"Say on Pay" and Other Corporate Governance Reform Initiatives

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Summary

The financial crisis and subsequent public criticism over bonuses awarded to employees of certain Troubled Asset Relief Program (TARP) recipients have refocused public policy interest on executive compensation and corporate governance, areas of periodically intense public policy interest. Regulatory and Treasury Department initiatives include (1) a Securities and Exchange Commission (SEC) proposal to give shareholders meeting certain standards the right to place their board nominees on a company's proxy card; (2) Treasury Department legislative proposals that would respectively (a) give the SEC power to ensure that companies' compensation committees have greater independence in setting executive pay; and (b) give shareholders the right to a non-binding vote on executive pay called "say on pay."

Among legislative initiatives, S. 1074(Schumer) would (1) allow shareholders with a certain amount of company stock to use a company's proxy (annual meeting shareholder communication) machinery to nominate directors; (2) require companies to create a corporate board committee on risk; (3) require companies to hold annual director elections; and (4) require that board chairs be independent directors (and not the CEO as is the common practice). Among other things, H.R. 3269(Frank), which passed the U.S. House on July 31, 2009, applies to certain financial firms and would (1) require the disclosure of incentive-based pay arrangements to federal regulators for the purpose of determining whether they are aligned with sound risk management; (2) authorize federal regulators to prohibit incentive structures that are seen to encourage inappropriate risk-taking; and (3) require them to adopt say on pay.

Despite their differences, several of the new executive pay and corporate governance initiatives require say on pay by publicly traded firms. TARP recipients are already subject to such regulations.

Particularly for financial firms, say on pay's proponents argue that current forms of compensation often lead to excessive risk taking, potential systemic risk, and the improper alignment of interests between company stakeholders. They also claim that the pay consultants who advise compensation committees on executive pay often have conflicts of interest that lead to a pro-management bias. In addition, say on pay's proponents cite evidence that the adoption of say on pay in the United Kingdom in 2002 appears to have led to better communication between companies and shareholders.

Critics of say on pay argue that the reform would adversely affect the traditional relationship between directors, management and shareholders, and the largely state-based corporate regulatory regime, which are said to have generally served our economy well. Critics have also raised other concerns over the ability of shareholders to understand the complexities of executive pay, and the increased costs, including the loss of top talent, that corporations might incur if say on pay were adopted. The detractors also cite developments such as the reductions in the average tenure of chief executive officers (CEOs) as an indication that boards are becoming less pro-management, greatly reducing the need for governance reforms such as say on pay. Critics have additional concerns that activist shareholders would improperly use leverage gained from adoption of say on pay to help attain certain parochial goals such as unionization, which they argue may not be in the best interests of the firm.

This report will be updated as events warrant.

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Introduction

Criticism that the compensation awarded to senior executives of publicly traded U.S. firms is excessive has a long, albeit somewhat cyclical history. According to Equilar, which tracks executive compensation, median chief executive officer (CEO) compensation at S&P 500 companies rose 23% between 2003 and 2008.[1] Another observer estimates that between 2000 and 2008, a variable known as total direct CEO pay (combined salary and bonuses) increased by 50%, greatly outpacing general increases in inflation and broad stock market indices.[2]

The current financial crisis and public outrage over the size of executive pay packages, particularly bonuses, paid to senior management (and in some cases also to junior employees) of participants in the Troubled Asset Relief Program (TARP) have resulted in a renewed focus on executive pay and corporate governance. The scrutiny also involves widely held concerns that financial firm pay packages encouraged the kinds of reckless risk taking that many believe was at the center of the financial crisis.

Such concerns were first manifested in federal law in September 2008 with the signing of the Emergency Economic Stabilization Act of 2008 (EESA, P.L. 110-343), which established TARP. Among other things, Section 111 of EESA as later amended by the American Recovery and Reinvestment Act of 2009 (ARRA, Title VII of P.L. 111-5) and as later implemented under the Treasury Department's Interim Final Rule on the TARP Standards for Compensation and Corporate Governance requires:[3]

- compensation committees of TARP recipients to discuss, evaluate, and review at least every six months with the company's senior risk officers: (1) the compensation plans applicable to the TARP recipient's senior executive officers (SEOs) to ensure that such plans do not encourage the SEOs to take unnecessary and excessive risks that could threaten the value of the TARP recipient; and (2) the compensation plans applicable to the TARP recipient's employees to limit any risks posed to the TARP recipient by such plans;
- TARP recipients to generally prohibit any golden parachute payments to an SEO or any of the next five most highly compensated employees of the TARP recipient; and

[1] Reported in Del Jones, "CEOs Openly Oppose Push for Say-on-Pay by Shareholders," *USA Today*, July 17, 2009. According to Equilar, a fall in median CEO pay at S&P 500 companies between 2007 and 2008 was largely driven by a 20.6% drop in median cash bonuses. Over the last several decades, a growing share of CEO pay has been in the form of performance-based stock options. Because of the generally bearish nature of the stock markets over the last year or so, many CEOs were given stock and option awards that have greatly declined in value since being issued. Such declines are not picked up in CEO data reported in SEC proxy filings from which the 2003 to 2008 data is derived. Using data that reflect these developments, Equilar also reported that the median total wealth of S&P 500 chief executives, including stock and deferred compensation awards earned in previous years, fell by 43% between 2007 and 2008. As reported in Mark Basch, "CEOs Take Pay Hit," *Florida Times Union*, April 26, 2009.

