STRUCTURING SAY-ON-PAY: A COMPARATIVE LOOK AT GLOBAL VARIATIONS IN SHAREHOLDER VOTING ON EXECUTIVE COMPENSATION

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I. INTRODUCTION

The financial crisis exposed executive compensation as an area ripe for new regulation. It is now widely agreed that the compensation structures in the financial sector encouraged excessive risk-taking and thereby contributed to the crisis.[1] The image of bank CEOs and their lieutenants rewarding themselves for delivering big short-term profits without being correspondingly penalized when their companies later suffered even bigger losses spurred calls for pay-related regulations like mandating deferred compensation, instituting clawbacks, and even imposing

[1] *See* G-20 Leaders' Statement: The Pittsburgh Summit 8–9 (Sept. 24–25, 2009), http://www.pittsburghsummit.gov/documents/organization/129853.pdf ("Excessive compensation in the financial sector has both reflected and encouraged excessive risk taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse . . . aligning compensation with long-term value creation, not excessive risk-taking, including by (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk; (iv) making firms' compensation policies and structures transparent through disclosure requirements; (v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and (vi) ensuring that compensation committees overseeing compensation policies are able to act independently.").

salary caps.[2] The return of outsize bonuses at firms that were "bailed out" by taxpayers only added urgency to the cause.[3] With the regulation of compensation suddenly so salient, it is natural that the U.S. Congress is once again considering the idea of granting shareholders a right to vote on executive remuneration—otherwise known as "say-on-pay."[4] The reappearance of say-on-pay is mostly due to the current backlash against what is viewed as unjustifiably high compensation: such shareholder votes are not intended to stymie excessive risk-taking and would have probably done nothing to prevent the financial crisis or lessen its effects because this reform merely attempts to align executive compensation with shareholder interests.[5] Since

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[2] *See id.* (calling for deferred compensation and clawbacks); Paul Krugman, Op-Ed, *Reform or Bust*, N.Y. TIMES, Sept. 21, 2009, at A23 (calling for aggressive regulation of compensation in the financial sector by stating "you can make the case that reforming bankers' compensation is the single best thing we can do to prevent another financial crisis a few years down the road"); Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay: Firms That Get Bailout Funds Face $500,000 Salary Cap, Must Disclose Luxury Purchases; A Move to 'Claw Back' Bonuses*, WALL ST. J., Feb. 5, 2009, at A1 (reporting on new regulations on executive compensation that include "salary caps of $500,000 for top executives at firms that accept 'extraordinary assistance' from the government").

[3] Edmund L. Andrews & Peter Baker, *At A.I.G., Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1 ("The payment of so much money at a company at the heart of the financial collapse that sent the broader economy into a tailspin almost certainly will fuel a popular backlash against the government's efforts to prop up Wall Street.").

[4] Corporate and Financial Institution Compensation Fairness Act, H.R. 3269, 111th Cong. (2009); Shareholder Bill of Rights Act, S. 1074, 111th Cong. (2009).

[5] Indeed, one recent study finds that the financial firms that most closely aligned executive compensation with shareholder interests performed worse during the financial crisis. Rüdiger Fahlenbrach & Rene M. Stulz, *Bank CEO Incentives and the Credit Crisis* 4–5 (Fisher Coll. of Bus. Working Paper No. 2009-03-13, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859 (finding that bank executives with well-aligned incentives "took exposures that they felt were profitable for their shareholders *ex ante* but that these exposures performed very poorly *ex post*").

shareholders' rational preference is for risk-taking, their input on compensation is not intended to make firms more risk-averse.[6] Still, the votes are not without merit. They introduce an important dose of accountability to boards' executive compensation decisions, which have been overly influenced by executives themselves and are often detrimental to shareholder value.[7] Thus, while say-on-pay is not meant to rein in risk-taking, the reform should still be adopted for the separate rationale of aligning compensation with shareholder interests.

A study of say-on-pay lends itself to a comparative analysis because several countries have already adopted reforms.[8] The fact that each country has adopted a unique version of shareholder voting on compensation makes a comparative study especially informative for U.S. policymakers. It is unfortunate, then, that almost all U.S. commentary has focused on the U.K. experience with say-on-pay.[9] Given this single-minded focus, it is not surprising that current proposed U.S. legislation mirrors the U.K. reform.[10] It is not too late for the U.S. to consider other possibilities. For instance, shareholder votes could be binding instead of advisory, include several factors instead of being merely up-or-down, be on future policy rather than past practices, or be firm-optional instead of mandatory.

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[6] *See infra* Part II.C.1 (discussing shareholders' preference for risk-taking relative to regulators and executives).

[7] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 23 (2004) ("Because directors hold only a tiny fraction of the firm's shares, their holdings are insufficient to outweigh their incentives and tendencies to side with executives. In any event, directors have thus far had neither the time nor the information necessary to serve shareholder interests when determining executive compensation.").

[8] *See infra* notes 13, 36, 37, and accompanying text.

[9] *See infra* Part II.B (discussing U.S. studies on U.K. experience).

[10] The Treasury Department's frequent references to the U.K. reform make it clear that the U.S. seeks to emulate the U.K. experience. *See, e.g.*, Press Release, U.S. Dep't of the Treasury, Administration's Regulatory Reform Agenda Moves Forward: Say-On-Pay (July 16, 2009), http://www.treas.gov/press/releases/tg219.htm.

This Note proceeds as follows: Part II reviews the global context in which the U.S. is considering adopting say-on-pay with a special emphasis on the Netherlands, the second country to adopt shareholder votes on compensation.[11] Part III considers the pros and cons of say-on-pay in light of the experience of other countries, focusing particularly on three broad criticisms that have been made of the reform. Part IV suggests that a U.S. reform that makes say-on-pay binding on boards may be more appropriate because of the difficulties U.S. shareholders face in replacing directors. Finally, Part V concludes.

II. THE HISTORY OF SAY-ON-PAY

Despite what the current controversy surrounding the say-on-pay proposal in the U.S. may suggest, the U.S. Congress has been debating the merits of shareholder votes on compensation since at least 2007, the first time Congress took up the issue.[12] Shareholder votes on pay have a longer history outside the U.S., particularly in the U.K., which was the first country to enact the reform.[13] After the U.K. mandated shareholder votes on pay in 2002, other countries followed with their own regimes, some of which grant shareholders a binding vote on executive compensation.[14] To better understand the current debate on say-on-pay, it is important to first establish the context in which the reform would be adopted. The U.K., global, and U.S. contexts will be taken up in turn.

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[11] STEPHEN DEANE, INSTITUTIONAL SHAREHOLDER SERVICES, WHAT INTERNATIONAL MARKETS SAY ON PAY: AN INVESTOR PERSPECTIVE 4 (2007), *available at* http://www.riskmetrics.com/system/files/private/SayOnPay.pdf.

[12] Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007).

[13] DEANE, *supra* note 11, at 7 ("In 2002, the U.K. became the first country to adopt requirements for shareholder votes on pay, effective the following year.").

[14] *Id.* at 4 (showing that the Netherlands, Sweden, and Norway have binding shareholder votes).

A. Say-on-Pay in the U.K.

In the early to mid-1990s, public outrage in the U.K. against excessive executive compensation became impossible for the country's politicians to ignore.[15] The gross pay of chief executives of large U.K. public companies had risen nearly 600% between 1979 and 1994—a dramatic increase that appeared to bear little relation to corporate performance.[16] At the same time, many U.K. companies cut staff, and media stories of rising CEO pay contrasted starkly with rising unemployment figures.[17] Fearing social upheaval, the Prime Minister, the main business lobby, and the Archbishop of Canterbury made repeated appeals for pay restraint by directors.[18]

Instead of passing legislation, the Conservative government at the time deferred to a Code of Best Practice that had been established by an industry-sponsored study group in 1995.[19] The so-called "Greenbury Code"

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[15] Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say Over Executive Pay? Learning from the US Experience* 3–4 (Vanderbilt Univ. Law School, Joe C. Davis Research Paper No. 01-6, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=268992 ("In the mid-1990s . . . interest in the topic [executive compensation] reached unprecedented levels. Articles on the topic appeared regularly in the press, sometimes with colorful headlines such as 'Derailing the Gravy Train,' 'Executive Gluttony Under Attack,' and 'Fat Cats in the Dock.' Politicians weighed in as well.").

[16] *Id.* at 4 ("For instance, executives in utilities privatized under Margaret Thatcher's Conservative government were being awarded generous increases in pay when profits earned could be attributed more easily to privileged access to markets than to managerial effort.").

[17] *Id.* ("During the first half of the 1990s, many UK companies cut staff costs and stories of rising executive pay contrasted starkly with this pattern of retrenchment.").

[18] DEBORAH GILSHAN, RAILPEN INV. & PIRC LTD., SAY ON PAY: SIX YEARS ON, LESSONS FROM THE UK EXPERIENCE 7 (2009), http://www.pirc.co.uk/publications/SayonPay.pdf.

[19] Fabrizio Ferri & David Maber, *Say on Pay Vote and CEO Compensation: Evidence from the UK* 6 (Harvard Bus. Sch. Working Paper, 2009), *available at* http://efmaefm.org/0EFMSYMPOSIUM/CGC%202009/papers/Ferri.pdf.

recommended that boards provide shareholders with an annual report on executive pay, but stopped short of endorsing the idea of an annual shareholder vote to ratify the report, arguing that shareholders prefer to focus on overall performance rather than the details of pay packages.[20] Instead, the Greenbury Code recommended that boards allow shareholders to vote on executive pay at the annual meeting only under special circumstances, as when there are changes in remuneration policy or when a compensation component proves particularly controversial.[21] Though Greenbury's primary aim of full disclosure was largely achieved,[22] a 1999 government audit discovered that "[o]nly seven of the 270 companies monitored chose to put forward the remuneration report for shareholder approval at the annual general meeting."[23]

After companies consistently resisted demands from institutional shareholders to voluntarily implement shareholder empowerment measures, the government responded in 2002 by introducing the Directors' Remuneration Report ("DRR") regulations.[24] The DRR regulations amended the U.K. Companies Act to require that companies include an executive pay report in their annual filing that was somewhat more detailed than under the London Stock Exchange's Listing Rules and then submit the report to a non-binding shareholder vote at the annual meeting.[25] The measures came into effect in 2003 and cover

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[20] *Id.*

[21] *Id.*

[22] Cheffins & Thomas, *supra* note 15, at 5 (noting that following the introduction of the Greenbury Code, "publicly quoted companies divulged a much wider range of information than had been the case previously" and incentive-oriented remuneration grew in importance).

[23] GILSHAN, *supra* note 18, at 7.

[24] *Id.* Regulations have since been transferred to the U.K. Companies Act 2006, c. 46, § 439, *available at* http://www.opsi.gov.uk/ACTS/acts2006/pdf/ukpga_20060046_en.pdf.

