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Shareholder Voting on Executive Compensation Begins

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A key provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] gives shareholders of public companies the right to vote on executive compensation (Say on Pay). Shareholders exercised this right for the first time on a widespread basis in the recently-completed 2011 proxy season. At a large majority of public companies, shareholders approved the compensation of the CEO, CFO and other leading executive officers, dispelling fears of a broad shareholder revolt on compensation issues. However, in a world of increasingly empowered institutional shareholders, the new Say on Pay rules mean that public company executives will need to periodically engage in a dialogue with shareholders to achieve at least a rough understanding on compensation issues.

Background of Say on Pay

Over the last twenty years, participation in the equity markets by institutional investors has dramatically increased. Individual investors in large numbers have found it more practical to invest through mutual funds, and other institutional investors have grown in size and influence. Over the same period, executive compensation at public companies has grown substantially in relative terms, generating criticism in several quarters. Even before the recession began in 2008, many increasingly-muscular institutional investors were pushing public companies to submit executive compensation to a non-binding shareholder vote, in order to allow shareholders to register their displeasure when executive compensation appeared to be out of sync with corporate performance.

When the recession hit and many financial firms required federal support under the Troubled Assets Relief Program (TARP), institutional investors and angry taxpayers succeeded in including in the TARP rules a requirement that financial firms receiving federal investments under the TARP program submit to an annual non-binding shareholder vote on executive compensation for as long as they held the unreturned investment.

Many of the same institutional investors had a major influence on the final shape of Dodd-Frank, which became effective on July 21, 2010. The Say on Pay laws were enacted as Section 951 of Dodd-Frank, subject to implementing regulations that were adopted by the Securities and Exchange Commission and became effective on April 4, 2011. Larger public companies were required to comply with the Say on Pay rules during the recently-completed 2011 proxy season; smaller public companies will be required to comply with those rules beginning with the 2013 proxy season. The Say on Pay rules represent a substantial shift in the relative power of management versus institutional shareholders and will pose a strong deterrent to excessive and inappropriate pay packages for executives.

The Rules

The Say on Pay rules require public companies to periodically hold a non-binding advisory shareholder vote on the executive compensation of the chief executive officer, the chief financial officer and the three other most highly-paid executive officers whose compensation is detailed in the company's annual proxy statement. Under previously-existing rules, the company is required to discuss in the Compensation Discussion and Analysis section of its proxy statement its compensation policies and practices in great detail, facilitating scrutiny of those matters by institutional shareholders with access to analysts skilled in reviewing such statements. Shareholders have the right to vote either for or against the compensation or to abstain from voting. Public companies must also hold an advisory shareholder vote at least once every six years on how often to hold the advisory vote on executive compensation: every one, two or three years. Those companies must discuss in the Compensation Discussion and Analysis section of their proxy statement how they have considered the results of prior years' shareholder voting on their compensation policies and practices.

If a public company solicits votes in favor of a merger or other corporate combination through a proxy statement, then the company must disclose the compensation arrangements that are triggered by the transaction and solicit an advisory shareholder vote on that compensation.

Non-Binding Vote—a Deterrent?

State corporation statutes and state court decisions on the common law "business judgment rule" have traditionally governed the rights and obligations of directors, officers and shareholders of U.S. corporations. Due to Congress' reluctance to interfere in these state law matters, it framed the Say on Pay vote under Dodd-Frank as a non-binding advisory vote. However, boards of directors must carefully consider the ramifications of ignoring the results of shareholder voting, given the various ways that shareholders currently have to register their displeasure.

Under the current public company proxy voting system, the two shareholder voting advisory services, Institutional Shareholder Services Inc. (ISS) and D.F. King & Co., Inc. (King), effectively control a large part of the shareholder vote. Most institutional investors do not have the staff or resources to assess compensation issues at the companies in which they invest and defer to the recommendations of these advisory services. Both firms annually research executive compensation data, corporate governance practices and company performance information and issue recommendations to institutional investors which subscribe to their services on how to vote on particular corporate proposals. ISS has made it clear that it will issue recommendations against the reelection of directors who serve on boards which have previously ignored shareholder votes on compensation. Due to the widespread use of these recommendations, a director who serves on a board which contradicts a shareholder vote on executive compensation will find him- or herself in a distinctly uncomfortable position.