[2] Joseph E. Bachelder III, "Say on Pay and Other Legislative Developments," July 4, 2009, available at http://blogs.law.harvard.edu/corpgov/2009/07/04/tarp-say-on-pay-and-other-legislative-developments/ TARP.

[3] U.S. Department of Treasury, "Interim Final Rule on TARP Standards for Compensation and Corporate Governance," press release, June 10, 2009, available at http://www.ustreas.gov/press/releases/tg165.htm.

- TARP recipients to provide for a "say on pay" mechanism, a process that involves a non-binding shareholder approval or rejection of executive compensation packages.[4]

Historically, public policy interest in the issue of executive pay has largely focused on two key concerns:

- *Issue of fairness.* Considerable discussion has revolved around the widening gap between the pay of corporate executives and the pay of U.S. workers, which has raised questions over fairness. According to one source, the ratio of an average large U.S. company CEO's annual pay to an average U.S. worker's salary grew from 140:1 in 1991 to 500:1 in 2006.[5]
- *Improper alignment of executive pay and performance.* Persistent concern that executive pay packages are often not properly aligned with the value added by executives to their firms (and thus to key corporate stakeholders such as shareholders and bondholders).

However, as noted earlier, the collapse of the financial sector has introduced another concern involving the possible negative consequences of the interactions between pay and risk taking:

- *Pay packages for senior executives and various financial operatives encouraged excessive risk taking***.**[6] Many are concern that "Wall Street" compensation arrangements for senior management and various financial operatives have provided incentives to engage in excessive risk taking in which the potential upside of the risk taking benefits the pay recipients, while the potential downside of the risk taking falls largely on shareholders, employees, and perhaps taxpayers.

In early 2009, concerns over TARP recipients' compensation packages not only led to the compensation provisions in ARRA (amending those in EESA) but also to a host of other largely TARP recipient-based compensation bills. A number of these were introduced as attempts to correct ARRA's exemption from its restrictions for bonus agreements made before a certain date.[7]

Regulatory and legislative initiatives in mid-2009 focused on both financial and non-financial corporate governance matters and executive pay. For a number of them, the executive

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[4] For an in-depth examination of the compensation requirements for TARP recipients, see. CRS Report R40540, *Executive Compensation Limits in Selected Federal Laws*, by Michael V. Seitzinger and Carol A. Pettit. On July 20, 2009, the SEC proposed to amend proxy rules under the 1934 Securities Exchange Act to ensure that shareholders of companies receiving financial support under TARP be given so-called say-on-pay. The proposals are a necessary step toward ultimate SEC adoption of the proposals as required under the laws governing TARP.

[5] Katayun Jaffari and Mu'min Islam, "The Future of 'Say on Pay' in Current Economic Times," *The Legal Intelligencer*, October 30, 2008.

[6] Among the criticism leveled at this widely held view is that (1) executives and trading operatives at the various publicly traded Wall Street firms involved in securitizing various kinds of eventually problematic mortgages and trading the securitized debt generally were often awarded significant parts of their overall pay in stock options, a form of long-term compensation that is not expected to nurture short-term risk taking; and (2) many of the risk assessment models used by various financial institutions, including financial various regulators, did not suggest that the U.S. economy was in the midst of a problematic "housing market bubble."

[7] For an examination of the legislation, see CRS Report RS22583, *Executive Compensation: SEC Regulations and Congressional Proposals*, by Michael V. Seitzinger.

compensation restrictions for TARP recipients, including the provisions on say on pay, appear to have provided a conceptual template.

This report describes these initiatives, giving particular emphasis to common demands involving, among other issues, say on pay. To this end, the report (1) examines key historical executive branch and regulatory approaches to executive pay and corporate governance, which includes a brief introduction to say on pay; (2) discusses more recent initiatives in this area; and (3) provides an in-depth examination of say on pay and its potential costs and benefits.

Historical Approaches to Executive Pay and Corporate Governance

Historically, there have been two broad approaches to constraining the general increases in executive pay: (1) amending the tax code to eliminate deductions for certain kinds of pay; and (2) strengthening the bargaining position of shareholders through corporate governance reform. Key developments of both approaches are described in this section.[8]

Amending the Tax Code

In 1993, Congress attempted to rein in the growth of executive pay by amending the Internal Revenue Code to eliminate the corporate tax deduction for compensation paid in excess of specified caps. This was done through the Omnibus Budget Reconciliation Act of 1993 (OBRA,P.L. 103-66.) The provision imposed a $1 million cap that applies to the CEO and the four next-highest-paid officers. No tax deduction for compensation above the $1 million limit is permitted, except for "performance-based" pay, such as commissions or stock options, where the ultimate compensation received by the executive depends on the stock price, reported sales or profits, or some other financial indicator. The provision is widely believed to have contributed to the increased use of stock options in CEO compensation in the mid- and late 1990s.[9] To the extent