[25] Ferri & Maber, *supra* note 19, at 8.

all U.K. corporations trading on U.K. exchanges except for the Alternative Investment Market.[26]

While U.K. shareholders have almost always approved the DRR,[27] perhaps the most visible shareholder rebuke occurred during the first year of mandatory say-on-pay, when 50.7% of shareholders at the pharmaceutical company GlaxoSmithKline ("GSK") refused to sign off on the remuneration report, which would have endorsed paying the CEO $35 million if he lost his job and granted him bonus continuation of two years, along with usual perks like career transition counseling, excise tax reimbursement, and immediate vesting of equity awards.[28] Though the vote was merely advisory, the company immediately asked its compensation consultants to conduct an independent review and subsequently overhauled the package: the "golden parachute" terms were cut back to one year's salary and bonus continuation, with equity vesting governed by an incentive plan.[29]

The media attention in the GSK case and resulting board embarrassment were critical factors in ensuring that the shareholder vote had any effect. But in an advisory say-on-pay system there is no guarantee that shareholders will always be accorded a willing ear. For instance, in May 2009, investors holding 59% of Royal Dutch Shell stock rejected the U.K.-incorporated company's pay package for 2008 to protest the payment of bonuses after the company missed performance goals.[30] Under the provisions of Shell's long-term incentive plan, executive directors would not receive bonus shares if the company ranked fourth or lower in a

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[26] *Id.*

[27] GILSHAN, *supra* note 18, at 29–34.

[28] Editorial, *Revolting Shareholders*, ECONOMIST, May 24, 2003, at 13; Paul Hodgson, *A Brief History of Say on Pay*, IVEY BUS. J., Sept./Oct. 2009, http://www.iveybusinessjournal.com/article.asp?intArticle_ID=856.

[29] Hodgson, *supra* note 28.

[30] *Attacking the Corporate Gravy Train*, ECONOMIST, May 30, 2009, at 71; James Herron, *Controversial Head of Shell Remuneration Committee to Retire*, DOW JONES NEWSWIRE, Sept. 11, 2009.

group of ten of its peers.[31] In 2008, Shell was fourth but the remuneration committee nevertheless decided to award executives half the shares allotted for third place.[32] Though the shareholder dissent was the fifth-largest ever registered in the U.K. at the time, Shell maintained its original pay package.[33]

B. Say-on-Pay Outside the U.S. and U.K.

Most scholarship and nearly all empirical work dealing with say-on-pay have been based on the U.K. experience.[34] This is not surprising given that the U.K., as the first adopter, provides the largest sample of data and the most anecdotal evidence. As the U.S. moves towards adopting its version of say-on-pay, academics and policymakers have been busy looking at the lessons learned from the U.K. experience.[35] The problem is that this single-minded attention on the U.K. has come at the expense of learning from other countries' versions of say-on-pay, which differ widely from the U.K. version, notably with respect to the binding nature of the vote.

The Netherlands adopted say-on-pay in 2004, one year after the U.K. did.[36] Australia followed suit in 2005, as did

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[31] Herron, *supra* note 30.

[32] *Id.*

[33] GILSHAN, *supra* note 18, at 28–33 (showing levels of dissent since 2003).

[34] *See, e.g.*, Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323 (2009); Steven Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, 1622 PLI/CORP 33, 47 (2007); Mary Ellen Carter & Valentina Zamora, *Shareholder Remuneration Votes and CEO Compensation Design* (Am. Accounting Ass'n 2008 Mgmt. Accounting Section Meeting Paper, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1004061; Ferri & Maber, *supra* note 19; Kym Sheehan, *Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia* (Univ. of Melbourne, Working Paper, 1997), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=974965.

[35] Gordon, *supra* note 34, at 323.

[36] DEANE, *supra* note 11, at 4.

Sweden in 2006, Norway and Demark in 2007, and Germany in 2009.[37] In addition, other countries have put pressure on companies to grant shareholders advisory votes, but have stopped short of passing new legislation.[38] The introduction of shareholder votes on pay in each of these countries was the result of the familiar mix of corporate scandal and public anger at pay unjustified by performance.

1. Countries with Binding Votes: Netherlands, Sweden, Norway, Denmark

In the Netherlands, the 2003 accounting scandal at the Dutch retailer Ahold led to a summer-long consumer strike after revelations that the incoming CEO was guaranteed fixed bonuses.[39] Dutch consumers responded so intensely to this accounting scandal because of already existing indignation over high-profile cases of "pay for failure" at the time.[40] Trade unions, which form an essential part of the Dutch corporate model, pointed out that executive pay was growing eight to ten times faster than average increases in regular wages.[41] The government responded by forming the Corporate Governance Committee (otherwise known as the Tabaksblat Committee) in 2003 and charging it with crafting a code of best practices similar to the Greenbury Code in the U.K.[42] In 2004, the Netherlands adopted the resulting Tabaksblat Code, which made compliance with the corporate

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[37] *Id.* (for Australia, Sweden, and Norway); RISKMETRICS GROUP, 2009 PROXY SEASON PREVIEW: NORDIC MARKETS 2 (2008), http://www.riskmetrics.com/system/files/private/2009_Preview_Nordic.pdf (for Denmark); FRESHFIELDS BRUCKHAUS DERINGER, BRIEFING: REMUNERATION AND CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS 8 (2009), http://www.freshfields.com/publications/pdfs/2009/oct09/26798.pdf (for Germany).

[38] *See, e.g.*, *infra* Part II.B.3 (reviewing Spain's precatory corporate governance code).

[39] *Trouble in Store*, ECONOMIST, May 17, 2003, at 55; DEANE, *supra* note 11, at 6.

[40] DEANE, *supra* note 11, at 6.

[41] *Id.*

[42] *Id.*

governance principles mandatory by law.[43] As per its overarching regulatory approach, the Netherlands had compliance with the Code accord with the "comply or explain" model: provisions of the code are to be applied unconditionally or an explanation must be given for any departure from them.[44]

The say-on-pay provision has several features that are distinct from the U.K. version.[45] First, the vote covers pay policy only, not the remuneration report itself.[46] In other words, Dutch shareholders vote only on the principles that will be used to devise the following year's pay package. By contrast, in the U.K., the shareholder vote is on both aspects of the remuneration report: pay policy for the following year as well as the prior year's compensation practices.[47] Second, the shareholder vote in the Netherlands is not necessarily annual.[48] If the company does not change its pay policy, then it does not have to put its already existing policy to vote. Third, the shareholder vote is binding. If shareholders vote down the new policy, the existing one remains in effect.[49]

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[43] For a more detailed history, see Reports on Compliance with the Dutch Corporate Governance Code issued by the Corporate Governance Code Monitoring Committee (2005), *available at* http://www.ecgi.org/codes/code.php?code_id=81.

[44] *See* DUTCH CORPORATE GOVERNANCE CODE *passim*, *available at* http://www.ecgi.org/codes/all_codes.php.

[45] *Id.*

[46] DEANE, *supra* note 11, at 7.

[47] *Id.* at 4.

[48] *Id.* at 7.

[49] *Id.* ("Dutch authorities chose to make the votes binding to avoid any legal uncertainty concerning the board's responsibilities in responding to a majority vote."). Dutch shareholders did not start striking down remuneration policies until 2008. In that year, shareholders rejected new pay practices at VastNed, a retail fund, Corporate Express Group, an office supplies group, and, most astonishingly, at Philips, the healthcare and electronics group that is one of Europe's biggest companies. Neil Baker, *In Europe, CEO Pay Gets Complicated*, COMPLIANCE WK., May 20, 2008, *available at* http://www.complianceweek.com/article/4148/in-europe-ceo-pay-gets-complicated. In 2009, some companies, like DSM, the life sciences group, and Heineken, the brewery, simply withdrew their new pay policies at the last minute once it became evident that shareholders

In the face of their own corporate scandals and concomitant public anger, the Scandinavian countries adopted the Dutch binding vote model with some minor deviations, rather than the U.K. advisory vote model.[50] Sweden, Norway, and Denmark all mandate binding shareholder votes on prospective pay policies, as in the Netherlands, but Sweden and Norway require the vote to be annual, even when there has been no year-to-year change in principles.[51]

2. The Non-Binding Model Outside the U.K.: EC, Australia

At the EU-wide level, the European Commission ("EC") recommended in 2004 that remuneration policy be submitted to a shareholder advisory vote.[52] To make the reform more palatable to business, the EC stated that companies could

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were displeased. Kate Burgess & Richard Milne, *European Investors Balk at Director Pay*, FIN. TIMES, June 2, 2009, at 15.

[50] For instance, in 2003 the Skandia scandal in Sweden saw executives lie about their bonus payments and the Finance Credit scandal in Norway saw the company go bankrupt after executives siphoned funds to offshore tax havens. *Skandal*, ECONOMIST, Dec. 6, 2003, at 67 ("Sweden is in the throes of one of its biggest scandals . . . . Executives told shareholders that they got SKr356m ($37m) in bonus payments between 2000 and 2002, but in fact pocketed a further SKr550m."); Nina Berglund, *Fraud Fears Mount in Finance Credit Scandal*, AFTENPOSTEN, Nov. 19, 2002, *available at* http://www.aftenposten.no/english/business/article43923 9.ece ("Banks that have filed criminal charges against Finance Credit worry that the money may have wound up in an offshore tax haven . . . .").

[51] *See* RISKMETRICS GROUP, *supra* note 37, at 2 (noting that, in Denmark, "guidelines concerning variable pay . . . must be considered and approved by shareholders whenever they are amended"); DEANE, *supra* note 11, at 5 (showing that Sweden and Norway have annual votes regardless of whether there is a policy change).

[52] *Commission Recommendation of 14 December 2004: Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies*, 2004/913/EC, Preamble Clause 8 (Dec. 29, 2004), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004H09 13:EN:HTML (recommending that "remuneration policy should be submitted to the annual general meeting for a vote" and the vote can "be advisory").

decide to adopt the vote only if shareholders holding at least a quarter of shares requested it.[53] In other words, shareholders could opt-in to a say-on-pay regime if a sufficient number chose to do so. After a 2007 EC study found that shareholders in most member states had a say in determining the remuneration of the supervisory board of directors, but that few states had adopted votes on executive compensation,[54] the EC brought forth more sharply-worded recommendations in 2009 aimed at "improving shareholders' oversight of remuneration policies."[55] In this latest communiqué, the EC recommends that "shareholders, especially institutional investors, exercise their voting rights on directors' remuneration."[56] While it is clear that the EC intends to more forcefully direct member states to empower shareholders on matters of executive pay, it has been equally clear that the EC is willing to accept diverging models of shareholder voting.[57]

Australia adopted say-on-pay in 2005 after the U.K. and the Netherlands, and chose to follow the U.K. advisory model. The spur for action again appears to have been popular outrage against what was seen as excessive

[53] *Id.* at Article 4.2 (suggesting that the vote can be "held only if shareholders representing 25% of the total number of votes held by shareholders present or represented at the annual general meeting request it").

[54] Guido Ferrarini, Niamh Moloney, & Maria Cristina Ungureanu, *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis* 28 (ECGI Working Paper 126/2009, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463&rec=1&srcabs=1425469, citing *Report on the Application by EU Member States of the EC Recommendation on Directors' Remuneration*, COM SEC (2007) 1022 (July 13, 2007).

[55] *Commission Recommendation Complementing Recommendation 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies* 3, COM (2009) 211 (Apr. 30, 2009), *available at* http://ec.europa.eu/internal_market/company/docs/directors-remun/COM(2009)_211_EN.pdf.