The Results of the 2011 Proxy Season

In the 2011 proxy season, shareholders at the large companies voting on executive compensation approved the described compensation in a large majority of cases. According to ISS,[2] shareholders voted to approve executive compensation in 91.2% of the cases reported.[3] Among S&P 500 companies, eight failed to receive shareholder approval for their compensation decisions. Within the Russell 3000 Index, 28 companies failed to receive shareholder approval. According to ISS, negative votes at 26 of these companies were due to pay-for-performance concerns. At half of these companies, the vote was attributed to double-digit negative three-year total shareholder returns. At other companies, it appears that the negative vote was motivated at least in part by awards of tax gross-ups,[4] discretionary bonuses to executives, benchmarking of awards with inappropriate peer companies,[5] excessive pay and failure to address significant opposition to compensation committee members in the past.

Based on these results, it appears that, as predicted, shareholders have exercised their new power over executive compensation in a judicious way. Although it is difficult to measure the effect, it is also reasonable to surmise that boards of directors and compensation committees have moderated their compensation decisions in order to minimize the risk of a vote against, since the risk of a negative vote on executive compensation is now so great.

Interestingly, according to ISS,[6] during the 2011 proxy season the number of directors who failed to win majority support for reelection dropped from 87 and 89 directors in 2010 and 2009 to 43 in 2011. It appears that shareholders who are displeased with a company's compensation decisions have shifted from registering their displeasure against the company's directors to the compensation vote itself. To the extent that that is true, the Say on Pay rules provide a valuable outlet for criticism of compensation decisions.

With regard to the frequency of the shareholder vote on compensation, shareholders voted overwhelmingly in favor of holding the vote on an annual basis. Many companies recommended to shareholders that they vote for holding a vote on executive compensation once every three years, believing that shareholders were not interested in second-guessing compensation annually. Prior to the start of the 2011 proxy season, ISS announced that it would recommend in favor of annual voting. Of the companies studied by ISS by June 20, 2011, shareholders at 1,658 companies voted by either a majority or a plurality in favor of an annual vote, shareholders at 15 voted in favor of a biennial vote, and shareholders at 378 companies voted in favor of a triennial vote. Based on these results, it will almost certainly become the standard for companies to hold an annual vote on compensation, and management will have a difficult time convincing shareholders to adopt a longer-term approach and evaluate executive compensation every two or three years.

Effects on Private Companies?

While the Say on Pay rules do not apply to privately-held companies, it is not difficult to imagine that, over time, Say on Pay votes will be instituted at some private companies as a *de facto* standard in corporate governance practices. Of course, where the composition of the board mirrors the significant shareholders of a company, Say on Pay will not have any impetus. However, many large companies, including some Fortune 500 companies, are private companies, and in some of these companies with relatively large and diffuse shareholder groups, Say on Pay may have a great deal of appeal among shareholders. Many of these shareholders will, no doubt, enjoy the new-found power they exercise when their public company proxies appear in the mail, and will ask why they cannot cast a similar vote with their private company shares.

[1] Public Law 111-203.
[2] *2011 U.S. Season Review: 'Say on Pay,'* Governance Weekly, June 23, 2011.
[3] The reported results are based on the number of votes cast for the compensation exceeding the number of votes cast against. The Say on Pay rules do not give guidance on how companies are to evaluate abstentions and broker non-votes in the results.
[4] In a tax gross-up, the company agrees to pay the executive an additional amount such that the after-tax effect to the executive is the same as if the award were not taxed.

[5] In the Compensation Discussion and Analysis that is included in a company's proxy statement, the company is required to disclose which companies were used as peer companies for purposes of benchmarking compensation awards.
[6] TheCorporateCounsel.net blog "US Proxy Season Review: Withhold Votes," July 19, 2011.