[8] Various observers explain what they regard as excessive and unfounded levels of executive pay by reference to the "managerial power" model. The model postulates that boards of publicly traded companies with dispersed ownership should not be expected to bargain at arm's length with senior managers, which results in the managers wielding great influence over their own pay. For example, see Lucian A. Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem," *Harvard Law and Economics Discussion Paper No. 421*, April 28, 2009. By contrast, others reject the assertion that executive pay tends to be unjustifiably excessive. But academic proponents of a "neo-classical" model of perfect competition argue that the compensation of an executive (or any worker) is determined by the executive's marginal product. The executive will be paid just as much as the revenue he contributes to the firm. If the firm tries to pay him less than his marginal product, he will seek employment elsewhere. Some economists and business experts regard the view as a fair approximation of the market reality for many corporate executives in which high pay is not a sign of over payment but an indication that the executive is highly productive, including the existence of a "superstar effect" wherein as firms have gotten larger and begun to operate in a global rather than domestic market, the value that executives can add to a firm has increased, and their compensation has followed suit. Using this logic, one study concluded that "the six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization." Xavier Gabaix and Augustin Landier, *Why Has CEO Pay Increased so Much?*, MIT Department of Economics, Working Paper No. 06-13, May 8, 2006.

[9] Other factors, such as the wave of public offerings by cash-poor technology firms and the bull market itself, also increased the popularity of options during the 1990s.

that this is true, many observers have argued that OBRA may have had the unintended consequence of increasing CEO pay.[10]

Strengthening the Bargaining Position of Shareholders

A number of governance-related strategies have also been proposed or adopted that were intended to help strengthen the bargaining position of shareholders. They included (1) requiring more complete and transparent disclosure of executive pay; (2) making corporate boards more responsive to shareholder interests; and (3) permitting shareholder votes on entire executive pay packages.

Disclosure-Based Approaches

The requirement that publicly traded companies disclose how much they pay top executives dates from the 1930s. The SEC has modified the disclosure format several times, as the forms of CEO pay have become more varied and complex. Recent changes occurred in 1992 and 2006.

SEC's 1992 Disclosure Reform. In 1992, the SEC adopted a new executive compensation rule mandating specific executive compensation disclosures in corporate proxy statements. The rule required companies to use tables, rather than narrative form, to disclose the total compensation paid to the CEO and the company's next four highest-paid executives. The shift in executive compensation from traditional salary and bonus awards toward more long-term compensation, such as stock options, provided some of the impetus behind disclosure rule modifications, a change in compensation practices that arguably made it harder for shareholders to comprehend the total amount paid to executives, especially since most stock options weren't expensed at that time.

The SEC required that proxy statements include tables setting out several categories of pay for the top five executives. These included base salaries, bonuses, and deferred and incentive-based compensation, including stocks and stock options.

SEC's 2006 Disclosure Reform. By 2006, the SEC had concluded that the 1992 disclosure rules, according to then-SEC Chairman Christopher Cox, were

> ... out of date.... [They] haven't kept pace with changes in the marketplace, and in some cases disclosure obfuscates rather than illuminates the true picture of compensation.... We want investors to have better information, including one number—a single bottom line figure—for total annual compensation.[11]

In July 2006, for the first time since 1992, the SEC adopted major changes to executive disclosure rules contained in public companies' registration and proxy statements.[12] The disclosure

[10] For example, see "Testimony Concerning Options Backdating, by Christopher Cox, Chairman, SEC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs," September 6, 2006.

[11] "Speech by SEC Chairman: Chairman's Opening Statement; Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules by Chairman Christopher Cox U.S. Securities and Exchange Commission, "January 17, 2006, available at http://www.sec.gov/news/speech/spch011706cc.htm.

[12] U.S. Securities and Exchange Commission, "Executive Compensation and Related Person Disclosure," *Federal Register*, vol. 71, no. 174, September 8, 2006, p. 53158.

requirements apply to the CEO, the chief financial officer (CFO), and the next three most highly compensated executive officers. The rules require the disclosure of the executives' total compensation, the fair value of their stock option grants, estimates of potential post-employment payments and benefits, and tabular disclosure of director pay. It requires that statements include a Compensation Discussion and Analysis (CD&A), a narrative that explains the objectives and implementation of a company's executive pay program. The rules require detailed information about a company's option grant practices in both the CD&A and in a supplemental table. They also require the disclosure of directors' compensation figures for the preceding fiscal year. SEC officials have said that the central contribution of the disclosure reform is the provision of enhanced transparency with respect to executive pay.[13]

Making Boards More Responsive to Shareholder Interests

Audit committees must now include independent directors and a financial expert. In 2002, the Sarbanes Oxley Act of 2002 (SOX), a legislative response to widespread accounting improprieties at firms like Worldcom and Enron, mandated that auditing committees be solely composed of independent auditors and that that the committees have a designated board member who is a "qualified financial expert" (QFE), also defining the knowledge that such a person must have. As has become the general practice, QFEs usually chair the audit committees and tend to be former top-level accountants, chief financial officers, or corporate controllers.

SEC requires mutual funds to publicly disclose their proxy voting. In early 2002, the SEC adopted a rule requiring mutual funds to disclose their proxy voting guidelines and votes cast. Funds are allowed to post their proxy voting records and guidelines on their websites.

NYSE and Nasdaq require shareholder approval of listed company equity-based compensation plans. In mid-2003, the SEC approved New York Stock Exchange (NYSE) and NASDAQ rules requiring that their listed companies receive shareholder approval of all of their equity compensation plans, including stock option plans.