[56] *Id.*

[57] *Id.* at 6 (noting that "[t]he Commission intends to increase monitoring mechanisms to enhance effective application" of its recommendations).

executive pay without performance.[58] As in the U.K., Australian boards are expected to produce an annual remuneration report and submit it to an advisory shareholder vote every year.[59] Though the legislation only mandates retrospective content, some companies have voluntarily included pay policies for coming years.[60]

As in the U.K., Australian boards do not always heed the non-binding shareholder vote. In 2007, for instance, investors holding two-thirds of Telestra, Australia's largest phone company, opposed doubling the CEO's pay package to more than $20 million.[61] The board ignored the vote, with the pay committee chair reportedly saying that the dissenting shareholders had "no expertise whatsoever" to decide the matter.[62]

Popular anger against excessive executive pay again reached a boiling point in Australia in 2009, largely due to the perception that pay practices had contributed to the financial crisis.[63] The government responded in March of that year by asking the Productivity Commission—the government's independent research and advisory body on economic issues—to examine executive salaries. One of the key recommendations of the Commission was the "two

[58] DEANE, *supra* note 11, at 6 (noting that a report of a parliamentary committee found that public revelations of excessive executive pay "triggered surprise and outrage and led to the public perception that boards . . . failed in their duty to restrain the size of executive payments") (internal quotation marks omitted).

[59] *Id.* at 7.

[60] *Id.* The legislation has been codified in the Corporations Act 2001, § 250R.

[61] Emma Alberici, *Shareholders Oppose High Pay for Telstra CEO*, ABC News, Nov. 7, 2007, http://www.abc.net.au/news/stories/2007/11/07/2084768.htm?.

[62] *Id.*

[63] *See* Press Release, Australian Government Productivity Commission, Executive Remuneration Inquiry (Sept. 30, 2009), http://www.pc.gov.au/projects/inquiry/executive-remuneration/press-conference ("Executive remuneration obviously has been a hot topic for some time. There have been widespread concerns that executive pay 'got out of hand' in Australia, concerns heightened by pay practices overseas seen as contributing to the global financial crisis.").

strikes" rule: if at least 25% of votes are cast against the remuneration report in two consecutive years, all directors must stand for re-election at the next shareholder meeting.[64] This rule is seen as an alternative to the binding vote called for by the conservative opposition leader.[65]

3. Non-Mandatory Regimes: Germany, Spain, Switzerland, Canada

The debate on say-on-pay continues in many other countries. In September 2009, Germany adopted the Act on the Appropriateness of Management Board Remuneration.[66] The new law grants shareholders an advisory vote on pay in two situations: (1) if the company volunteers to hold the vote; and (2) if shareholders holding at least 5% or €500,000 of the company's share capital demand a vote.[67] Thus, the German version of say-on-pay echoes the EC recommendation that votes be firm-optional depending on sufficient shareholder interest.

In Spain, no legislative action has been taken, but corporate governance guidelines recommend that the board submit a report on remuneration policy to the advisory vote of the general shareholders' meeting as a separate point on the agenda, as opposed to folding a vote on pay practices into a vote on the annual accounts.[68] The guidelines suggest that the vote be on current policies and that the report explain the most significant changes in remuneration policy with respect to the previous year, include a summary of how the policy was applied over the period in question, and detail the

[64] *Id.*

[65] *See* Interview by Journalist with Hon. Chris Bowen, Minister for Financial Services, in Sydney, Austl. (Sept. 30, 2009), http://mfsscl.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/036.htm&pageID=004&min=ceba (noting Liberal party policy supports binding votes).

[66] Otherwise known as the VorstAG.

[67] FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 37, at 8.

[68] European Corporate Governance Institute, Answers to Questionnaire on Directors' Remuneration in Listed Companies, Spain (2008), *available at* http://www.ecgi.org/remuneration/questionnaire/spain_update_2008.pdf.

role of the remuneration committee in designing the policy, along with the identities of any external advisors engaged.[69]

In Switzerland, institutional shareholders have been particularly successful at getting companies to voluntarily adopt resolutions requesting an advisory vote on pay. Large Swiss companies such as Nestle, UBS, and Credit Suisse have already agreed to hold shareholder votes.[70] The experience in Canada has been largely similar. The Canadian Coalition for Good Governance, a shareholder group representing most of Canada's large institutional investors, has called on companies to voluntarily adopt say-on-pay.[71] Several companies have heeded the call, including the country's nine largest financial institutions.[72]

C. Say-on-Pay in the U.S.

In the U.S., executive compensation has risen exponentially by almost every measure since the early 1980s.[73] While the compensation ratio of S&P 500 CEOs and the average American worker dipped slightly from 344-to-1 in 2007 to 319-to-1 in 2008 largely as a result of the burgeoning financial crisis, the latest figure is still several orders of magnitude greater than it was a generation ago, when corporate executives seldom earned much more than thirty

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[69] *Id.* at 16–17.

[70] Press Release, Ethos Fund, Say on Pay Resolutions Submitted by Ethos and Eight Swiss Pension Funds (Jan. 23, 2009), http://www.ethosfund.ch/e/news-publications/news.asp?code=206.

[71] CANADIAN COALITION FOR GOOD GOVERNANCE, MODEL SHAREHOLDER ENGAGEMENT AND "SAY ON PAY" POLICY FOR BOARDS OF DIRECTORS 1 (2010), http://www.ccgg.ca/index.cfm?pagePath=CCGG_Policies_Best_Practices/Guidelines_Principles/Engagement_and_Say_on_Pay&id=17578 ("CCGG regards annual 'Say on Pay' shareholder advisory votes as an important part of [the] ongoing integrated engagement process between shareholders and a board . . . .").

[72] Janet McFarland & Susan Krashinsky, *Banks Go For Uniformity With Say-on-Pay Votes*, GLOBE AND MAIL, Oct. 25, 2009, at B1 ("Canada's largest companies are championing a voluntary approach to compensation reform and are working together to ensure a standardized process for the first votes next year.").

[73] Davis, *supra* note 34, at 45.

or forty times the pay of average workers.[74] Many commentators see such pay disparity as a social injustice and have argued for government intervention in capping executive compensation or at least actively limiting its growth.[75] This kind of government intervention has long been disapproved of in the U.S.[76] Instead, investors, regulators, and lawmakers have condoned generous pay packages so long as they are justified by performance.[77] To this end, several policies have been implemented. In the early 1990s, the IRS imposed tax penalties on pay over a certain level that was not linked to performance.[78] In 2003,

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[74] INSTITUTE FOR POLICY STUDIES, EXECUTIVE EXCESS 2009 1–2 (2009), http://www.ips-dc.org/reports/executive_excess_2009 ("In 2008, amid an economic collapse that rivaled the early days of the Great Depression, top executives averaged 319 times more than average American workers. The architects of this collapse, America's top 20 financial industry executives, took home even more. They averaged compensation that outpaced typical American worker pay by 436 times.").

[75] For an example of such views, see Sarah Anderson & Sam Pizzigati, *Ending Plutocracy: A 12-Step Program*, THE NATION, June 30, 2008, at 30, *available at* http://www.thenation.com/doc/20080630/anderson_pizzigati (steps include requiring "the superrich to make their tax returns public" and increasing the excise tax on "elite endowments").

[76] *See, e.g.*, President Barack Obama, Remarks on the Economy and Executive Pay (Feb. 4, 2009), http://www.presidentialrhetoric.com/speeches/02.04.09.html ("This is America. We don't disparage wealth. We don't begrudge anybody for achieving success. And we believe that success should be rewarded.").

[77] *See, e.g.*, U.S. Securities and Exchange Commission, Executive Compensation, http://www.sec.gov/answers/execomp.htm (last visited Mar. 2, 2010) (noting that regulation of executive compensation is not meant to institute strict pay levels, but to make it easier for investors to link pay with performance: "The decision by a company regarding the amount and type of compensation to give an executive officer is a business decision and is not within the jurisdiction of the Commission. Rather, the Commission's jurisdiction extends to disclosure—making sure that the investing public is provided with full and fair disclosure of material information on which to base informed investment and voting decisions."); *see also* BEBCHUK & FRIED, *supra* note 7, at 6 ("[S]hareholders have often accepted the increase in executive pay as the price of improving managers' incentives.").

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

the U.S. Securities and Exchange Commission ("SEC") approved stock market listing rules that required companies to obtain shareholder approval of equity-based compensation plans.[79] In 2006, the SEC required more disclosure and explanation of pay details, adopted rules to ensure that corporate compensation committees were truly independent, and asked boards to control conflicts among outside compensation consultants.[80] However, there is little evidence that such measures have produced the desired effect of binding pay to shareholder value.[81] In fact, some studies suggest that enhanced disclosure and tax reforms have probably ratcheted pay even higher.[82]

1. Current Say-on-Pay Proposal

One proposal that is gaining ground is to grant shareholders an advisory (i.e. non-binding) vote on compensation in publicly traded U.S. companies.[83] Since it is in the shareholders' interest to tie pay to performance, the logic is that they will have the right incentives to oversee a board decision-making process that has been distorted by undue management influence.[84] Such a vote could be adopted in a variety of ways, for example by stock markets

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[79] Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 48108, 2003 WL 21510305 (June 30, 2003), *available at* http://www.sec.gov/rules/sro/34-48108.htm.

[80] Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54302A, Investment Company Act Release No. 27444A, 2006 WL 2570264 (Aug. 29, 2006), *available at* www.sec.gov/rules/final/2006/33-8732a.pdf.

[81] Davis, *supra* note 34, at 45.

[82] *See, e.g.*, Gregg Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE L. REV. 877 (2007) (arguing that setting a $1 million threshold for the introduction of tax penalties probably increased the level of executive compensation at many firms).

[83] Corporate and Financial Institution Compensation Fairness Act, H.R. 3269, 111th Cong. (2009).

[84] BEBCHUK & FRIED, *supra* note 7, at 2 (finding that "[t]he pervasive role of managerial power can explain much of the contemporary landscape of executive compensation").

as a listing standard, by a state legislature as a matter of substantive corporate law, by a state court as a condition for "business judgment" review of compensation, or by shareholder initiative as a bylaw amendment.[85] But each of these methods is a piecemeal approach to the solution. A national approach would have Congress amend the Securities and Exchange Act of 1934 to grant the SEC the power to make shareholder advisory votes a condition for the circulation of a proxy statement. In 2007, the House of Representatives passed the Shareholder Vote on Executive Compensation Act, by a vote of 269 to 134, that would do just this.[86] The companion legislation in the Senate, introduced by then-Senator Barack Obama, was referred to the Committee on Banking, Housing and Urban Affairs, but was never considered.[87] In 2009, the U.S. Congress once again took up legislation to give shareholders the right to vote each year on pay packages for executives and on "golden parachutes" for those who leave. On July 31, 2009, the House passed the Corporate and Financial Institution Compensation Fairness Act, by a vote of 237 to 185;[88] as of this writing, the companion Senate legislation remains within the Banking Committee.[89] Given the election of President Obama and the increased public attention to executive compensation, commentators expect some version of say-on-pay legislation to pass.[90]

Though the current say-on-pay bill includes a separate provision that would allow regulators to assess whether pay practices at financial institutions are likely to encourage

[85] Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 677 (2005).

[86] Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007).

[87] Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007).

[88] Corporate and Financial Institution Compensation Fairness Act, H.R. 3269, 111th Cong. (2009).

[89] Shareholder Bill of Rights Act, S. 1074, 111th Cong. (2009).

