

EXECUTIVE COMPENSATION

‘Say on Pay’: Anticipating the Path Ahead



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The recent financial crisis and related economic downturn have resulted in the continued focus on the compensation of executives on Wall Street and in other U.S. public companies. In response to outcries from various constituencies and populist sentiment, Congress took action to increase public company accountability for executive compensation when it enacted the Dodd-Frank Wall Street and Consumer Protection Act in July 2010. Among other reforms, the Dodd-Frank Act requires that every public reporting company include a non-binding shareholder vote to approve the executive compensation information set forth in the proxy statement for its first annual shareholder meeting occurring on or after Jan. 21, 2011 (commonly referred to as a “say-on-pay” vote) and periodically thereafter.

In addition, with its rule-making authority, the Securities and Exchange Commission released proposed rules that, if adopted in their current form, would require companies to address in their proxy statements for future shareholder meetings whether and, if so, how their compensation policies and decisions have taken into account the results of prior say-on-pay votes.

Despite the understandable focus by the U.S. media in recent months on the new requirements, the shareholder say-on-pay concept is not a recent innovation. In fact, say-on-pay rules have been in effect in the United Kingdom for close to a decade, and a number of companies in the United States have implemented say-on-pay votes—most as a result of a mandate under the Troubled Asset Relief Program (TARP)—in recent years. As the vast majority of U.S. public companies and their advisers prepare to grapple with say-on-pay rules for the first time, a look at this history provides a window into where the Dodd-Frank Act regime will likely lead as well as instructive insights for companies seeking to be well prepared.

Past Is Prologue?

The United Kingdom introduced non-binding shareholder voting rights to approve (or not) executive compensation in 2002. For the first



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few years after its introduction, the effect of this voting system was relatively minimal. Despite fears that there would be a pandemic of shareholder votes against say-on-pay proposals, less than 10 companies saw their say-on-pay proposals fail during the first six years of the regime.¹ In fact, it appears that proxy advisory services were fairly conservative in recommending a vote against say-on-pay proposals in the United Kingdom during this period.

For example, in 2006, the proxy advisor Institutional Shareholder Services World UK (ISS UK) recommended voting against say-on-pay proposals for just 13.4 percent of companies, and the proxy advisor Glass Lewis & Co. recommended voting against say-on-pay proposals just 10 percent of the time.² Following the global financial crisis that began in 2007, there has been some acceleration in the failure of say-on-pay votes in the United Kingdom, but even so, only five U.K. companies had their say-on-pay proposals fail in 2009—in the thick of the crisis.³

The small number of “no” votes in the United Kingdom does not mean that implementing say on pay was a non-event. To the contrary, the beginning of mandatory say-on-pay advisory votes can be linked to several important changes in executive compensation practices in the United Kingdom. Although executive compensation in the United Kingdom continues to rise, say-on-pay votes are widely seen as having played a part in slowing the rate of increase; more effectively linking pay to performance through the use of variable pay with performance-vesting and the use of stock grants that are tied to performance in lieu of stock options; and increasing dialogue among boards, management and institutional investors. In particular, the focus on pay for performance has helped to increase the alignment of shareholder and management interests—a primary goal of say on pay.

In the United States, say-on-pay proposals began to gain prominence in 2009, when Congress mandated that companies that received financial assistance under TARP conduct annual say-on-pay votes. In addition, by 2010, approximately 70 companies voluntarily implemented say-on-pay votes in response to shareholder proposals or as a best practice in corporate governance.⁴ Notwithstanding the intense public sentiment against excessive executive compensation in the midst of the financial crisis and economic downturn, the vast majority of say-on-pay proposals for both TARP and non-TARP companies in the United States have passed without difficulty. Only three have failed to pass to date, all of which occurred in 2010.⁵ Nevertheless, the average support for say-on-pay proposals in the United States in 2010 has exceeded 80 percent.

If history is a guide, these statistics would seem to predict that pay practices will evolve, but that we should not expect the widespread implementation of say-on-pay voting in the United States to result in rampant shareholder revolts. However, companies should view this history with caution as proxy advisory firms—with their outsized influence on shareholder voting perhaps increasing due to technical voting changes imposed by the Dodd-Frank Act—have made clear that they intend to fully jump into the fray.

