More Shareholders Are Just Saying No on Executive Pay

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It is often said that social change can't occur until what was seen as misfortune is seen as injustice. There is a corollary in the financial world. It says change can't occur until what was seen as immaterial is seen as risky. That's happening with executive compensation.

Investors are recognizing that excessive pay for chief executive officers does more than shave a few cents off earnings; it also provides important clues about the alignment of executives' and shareholders' interests. Misalignment can be very expensive.

More important, compensation provides crucial information about the effectiveness of a board's independent oversight. If directors can't say no to the CEO on pay, they probably can't say no to poorly designed strategy or head off operational fiascos.

One important reason investors are looking at pay more closely is that the question is being presented to them more directly. For the second year, shareholders in 2012 had a "say on pay," a nonbinding vote on executive compensation, as required by the Dodd-Frank financial-reform law. The key word here is nonbinding. Even a 100 percent vote against a pay plan imposes no obligation on the company's board of directors to make changes. Four companies whose shareholders rejected a pay plan in 2011 got a second no vote this year.

Saying No

Shareholders said no to pay packages at about 50 of the more than 3,000 companies that held votes this year. (The tally excludes smaller companies and those on a two- or three-year voting cycle.)

This year's no votes included some big corporate names, including Citigroup Inc. (The compensation committee members were Alain Belda, former Alcoa Inc. chairman who is no longer on the board; Michael E. O'Neill, the incoming Citigroup chairman who has held senior positions at Barclays Plc (BARC) and Bank of America Corp.; Richard D. Parsons, the outgoing Citigroup chairman; Diana L. Taylor, managing director at Wolfensohn Fund Management LP and the companion of New York Mayor Michael Bloomberg, the founder and majority owner of Bloomberg News parent Bloomberg LP; and William S. Thompson Jr., the former CEO of Pacific Investment Management Co.)

One of the most important lessons from this year's proxy season is that, even at companies where a pay plan wins majority support, shareholder-approval votes are shrinking. Law firm Davis Polk reported that, as of mid-May, only 454 companies that held say-on-pay votes got more than 90 percent in favor, down from 540 companies last year. An additional 85 companies received votes in the 80 percent to 89 percent range, down from 126 in 2011.

It is also clear that proxy advisory firms are increasingly influential. Institutional Shareholder Services and Glass, Lewis & Co. are the most prominent of the firms that make

recommendations to large investors after analyzing executive- compensation plans and other matters on which shareholders can vote.

When the proxy advisory firms recommend a no on pay, their clients usually follow suit. The Davis Polk report found that 14 of the 15 no votes on pay also had recommendations to vote no from Institutional Shareholder Services. When it recommended a yes vote, shareholders agreed 92 percent of the time.

Improved Plan

Significantly, some companies are revising their pay packages and disclosures to avoid a no recommendation. For example, Motorola Solutions Inc., which had failed a say-on-pay vote, won shareholder approval this year for an improved pay plan. (The compensation committee members are William J. Bratton, the chairman of Kroll Inc.; Kenneth C. Dahlberg, the retired chairman and CEO of Science Applications International Corp.; David W. Dorman, the chairman of CVS Caremark Corp. (CVS); and Samuel C. Scott III, the retired chairman and CEO of Corn Products International Inc.)

Other companies are heading off no votes by consulting directly with investors to respond to International Shareholder Services and to better explain compensation plans.

It is also apparent from this proxy season that compensation committees can run, but they can't hide. Dodd-Frank gives companies the right to ask shareholders to allow votes on pay every two or three years, rather than annually. Most shareholders, especially in larger companies, prefer annual reviews, but some companies have succeeded in getting approval for votes every three years. Cablevision Systems Corp., for example, didn't hold a vote on pay this year because the company is on a three-year cycle. But shareholders found a way to show their concerns: A majority withheld support for members of the board compensation committee. Like the pay vote, this no vote on directors is advisory, yet it shows that shareholders with concerns about pay will find a way to deliver that message.

Key predictors of a no vote are emerging. Shareholders are more likely to vote against pay plans when shareholder returns are below those of the market or a peer group, or when a company has shareholder-unfriendly provisions, such as paying part of an executive's taxes. Other indicators include anti-takeover clauses and high rates of dilution from the issuance of stock options.

Compensation-committee members with longer-than-average tenure are associated with no votes, according to research from Stephen M. Davis, a senior fellow at Harvard Law School's Program on Corporate Governance, and Jon Lukomnik, executive director of the Investor Responsibility Research Center Institute.

The season's most overlooked indicator isn't the level of pay or the board's makeup but the percentage of stock held by institutional shareholders. Broc Romanek, the editor of TheCorporateCounsel.net, told me that shareholder composition is more significant than the specifics of a compensation package. Professional investors are more likely to vote against excessive pay.

The U.K., which was ahead of the U.S. with legislation requiring advisory votes in 2003, is now moving to give shareholders the right to forbid excessive compensation. A nonbinding no vote on pay at British insurer Aviva Plc was considered such a powerful message of no confidence that it led to the CEO's departure in May.

In the U.S., if no votes against pay plans and compensation committees continue to have no effect, investors may seek the same right. Corporations could find that, finally, no means no.

(Nell Minow, the co-founder and director of GMI Ratings, which evaluates governance risk at public companies, is co- author of the textbook, "Corporate Governance," now in its fifth edition. This is the last in a three-part series on corporate- governance issues. Read Part 1 and Part 2. The opinions expressed are her own.)