[90] *See, e.g.*, Gordon, *supra* note 34, at 325 ("[A]doption of some sort of 'say on pay' requirement seems highly likely.").

risk-taking so excessive that it threatens the stability of the financial system, it is important to note that shareholder votes themselves have nothing to do with systemic risk regulation.[91] Separating power between a government that regulates systemic risk and shareholders who vote on compensation packages makes sense for two distinct reasons. First, shareholder advisory votes are being proposed for all firms subject to SEC oversight, not just firms that are so large or interconnected that they are capable of destabilizing the economy.[92] Second, shareholders are not in a position to provide a check on a company's risk-taking. Indeed, shareholders may be quite content with compensation incentives that encourage aggressive risk-taking.[93] Not only are shareholders less risk-averse than regulators, it is likely that they are also less risk-averse than executives.[94] One

[91] As Barney Frank, the chairman of the House Financial Services Committee, puts it, "[t]he question of compensation amounts will be in the hands of shareholders and the question of systemic risk will be in the hands of the government." Editorial, *Pay and Politics*, ECONOMIST, Aug. 8, 2009, at 14.

[92] In the case of firms that are found to pose a systemic risk, such as large banks, the government has issued a proposal that would have the Federal Reserve review the firms' compensation policies and practices to determine their consistency with the principles for risk-appropriate incentive compensation. Press Release, Federal Reserve, Federal Reserve Issues Proposed Guidance on Incentive Compensation (Oct. 22, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm (singling out "28 large, complex banking organizations"). The Fed has also proposed a less strenuous review of compensation practices at regional, community, and other banking organizations not classified as large and complex as part of the regular, risk-focused examination process. *Id.* Thus, in these financial firms, the question of executive compensation would involve an interplay between boards, regulators, and, if say-on-pay is mandated, shareholders. Presumably, regulators would be able to strike down any compensation packages they deem risk-inappropriate, even if approved by shareholders.

[93] Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 177, 181 (2008) ("[B]ecause shareholders are residual claimants who may hold fully diversified portfolios of securities, maximizing profit for shareholders often requires significant risk-taking.").

[94] A Failure of Capitalism, http://www.theatlantic.com/richard_a_posn

study finds that bank executives whose incentives were better aligned with the interests of their shareholders actually performed worse during the financial crisis because they took highly leveraged positions that would have greatly benefited their shareholders had the market not turned sour.[95] Perhaps say-on-pay has been confused with systemic risk regulation because the 2009 stimulus bill passed in response to the financial crisis simultaneously mandated non-binding shareholder votes at firms receiving emergency federal support.[96] Thus, although it is likely that the short-term focus of pay packages in the financial sector encouraged excessive risk-taking, it is clear that the government did not mandate say-on-pay for financial firms out of systemic risk concerns.[97]

er (July 14, 2009, 1:03 EST) ("[S]hareholders are likely to be less risk averse than top executives, because the former have a lesser stake in the continued survival of the corporation. By holding a diversified portfolio of common stocks, a shareholder can mitigate the risk to him of a collapse of the value of an individual stock. In contrast, a corporate executive is likely to have both a large financial and a large reputational stake in his firm. Measures that align the executive's interest with that of the shareholders may thus increase the danger of a corporate collapse . . . .").

[95] Fahlenbrach & Stulz, *supra* note 5, at 3; *see also* David Erkens, Mingyi Hung & Pedro P. Matos, *Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide* 1 (ECGI Fin. Working Paper No. 249/2009, 2009), *available at* http://papers.ssrn.co m/sol3/papers.cfm?abstract_id=1397685 (finding "evidence consistent with shareholders having encouraged managers to take aggressive risks before the crisis").

[96] 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)).

[97] *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010) ("[P]ay arrangements have provided executives with incentives to focus excessively on short-term results and give insufficient weight to the consequences that risk-taking would have for long-term shareholder value.").

2. Origin of Shareholder Power Over Executive Pay

While Congress has been pursuing say-on-pay legislation since 2007, the history of such advisory votes actually begins back in 1992. In that year, the SEC permitted shareholders to bring resolutions concerning executive compensation under Rule 14a-8, which requires companies to circulate shareholder resolutions to other investors and put them to a vote at the subsequent shareholder meeting.[98] Previously, the SEC allowed companies to oppose such resolutions on the grounds that they raised matters of "ordinary business," an exception to Rule 14a-8 meant to preclude investors from meddling in day-to-day operations.[99] The SEC included an important caveat in its ruling, noting that only advisory shareholder resolutions would be exempt from the ordinary business exception because these did not seek to dictate how the board must proceed.[100]

In the years following the SEC's 1992 ruling, U.S. shareholders showed little interest in executive compensation resolutions. For instance, in 1994 the average level of support for compensation-related proposals was only 12.8%, compared with 21.5% of all proposals, and 53.7% for proposals recommending that takeover defenses be dismantled.[101] The experience of 1994 was not an isolated one. According to another study, the average percentage of votes cast in favor of compensation proposals from 1993 to 1997 was only 11.3%, with none of the proposals receiving

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[98] *See* Rule 14a-8 under the U.S. Securities and Exchange Act, 17 C.F.R. § 240.14a-8 (1934).

[99] *Id.* In reversing its interpretation of executive pay, "[t]he SEC noted that executive compensation issues had become the focus of widespread public debate and thus were no longer in the realm of ordinary business matters." Cheffins & Thomas, *supra* note 15, at 30.

[100] Cheffins & Thomas, *supra* note 15, at 30.

[101] Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed To Make Shareholder Proposals?*, 73 WASH. L. REV. 41, 67–68 (1998).

enough votes for passage.[102] The experience in the last three proxy seasons, however, has been notably different. In 2007, there were about fifty shareholder resolutions calling for an advisory vote on executive pay garnering an average support of 40.8% and majority support at eight companies; in 2008, there were more than ninety resolutions with an average support of 41.7% and a majority vote in at least eleven companies.[103] By May 2009, shareholders had filed 100 resolutions targeting executive compensation, with ten of the twenty-nine that had already been voted on winning majority support.[104]

Some companies have reacted to majority support for such resolutions by introducing or promising to introduce a say-on-pay vote, while others have ignored the majority of their shareholders and made no such moves.[105] So far, the shareholders who have been given a chance to express themselves on executive pay have overwhelmingly endorsed the pay practices at their companies.[106] Of the U.S. companies that have already put their compensation programs to a vote, all have garnered majority support and most have experienced a very high level of support.[107] Perhaps most surprisingly, of the firms that received

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[102] Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1061 (1999).

[103] Hodgson, *supra* note 28.

[104] Robert Kropp, *Shareowner Resolutions on Say on Pay Gain Widespread Support*, SOCIAL FUNDS, May 6, 2009, http://www.socialfunds.com/news/article.cgi/article2690.html.

[105] Hodgson, *supra* note 28 ("Some companies, like Apple and Motorola, have reacted to majority support for such resolutions by introducing or promising to introduce a Say on Pay vote. Others, such as Ingersoll-Rand, have ignored the majority of their shareholders and made no such moves.").

[106] Charlie Dunn & Carol Bowie, *RiskMetrics Group, Market Report, Evaluating U.S. Company Management Say on Pay Proposals*, 862 PLI/TAX 79, 92 (2009).

[107] *See id.* (showing that five of the six companies that had votes—Aflac, RiskMetrics, H&R Block, Littlefield, and Zale—garnered at least 89.6% of the vote and the sixth—Jackson Hewitt Tax Services—garnered 53.6%).

emergency federal assistance under the Treasury's Troubled Asset Relief Program, thus required to hold say-on-pay votes in 2009, all received majority support, usually with very high margins.[108] Thus, while shareholders are increasingly supportive of say-on-pay, they are not necessarily interested in voting down compensation packages just yet.

3. Corporate Reaction to Say-on-Pay Proposal

In the face of growing shareholder and government interest in say-on-pay, some companies have adopted advisory votes on compensation without waiting for shareholders to recommend the company do so through a 14a-8 resolution. In September 2009, Microsoft voluntarily instituted a triennial advisory vote on its executive compensation packages after discussion with some of its largest shareholders.[109] Pfizer and Prudential followed suit in October with measures that would grant shareholders a vote every two years.[110] The fact that the three companies chose to adopt policies that were less onerous than the current Congressional bill would mandate suggests that these companies may be attempting to provide an alternative to the more stringent annual shareholder vote, or perhaps expect

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[108] *See* Cari Tuna, *Investors Say "Yes" on Pay at TARP Firms*, WALL ST. J., Sept. 2, 2009, http://online.wsj.com/article/SB125190043514279681.html; *see also* Hodgson, *supra* note 28 (noting that Bank of America's support topped 70%, Citigroup's reached almost 85%, and Goldman Sachs' came in at 98%).

[109] Posting of Brad Smith & John Seethoff to Microsoft on the Issues Blog, http://microsoftontheissues.com/cs/blogs/mscorp/archive/2009/09/18/microsoft-s-board-adopts-new-say-on-pay-policy.aspx (Sept. 18, 2009, 14:38 EST).

[110] Press Release, Pfizer, Pfizer's Board Of Directors Approves Shareholder Advisory Vote On Executive Compensation (Oct. 29, 2009), http://mediaroom.pfizer.com/portal/site/pfizer/?ndmViewId=news_view&newsId=20091029006512&newsLang=e; Press Release, Prudential, Prudential Financial, Inc. Board of Directors Adopts Non-Binding "Say on Pay" Shareholder Vote (Oct. 19, 2009), http://www.news.prudential.com/article_display.cfm?article_id=5592.

their policies to be grandfathered if the current legislation is passed as is.[111]

Whatever the motivations of early voluntary adopters, the experience from the U.K., which has mandated a shareholder advisory vote at all listed companies since 2002, suggests that relying on voluntary adoption is not a feasible option for proponents of say-on-pay. The 23% of FTSE All-Share companies that adopted say-on-pay before the votes became mandatory were largely known for their healthy corporate governance, whereas the companies that watchdogs deemed most in need of greater accountability shunned the measure until it was required.[112]

III. THE DEBATE ON SAY-ON-PAY: LESSONS FROM OTHER COUNTRIES

With a more complete view of the history of say-on-pay, it is clear that countries have adopted widely varying regimes. The Netherlands and Scandinavian countries have mandated binding votes, but only on the contours of prospective policy.[113] By contrast, the U.K. has adopted an advisory vote on both prospective policy and the prior year's compensation.[114] Though it has recently flirted with binding

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[111] *See, e.g.*, Posting of Jeremy L. Goldstein to Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/10/13/microsoft-adopts-triennial-say-on-pay-policy (Oct. 13, 2009, 12:05 EST) (arguing that if say-on-pay is inevitable, then the triennial policy is the preferable option).

[112] Davis, *supra* note 34, at 53. It is not surprising that well-run firms like Goldman Sachs, which received 98% support when it put its compensation plan to a shareholder vote in 2009, have voluntarily adopted say-on-pay. Jenny Anderson, *Goldman Sachs Alters Its Bonus Policy to Quell Uproar*, N.Y. TIMES, Dec. 11, 2009, http://www.nytimes.com/2009/12/11/business/11goldman.html ("While Goldman will give shareholders a say on pay, the bank would not be required to bow to its investors wishes. Still, a vote against Goldman would be deeply embarrassing for the bank."). Such voluntary adoption probably does not foreshadow other, less well-run firms doing the same.

