New York Law Journal
Corporate Governance
WWW.NYLJ.COM
An ALM Publication
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MONDAY, NOVEMBER 30, 2009

Say-on-Pay: **Less** May Be **More**

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Microsoft, Prudential Financial and Pfizer all recently adopted alternative formulations that call for less frequent votes (triennial for Microsoft; bi-annual for Prudential and Pfizer), which they would couple with better shareholder outreach.[1]

This multi-year approach may be more effective in promoting pay accountability, while alleviating some of the disadvantages and practical difficulties of annual votes.

Say on pay votes have been gaining momentum in the United States for several years, particularly as experience with them has grown in other countries, such as the United Kingdom.[2] In 2006, the American Federation of State, County and Municipal Employees (AFSCME) began advocating for say on pay votes in the United States through the shareholder proposal process.

In each proxy season since then, shareholder say on pay proposals have been submitted at a growing number of companies: over 50 in 2007, over 70 in 2008 and over 90 in 2009.[3] On average, the proposals have generally garnered support of upwards of 40 percent, with the average favorable vote increasing year to year, and at some companies they have received majority support.

Say on pay proponents reportedly plan to file more proposals, about 100, for the 2010 proxy season.[4]

In 2008, Aflac became the first U.S. company to hold a say on pay vote. Currently, 18 companies (including Microsoft) have voluntarily held at least one such vote and an additional 10 (including Prudential and Pfizer) have announced their intention to do so.

There have also been moves by legislators to require say on pay votes; they are already required for recipients of assistance under the Troubled Asset Relief Program (TARP).[5] Most recently, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act (H.R. 3269) in July 2009, although the bill appears to be stalled in the Senate.

The Pros and Cons

Say on pay proponents argue that the votes promote greater accountability to shareholders and improved communication between boards and shareholders.

But it is also important to recall that say on pay votes do not occur in a vacuum. The most effective votes will be designed with a view to U.S. public company governance processes and the nature of a company's compensation programs.

The way a vote is designed could mean the difference between undifferentiated feedback and constructive engagement on compensation matters. The typical features of executive compensation in the United States and the nature of the U.S. proxy solicitation process suggest that multi-year votes may be a better approach for many companies.

All sides appear to agree that the purpose of say on pay votes is not to establish direct shareholder control over compensation decisions; oversight of executive compensation is ultimately the responsibility of the board (or the compensation committee). The complexity of executive compensation makes it ill-suited to the exercise of authority by shareholders.[6] Say on pay votes instead are understood to permit shareholders, principally large institutional holders, to react to compensation decisions and influence the board's perspective.

If shareholder input is the purpose, the vote must be designed so that it can be interpreted in a constructive way. This presents obvious difficulties.

Compensation design is informed by a wide range of considerations, including the company's business strategy and competitive position; the desire to focus managers' attention on specific aspects of short- and long-term performance; retention issues; and the company's culture, to name just a few.

Some of these factors may be described in the CD&A, but not all are required to be, and in any event shareholders are unlikely to have (or to want to have) the depth of familiarity with them that directors call on in setting compensation.

In making compensation decisions, considerable judgment is required to strike a reasonable balance among the varying and often conflicting factors in play and the company's overall risk profile. The more complex a company's operations, the more complex its compensation decisions are likely to be. Board or compensation committee decisions are the result of a multifaceted deliberative process in which shareholders cannot participate as a practical matter.

Moreover, a company's compensation program is an aggregation of many such decisions, some made in the preceding year and some made years before. Of course, a "no" vote should be a signal that more vigorous shareholder outreach is in order, but a "no" vote could have any number of meanings.

Do shareholders object to the design of this year's annual incentive program? To the payment of a sign-on bonus promised three years before? To total compensation? To the fact that some executives still have employment contracts, retirement plans or other arrangements entered into years ago that may now seem inconsistent with "best" practices? Or something else altogether; perhaps strongly felt discontent with the stock price?

Conversely, a "yes" vote does not necessarily reflect unalloyed approval of a compensation program.

The multiplicity of interpretations raises a question about the efficacy of say on pay votes generally and whether more effective input could be had through a better process of shareholder consultation.

Alternative Input Methods

This consideration may be behind some companies' efforts to seek shareholder input on executive

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compensation outside a voting context.

