholder 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 being excessively critical of this form of shareholder empowerment to concede this possibility; it may be a good thing to give activists another tool. The question is, what are the checks and constraints? In the United Kingdom, these checks have historically arisen from a pattern of repeat interactions among a relatively small number of institutional investors of similar long-term payoff horizons concentrated geographically in London.[161] In other words, behavior can be observed, and reputations gained or lost.

Whether or not this pattern will persist in the United Kingdom is an open question,[162] but it has never existed in the United States, with its dis-

---

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

[160] *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*, REV. FIN. STUD. (forthcoming).

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

[162] *See generally* Armour & Gordon, *supra* note 93. Indeed, a major new project of corporate governance reform is to deal with a worldwide pattern of increased ownership by increas-

persed institutional ownership. 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.[163] 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, is 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 way to establish such a threshold would be to impose "say on pay" on the largest 500 reporting companies by market capitalization, net of shares beneficially owned by insiders and affiliates. Market capitalization would be determined as of year-end 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.[164]

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.[165] 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 large liquidity-providing firms the failure of which would create significant systemic risks, reform should take a different direction—one that evaluates safety and soundness concerns created by particular compensation structures.[166]

---

ingly diverse and geographically dispersed institutional investors, an ownership pattern that confounds the assumptions of both the U.S. (retail) and the U.K. (concentrated institutional) systems. *Id.*

[163] For recent articles on the "size effect" and "performance effect" of activist hedge funds, see Brav, *Hedge Fund Activism, supra* note 102; Alon Brav et al., *The Returns to Hedge Fund Activism,* 64 FIN. ANALYSTS J. 45 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors,* 64 J. FIN. 187 (2009).

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

[165] *See supra* notes 4, 7 and text accompanying notes 10–14.

[166] 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 (2009), *available at* http://www.group30.org/pubs/recommendations.pdf. Chairman Ben Bernanke also seems to be making a similar suggestion. *See* Ben S. Bernanke, Chairman, Fed. Res. Bd., Address at the Independent Community Bankers of America's National Convention and Techworld: The Financial Crisis and Community Banking (Mar. 20, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm).

The compensation structure for senior executives at many Wall Street firms was in many respects quite focused on "pay for performance."[167] Firms were generating record level profits. Star traders received $10 million-plus bonuses because senior executives 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 at least one quarter of the stock in Lehman Brothers and one third of the stock in Bear Stearns.[168] The gold ring for senior AIG executives was participation in a lucrative restricted stock plan that could not be disposed of until retirement.[169]

Wall Street firms were built on high-powered incentives. In the midst of the financial crisis, some blamed excessive risk-taking by hedge funds on their "two and twenty" compensation structures. The response was that the compensation structure for investment bankers was "zero and fifty," meaning that the bankers took home fifty percent of trading profits and fees, not a mere twenty. But shareholders were doing exceedingly well too. Over the four-year period from January 2003 to January 2007, indices of financial stocks nearly doubled, an eighteen percent annualized return.[170] 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 advised them were essential to retain the talent that generated these profits. As recently articulated by a financial firm governance consultant: "If one uses return on equity as a measure for corporate performance, we did not find

---

[167] *See* Nestor Advisors, *Governance in Crisis: A Comparative Study of Six US Investment Banks* (Nestor Advisors, Research Paper 0109, 2009), http://www.nestoradvisors.com/Articles/USBank09.pdf.

[168] *See* Randall Smith et al., *The Lehman Stock Slide Hits Home: Employees Face $10 Billion in Losses,* WALL ST. J., Sept. 12, 2008, at C1; Peter Lattman & Jenny Strasburg, *Bear's Fall Sparks Soul Searching; " 'We Are All in a Daze' " Says One Employee, Life Savings Wiped Out*, WALL ST. J., Mar. 18, 2008 at C1; Daisy Maxey, Jaime Levy Pessin & Ian Salisbury, *The Job/Stock Double Whammy; Bear Saga Shows Perils of Loading Up On Employer Equity*, WALL ST. J., Mar. 18, 2008, at D3. At Bear Stearns the senior executives and board members together owned almost ten percent of the outstanding equity interest; the CEO owned almost six percent. Bear Stearns Companies, Inc., Notice of the Annual Meeting of Shareholders to be Held April 14, 2007 (Schedule 14A), at 10 (Mar. 27, 2007), http://www.sec.gov/Archives/edgar/data/777001/000120677407000789/bearstearns_def14a.htm. At Lehman Brothers, senior management and the board owned approximately 4.5% of the equity, including an approximate 2.5% stake by the CEO. Lehman Brothers Holdings, Inc., Notice of 2008 Annual Meeting of Shareholders (Schedule 14A), at 18 (Mar. 5, 2008), http://sec.gov/Archives/edgar/data/806085/000104746908002261/a2183244zdef14a.htm.

[169] *See* Am. Int'l Group, Inc, Notice of Annual Meeting of Shareholders to be held May 17, 2006 (Schedule 14 A), at 30 (Apr. 5, 2006), http://www.sec.gov/Archives/edgar/data/5272/000095011706001639/a41169.htm.