[113] *See supra* Part II.B.1 (reviewing say-on-pay in the Netherlands and the Scandinavian countries).

[114] *See supra* Part II.A (reviewing say-on-pay in the U.K.).

votes, at the moment Australia only requires a retrospective advisory vote on the prior year's pay practices.[115] Meanwhile, some countries, like Canada and Spain, encourage shareholder votes on pay, but do not require them.[116] Germany also does not require such votes, but has clear rules delineating who can institute such votes and how.[117]

Despite the great variance in say-on-pay regimes, there are three broad criticisms that have been made of each: (1) shareholders do not have the resources to provide meaningful input on compensation; (2) in light of this lack of resources, shareholders will blindly outsource their vote to proxy advisory firms; and (3) say-on-pay votes do not provide adequate information to boards about their pay practices.[118] Each of these criticisms is taken up in turn.

A. Do Shareholders Have the Resources to Provide Meaningful Input?

Executive compensation is a complex art that requires boards to reward managers for prior successful performance, provide incentives for future performance, retain and attract top talent, and align managerial interests with those of shareholders.[119] Executive compensation should also be in tune with the company's long-term strategy, include appropriate performance metrics, and be tax efficient. Moreover, the recent financial crisis has exposed how crucial it is to properly balance short-term incentives that promote robust growth and long-term incentives that encourage the creation of lasting value.[120] More recently, governments have called on boards of financial companies to fashion

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[115] *See supra* Part II.B.2 (reviewing say-on-pay in Australia).

[116] *See supra* Part II.B.3 (reviewing non-mandatory regimes).

[117] *Id.*

[118] *See, e.g.*, CENTER ON EXECUTIVE COMPENSATION, SAY ON PAY VERSUS MANDATORY VOTES ON PAY 12 (2008), http://www.execcomp.org/papers/c08-16_Say_On_Pay_031908.pdf.

[119] Gordon, *supra* note 34, at 329.

[120] James F. Reda, *Executive Compensation: Balancing Risk, Performance and Pay*, FIN. EXECUTIVE MAG., Nov. 2009, at 3, *available at* http://www.jfreda.com/page/publications.html.

compensation plans that are aligned with sound risk management.[121] The question this complexity brings up is whether investors have the expertise or time to second-guess directors on executive compensation.

Much as a right to vote for the U.S. president does not presume voters' intimate knowledge of the nuances of public policy, a shareholder vote does not require the ability to construct a compensation package that accounts for the variables listed above. Instead, voters in both cases are asked to provide simple yes-or-no feedback on the few issues that gain prominence due to controversy. Furthermore, this criticism improperly assumes that the full burden of shareholder votes falls on the shareholders themselves. Disclosure is an essential element of say-on-pay and a company that loses a vote can always partly blame itself for not clearly explaining and justifying its compensation plan to investors.[122] Nevertheless, just as more effort should be expected from companies and their directors, it is plain that shareholders will have to devote greater resources to building or acquiring expertise.[123] It is promising, then, to find that in countries that have adopted say-on-pay, institutional investors have in fact endeavored to increase their familiarity with compensation issues.[124]

Shareholder votes on pay have been a non-event for the vast majority of companies that have held them. Prior to enactment, it is generally reported that there is a fear that these votes will act as a lightening rod for all forms of shareholder protest.[125] Given the populist context in which

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[121] *See, e.g.*, Press Release, Federal Reserve, *supra* note 92.

[122] Keith L. Johnson, *Shareholder Say on Pay: Ten Points of Confusion* (S'holder Forum Program on Reconsidering Say on Pay Proposals, Columbia Sch. of Journalism, Oct. 14, 2008), http://www.shareholde rforum.com/sop/Library/20081014Johnson.pdf.

[123] *Id.*

[124] *See infra* Part III.B, note 150 (noting that institutional investors gradually develop in-house expertise to guide their voting on executive compensation in response to a new voting right).

[125] *See* Davis, *supra* note 34, at 48 ("[C]orporate fears that shareowners would resort too readily to voting against board pay policies . . . .").

say-on-pay legislation has often been adopted, that fear is probably legitimate.[126] But experience shows that this has not come to pass. In the U.K. from 2003 to 2009, just nine companies—all relatively small in size, except for GSK and the Royal Bank of Scotland—saw say-on-pay resolutions defeated.[127] Between 2002 and 2007, just 64 companies out of 596 reporting voting results experienced dissent of more than 20%.[128] Meanwhile, the proxy advisory firms have largely exercised restraint in their advice.[129] The level of dissent has been equally as low in other say-on-pay countries.[130]

Opponents of say-on-pay have also argued that the only shareholders who will exercise their right to vote against compensation packages will be special interest groups or "activist shareholders" with ulterior social motives.[131] But in countries that have adopted shareholder votes, there is no indication that special interests have hijacked the process.

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[126] *See supra* Parts II.A and II.B (reviewing the populist contexts in which say-on-pay was adopted in the U.K. and the Netherlands.).

[127] GILSHAN, *supra* note 18, at 29–34.

[128] Davis, *supra* note 34, at 48 (using data from Deloitte & Touche provided in a 2007 email).

[129] Glass Lewis recommended negative votes at approximately 10% of U.K. companies covered from 2003 to 2007. *Id.* at 48. In 2006, Institutional Shareholder Services, which is now a part of RiskMetrics, recommended negative votes in just over 13% of cases. *Id.*

[130] DEANE, *supra* note 11, at 11–12 ("[S]hareholders have voted down compensation reports or policies only rarely" since 2003.).

[131] *See, e.g.*, Stephen Bainbridge, *Remarks on Say on Pay: An Unjustified Incursion on Director Authority* 10 (UCLA Sch. of Law, Law-Econ Research Paper No. 08-06, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1101688 ("Most shareholders recognize that they are better off pursuing a policy of rational apathy rather than an activist agenda. They know that directors have better information and better incentives than do the shareholders. Instead, activist shareholders—the type likely to make use of . . . say on pay . . . —have tended to come from a distinct sub-set of institutional investors; namely, union and public employee pension funds."); *see also* CENTER ON EXECUTIVE COMPENSATION, *supra* note 118, at 12 (fearing that labor union pension funds will hold up the remuneration of executives of companies with which they have had a labor dispute).

In the U.K., "[s]hareholders have shied away from opining on pay levels and focused instead on strengthening the link between pay and performance . . . ."[132] Populist interests have been similarly sidelined in Dutch and Australian shareholder votes.[133] A mainstream response is similarly likely in the U.S. where, in the shareholder resolution context, investors have "systematically rejected proposals trying to micromanage executive pay."[134] While executive pay in say-on-pay countries has continued to rise more quickly than average wages,[135] studies note a moderation in the increase and find that the compensation is more closely correlated with performance.[136] Moreover, several empirical studies of the U.S. experience with shareholder resolutions

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[132] Posting of Fabrizio Ferri to Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/08/31/shareholder-activism-say-on-pay-and-executive-compensation (Aug. 31, 2009, 11:15 EST).

[133] DEANE, *supra* note 11, at 12 ("Investors interviewed for this report in the U.K., the Netherlands, and Australia all agree that shareholder votes in those markets have proven neither divisive nor driven by special interests.").

[134] Ferri, *supra* note 132.

[135] *See, e.g.*, DEANE, *supra* note 11, at 9 ("In the U.K., total pay for the highest paid directors at FTSE 100 companies rose at an annual rate of 11 percent to 13 percent for each of three fiscal years from 2003–04 to 2005–06 . . . .").

[136] One study reports that "votes are widely seen as having been an important contributing factor in taming the rate of increase, curbing opportunities for 'pay for failure' and linking compensation dramatically closer to performance." Davis, *supra* note 34, at 49. Another study finds that after the introduction of advisory votes, variable pay makes up a bigger proportion of executive compensation. DEANE, *supra* note 11, at 10. One 2009 empirical study finds that say-on-pay lowered CEO compensation in the U.K. when companies had negative operating performance and that the "effect is more pronounced in firms with high voting dissent but it extends more generally to firms with excessive compensation in the 'pre' period (2000–02), regardless of the voting dissent, suggesting that some firms responded to the threat of a negative vote by acting ahead of the annual meeting." Ferri & Maber, *supra* note 19, at 1.

indicate that investors effectively target their rare instances of significant dissent.[137]

Still, opponents of say-on-pay argue that even if shareholders can influence executive compensation for the better, shifting power in this domain from directors to shareholders allows the latter to inappropriately micro-manage the company and upsets the proper balance among corporate stakeholders.[138] This criticism is exaggerated for

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[137] One 2009 study using a sample of 134 vote-no campaigns (campaigns by investors to convince their fellow shareholders to withhold their vote from one or more directors in an effort to communicate a message of shareholder dissatisfaction to the board) and 1,198 non-binding shareholder proposals related to executive pay between 1997 and 2007 finds that "shareholders are sophisticated enough to identify firms with excess CEO pay both when targeting firms and when casting their votes." Yonca Ertimur, Volkan Muslu & Fabrizio Ferri, *Shareholder Activism and CEO Pay* 1 (CELS 2009 4th Annual Conference on Empirical Legal Studies Paper, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1443455. This conclusion mirrors an empirical study covering the period from 1993 to 1997 that found that shareholder proposals are not made on a random basis, but instead "target companies that pay executives more than competitors in the same industry and underperform in comparison with key stock market benchmarks." Cheffins & Thomas, *supra* note 15, at 35. This study found that companies responded to such targeting: "in the two years after receiving a shareholder proposal, executive pay rose more slowly in a typical target company than it did in other firms in the same industry" and "[t]his pattern was more pronounced when proposals received substantial support than when the level of support was low." *Id.* at 36. The fact that shareholders effectively target their rare instances of significant dissent may help explain the striking result of a 2008 study that found that when the U.S. House of Representatives passed the first say-on-pay bill in 2007, "the market reaction was significantly positive for firms with high abnormal CEO compensation, with low pay-for-performance sensitivity, and responsive to shareholder pressure" suggesting that market participants knew which firms could gain from greater shareholder influence. Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does it Create Value?* 1 (Drexel Coll. of Bus. Research, Working Paper No. 2008-06, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1030925.

[138] *See, e.g.*, Bainbridge, *supra* note 131, at 8 ("The trouble is that shareholder involvement in corporate decision making seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the vesting of 'authoritative control' in the board of directors.").

three reasons. First, say-on-pay leaves much power with the board, which continues to craft compensation but finds itself subject to the equivalent of a vote of confidence.[139] Second, say-on-pay would never be on the table without the public perception that boards had failed at their duty.[140] The egregious examples of "pay for failure" in the last decade would seem to warrant more accountability of board compensation committees.[141] Third, say-on-pay could just as easily be seen as an effort to empower directors who, the argument goes, have hitherto been bullied by CEOs into signing off on ever-generous pay packages.[142] The threat of a negative vote, under this theory, gives directors the leverage to stand up to assertive managers.[143] Similarly, those who see high levels of executive compensation as the result of chummy negotiations between directors and managers welcome the disruptive effect shareholder oversight promises.[144]

In sum, shareholders will overcome their relative lack of expertise in the compensation domain by focusing their resources on the few egregious cases of unjustified pay. If other markets are any indication, greater attention to compensation on the part of shareholders will force directors

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[139] Johnson, *supra* note 122, at 3.