For example, Schering-Plough Corporation distributed a survey to shareholders with its 2009 proxy statement,[7] citing the difficulty of interpreting an "up or down" vote:

"If a shareholder votes to ratify executive pay, it does not mean he/she likes every aspect of the current compensation system. Likewise, if a shareholder votes not to ratify executive pay, the Company must then talk to the shareholder to learn what aspects of the compensation system led to the negative vote."[8]

Proponents of say on pay votes have not considered these initiatives to be an adequate substitute for a vote. Before Prudential adopted a biannual vote, for example, it provided shareholders with a Web-based feedback form as a means to provide input.[9] Shareholders nonetheless voted to approve a resolution to adopt say on pay voting. A reasonable inference is that say on pay proponents may be motivated by goals other than providing boards with constructive feedback on pay policies.

A multi-year vote has the potential to combine some of the advantages of shareholder outreach and the perceived greater impact, however symbolic, of an advisory vote. This is partly because a multi-year approach simply allows more time for shareholder consultation and consideration of that input by the board in reconfiguring compensation plans and arrangements. The interval between votes seriously limits the impact that shareholders can meaningfully expect from an annual vote.[10]

A multi-year vote also makes multi-part resolutions more practical, in keeping with the multifaceted nature of compensation programs, allowing investors to provide more differentiated feedback on key features or arrangements.

This approach is reflected in the resolution that the United Brotherhood of Carpenters and Joiners of America (UBC) proposed at 18 companies in 2009.[11] UBC's proposal would have implemented separate triennial votes on the compensation of the named executive officers and on three key components of their compensation: the annual incentive plan; long-term incentive plan(s); and post-employment benefits such as retirement, severance and change of control benefits.

For shareholders to undertake the information-gathering and analysis necessary to cast an informed vote on each of these resolutions can be expected to be challenging enough every three years, and likely impossible on an annual basis. One company, RiskMetrics Group Inc., held a say on pay vote on a three-part resolution in 2008, but used a two-part resolution in 2009, perhaps reflecting the considerable burden to shareholders of voting each year on three separate resolutions about complex, interrelated questions.

Use of Proxy Advisory Firms

The analytical burden of say on pay votes spotlights an important feature of the U.S. proxy solicitation framework: the "outsourcing" of decision-making to proxy advisory firms by many institutional investors, including mutual funds that own a significant percentage of public company shares.

The importance of this trend cannot be underestimated, given the increasing significance of institutional investors in the wake of e-proxy, which has resulted in reduced retail participation.[12] Reliance on proxy advisory firms also means that those with the economic interest do not themselves investigate the company's compensation program. Whatever one's views about this disjunction, this result is also surely inimical to the stated purpose of say on pay votes to promote dialogue between directors and shareholders.

In a recent Washington Post article, UBC's director of corporate affairs explained the practical consequence of shortcuts:

"When you're an institutional investor and you have a lot of these companies, it's almost an unmanageable process to thoughtfully analyze these plans…[for most companies] you take a quick look at their plan, see if they have some good or bad features and make a quick judgment."[13]

If say on pay voting is extended to all U.S. public companies, some 14,000 organizations, these "quick judgments" will significantly undercut the efficacy of say on pay votes as a means to influence a particular company's practices. Either the quality of decisions will be poor or institutions will rely increasingly on proxy advisory firms, which identify generally favored and disfavored practices and reflect a relatively heavy-handed means of exercising influence.

Nor are proxy advisory firms likely to change their business model to favor in-depth analysis of individual companies if say on pay votes become mandatory. As stated by one commentator, "[c]ustom-tailored evaluation is costly; monitoring for adherence to 'guidelines' or 'best practices' is cheap."[14]

The almost inevitable result is that companies seeking to forestall unfavorable votes will move en masse towards pay practices that are endorsed by the main proxy advisory firms, rather than choosing compensation designs based on their own particular business needs and circumstances. Indeed, Gordon argues that a U.S. annual say on pay regime "is likely to lead to a narrow range of approaches to the inherently difficult problem of executive compensation that will then be adopted across the board."[15]

In making compensation decisions, **considerable judgment** is required to strike a reasonable **balance** among the **varying** and often **conflicting** factors in play and the company's overall risk profile.

This pattern is familiar—the wholesale enthusiasm for stock options in the 1990s is one excellent example—and can be expected to result in unintended consequences. Multi-year votes would mitigate this risk.

Having more time between votes and a smaller number of votes to monitor in each year would allow shareholders more opportunity to understand the details of a company's compensation program and to judge for themselves whether a practice branded as undesirable by the proxy advisory firms may actually be appropriate for a particular company in light of its circumstances and overall program design.