NYSE and Nasdaq require that key committees, such as the nominating and the compensation committee, are composed of independent directors. In late 2003, the SEC approved a NYSE rule requiring each listed company to have nominating committees (responsible for nominating directors to the board), corporate governance committees (often the same as the nominating committee), and compensation committees (responsible for crafting executive pay packages), all entirely composed of independent directors. It also approved a requirement that Nasdaq-listed firms have their director nominees approved by a nominating committee composed solely of independent directors or by a majority of the independent directors. It also approved a requirement for each Nasdaq-listed company to have independent directors approve CEO compensation, either by an independent compensation committee or by a majority of the independent directors.

Majority director requirement at firms listed on NASDAQ and the NYSE. In late 2003, the SEC approved NYSE and Nasdaq standards mandating that their listed companies have boards in which independent directors constitute a majority.

[13] "Speech by SEC Chairman Christopher Cox: Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules," available at http://www.sec.gov/news/speech/spch011706cc.htm.

Recent Executive Pay and Corporate Governance Initiatives

Several recent regulatory and legislative initiatives focus on financial and non-financial corporate governance matters and executive pay. For at least some of them, the executive compensation restrictions for TARP recipients under EESA as amended appear to have provided a conceptual template, including say on pay. This section discusses these key initiatives, including say on pay.

SEC Initiatives

The SEC has unveiled one initiative in the area of executive pay disclosure and risk, and one on shareholder proxy access:

SEC's July 2009 Proxy Access Reform Proposal. Rule 14a-8(i)(8) under the 1934 Securities Exchange Act allows companies to exclude shareholder proposals relating "to an election." The provision makes it rather difficult for outside board nominees to be included in the company proxy ballot, a comparatively efficient and inexpensive way for a nominee's backers to get their choice(s) for director(s) before a shareholder vote.[14] The alternative is that shareholders who want to nominate a director must wage an expensive proxy fight that involves sending their own ballots to the company's many dispersed shareholders. Under a proposal promulgated by the SEC in May 2009, Rule 14a-8(i)(8) would be amended to create a new Rule 14a-11. Under the new rule, shareholders who meet certain ownership thresholds[15] and who are permitted under state law or their corporate charter to nominate a candidate, would be able to have their nominees included on the company proxy ballot.[16]

[14] By August 2009, according to RiskMetrics, an investors consulting firm, there were 67 shareholder contests for board seats so far in 2009, 51 of which were successful. In addition, Broadridge Financial Solutions, a securities processing firm, has estimated that on average, shareholders spend about $368,000 per proxy contest in mailings, legal fees, and public-relations expenses in such proxy fights. For large companies, the cost of a proxy fight can run into the millions. Delaware's amendments, though not as far-reaching as the SEC proposal, could still have a big impact because they allow bylaws for reimbursement of expenses.

[15] Under the proposed rule, a shareholder (or group of shareholders) meeting the following ownership thresholds and who have held such shares for at least one year would be able to include their director nominations in the company's proxy statement and proxy materials if they (1) own 1% of outstanding voting securities for large accelerated filers (public float in excess of $700 million); (2) own 3% of outstanding voting securities for accelerated filers (public float between $75 million and $700 million); or (3) own 5% of outstanding voting securities for all other public companies.

[16] U.S. Securities and Exchange Commission, "Proposed Rules Facilitating Shareholder Director Nominations," *Federal Register*, June 18. 2009, vol. 74, no. 116, p. 29024. During the vote on the proposal, the two Republican SEC commissioners reportedly questioned whether the SEC has jurisdiction to make the rules, noting that Delaware, where most large U.S. publicly owned companies are incorporated, recently amended the Delaware General Corporation Law to include provisions that permit, but do not require, companies to adopt bylaws that would require a shareholder nomination process using its proxy materials. Among the amendments is a provision that would a corporation to adopt a bylaw setting forth the circumstances under which shareholders may be reimbursed for proxy-related expenses incurred in proxy fights. Jena McGregor, "Board Shakeups Made Easier," *Business Week*, August 10, 2009. Sarah N. Lynch, "SEC Votes To Change Proxy Rules," *Wall Street Journal*, May 21, 2009. 2009. Dean F. Hanley "Updates to Delaware General Corporation Law - Part 3: Improved Shareholder Access to Proxy Materials – Now, What Will the SEC Do?," *Foley Hoag News Release*, May 1, 2009, available at http://74.125.47.132/search?q= cache:diNq7IpxD0EJ:www.foleyhoag.com/en/NewsCenter/Publications/Alerts/Business/Business_Alert-050109.aspx+delaware+and+reimburse+and+proxy+fight&cd=1&hl=en&ct=clnk&gl=us. Historically, among the key arguments against shareholder access have been concerns that if elected, shareholder-nominated directors would result (continued...)