[140] Ferri & Maber, *supra* note 19, at 34 (noting that, at least in the context of the U.K., "'rewards for failure' . . . led to [the] introduction of say on pay").

[141] *See, e.g.*, PAUL HODGSON, PAY FOR FAILURE II: THE COMPENSATION COMMITTEES RESPONSIBLE (2007), *available at* http://www.thecorporatelibrary.com/info.php?id=76 (finding, after a five-year analysis of twelve large U.S. companies, that boards' compensation committees authorized a total of $1.26 billion in pay to CEOs who presided over an aggregate loss of $330 billion in shareholder value).

[142] *See, e.g.*, Johnson, *supra* note 122, at 3 ("Say on Pay leaves boards with full control over executive compensation while giving them the opportunity to display more backbone.").

[143] *Id.*

[144] *See generally* BEBCHUK & FRIED, *supra* note 7, at 195–98 ("The most natural way to limit director discretion . . . is to require shareholder approval of certain board decisions . . . . Shareholder voting could establish some outer limits to what boards can do without specific shareholder approval.").

to more closely align pay with performance, which will result in an increase in the use of incentive compensation and perhaps a moderation in the rate of increase in the level of pay.

B. Will Shareholders Outsource Their Vote to Proxy Advisory Firms?

If investors feel that they do not have the resources to properly decide on how to vote, a rational response—for the institutional investors who can afford it—would be to outsource the heavy lifting to proxy advisory firms, which provide research and recommendations on corporate governance matters. The fear is that proxy advisory firms will develop "one size fits all" guidelines for voting on compensation plans instead of evaluating the plans according to a company's specific circumstances.[145] If many institutional investors come to rely on the few existing proxy advisors, then it is expected that cautious firms will tailor their plans to meet the broad guidelines of the proxy advisors rather than develop policies that are tailored to the company's unique long-term strategic goals.[146]

Proxy advisory firms would develop "one size fits all" guidelines for two distinct reasons. First, it is in the interest of the proxy advisors' profitability to develop broad guidelines instead of firm-specific recommendations because the former is presumably less costly than the latter. Second, they may also decide to take this route in order to appear unbiased. Often, proxy advisors providing corporate governance scores to shareholders have separate units that provide consulting services to companies interested in improving their corporate governance scores.[147] This conflict

[145] Davis, *supra* note 34, at 51.

[146] For an example of a proxy advisory firm's compensation guidelines, see RiskMetrics Group, 2009 Policy Information, http://www.riskmetrics.com/policy/2009/policy_information (last visited Mar. 2, 2010). In the U.K. context, see Institutional Voting Information Service, Guidelines, http://www.ivis.co.uk/Guidelines.aspx (last visited Mar. 2, 2010).

[147] Gordon, *supra* note 34, at 351–52.

of interests is reminiscent of the role that credit rating agencies played to such a damaging effect in the recent financial crisis.[148] A "one size fits all" approach to say-on-pay minimizes the appearance of this conflict of interests.[149]

Providers of proxy analysis and recommendations have indeed found their role enhanced after the U.K. enacted say-on-pay.[150] For example, the two most influential U.K. proxy advisors reported a rise in the outreach they received from corporate directors.[151] Proxy advisors are likely to find their role even more enhanced in the U.S., where a much more diffuse share ownership structure makes it harder for institutional investors and companies to make agreements without an intermediary.[152]

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[148] *Id.* at 326 ("As we have learned in the case of . . . credit rating agencies in valuing mortgage-backed securities, there are inherent risks to the combination of consulting and rating functions.").

[149] *Id.* at 353 ("[T]he 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.").

[150] *See* Davis, *supra* note 34, at 51 ("Investment funds in Britain expect proxy service providers to vet remuneration plans with companies and to engage in dialogue with boards in search of improvements before plans are finalized. Other funds use service providers merely for guidance in voting.").

[151] *Id.* The two firms are the Association of British Insurers' Institutional Voting Information Service ("IVIS") and the National Association of Pension Funds' Research, Recommendations and Electronic Voting ("RREV"), a joint venture with RiskMetrics. *Id.*

[152] Gordon, *supra* note 85, at 701 ("[A] relatively small number of UK institutional investors hold sixty percent of the publicly traded equity, and the UK regulations on collaboration by such shareholders are much less burdensome than in the United States."). It is ironic that the relatively diffuse share ownership in the U.S. has been used as a rationale for arguing against shareholder voting on compensation. After all, the need for shareholder voice—even when conditioned on a third-party opinion—is more usually associated with dispersed ownership. Ferrarini et al., *supra* note 54, at 17 ("[S]hareholder voice is more usually associated with dispersed ownership . . . ."). In blockholding systems common in Europe, shareholder votes often serve to formalize the implicit influence large shareholders have on the board. *Id.* In other words, say-on-pay might be most appropriate precisely when shareholder ownership is so diffuse that

While the U.S. market features a much more diverse shareowner base than the U.K.'s, and there are no U.S. investor trade associations with the financial and political clout that the ABI and NAPF wield in the U.K.,[153] institutional ownership of U.S. corporations grows almost every year and institutional investors play increasingly important roles in monitoring corporate governance.[154] Though few of these increasingly powerful institutional investors currently have the in-house expertise to guide their voting on executive compensation,[155] the experience in the U.K. suggests that such investors will gradually develop capabilities in this domain in response to a new voting right.[156]

Moreover, an increase in power for proxy advisory firms is not necessarily inimical to the goals of say-on-pay. While the idea of "shareholder voice" in its pure form will likely prove illusory, the ultimate goal of shareholder voting is to align executive pay with company performance.[157] Thus, whether it is the shareholders themselves or their proxy advisors who

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a company cannot get an accurate read on what the market thinks of its pay policies.

[153] Davis, *supra* note 34, at 54.

[154] *See, e.g.*, Press Release, The Conference Board, U.S. Institutional Investors Boost Ownership of U.S. Corporations to New Highs (Sept. 2, 2008), http://www.conference-board.org/utilities/pressdetail.cfm?press_id=3466 ("Data on institutional investor ownership in the largest 1,000 U.S. corporations show that institutions have substantially and consistently increased their holdings from 1987 with an average of 46.6 percent of total stock to an average of 61.4 percent of total stock by 2000 and then rising to an unprecedented 76.4 percent of corporations by year-end 2007 . . . .").

[155] Gordon, *supra* note 34, at 351.

[156] Davis, *supra* note 34, at 62–63 ("[F]unds have . . . had to raise their in-house capacity to analyze compensation . . . [and] revisit corporate governance and voting guidelines to ease the process of casting ballots on advisory votes. This has meant one-time internal reviews by individual funds but, equally, work by collective investor bodies to update joint guidance on compensation. Finally, funds have often found it necessary to allocate additional staff time for consultation exercises with companies. Presumably, US funds would have to consider following a similar path in the context of advisory votes.").

[157] *See supra* Part I (introducing aim of say-on-pay).

are actually making decisions is largely irrelevant. The problem is not empowerment of proxy advisors, but the "one size fits all" recommendations it is feared they will make. Again, the experience in the U.K. is enlightening. There, proxy advisors that did not have compensation expertise before say-on-pay legislation was enacted ended up acquiring the expertise to provide sophisticated analysis of pay policies.[158] This radical shift was in reaction to investor clients who suddenly expected a more rigorous investigation of how a company's remuneration policy was tethered to long-term performance.[159]

In addition to institutional investors improving their compensation expertise in response to new voting rights and proxy advisors making more firm-specific recommendations in response to client concerns, it is also possible that important investors will cooperate to proactively develop best-practice compensation principles and insist that proxy advisors abide by them.[160] Such a code would include a principle that proxy advisors refrain from applying "one size fits all" models to their compensation recommendations. If compliance with a code of best practices proves elusive, the SEC could always step in and mandate rules of operation for proxy advisors.[161]

C. Can Shareholder Votes Provide Adequate Information to Boards?

The third major criticism of say-on-pay is that shareholder votes on compensation packages will yield little

[158] Davis, *supra* note 34, at 62–63.

[159] *Id.*

[160] *Id.* at 54 (proposing that the Council of Institutional Investors serve as the entity that develops the principles).

[161] For a discussion of government oversight of proxy advisors, see Albert Verdam, An Exploration of the Role of Proxy Advisors in Proxy Voting 16–19 (Dec. 2006) (unpublished paper, on file with the VU University Amsterdam), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978835.

information to boards.[162] In the event of a negative vote, shareholders might be upset about any number of pay components: base salary, stock options, additional perks, or perhaps the remuneration philosophy that undergirded the board's decision. Sometimes shareholders want to voice displeasure on all the pay components. Worse still, dissenting shareholders may each have different reasons for voting no. How, then, are directors supposed to respond to an up-or-down vote on such a complex issue?

In markets that have adopted say-on-pay, this difficulty has proved surmountable.[163] Dissent reaches significant levels in very few votes, and there are typically a small number of issues that rise to prominence to galvanize opposition.[164] Moreover, companies can learn about shareholder views on compensation, both before and after a vote, through multiple channels. Compensation committees can meet with important shareholders one-on-one to discuss concerns, consult analytical reports provided by proxy advisors, communicate with shareholders at annual general meetings, and perhaps most easily, follow the financial media, which covers compensation practices, particularly when they are controversial.[165] Some companies have been especially creative in soliciting shareholder feedback on compensation.[166] In the run-up to its shareholder meeting, the biotechnology firm Amgen directed shareholders to a ten-

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[162] *See, e.g.*, CLEARY GOTTLIEB STEEN & HAMILTON, "SAY ON PAY" AND SHAREHOLDER INPUT ON EXECUTIVE COMPENSATION: SUMMARY OF APPROACHES 5 (2010), http://www.cgsh.com/say_on_pay_resource_center ("A single resolution does not permit differentiation among aspects of program and, therefore, may be too blunt an instrument to provide meaningful input.").

[163] Davis, *supra* note 34, at 56.

[164] *Id.*

[165] DEANE, *supra* note 11, at 13.

[166] For instance, Verizon has established an e-forum to address executive compensation matters; Lockheed Martin has posted an executive compensation survey for shareholders to complete on the investor relations portion of its website; and Northrop Grumman at one point created a web-based executive compensation and corporate governance survey. CLEARY GOTTLIEB STEEN & HAMILTON, *supra* note 162, at 10–11.

question online survey that included queries on whether shareholders thought pay policies were based on performance and whether performance goals were clearly disclosed and understandable.[167] After Amgen's successful use of the survey, several other companies followed its lead.[168]

The increase in dialogue between companies and shareholders after the enactment of say-on-pay is seen as one of the legislation's main benefits.[169] Shareholders are grateful that their proposals on compensation are taken into account; companies are grateful to learn what the marketplace thinks of their pay practices at the marginal additional cost of annual consultation and document preparation.[170]

For commentators who view say-on-pay as a blunt instrument, there are few savory alternatives. At one extreme, shareholders could be asked to vote on the separate components that make up a compensation package.[171] This would allow shareholders to provide more granular feedback to the company.[172] But such a multi-part vote is probably unnecessary: the shareholders of most companies are not interested in voting down compensation policies and

[167] Phred Dvorak, *Companies Seek Shareholder Input on Pay Practices*, WALL ST. J., Apr. 6, 2009, at B4.