Proxy Advisory Firms

Many institutional investors and other shareholders depend on the analysis and recommendations of proxy advisory firms to guide their own voting decisions. It should be no surprise that the role of proxy advisory firms has expanded in the United Kingdom as say-on-pay voting became mandatory. In the United States, proxy advisory firms have a long-established footprint in the area of executive compensation. Of the major U.S. proxy advisory firms, Institutional Shareholder Services (ISS), which has been reported to have more clients than the other four major proxy advisory firms combined, is by far the largest.⁶ ISS has estimated that “its opinions affect the governance decisions of professional investors controlling...half the value of the world’s common stock.”⁷

In the United Kingdom, established best practices make it easier for a shareholder to identify when a company’s executive compensation policy deviates from the norm. These best practices are memorialized in a joint statement on responsible

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voting practice issued by the Association of British Insurers and the National Association of Pension Funds (which was most recently updated in 2009) and a green paper on corporate governance in financial institutions and remuneration policies published by the European Commission in 2010. The U.K. government also drafted regulations on bankers' remuneration in 2010, although an implementation date for these regulations has not yet been set. The evolution of compensation policies in the United Kingdom is generally considered to be attributable to the widespread adoption of such executive compensation principles.

Meanwhile, in the United States, ISS announced in 2009 that it integrated three of its previous policies related to executive pay into one overall executive compensation evaluation policy. ISS uses this policy to formulate its recommendations for say-on-pay votes. If egregious pay practices are identified or if a company previously received a negative recommendation on a say-on-pay proposal and the company has not addressed the underlying issue, ISS may also recommend a "withhold" or "against" vote with respect to the election of directors who are members of the company's compensation committee.

In 2010, ISS published a specific list of poor compensation practices that it would consider in analyzing, and formulating voting recommendations for, say-on-pay proposals. These practices include egregious employment contracts, overly generous new-hire packages for CEOs and excessive change in control payments.⁸ Given the powerful role that proxy advisors such as ISS play in the United States, as well as past experience,⁹ it can be expected that U.S. companies will steer away from implementing the poor practices identified by ISS and other proxy advisory firms.

Going forward, the influence of proxy advisory firms in the voting decision process may also increase for companies that have a large retail investor base as a result of a new provision in the Dodd-Frank Act that prohibits broker discretionary voting of uninstructed shares with respect to votes on executive compensation. With brokers not permitted to vote without instruction, a large number of shares owned by retail investors may go unvoted and voting on say-on-pay proposals for these companies is likely to be more heavily weighted than before toward institutional and other large shareholders whose voting is traditionally guided by proxy advisors. The reliance on proxy advisors by these shareholders may, in fact, increase as institutional shareholders are confronted with the task of analyzing a myriad of say-on-pay proposals for companies in their portfolios.

Getting Ready for Say on Pay

Despite the measured experience with say-on-pay proposals to date, the increased focus on these proposals—especially the regimented check-the-box analysis of proxy advisory firms—make a passive approach to the new regime a recipe for surprise. Instead, public companies would be well advised to be proactive in order to ensure that their say-on-pay proposals are not met by shareholder antipathy. As the proxy season for most public companies approaches, companies should consider taking some or all of the actions below.

When Drafting Disclosure

As a result of say on pay, the executive compensation disclosure in a company's proxy statement will have heightened importance as

it becomes part of the story that is conveyed to shareholders. In past proxy statements that included say-on-pay votes, there has been a noticeable trend in the executive compensation sections toward greater use of an executive summary or similar high level section. Many of these executive summaries provide an overview of the company's financial performance for the prior fiscal year, which can serve to substantiate pay-for-performance alignment and a link between a company's strategic goals and long-term value.

Identifying circumstances and concerns that are unique to a company's business also serves to put its executive compensation system in context. In addition, sections identifying peer group companies have generally been moved closer to the beginning of the executive compensation portion of proxy statements, which can serve to highlight alignment with market compensation levels.