During the SEC's commissioners' discussion before the vote on the proposal, Chairman Linda Schapiro observed that the financial crisis has raised concerns about the "accountability and responsiveness" of some companies and boards of directors. Given this, she described the proposed proxy access reform as a response to a need "to revisit whether and how federal proxy rules may be impeding the ability of shareholders to hold boards accountable through the exercise of their fundamental right to nominate and elect members to company boards."[17]

SEC Proposals on Disclosing the Possible Relationship Between Executive Compensation and Corporate Risk. On July 1, 2009, the SEC proposed enhanced compensation disclosure aimed at providing investors with additional information regarding how a public company's overall compensation policies may impact its risk profile as part of their financial disclosures. Building on requirements already applicable to institutions participating in the TARP program, the proposals would amend the Compensation Discussion and Analysis (CD&A). The CD&A requires companies to provide a comprehensive explanation of their executive compensation practices and is aimed at giving investors insight into why certain executive compensation decisions are made, and the effect of those decisions. The proposals would expand the CD&A to include discussion and analysis of a company's policies with respect to the compensation of non-executive officer employees. CD&A would not require the disclosure of specific salaries paid to employees beyond the principal executive officer, the principal financial officer, and the three most highly compensated executive officers.

Companies would have to provide the information only if the risks arising from the policies could materially affect the company. Companies may also need to ask their directors for more information on their background and qualifications, and consider the board's role in the company's risk management programs. In addition, if a compensation consultant (a firm that advises corporate boards on pay packages, including those for senior executives) or its affiliates played a role in helping to devise executive or director compensation, while also providing additional services, then the company would be required to disclose the following: (1) the nature and extent of all additional services it provided; (2) the fees paid for all additional services, and the fees paid providing advice on executive and director pay; (3) whether the decision to engage the compensation consultant for non-executive compensation services involved management; and (4) whether the board of directors or the compensation committee has approved all of the services provide.[18]

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in balkanized, dysfunctional boards and would provide an opportunity for their activist institutional investor backers to push for action on parochial agendas often having little to do with the best interests of the firm or most of its shareholders.

[17] "In Split Vote, SEC Agrees to Propose Shareholder Proxy Access Rule Amendments," *BNA's Securities Regulation & Law Report*, May 25, 2009.

[18] "SEC Proposes Measures to Improve Corporate Governance and Enhance Investor Confidence," July 1, 2009, available at http://www.sec.gov/news/press/2009/2009-147.htm. Among other things, H.R. 3269 (described in detail below) would direct the SEC, the Federal Reserve, and other financial regulators to jointly prepare regulations that would proscribe any compensation structure or incentive-based pay arrangement (such as bonuses) at financial institutions that encourage "inappropriate risks." In publicly owned firms, the shareholders' interests are represented by the board of directors. The board of directors is responsible for setting and approving the compensation for the CEO and the top executives of publicly owned firms. In most publicly traded U.S. firms, the CEO is also the board chair. Shareholders' interests are supposed to be represented by the board, because they have little direct say in setting executive compensation and must ultimately approve nominated directors. The board's decisions on compensation are one of a number of factors that they may consider when deciding whether to approve a particular nomination. But significant debate has arisen over the ability of boards to monitor management effectively and discipline subpar

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Treasury Department Initiatives

The Treasury Department is also responsible for several recent initiatives, including

Treasury's Four Principles on Compensation Practices. On June 10, 2009, the U.S. Treasury Department released a statement on compensation that set forth five broad-based principles meant to serve as the foundation for future reforms, which are intended to "particularly" apply to financial firms (with possible future applicability to all public companies). Treasury officials have indicated that these standards are intended to guide compensation practices towards prudent risk-taking and properly aligned incentives. Although several of the principles involve the alignment of pay and performance, others involve the relationship between pay and risk taking:

- compensation should be structured to account for the time horizon of risks;
- compensation practices should be aligned with sound risk management;
- golden parachutes and supplemental retirement packages should align the interests of executives and shareholders; and
- transparency and accountability should be part of the process of setting compensation.[19]

Treasury's Proposed Say on Pay Legislation. In July 2009, the U.S. Treasury Department submitted a legislative proposal for say on pay legislation.

A relatively new phenomenon in the United States, the say on pay movement has consisted of efforts via shareholder proxy proposals, largely by activist shareholders, to temper the growth of executive compensation at publicly-traded firms. When adopted, say on pay gives shareholders an up or down advisory vote on compensation committee decisions on executive pay. Regardless of the nature of this shareholder vote, the board, whose members are elected by those shareholders, has final authority over executive pay. In 2006, shareholders at U.S. companies voted on a handful of proxy proposals to adopt say on pay. During the 2009 proxy season, that number had risen to more than 100.

To date, roughly 25 U.S. companies have implemented say on pay. Two firms, Aflac and RiskMetrics, did so voluntarily without a shareholder vote. No U.S. firms with say on pay have reportedly rejected executive pay packages.[20] In addition, as noted earlier, EESA requires TARP recipients with outstanding TARP balances to have a say on pay mechanism in place.[21] Globally,

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performance. Many cite the risk of "board capture" by senior management, citing the unified CEO and chair, as well as the fact that CEOs are often involved in the selection of board members. By contrast, others say that board capture appears to have significantly diminished: they argue that during the 1980s and 1990s, several factors combined to encourage more active and effective board oversight, including the fact that director compensation began to be paid in stock, helping to align director and shareholder interests.

[19] "Statement by Treasury Secretary Tim Geithner on Compensation," June 10, 2009, available at http://74.125.47.132/search?q=cache:uPvdcvAfItoJ:www.ustreas.gov/press/releases/tg163.htm+treasury+and+%22five+principles%22+and+compensation&cd=1&hl=en&ct=clnk&gl=us.