[168] *Id.*

[169] Davis, *supra* note 34, at 48 (finding that "[v]otes on compensation policy resulted in a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other" and that this has "transformed the way compensation policies are constructed").

[170] *Id.* at 66 (noting that in the U.K., increased dialogue has resulted in compensation committees that "meet more frequently, use more information, demonstrate more awareness that their work will be scrutinized, seek more independent outside advice, show enhanced abilities to defend their decisions, and focus more on overall strategy").

[171] *See, e.g.*, CLEARY GOTTLIEB STEEN & HAMILTON, *supra* note 162, at 5–6 (discussing "multi-part votes" as an alternative to "up or down votes").

[172] *Id.* ("For example, a shareholder who thinks the company's overall compensation philosophy is appropriate, but disagrees with the way it was implemented in a particular year, can reflect that in his or her vote.").

practices, and in the exceptional cases it is usually clear from shareholder feedback which component—for instance, a generous severance payment for a failed CEO—was the cause for concern.[173]

At the opposite extreme has been the argument that shareholders can already vote against directors on the compensation committee to protest compensation practices.[174] Leaving aside the fact that it is nearly impossible for investors to replace directors at large U.S. companies, voting against directors' re-election as a proxy for voicing displeasure with pay is unsatisfactory because investors often take issue with compensation policies but otherwise consider the company well-governed.[175] In other words, votes on directors are especially blunt instruments. By contrast, if such votes are coupled with say-on-pay, the result is an escalating shareholder tactic that is easier on boards and more effective for investors. If companies do not properly respond to a negative advisory vote on pay, then it may be sensible for shareholders to use the "nuclear option" to elect new directors.[176]

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[173] DEANE, *supra* note 11, at 11 ("[S]hareholders have voted down compensation reports or policies only rarely."); *see also* Hodgson, *supra* note 28 ("[T]here has been little protest in the U.S., despite the furor over executive compensation, the economic crisis, the collapse in the markets, and shareholders reeling from the consequent loss of value. . . . [W]ith this level of protest at such a time, corporate opposition to say on pay is . . . beginning to look histrionic.").

[174] *See, e.g.*, Gordon, *supra* note 85, at 701 ("If the goal [of say-on-pay] is to provide a vehicle for broader mobilization of popular and elite opinion, the targeted 'just vote no' option [i.e. vote against director re-election in order to object publicly to specific corporate behavior] may be almost as effective.").

[175] *See infra* Part IV.A (analyzing how the inability to replace directors affects the say-on-pay analysis).

[176] For a soccer metaphor, see *Empowering Shareholders on Executive Compensation: Hearing on H.R. 1257 Before the H. Comm. on Financial Servs.*, 110th Cong. (2007) (testimony of Richard Ferlauto, Director of Pension and Benefit Policy, American Federation of State, County and Municipal Employees), *available at* www.house.gov/financialservices/hearing110/htferlauto030807.pdf ("A large shareholder vote against a pay report is the yellow card warning to the company board. If this warning is

IV. PROPOSAL FOR IMPROVING U.S. SAY-ON-PAY BILL

The say-on-pay legislation currently making its way through the U.S. Congress is modeled on the U.K. regime.[177] If enacted, the new law would grant shareholders of U.S. companies an up-or-down vote on the Compensation Discussion & Analysis (CD&A) section that must be included in the annual 10-K filing with the SEC.[178] The CD&A is roughly equivalent to the DRR that is put to a shareholder vote in the U.K.[179] Like the DRR, the CD&A encapsulates both prospective pay policy and retrospective pay practices for the prior year, and thus includes many compensation components.[180] Such a broad-based advisory vote is far from being the only option open to U.S. lawmakers interested in enacting say-on-pay.[181] In particular, the U.S. could institute a binding vote. Though this option has not been granted much, if any, attention in the U.S., it has proved successful

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not heeded and pay practices are not reformed and better aligned with performance, then shareholders have the opportunity to use the red card by replacing failed directors.").

177 Press Release, U.S. Dep't of the Treasury, *supra* note 10.

178 Corporate and Financial Institution Compensation Fairness Act, H.R. 3269, 111th Cong. § 2(i)(1) (2009); Shareholder Bill of Rights Act, S. 1074, 111th Cong. § 3(a) (2009).

179 Davis, *supra* note 34, at 55 (noting that the significant difference between the two is that "the CD&A is a product principally of management, though it may be approved by the board Compensation Committee, whereas the UK report is authored exclusively by the board").

180 The SEC requests that the CD&A include the following: the objectives of the company's compensation programs; what the compensation program is designed to reward; each element of compensation; why the company chooses to pay each element; how the company determines the amount (and, where applicable, the formula) for each element; and, finally, how each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements. Securities Act Release No. 8732A, *supra* note 80, (codified at 17 C.F.R. § 229.402(b)(1) (2009) (Item 402(b)(1) of Regulation S-K)).

181 *See supra* Part II.B (reviewing say-on-pay regimes outside the U.S. and U.K.).

in countries that have adopted it and may be especially suitable for U.S. shareholders.

A. The Case for Binding Votes in the U.S. Context

Implementing binding rather than advisory votes gets around the worrisome prospect of boards simply ignoring negative votes on their compensation plans, as Shell recently did in the U.K.[182] It is true that most companies usually respond appropriately to mere advisory votes out of embarrassment or fear of punishment by the market.[183] However, as companies become more comfortable with shareholder votes, there is the risk that they will always treat them as the non-events that they usually are, even when dissent reaches higher levels. It is telling that the instances of companies disregarding negative votes have only occurred after a say-on-pay regime has been in place for a few years.[184] Such indifference to shareholder voice can be preempted in the U.S. by instituting a binding vote.

Moreover, it can be seen that, after a few years, shareholders will come to rely on say-on-pay as an effective check on the board's compensation practices.[185] In the U.K., the Netherlands, and Australia, shareholders were at first hesitant to use their new power, but gradually became more comfortable voting no on a few egregious compensation

[182] *See supra* Part II.A (reviewing say-on-pay in the U.K.).

[183] *See supra* Parts II.A and II.B (reviewing corporate reactions to negative votes in Europe); *see also* Ferrarini et al., *supra* note 54, at 17 ("[T]he failure to obtain approval effectively amounts to a vote of 'no confidence' in the remuneration committee, is regarded as a significant blow to the board's authority and is typically widely reported.").

[184] Telestra's disregard of its shareholders' negative vote took place in 2007, three years after Australia adopted say-on-pay; Shell's disregard took place in 2009, five years after the U.K.'s reform. *Supra* text accompanying notes 60–62 (discussing Telestra) and text accompanying notes 30–33 (discussing Shell).

[185] *See* Hodgson, *supra* note 28 (noting that European shareholders have begun voicing dissent only once they have had the power to do so for a few years).

schemes.[186] This reliance on say-on-pay may come at the expense of investment in other plausible checks like director elections that are binding in nature. Encouraging shareholders to voice their dissent via say-on-pay rather than binding director elections and then allowing companies to disregard the new accountability mechanism might leave shareholders in a less powerful position than they were in before being granted a vote on pay because they will have lost momentum on other shareholder empowerment fronts.[187] If shareholders agree to voice dissent via more targeted methods, then it seems only fair to give the new method just as much bite as director elections.

Binding shareholder votes may be especially appropriate in the U.S. context because the "nuclear option" of voting out directors, though available in theory, is not really a viable option.[188] Advisory votes in the U.K. are seen as a warning

[186] *See, e.g.*, Richard Milne, *Dutch Pioneers Blaze Trail on Executive Pay*, FIN. TIMES, Sept. 1, 2009, at 21 ("Shareholders in Dutch companies have had a binding vote on pay since 2004 but only in the past year [2009] have they started to use their power . . . .").

[187] For instance, it is not unreasonable to speculate that some of the momentum behind the long campaign to amend Rule 14a-11 might be lost if shareholders are given the right to vote on executive compensation. Much of the support behind amending this proxy access rule, which would make it possible for certain shareholders to include the names of opposing candidates for the board on a company's proxy ballot, is rooted in shareholder activists' and pension funds' dislike of board decisions in the executive compensation domain. Given the back-and-forth on the SEC's proposed amendments, which has seen the agency drop similar proposals in 2003 and 2007, the authorities in Congress and at the SEC could decide to find the middle ground between shareholder interests and company interests by granting a shareholder demand on say-on-pay and a board demand on proxy access, or vice versa. *See, e.g.*, Hodgson, *supra* note 28 (noting that "various recent legislative actions appear to have deflated . . . shareholder campaign[s]" because investors expect impending regulation to accomplish their original goals).

[188] *See, e.g.*, INVESTORS' WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 27 (2009), http://www.cii.org/iwgInfo ("[S]hareowners currently have few ways to hold directors' feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing names of their own director candidates on proxy cards.

shot: if directors do not respond to shareholder dissatisfaction, shareholders may then choose a more hostile approach by voting out the directors on the compensation committee. A warning shot is effective only if it can be followed by more serious firepower. Despite the introduction of majority voting,[189] it is notoriously difficult for U.S. shareholder to remove directors, even ineffective ones, largely because they lack easy proxy access.[190] Unless the replacement of directors becomes easier in the U.S.,

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Shareowners who want to run their own candidates for board seats must mount costly full-blown election contests.").

[189] Changing the traditional plurality voting standard to a majority voting standard for the election of directors was a major shareholder demand of the last decade. *See, e.g.*, Stinson Morrison Hecker LLP, Supporters of Majority Voting Bolstered by Recent Legislative Changes (Sept. 27, 2006), http://www.stinson.com/legalpublications/smhlupage.asp?key=429 ("[P]lurality voting fails to provide shareholders with an adequate mechanism to voice their dissatisfaction with existing management, particularly in the context of an uncontested election, where a single vote is sufficient to secure a director's re-election.").

[190] Professors Bebchuk and Fried discuss this difficulty in stark terms:

> Shareholders' power to replace directors plays a critical role in the accepted view of the corporation. Although this power is not supposed to be used regularly, it is expected to provide a critical safety valve . . . . In reality, however, this safety valve is largely a myth. Indeed, attempts by shareholders to replace incumbents with a team that would do better . . . are even more rare than is commonly recognized. During the seven-year period 1996–2002, proxy contests over who would run the firm . . . occurred in only about 80 companies among the thousands of publicly traded firms. Furthermore, most of the firms in which these contests took place were small companies . . . . Thus, for firms with a market capitalization exceeding $200 million, the incidence of such contest was practically negligible . . . . This means that the safety valve of potential ouster via ballot box—on which our corporate governance system is supposed to rely—has been all but shut off. The risk of being removed in a proxy contest is far too remote to provide a strong incentive for directors to focus fully on shareholder interests.

BEBCHUK & FRIED, *supra* note 7, at 207–08.

shareholders are unlikely to be able to affect executive compensation with merely an advisory vote.[191]

The major flaw with binding votes is that they can force a company to renege on pay arrangements, making it difficult to hire new executives and attract top talent.[192] However, there is no requirement that say-on-pay address current or past pay practices.[193] In countries that have adopted binding votes, shareholders have a say only on prospective pay policies.[194] In this way, investors are assured that their vote has an impact and directors are assured that they will not face the messy legal implications of ripping up an employment contract.

