Dodd-Frank's 'say on pay' could impact executive pay

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One of the lesser-known elements of the sweeping Dodd-Frank Act aimed primarily at reforming the nation's banks is directing the Securities and Exchange Commission to write rules that could temper the compensation of executives across multiple industries.

At issue is a requirement in the statute that directs the SEC to give institutional investors – starting in 2011– a vote on the pay packages of top executives at U.S. corporations. While the vote is non-binding and corporations are not required to follow the wishes of shareholders, the provision is expected to have a transformative impact on the relationship between CEOs and institutional investors, in part, because of the embarrassment a company could experience if investors give its executive pay a strong negative vote.

For the nation's top chief executives, much is at stake – in 2009, the median total compensation for S&P 500 CEOs was roughly $7.5 million, down from approximately $8.2 million in 2008, according to Equilar Inc., a Redwood City, Calif., based executive compensation research firm.

In addition to a say on pay, the SEC adopted a controversial director election rule Wednesday giving shareholders the power to nominate one or two director candidates onto corporate boards using an inexpensive method.

Stephen Davis, executive director at the Millstein Center for Corporate Governance at Yale University's School of Management, argues that institutional investors are likely to use both say-on-pay rules together with new director election powers interchangeably.

"If boards fail to persuade shareholders that the compensation plans they are providing to CEOs are sensible then, going forward, directors could lose their seats to shareholder nominees because they are not being responsive," Davis said.

John Olson, a partner at Gibson Dunn & Crutcher LLP in Washington, said he expects an antagonistic relationship to emerge between activist shareholder groups and some corporate managers, in part, because there isn't a consensus in the U.S. as to what are desirable pay practices.

Olson said he expects that over time, pay packages in the U.S. will become homogenized and heavily influenced by standards set by institutional investor groups and proxy advisory companies such as RiskMetrics Group, formerly Institutional Investor Services.

RiskMetrics and a couple other proxy advisory firms are expected to make recommendations to a large chunk of the U.S. institutional investor community about whether to accept a particular pay package.

Temple University professor Steven Balsam said a recommendation by one of the proxy advisory firms against a pay package will drive a massive amount of institutional investors to oppose it as well.

"The proxy advisory companies are going to wield a lot of the power," Balsam said. "If a company believes that RiskMetrics is going to reject their plan they will go to RiskMetrics, behind-the-scenes, and say, 'What can we do to get your approval?'"

Gibson's Olson said that corporate boards will tailor executive pay packages to meet advisory firm standards so they don't receive negative votes.

Not everyone agrees. Harvard Law School Professor Lucian Bebchuk contends that shareholders understand that compensation packages should differ based on unique expectations at each firm.

However, he argued that there are some compensation arrangements that investors can agree are undesirable and should be removed from all U.S. corporations. A golden parachute pay-package for a CEO that is retained as a top executive by an acquiring firm, is a good example of the kind of compensation provisions that could be removed, he said.

"There are a number of arrangements and features that have been recognized as undesirable, nonetheless they still remain common. The new reality will encourage companies to move away from them," Bebchuk said.

Michael Garland, director at Change to Win Investment Group, a labor-backed advisor to union funds, said voting on compensation will help moderate pay packages and force companies to provide better disclosure.

Temple University's Balsam said he worries the 'say on pay' votes could create a one-size-fits-all approach to pay, which could cause problems. He contends that a 40-year-old CEO needs a different kind of golden parachute package than a 70-year-old.

"The 40-year-old needs more because he has more to lose. He needs a job," Balsam said.

The U.K. experience

Many regulatory observers believe the U.S. system will soon resemble, in part, the system that already exists in Britain, where investors have long had the right to an annual vote on executive compensation. That said, companies there rarely experience a negative vote from institutional investors because pay packages have already been negotiated well in advance between shareholders and companies in private.

British executives have hardly starved – nearly a quarter of FTSE 100 chief executives received total 2008 pay packages in excess of 5 million pounds (or about $9.15 million at the time), according to the U.K. newspaper Guardian.

Yale's Davis argues that the U.K. model has lead to a closer alignment of pay for performance. "There is less pay for failure there," Davis said.

Davis, who evaluated the U.K. say-on-pay model as part of a 2007 report, said it would be a mistake to focus on the ballot results for the votes in the U.S.

"The important point to learn from the U.K. experience is that say-on-pay seems to stimulate dialogue between boards and investors because directors have to convince their shareholders that that what they are doing is sensible," Davis said.

One exception to the mostly behind-the-scenes U.K. negotiations environment is a recent battle at U.K-based Tesco, where participating shareholders cast 38% of their votes against the retail grocer chain's pay report at the company's annual meeting in July. That effort was driven, in part, by U.S.-based Change to Win Investment Group. The strong vote of opposition was directed in part at Tim Mason, the chief of the supermarket-chain's U.S. business, Fresh & Easy, who received £4.2 million for leading the loss-making unit.

Say-on-pay also is already a reality in some parts of the U.S. Financial institutions that received funds from the $700 billion bank bailout package have been required to submit top executives compensation plans to a shareholder vote. Some corporations, including Microsoft Corp., have decided to voluntarily have a say on pay.

Three or one years?

A last-minute addition to the statute requires shareholders to vote on whether they would like to see a 'say on pay' every year, every two years or every three years. Davis points out that the U.S. institutional investor community is divided on the subject. "For me, it's about whether you trust the board or not," he said.

Corporations are pressing shareholders to agree to let there be only one 'say on pay' vote every three years. David Katz, partner at Wachtell, Lipton, Rosen & Katz in New York, said investor advocates are pushing for executive compensation to be based on a three-year metric as means to have CEOs focus more on long-term performance rather than short-term gain. "How can shareholders evaluate those kinds of packages with an annual vote?" he said. "Corporations can be more responsive to shareholders if you give them three years to do it."

However, Harvard's Bebchuk worries that a once-every-three-years vote would limit the ability of investors to influence pay packages. He said it is very possible that shareholders could agree to a once-every-three year vote at companies where boards set up pay packages with big rewards for short-term results.

"The concern I have with a once every three year vote is that if a board puts in place a package which is strongly disfavored by shareholders in year one then the possibility that shareholders would have a say on it two-and-a-half years down the road might be an insufficient deterrent," he said.

Anne Simpson, chief of California Public Employees' Retirement System's Corporate Governance division, said CalPERS hasn't formalized an official policy position on how frequently they would like to see votes on pay. But she added that CalPERS could be persuaded that an annual vote is not necessarily needed.

"We see good reason for flexibility and having votes aligned with a long term strategy for pay," she said. "But we have accepted the proposal that annual voting is not necessarily in line with a long-term approach."