Identify Red Flags

As companies prepare for their upcoming shareholder meetings, they should begin identifying any problematic pay practices that are part of their overall executive compensation policies. A company's existing practices should be compared to the guidelines published by ISS and other proxy advisors.

Red flags that should be avoided include high CEO compensation in comparison to other companies in the same industry, lack of correlation between company performance and pay, reward for

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failure (including long-term employment contracts and excessive severance) and a passive or non-independent compensation committee. To the extent that red flags are identified, companies should be prepared to explain the rationale for such compensation components and, potentially, to alter those components going forward.

Understand Shareholder Base

If management has not done so already, it should begin engaging large shareholders (directly or through a proxy solicitor) in a dialogue about the company's executive compensation practices. These interactions will give companies an indication of how shareholders view the company's compensation practices and provide the company with an opportunity to react by either explaining its practices more fully or changing them.

Although companies need to be careful not to share material non-public information in these discussions, there is typically room for productive conversations that give companies insight not only about the mind-set of their shareholders, but whether their institutional investors have formulated guidelines against which the company's executive compensation practices should be evaluated. These discussions can also lay the groundwork with shareholders for an upcoming say-on-pay vote.

Be Responsive

If shareholders express discontent with certain practices, a company should address these issues through conversation and disclosure. To the extent that a company has already identified weaknesses in its compensation practices, it should devise a strategy to cure these weaknesses. As recommended by ISS, a company should disclose its challenges and goals, and whether there are any issues that are unique to the company.¹⁰ By acknowledging any weaknesses head on and explaining the company's strategy to meet its challenges and goals, a company can prevent any potential backlash from shareholders regarding what they see as problematic practices.

Conclusion

Although non-binding, say-on-pay proposals are important indicators of how shareholders view a company's compensation practices and will give them a greater voice with respect to executive compensation. Companies should pay careful attention to the views of their shareholder base, as unaddressed discontent relating to executive compensation can lead shareholders to take more drastic actions to register their disapproval, including by voting against the election of board members.

As we have seen with the companies whose say-on-pay votes have been rejected to date, the negative publicity likely to accompany a failed vote can also be damaging to the reputation of a company and its management, and embolden dissident shareholders. Consequently, companies should be more analytical in identifying potential areas of concern in their compensation practices, more proactive in communicating with shareholders, and more thoughtful about drafting executive compensation disclosure in their proxy statements.

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1. Jeffrey N. Gordon, "Say on Pay: Cautionary Notes in the U.K. Experience and the Case for Shareholder Opt-in," 46 HARV. J. ON LEGIS. 323, 343 (2009).

2. Stephen M. Davis, "Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable," MILLSTEIN CENTER FOR CORPORATE GOVERNANCE AND PERFORMANCE, POLICY BRIEFING NO. 1, 10 (2007).

3. The three companies that had their votes fail were Bellway, Provident Financial, Punch Taverns, Royal Dutch Shell and Royal Bank of Scotland.

4. Bruce N. Goldberger, "Say, Say, Say: Say on Pay, Say When on Pay, and Say on Golden Parachutes Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010," 1839 P.L.I. CORP. 39, 52 (2010).

5. The three companies were KeyCorp, Occidental Petroleum Corporation and Motorola, Inc.

6. U.S. GOVT ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, 13 (2007), available at <http://www.gao.gov/new.items/d07765.pdf>.

7. Robert D. Hershey, Jr., A Little Industry With a Lot of Sway on Proxy Votes, N.Y. TIMES, June 18, 2006, at S3, available at <http://www.nytimes.com/2006/06/18/business/yourmoney/18proxy.html>.

8. See 2010 Compensation FAQs, RISKMETRICS.COM, http://www.riskmetrics.com/policy/2010_compensation_FAQ.

9. Although each company had unique issues driving shareholder sentiment, the three rejections (KeyCorp, Occidental Petroleum Corporation and Motorola Inc.) of say-on-pay votes for U.S. companies to date were no doubt impacted by ISS having recommended voting against each of the proposals.

10. Proposed Best Practices in Executive Compensation, RISKMETRICS.COM, www.riskmetrics.com/system/files/private/ExecCompBestPractices.pdf.