[170] This was the performance of the Fidelity Financial Services sector fund. *See* Select Financial Services Portfolio, http://personal.fidelity.com/products/funds/mfl_frame.shtml?316390608 (last visited Apr. 10, 2008) (author' application of "rule of 72s" to performance results).

significant discrepancies between executive pay levels and company performance."[171]

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. The contrast with a firm like Enron is revealing. Enron, too, was brought down at least in part because of misguided compensation.[172] Yet most of the fallout was internalized by its capital suppliers, equity and debt; its failure did not ramify broadly throughout the economy. The fallout from Lehman Brothers produced dramatically different consequences. In other words, much like improvident lending or failure to maintain sufficient capital, particular compensation structures may so threaten the safety and soundness of systemically important financial firms that they 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 be capable of evaluating and internalizing systemic risk. Among other things, the disclosure system, necessarily targeted at firm-level results, does not provide that kind of information. In a deeper sense, however, the intrinsic leverage in financial sector firms means that firm-specific shareholder interests may be enhanced by compensation structures that induce risk-taking with potentially systemic consequences. Yet shareholders do not fully internalize the risk of systemic costs.[173] "Say on pay" would give a legitimacy-enhancing illusion of appropriate compensation structures at such firms. Thus, for a crucial set of liquidity-providing firms that are above a certain size, compensation may require a regulatory review on the systemic risk dimension.

An appropriate compensation structure at a financial firm should force risk-creating actors to internalize own-firm created risk. That is, an employee who creates risk—a trader taking on a position or an investment banker who commits the firm to a bridge loan, for example—needs to be compensated on a risk-adjusted basis. The actor needs to be "charged" for risk—including for the firm's capital that he or she puts at risk. Internalization of own-firm risk does not fully cover systemic risk, but it is an important step in that direction. If financial firms adopt compensation structures

---

[171] Nestor Advisors, *supra* note 167, at 17.

[172] *See generally* Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 U. Conn. L. Rev. 1125 (2003).

[173] This is a version of the conflict between equityholders and debtholders (or guarantors) sketched in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976). *See also* Nestor Advisors, supra note 167, at 17 ("The right question to ask is whether management of financial institutions that are systemically important should be fully aligned with shareholders. . . .[W]hen in comes to firms that are by definition highly geared due to their maturity transformation function, full alignment with shareholder interests might be the riskiest of all alignments.")

that at least internalize own-firm risk, this should reduce systemic risk as well, because it will reduce the risk of the failure of a firm whose failure would have systemic consequences.

Senior managers of financial firms are typically aware of the desirability of the risk-internalization point, of course. "Value at risk" measures are often used to rate traders, for example.[174] Yet faced with competitive pressure to retain "stars," senior managers may award bonuses on an actor's "production" without insisting on clawback or permit the rapid sale of vested stock. Such a competitive race makes it difficult for a single firm to do the right thing. This is why it is important to include review of the structure of a firm's compensation packages in the systemic regulator's mandate.

This Article suggests that the systemic regulator cannot be the only source of compensation counter-pressure. This would bring the systemic regulator into constant tension with politically powerful private actors who, in normal times, will have access to legislators the regulator will not want to antagonize. Here is where corporate governance—but not shareholder empowerment—can play a useful role. Boards should establish a committee to take charge of risk management oversight within the firm, including, in particular, the compensation structure. The board should be required by the systemic regulator to retain outside risk management consultants to evaluate the firm's internal risk management controls: whether risk managers can say "no" to traders as well as whether the compensation structure adequately forces the internalization of risk by those who create it. In other words, for a specifically targeted group of systemically important financial firms, we need a new class of gatekeepers. This internal governance mechanism can take political pressure off of the systemic regulator, who will backstop risk-assessment of compensation structures rather than be on the front lines.

V. Conclusion

Executive compensation reform is difficult because of the challenges in devising a compensation structure that satisfactorily addresses company-specific and officer-specific rewards and incentives objectives. It is also 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,[175] better disclosure,[176] and more board accountability.[177] The saliency of high levels of

---

[174] *See* Joe Nocera, *Risk Mismanagement*, N.Y. Times, Jan. 4, 2009, § 6 (Magazine), at 24 (discussing JPMorgan's pioneering use). On the uses (and misuses) of "Value at Risk" methodology, see the prescient 1997 exchange between critic Nassim Taleb and defender Phillipe Jorion, *The Jorion-Taleb Debate*, DerivativesStrategy.com (1997).

[175] For example, the expensing of stock options. *See supra* note 110.

[176] This has been accomplished through the SEC's augmented disclosure regime. *See supra* notes 45, 51, 124 and accompanying text.

executive compensation, especially "pay for failure," have made an additional tool, "say on pay" modeled on the U.K. example, seem like an attractive reform. The evidence suggests that "say on pay" has some downsides even in the United Kingdom, downsides that would be exacerbated by a simple transplant into the United States. 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, this Article has 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 firms where compensation looks to be a particular problem, and those experiences will provide useful information for other firms. This would be a significant step.

If some sort of mandatory "say on pay" regime is, nevertheless, the legislatively preferred choice, then this Article would recommend that mandatory application be limited to the largest firms—perhaps the largest 500 firms by public market float—rather than to the full range of reporting public firms, numbering approximately 10,000. Compensation concerns have arisen particularly at the largest firms; smaller firms present a different set of governance and compensation issues that would be particularly ill-served by a 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 raise systemic concerns that transcend shareholder objectives. The most important direction for corporate governance innovation is in devising internal governance mechanisms that will backstop the systemic regulator's oversight, particularly in the compensation area, not shareholder empowerment through "say on pay."

---

[177] This has been achieved, for example, through withhold vote campaigns. *See supra* note 124 (discussing withhold vote campaigns).