



OUTSIDE COUNSEL

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'Say-on-Pay': Linking Executive Pay to Performance

Over the past decade, increases in executive compensation have given rise to a debate over the role of shareholders in determining management's pay packages. Both internationally and domestically, this debate has led to a movement known as "say-on-pay"—an activist shareholder effort to rein in executive compensation unrelated to performance by giving shareholders the ability to cast a nonbinding vote on executive compensation packages.

The impetus behind this movement is a concern among some shareholders that executive compensation is too high, especially when coupled with compensation policies that seem to sometimes reward failure. On May 5, 2008, shareholders of the insurance company Aflac became the first to cast an advisory vote on executive compensation in the United States.¹

History

The "say-on-pay" movement results from the perception by activist shareholders that executive compensation is excessive.² Executive compensation rose sharply throughout the 1980s, the 1990s and into the new millennium. In 1980, the ratio of average executive compensation to average production worker compensation was 40-to-1.³ By 1990, this ratio had more than doubled.⁴ In 2003, the ratio was 400-to-1, an increase by a factor of 10 over the course of two decades.⁵ A 2007 survey revealed that 80 percent of Americans believe that executives are overpaid.⁶ It is this popular sentiment, not without its critics, which helped jump start the say-on-pay movement.

Domestic Approaches to Say-on-Pay

Say-on-pay is a relatively recent phenomenon in the United States. In 2006, seven say-on-pay proposals came to a vote at annual shareholders' meetings.⁷ The following year saw shareholders vote on 51 proposals and say-on-pay proposals ranked as the number one proxy resolution for the 2007 proxy season.⁸ While most proposals were rejected, several notable corporations had shareholders vote in favor of



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annual advisory votes on executive compensation, including Blockbuster, Motorola and Verizon.⁹ Of these companies, only the Verizon board agreed to actually hold such a vote, beginning in 2009.¹⁰ In total, only three companies adopted say-on-pay proposals in 2007.¹¹ In 2008, 76 proposals came up for a vote, although only nine proposals, including a proposal before Apple Computers, received majority shareholder support.¹²

In 2007, Aflac became the first United States corporation to voluntarily give shareholders an advisory vote on executive compensation.¹³ While the debate on whether say-on-pay was necessary or beneficial was in full gear, Aflac decided to take the initiative to introduce the measure itself. It seems that this decision has impacted Aflac favorably. When Aflac shareholders cast their first vote this May, they overwhelmingly approved of the company's executive compensation packages with 93 percent voting in favor.¹⁴

Whether companies are amenable to such proposals or not, they cannot legally exclude them from their proxies. The Securities and Exchange Commission (SEC) informed AT&T that such proposals could not be excluded from their 2007 proxy.¹⁵ For proactive companies anticipating shareholder dissatisfaction, this means they will either have to prepare to potentially deal with say-on-pay proposals or attempt to preemptively craft compensation policies and arrangements that will ward off shareholder desire to implement such proposals.

Outside of shareholder initiatives, Congress has also taken an interest in say-on-pay. In 2007, Senator Barack Obama, D-Ill., the Democratic presidential nominee, introduced a bill entitled the Shareholder Vote on Executive Compensation Act¹⁶ and Representative Barney Frank, D-Mass., introduced an identical bill in the House of Representatives.¹⁷ The act would amend §14 of the Securities and Exchange Act of 1934 by requiring an

annual, nonbinding shareholder vote on executive compensation, as well as a vote on golden parachute compensation when the company is entering into a merger, acquisition or substantial asset sale.¹⁸ The bill, opposed by the White House,¹⁹ passed in the House but remains in committee in the Senate.²⁰

Republican presidential nominee Senator John McCain, R-Ariz., also addressed say-on-pay in a speech to the National Federation of Independent Business, a small business advocacy group, on June 10, 2008.²¹ Senator McCain proposed that "all aspects of a CEO's pay, including any severance agreements, must be approved by shareholders," setting what appears to be a higher standard than Senator Obama's nonbinding, advisory vote legislation that is partially limited to only certain transactions.²² Senator McCain's campaign has declined to express a position on Senator Obama's proposed legislation or whether Senator McCain intends to propose a bill of his own.²³ Regardless of the outcome of the 2008 presidential election, it is likely that the next president will attempt to implement some version of say-on-pay reform.

International Approaches to Say-on-Pay

The say-on-pay movement did not originate in the United States. In 2002, the United Kingdom became one of the first countries to enact say-on-pay legislation, requiring an annual advisory vote on executive remuneration.²⁴ There were almost immediate shock waves. Within a year, the majority of GlaxoSmithKline's shareholders voted to reject the CEO's compensation package. Shareholders were upset by the way bonus opportunities, rolling retesting (the practice where boards grant executives a year extension to meet performance goals) and potential severance agreements were handled. Although the vote was nonbinding, the board, believing that they ignore the shareholder's voice at their own peril, decided to take the repudiation seriously and ultimately reduced the CEO's severance package by half, eliminated rolling retesting and introduced new performance conditions.²⁵

Sweden and Australia have also enacted legislation similar to the United Kingdom's, which requires only an advisory vote.²⁶ The Netherlands and Norway, however, have gone a step further. Both countries require a binding, rather than merely advisory, annual confidence vote on executive compensation.²⁷ Shareholders and legislators in the United States have generally followed the advisory approach and have not embraced the idea of giving shareholders binding power.