[20] Joseph E. Bachelder, "TARP, Say on Pay' and Other Legislative Developments," available at http://blogs.law.harvard.edu/corpgov/2009/07/04/tarp-say-on-pay-and-other-legislative-developments/.

[21] "TARP Standards for Compensation and Corporate Governance; Interim Final Rule," *Federal Register*, June 15, 2009, vol. 74, no. 113.

the Netherlands requires binding say on pay, whereas the United Kingdom, Australia, Norway, Spain and France have legislated non-binding say-on-pay.

Treasury's legislative proposal on say on pay would apply to any publicly owned company listed on a national securities exchange such as the NYSE or Nasdaq and would require

- the SEC to require public companies to include, in their annual proxy statements, a resolution requesting non-binding shareholder approval or disapproval of disclosed executive compensation (including the CD&A);
- giving shareholders the right to a non-binding vote on annual compensation for the top five named executive officers, including all compensation described in the CD&A and covered by the summary compensation table; and
- giving shareholders the right to a nonbinding vote to approve or disapprove golden parachute compensation spelled out in the proxy solicitation materials for shareholder votes to approve a merger, acquisition or other possible change of control.[22]

In its release, the Treasury Department said that "say on pay will improve directors' accountability to the owners of the company by giving shareholders a way to express their views on executive compensation and will allow boards and shareholders to work together to design compensation that gives executives strong incentives to maximize long-term firm value."[23]

Treasury's Proposed Legislation on Compensation Committees. In July 2009, the Treasury Department released proposed legislation aimed at reforming corporate compensation committees, the board committees that are responsible for crafting executive pay packages. By enacting a new section to the Securities Exchange Act of 1934, the proposed legislation would require the SEC to direct the national securities exchanges to prohibit the listing of companies that do not comply with the following standards:

- a compensation committee member would be prohibited from receiving any consulting, advisory or other compensatory fees and may not be an "affiliated person" of the issuer or any of its subsidiaries;[24]
- the SEC would be required to write rules establishing independence standards for compensation consultants, legal counsel and other advisers to the compensation committee;
- the compensation committee of each company would have to possess the authority to engage an independent compensation consultant and be directly responsible for the oversight of its work. In the proxy material for its annual meeting held one year after enactment of the legislation, a company would be required to disclose whether it secured the advice of an independent compensation consultant and, if it did not, it would have to explain why it chose not to do so;

[22] U.S. Treasury Department, "Ensuring Investors Have a 'Say on Pay'," fact sheet, .June 10, 2009, available at http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf.

[23] Ibid.

[24] This is basically similar to a standard for auditing committees under SOX.

- the compensation committee would have to possess the authority to retain independent legal and other advisers and would be responsible for oversight of these advisers; and
- each company would have to provide appropriate funding for the compensation committee to pay the fees for the aforementioned consultants and advisers.[25]

As part of its release, the Treasury Department noted two supportive arguments. First, some board members have financial relationships with their companies and its executives, which may compromise their independence. Second, the major stock exchanges require compensation committee members to meet certain minimum standards for independence. However, under New York Stock Exchange standards, along with director's fees, an independent director can receive up to $100,000 in outside compensation from the company. Moreover, a director who owns or operates a business that receives up to $1 million in revenue from the company is still considered to be independent.[26]

Non-TARP Executive Compensation Legislation

Various bills have also been introduced that are aimed at restraining various aspects of executive pay and reforming corporate governance beyond firms receiving TARP funds. These bills are described below.

S. 386 (Leahy), which became P.L. 111-21on May 20, 2009, among other things, establishes a Financial Crisis Inquiry Commission, a bipartisan commission that would study the causes of the financial and economic crisis and make regulatory recommendations. Among other things, the commission would also look at a broad range of areas, including fraud and abuse in the financial sector and how this is addressed by state and federal regulatory enforcement; credit rating agencies; lending practices and securitization; corporate governance and executive compensation; federal housing policy; derivatives; government sponsored enterprises; and short-selling, among others.

S. 1006 (Durbin) would mandate that no employee's compensation can exceed 100 times the average compensation paid to all employees of a given company unless no fewer than 60% of shareholders have voted to approve such employee's compensation within the preceding 18 months.

S. 1074 (Schumer) would

- require publicly traded firms to provide for a non-binding shareholder vote on executive compensation as disclosed in the proxy statement;
- require that a person making a proxy solicitation (for an annual or other meeting of shareholders) in connection with a transaction such as an acquisition, merger

[25] U.S. Treasury Department, "Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees, fact sheet, July 16, 2009," The last three provisions of the proposed legislation are described as being conventional practices among most compensation committees. Available at http://74.125.93.132/search?q=cache:PlncDC6KUZoJ:www.ustreas.gov/press/releases/tg218.htm+treasury+fact+sheet+compensation+committees&cd=2&hl=en&ct=clnk&gl=us.