B. Incidental Advantage of Binding Votes on Prospective Policy

The upside of having investors vote only on prospective policy is that the vote becomes more focused. In the event of a negative vote, there is no question as to the cause of investors' disapproval.[195] Moreover, in comparison to a vote on the multi-factored CD&A, a vote on policy would probably make it easier for investors to come to a decision and less

[191] The outcry over the SEC's most recent attempt to amend Rule 14a-11 suggests that the replacement of directors is unlikely to become easier in the near future. *See, e.g.*, Jeffrey McCracken & Kara Scannell, *Fight Brews as Proxy-Access Nears: Companies Race to Derail or Soften SEC Plan; 'Ultimate Vehicle' for Activists*, WALL ST. J., Aug. 26, 2009, at C1 ("The largest U.S. businesses, law firms and business groups have stepped up their challenge to the 'proxy access' rule . . . .").

[192] Indeed, one of the selling points of advisory votes in the U.S. has been that such votes allow "boards sufficient flexibility to meet agreed contracts with executives while striving to address investor concern in the following year." Davis, *supra* note 34, at 59.

[193] *See supra* Parts II.A and II.B (reviewing global variations of say-on-pay regimes).

[194] *See supra* Part II.B.1 (reviewing say-on-pay in the Netherlands and the Scandinavian countries).

[195] Though, as Part III.C makes clear, this should not be a major concern for say-on-pay proponents.

likely that they will outsource the heavy lifting to proxy advisory firms.[196]

Investors are also more likely to approach votes on policy in a more consistent manner than they would approach votes on past practices, as the following hypothetical suggests.[197] Consider an investor voting on retrospective pay practices who may disapprove of a bonus for the CEO because he finds that the huge figure simply shocks his conscience. Putting the bonus in the context of policy can neutralize this emotional reaction: the same investor might gladly support a plainly-stated policy provision that, say, calls for executive bonuses up to twice the level of salary when a specific performance metric indicates that the company has outperformed its peers. Though the two hypothetical provisions lead to the same result, the policy vote orients investors towards the objectives of the company.

An important caveat is in order: while policy provisions are inherently more general because they must leave room for different responses to company performance, it is critical that policies not be drafted so broadly that they become bland, uncontroversial statements.[198] Policy votes ask

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[196] It is reasonable to presume that shareholders will feel less overwhelmed by a single up-or-down vote on prospective policy than a multi-factored vote that requires knowledge of all the compensation components that were used in the previous year. *See* CLEARY GOTTLIEB STEEN & HAMILTON, *supra* note 162, at 7 ("A multi-part resolution is more complicated and requires shareholders to devote more analytical resources to a response.").

[197] This is important because one of the fears associated with say-on-pay is that shareholders will let their aversion towards a particular CEO or outrage over high levels of pay cloud their analysis of the long-term interests of the company. *See, e.g.*, Tomoeh Murakami Tse, *Bailed-Out Firms Clamber to Satisfy Say on Pay Proviso*, WASH. POST, Apr. 8, 2009, at A11 ("Some compensation experts worry shareholders may vote their emotions in this populist environment, rather than analyze hundreds of proxy statements in a matter of weeks.").

[198] The fear is that executive compensation policies will go the way of corporate social responsibility codes, which are often broad to the point of meaninglessness. *See* Ann Florini, *Business and Global Governance: The Growing Role of Corporate Codes of Conduct*, 21 BROOKINGS REV. 2, 6–7 (2003), *available at* http://www.brookings.edu/articles/2003/spring_busines

investors to consider inputs, but the resulting outcomes must not come as a surprise.

C. The Political Reality of Mandating Binding Votes

A binding vote on executive compensation may seem like a radical idea, but U.S. shareholders have had such a right in a limited form for quite some time. In 2003, the SEC approved revisions to stock exchange rules that required shareholders to vote on stock option plans.[199] Thus, all equity-compensation plans, and any material revisions to the terms of such plans, are subject to shareholder approval.[200]

s_florini.aspx ("Corporate codes are of two sorts. The first is 'aspirational'—a general statement of what corporations aim to do . . . . They consist of general principles, broad to the point of mushiness (corporations should operate in a spirit of honesty and fairness, should contribute to the economic and social development of the communities where they operate and the world community at large) . . . [and] require no confirmation of whether firms are meeting their commitments . . . . The second type of code is more demanding. It requires specific commitments on labor or environmental standards, along with independent confirmation of whether commitments are being met. Once a code is established, an independent external auditor comes in, assesses whether a company is in full compliance, and if so, certifies it.").

[199] Exchange Act Release No. 48108, *supra* note 79. Before 2003, shareholders were already voting on most equity-based plans because they had the right to do so under state corporate law or stock exchange rules. Even when companies were not required to put option plans to shareholder votes, they often chose to do so. Section 162(m) of the Internal Revenue Code disallows deductions of executive compensation in excess of $1 million per year unless the compensation is "performance-based," and one of the requirements for a "performance-based" option plan is that it receive shareholder approval. BEBCHUK & FRIED, *supra* note 7, at 48–50.

[200] Exchange Act Release No. 48108, *supra* note 79. Since annual and long-term incentive plans make up such a large portion of executive compensation today, some opponents of say-on-pay argue that granting shareholders a vote on all executive compensation is largely redundant. Hodgson, *supra* note 28. However, the appearance of large severance packages and "golden handshakes" belies the assertion that incentives in the form of stock options represent the most important or controversial element of compensation. *Id.* Moreover, it has been argued that the way binding votes on equity-based compensation are construed prevents them

While the origin of this reform was to protect shareholders against dilution of capital rather than to align pay with performance and thus puts it in a category apart from say-on-pay,[201] there were similar fears that the binding nature of the vote would disrupt the implicit agreement between directors and shareholders that the latter can only question board decisions in a non-advisory manner when those decisions are of fundamental importance to the company. Boards made this argument and correspondingly attempted to fit stock option decisions within certain exemptions from shareholder voting that existed prior to 2003.[202] In the end, though, these binding votes on a non-fundamental transaction did not disturb the separation of powers that undergirds corporate law. Indeed, empirical studies find that shareholders have only rarely disapproved of stock option plans, and that in instances where shareholders defeated plans, they were justified in doing so.[203]

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from imposing much of a constraint on executive compensation. Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 782–83 (2002) ("[E]ven if shareholders were to vote on every stock option plan, such voting could not produce outcomes equivalent to arm's length bargaining. To begin, the stock option plans on which shareholders vote do not specify the design of a particular executive's compensation but rather set out general parameters for the use of stock options to compensate employees—such as the total number of options that can be issued under the plan. Thus, shareholders cannot use the vote to reject or approve a particular executive's pay package.").

[201] Ferrarini et al., *supra* note 54, at 18 n.47.

[202] Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 50 (2000) ("[I]ncreasing shareholder opposition levels have led some boards to devise strategies to avoid shareholder votes when possible. For example, one such strategy is to add a provision to a shareholder-approved plan that allows management to replenish the pool of authorized shares in the plan using repurchased shares.").

[203] *Id.* at 33–34 ("Firm performance significantly impacts the level of shareholder opposition to stock option plans. We find that shareholders are more likely to support stock option plans at relatively poorly performing firms than at firms that are experiencing better performance. We interpret this finding to mean that investors are more inclined to try to incentivize managers at poorly performing firms to do better than they are

Nevertheless, if enacting binding votes on pay policy proves politically impossible, one strategy would be to forge a compromise by not making the votes mandatory.[204] In other words, the U.S. can mandate shareholder votes only at companies where a sizeable contingent of shareholders demands it.[205] Such say-on-pay opt-ins were reviewed in Part II.B. The European Commission recommends that companies grant a vote on pay when shareholders holding at least 25% of the company's stock request it; new German legislation allows shareholders representing at least 5% or €500,000 of the company's share capital to bring a vote.[206] The advantage of this version of say-on-pay is that companies with satisfied shareholders are not saddled with the extra costs of annual consultation and document preparation that shareholder votes impose. An opt-in would

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to reward executives at stronger companies for performing well. With respect to the features of stock option plans, we continue to find significant relationships between the level of shareholder opposition to stock option plans and the presence of option repricing, the issuance of restricted stock, and the provisions of loans to executives to purchase shares when they exercise their options. We further find some support for statistically significant positive relationships between the percentage of negative votes on stock option plans and whether the plan offers discounted options or has evergreen features.").

[204] Gordon, *supra* note 34, at 356 (arguing that, ideally, say-on-pay should be made optional based on a shareholder opt-in right, and if that is rejected, then any mandatory version should be limited to the largest firms). A separate compromise would be to grant the right to vote on executive compensation only to shareholders who have held their stock for a given amount of time. Boards appreciate such time-vested shareholder rights because they empower long-term shareholders, who are seen as more loyal to management. *See, e.g.*, Posting of Gary Larkin to The Conference Board's Governance Center Blog, http://tcbblogs.org/governance/2009/12/09/qa-with-martin-lipton-and-richard-ferlauto-short-termism/ (Dec. 9, 2009, 14:34 EST) (quoting Martin Lipton, a well-known counselor to boards, as saying that "instead of focusing on increasing shareholder power, the government should rein in the power of hedge funds and short-term shareholders").

[205] Such a regime is different from shareholder resolutions calling for say-on-pay, which companies can legally disregard, even when they receive broad-based support.

[206] *See supra* Part II.B (reviewing EC and German regimes).

also allow shareholders to focus on the firms whose pay practices raise the most serious objections.[207]

V. CONCLUSION

The current debate on say-on-pay in the U.S. has not paid adequate attention to the many options that are available. In particular, simply transposing the U.K. version to the U.S. may not be optimal. Given the relative difficulty shareholders in the U.S. face in replacing directors, making the vote on executive compensation a binding one gives the reform the chance of being as effective as it has been in other countries. Without the credible threat of ouster, directors are unlikely to heed a merely advisory vote.[208] Since the replacement of directors is unlikely to become easier in the near future, the votes should be binding.[209]

A binding vote would necessitate having shareholders vote on prospective compensation policy, as in the Netherlands and Scandinavia, rather than on the CD&A, which is both retrospective and prospective. A prospective vote may result in a more focused vote that is more informative to directors and less likely to be skewed by shareholder emotion.[210]

While granting shareholders a binding vote on executive compensation may appear radical in the context of U.S. corporate law, it is in fact merely a moderate extension of a power that shareholders currently possess, that of voting on equity-based compensation.[211] In the few instances that U.S. shareholders have used this power to vote down equity-based compensation plans, empirical studies suggest that they were justified in doing so.[212] The shareholder experience in countries that have already adopted say-on-pay gives reason to believe that this successful targeting of egregious

[207] Gordon, *supra* note 34, at 356.

[208] *See supra* Part IV.A.

[209] *Id.*

[210] *See supra* Part IV.B.

[211] *See supra* Part IV.C.

[212] *Id.*

compensation plans will also take place with regards to say-on-pay.

Whichever form say-on-pay ends up taking in the U.S., this reform alone will not be sufficient to bind pay to performance, the ultimate goal of compensation reform. Increasing shareholder accountability only works if directors are willing to reform their practices in response to feedback. To that end, other reforms that should be studied in conjunction with say-on-pay would look to, for example, making compensation committees more independent, the policy guidelines they put to a vote more informative, and the procedures they use to construct pay packages more transparent.