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Arguments For and Against

The debate over say-on-pay sometimes pits the business community against activist shareholders. Many in positions of management oppose say-on-pay and have attempted to convince shareholders and investors that say-on-pay is ineffective and unnecessary. Activist shareholders and other say-on-pay proponents believe that say-on-pay is beneficial to shareholders and saves a company from devoting a disproportionate amount of its revenue towards its executive officers.

Many shareholder activists believe that say-on-pay is a positive step and they desire to see it enacted in companies across the United States. Proponents have advanced some basic arguments as to why they believe say-on-pay is beneficial and necessary.

First, proponents argue that say-on-pay gives shareholders a voice concerning pay packages. The level of executive compensation authorized by a board can be an important factor to shareholders when determining whether to initiate or continue investing in a company. Just as the new executive compensation disclosure regime instituted by the Securities and Exchange Commission (SEC) was designed to provide more detailed information on compensation to investors, say-on-pay provides a powerful way to allow shareholders to voice their concerns.

Second, and in many ways related to the first argument, say-on-pay provides needed granularity. Although opponents argue that shareholders can simply vote out directors if they do not like how compensation is handled, the activist shareholder retorts that that is an inefficient way to deal with a specific problem. If a director is generally a good director, but is following past pay practices that shareholders disagree with, say-on-pay proposals provide a necessary middle ground where compensation packages can be addressed without taking the drastic step of ousting a sitting director.

Finally, proponents argue that say-on-pay has been used in foreign countries for a number of years and there have been no dire catastrophes or major disruptions. They claim that say-on-pay in overseas markets has strengthened pay-for-performance linkage and eliminated severance arrangements that were rewarding failure. Furthermore, according to some institutional investors, critics' warnings have failed to materialize and the impact on the relationship between the board and shareholders has actually improved, increasing board accountability without invading board responsibility.²⁸

Naturally, many in the business community do not see say-on-pay in the same light as activist shareholders. They argue, first, that shareholders do not understand the complexity of the pay-setting process. The board and compensation committee have the competence and ability to understand the nuance of the various compensation elements and how they fit together as incentives. Often, the media reports compensation numbers that seem outsized at first glance, but they do not necessarily report the entire story. A breakdown of the numbers often demonstrates that a substantial amount of that total number is compensation deferred from previous years or equity awards that were awarded years ago but are only currently vesting. Such reports also sometimes fail to mention if the executive has performed positively, increasing the returns investors have realized as the value of the company increased. An uninformed shareholder sees such numbers and votes against a compensation package without understanding its structure or how it was arrived at.

Second, opponents contend that allowing say-on-pay proposals is the first step down a slippery slope of transferring more power to shareholders than they should rightfully have. They argue that giving shareholders a vote on pay packages encroaches on what is the traditional province of the board and upsets the long-standing balance between the board and shareholders. They worry that if say-on-pay becomes standard practice, it will embolden activist shareholders to attempt to amass an even greater ability to interfere in board decisions.

Finally, opponents point out that such proposals are superfluous and unnecessary. Shareholders already have the ability to vote out directors they disagree with. If a bloc of shareholders determined that pay packages were excessive, they could exert their voting power to remove any director they believed was responsible for implementing unwanted compensation policies. Giving shareholders what amounts to a duplicative power is especially dangerous when coupled with the slippery slope argument.

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Conclusion

The future of say-on-pay in the United States is uncertain. On one hand, Americans routinely express concern about executive compensation packages and this concern could become more potent if the current economic downturn continues. The number of say-on-pay proposals have increased in each of the preceding three years and the number of proposals this year surpasses the previous three years combined, although it remains to be seen how many proposals will eventually be approved by shareholders and implemented by companies. Even though the Aflac vote was clearly in favor of the company's executive compensation packages, that is only one vote of many that we may be seeing in the near future. There is also the possibility that either Senator Obama or Senator McCain will follow through on their promises concerning say-on-pay reform.

On the other hand, the first say-on-pay vote in U.S. history resulted in overwhelming approval for Aflac's current compensation scheme. Furthermore, increased executive compensation disclosure in annual proxy statements have made it much easier for investors to understand an individual executive's compensation structure and a company's compensation policies, resulting in more knowledgeable shareholders and boards. The fulsome new disclosure rules also make it difficult for companies to surprise investors with previously unreported compensation information and it encourages companies to avoid scrutiny by preemptively toning down outsized executive compensation packages. Activist shareholders already have a poor track record of getting say-on-pay proposals approved and, so far, only Aflac has actually held a say-on-pay vote. All this may

obviate the need for say-on-pay. Only time will tell whether say-on-pay becomes integrated into regular corporate practice or is remembered simply as a passing shareholder fad.

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