[26] Ibid.

or a sale of all or most of a company's assets of an issuer, disclose in its proxy solicitation materials any agreements that it has with principal executives of the company attempting the acquisition;

- require that in the event that the aforementioned disclosure is necessary, a company's shareholders must be given a non-binding vote on such agreements; and
- require the SEC to establish rules relating to shareholder proxy access, which would impose the following limitations on shareholder eligibility: (1) minimum beneficial ownership of 1% of the voting securities; and (2) require that shares must be held for a minimum of (two years preceding the date of the next scheduled annual meeting; and (3) require the SEC to direct the NYSE and NASDAQ to set new corporate governance standards for listed companies that would include (a) a requirement that an independent director serve as chair of the board of directors; and (b) a requirement that directors annually stand for election, thus eliminating staggered boards.[27]

In a joint press release announcing the bill's introduction, Senator Schumer and Senator Cantwell indicated that the bill was "aimed at empowering shareholders in order to curb the types of excessive risk-taking and runaway executive compensation that contributed to the nation's economic recession."[28]

H.R. 1594 (Barbara Lee) would disallow any business tax deduction for compensation paid to any employee in excess of the greater of (1) 25 times the compensation of the lowest paid employee or (2) $500,000.

H.R. 2861 (Peters) would

- require directors to receive a majority vote in uncontested elections;
- allow shareholders to nominate a candidate for director on management's proxy card;
- eliminate uninstructed broker votes that allow fund managers to vote on investors' behalf;
- prohibit compensation consultants from performing other consulting in which they report to company management;[29]

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[27] This "risk" subcommittee can be seen as an attempt to address concerns that many corporate boards did not understand the risks that their financial firms were taking on. According to some estimates, currently about 5% of boards have dedicated, board-level risk committees, while many companies currently combine a risk function with their audit committees. For example, see Elizabeth Mays, "Scenario Analysis for Board Risk Management," Corporate Board, July-August 2009.

[28] "Schumer, Cantwell Announce 'Shareholder Bill of Rights' to Impose Greater Accountability on Corporate America," *Press Release from Senator Charles Schumer*, May 19, 2009, available at http://schumer.senate.gov/new_website/record.cfm?id=313468.

[29] A 2007 report released by the House Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interests Among Compensation Consultants*, found that the median CEO salary of Fortune 250 companies in 2006 with compensation consultants with the most pronounced conflicts of interest (from multiple single firm consulting contracts) were 67% higher than median CEO salary at companies with compensation consultants that performed no other work. U.S. Congress, House Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interests Among Compensation Consultants*, 110th Cong., 2nd sess., December 2007. By contrast, another study (continued...)

- provide for an annual advisory shareowner vote on the compensation of senior executives;
- prohibit the same person from serving as CEO and board director;
- require the SEC to direct the national securities exchanges to prohibit the listing of companies that do not adopt a policy for the recovery of bonus payments, incentive payments, or equity payments previously awarded to executive officers in the event of fraud or financial restatement;[30]
- prohibit the awarding of golden parachute payments to executives who are terminated for poor performance; and
- curb excessive risk-taking by requiring shareholders to be informed of the performance targets being used to determine bonuses and other incentives.

In a press release accompanying the bill's release, Representative Peters stated:

> As an investment advisor for over 20 years, shareholder rights issues have always been very important to me. This bill empowers shareholders, a company's true owners. Wall Street executives who pursued reckless investment strategies were a major contributing factor to the recent financial meltdown. Ensuring that executives act in investors' long-term interest rather than for their own short-term gain is critical to prevent a similar economic collapse in the future.[31]

For depository institutions, depository institution holding companies, broker-dealers, credit unions, investment advisors, Fannie Mae, and Freddie Mac, and any other financial institution deemed appropriate by the federal regulators, **H.R. 3269** (Frank), which passed the U.S. House on July 31, 2009, would [32]

- require annual "say on pay" votes at all U.S. companies, while giving the SEC authority to exempt smaller companies;

(...continued)

examined S&P 1500 firms in 2006. It divided compensation consulting firms into two broad groups, those that may provide no services except for compensation consultation were categorized as having no conflict of interest and firms that may provide other services were characterized as having potential conflicts of interest. It found that there was no compelling evidence of unjustified or unwarranted pay to the CEO for firms serviced by the potentially conflicted compensation consultants. Brian D. Cadman Mary Ellen Carter, and Stephen A. Hillegeist, "The Incentives of Compensation Consultants and CEO Pay," February 1, 2009, available at SSRN: http://ssrn.com/abstract=1103682.

[30] Clawbacks are contractual provisions that require an employee to repay compensation received from an employer following certain "trigger" events. Although some companies employed clawbacks before the adoption of SOX, it represented the first federal statute requiring that certain bonuses previously paid to an executive be forfeited or repaid to his or her firm. The clawback provisions in SOX apply to the CEO and the chief financial officer and the only trigger is a financial restatement caused by misconduct. Under Section 111 of the EESA, clawback rules for TARP recipients apply to senior executives and the 20 next most highly compensated employees and expand the trigger to include not only fraud or misrepresentation but also financial statements that are found to be simply "inaccurate." Sixty-four of the nation's largest 100 companies had adopted clawback provisions by 2008. An additional 30 of the nation's largest 500 companies have indicated that they adopted clawback provisions for the first time in the 2009 proxy season. However, as of May 2009, the only case in which a clawback had reportedly been used was Warnaco's recovery of $120,000 from three executives following a 2006 restatement. "The Right Way to Pay," *Forbes*, May 11, 2009.

[31] "Congressman Peters Introduces Bill to Empower Shareholders," June 12, 2009, available at http://peters.house.gov/index.cfm?sectionid=22&parentid=21&sectiontree=21,22&itemid=148.