During debate on H.R. 3269, an amendment was proposed, but ultimately rejected, that would have required triennial instead of annual voting.[16] The amendment was supported by Republican members of the House Committee on Financial Services, who stated that annual votes would make it "impossible [for pension funds]…to adequately fulfill their fiduciary duties to their investors by performing comprehensive evaluations of all the companies in which they hold equity securities."[17]

The adoption by Microsoft, Prudential and Pfizer of multi-year say on pay votes may give this approach new momentum, if only because it balances more effectively the interests of shareholders in greater accountability with the interests of companies in a constructive communication process that acknowledges the board's ultimate responsibility for executive pay decisions.

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1. Microsoft's first vote was held on Nov. 19, 2009. See Microsoft's proxy statement, available at http://www.sec.gov/Archives/edgar/data/789019/000119312509200055/ddef14a.htm#tx78904_66, and press release, available at http://www.microsoft.com/Presspass/press/2009/sep09/09-18BoardPR.mspx. See also Prudential's press release, available at http://www.news.prudential.com/article_display.cfm?article_id=5592, and Pfizer's press release, available at http://mediaroom.pfizer.com/portal/site/pfizer/?ndmViewId=news_view&newsId=20091029006512&newsLang=en.

2. U.K. companies have been required to hold advisory say on pay votes since 2002. Outside the United States, these votes are typically undertaken annually and are advisory, although some countries (the Netherlands, Norway and Sweden) have imposed a binding vote. See Jie Cai and Ralph Walkling, "Shareholders' Say on Pay: Does it Create Value?" (December 2008) (available at http://ssrn.com/abstract=1342656).

3. Walden Asset Management, "Investors Demonstrate Strong Support for Advisory Vote on Executive Compensation," Appendix to SEC Comment Letter (File No. S7-12-09) (July 14, 2009), http://www.sec.gov/comments/s7-12-09/s71209-5.pdf.

4. See RiskMetrics 2009 Postseason Review, available at http://www.riskmetrics.com/docs/2009-postseason-report.

5. Section 111(e) of the Emergency Economic Stability Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009.

6. Indeed, under New York law, the delegation by a board of decision-making authority concerning executive compensation to shareholders could cause the board to violate state law because it conflicts with the fundamental state law principle that the board must manage the business and affairs of a corporation. See American Express Company (Nov. 24, 2008), available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/keegalteamsters020609-14a-8.pdf.

7. Available at http://www.sec.gov/Archives/edgar/data/310158/000095012309007280/y74527dadefa14a.htm. Results are available at http://www.compensationstandards.com/Member/Memos/Firms/Schering-Plough/10_09_survey.pdf (subscription required).

8. "Questions and Answers" section accompanying Schering-Plough's shareholder survey.

9. See http://www.prudential.com/Executivecomp.

10. For example, assume that shareholders of a company vote "no" on executive pay and the board reconfigures its executives' pay packages in response. At the next annual meeting, the shareholders vote "yes" on pay. Since the proxy statement for the second meeting would principally concern pay for the prior year, before the changes took effect, it would be difficult to interpret the meaning of the changed voting results. Did the shareholders approve the changes, or change their minds about the old compensation packages, or was there a change in the shareholder base?

11. UBC has since withdrawn the proposals and is focusing on the legislative process. "Carpenters Withdraw Triennial Pay Vote Proposals," RiskMetrics Group Risk & Governance Blog (Sept. 11, 2009). Microsoft adopted its approach in response to a UBC proposal.

12. Under NYSE Rule 452, voluntarily adopted say on pay proposals have been treated as routine matter, thus allowing uninstructed shares to be voted by brokers and increasing the likelihood of approval. The NYSE's Chief Counsel of U.S. Listings has stated (in a Corporate Counsel webcast) that, while the NYSE has not yet taken a position on mandatory votes, they may adopt a rule change to make mandatory say on pay proposals non-routine items on which broker discretionary voting would not be permitted. See webcast transcript at http://www.thecorporatecounsel.net/member/Webcast/2009/10_07/transcript.htm#1 (subscription required).

13. See "Shareholders Say Yes to Executive Pay Plans," The Washington Post, Sept. 26, 2009.

14. Jeffrey Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In," 46 Harv. Jnl. on Legislation 323, 324 (2009).

15. Id.

16. The amendment also would have permitted shareholders to vote for the company to opt out of say on pay voting altogether, similar to Gordon's proposal that shareholders should vote on whether to opt into a say on pay regime.

17. H.R. Rep. No. 111-237, at 4 (2009). For U.S. private sector pension plans, the Department of Labor considers it a fiduciary obligation to vote shares on issues that may affect the economic value of the plan's investment, but fiduciaries must also take costs into account. See Department of Labor Interpretive Bulletin 2008-2 (Regulation Section 2509.08-2).

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