[32] The legislation passed the House soon after New York Attorney General Andrew Cuomo reported that nine large banks, who had received TARP aid, paid $32.6 billion in bonuses in 2008.

- require hedge funds, pension funds and other large institutional investors with more than $100 million in assets to make public their votes on pay proposals for the stocks that they own, unless the votes are otherwise required to be reported publicly by the SEC; [33]
- mandate separate investor votes on "golden parachute" payments, while giving the SEC authority to exempt smaller companies;
- require compensation committees: (1) to only have independent directors; and (2) be directly responsible for the appointment, compensation, and oversight of the work of independent compensation consultants, which are to be promulgated by the SEC; the SEC is also authorized to exempt smaller companies from these restrictions;
- require firms with more than $1 billion in assets to disclose incentive-based pay arrangements to federal regulators, who would determine whether the compensation structure (1) aligns with sound risk management; (2) accounts for the time horizon of risks; and (3) reduces unreasonable incentives for officers and employees to take undue risks that could threaten the firm's safety and soundness;
- require federal regulators to jointly prescribe regulations prohibiting incentive-based payment arrangements that encourage inappropriate risks that have a seriously adverse impact on economic conditions or financial stability or threaten a financial institution's safety and soundness; firms with under $1 billion in assets would be exempted;[34] and
- direct the Government Accountability Office to study the correlation between compensation structures and excessive risk-taking.

At the time of the release of the draft of the bill, Chairman Frank, the bill's sponsor, observed that it was

> similar to [say on pay] legislation that the House passed in 2007 [Frank, H.R. 1257] during the 110th Congress. In addition, we will consider legislation to empower federal regulators to proscribe inappropriate or imprudent compensation practices as part of solvency regulation of all financial firms. The committee is acting because of a broad consensus of leading national and international finance experts including Paul Volcker and the Group of 30 and Lord Turner of the United Kingdom who believe that compensation structures were a factor in the financial crisis.... [35]

In a press release published after the bill's passage in the House, Chairman Frank observed that,

> the major intent of the legislation is to better align the interests of corporate executives with those of the corporations they serve. At the height of the mortgage bubble, financial

[33] Mutual funds, another major group of institutional investors, are already required to do so.

[34] In the private sector, there is growing interest in firms adopting a "bonus bank" in which financial services companies hold bonuses in escrow accounts for three years, bonuses that are only paid out if certain longer-term performance measures are met. UBS, a Swiss bank, has created such a structure, which has generated considerable and growing attention.

[35] "Frank Statement on Executive Compensation," *House Financial Services Press Release*, July 16, 2009, available at http://www.house.gov/apps/list/press/financialsvcs_dem/pr_071609.shtml.

> company executives had enormous incentives to make highly risky investments. Many were rewarded lavishly, even after their companies faced catastrophic losses and were loaned billions by American taxpayers in an effort to prevent an economic meltdown.... [36]

Among some of the negative congressional reactions to the bill were comments from Representative Michael Castle:

> This bill is a vast overreach and an overreaction to the current financial crisis. Like many, I am concerned that executives at a handful of large companies, like AIG, have been awarded extravagant pay packages and bonuses even after the companies have faced failure and received assistance from the Federal Government to the tune of billions of taxpayer dollars. In these cases, when Federal assistance has been granted, I believe the Federal Government does have a right to mandate the pay structure of these firms, which is why I voted for a [rejected] amendment during committee consideration of H.R. 3269 to only apply the provisions in the underlying bill to TARP recipients for the amount of time that the TARP money is outstanding.... Finally, this bill undermines the primacy of State corporate governance laws. Corporate law has typically been left up to the States, allowing this diversity to foster competition. Passing this bill would eliminate these traditions, which run against the American free market ideals we have always stood for.... [37]

Negative responses from the private sector included comments by the National Association of Manufacturers (NAM), which along with the U.S. Chamber of Commerce and the Business Roundtable, had opposed the bill. NAM officials stated that the legislation would be "excessively burdensome and disruptive to companies at a time when they are facing significant economic challenges."[38]

Although Treasury Secretary Timothy Geithner called the legislation a "positive step" toward increasing accountability,[39] news reports indicated that Robert Gibbs, the Obama Administration's press secretary, spoke of the Administration's concerns that the bill would give regulators too much authority over incentive pay; President Obama has supported say on pay itself. [40]

H.R. 3272 (Ellison) would

- require boards to have a committee on risk management and companies to have a chief risk officer;
- require compensation committees to be solely comprised of independent directors;
- require a non-binding shareholder votes on executive compensation; and
- require the SEC to carry out a study on the feasibility of requiring a certification process for prospective board members.

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[36] "House Votes to Pass Frank's Bill on Executive Compensation Reform," July 31, 2009, available at http://www.house.gov/frank/pressreleases/2009/07-31-09-executive-compensation-passes.html.

[37] "Corporate and Financial Institution Compensation Fairness Act of 2009," *Congressional Record*, July 31, 2009, p. H.R. 9213.

[38] Richard Simon, "House Backs Executive Pay Limit," *Los Angeles Times*, August 1, 2009.

[39] Anne Flaherty, "House Votes to Clamp Limits on Wall Street Bonuses," *Associated Press*, August 1, 2009.

[40] Jesse Westbrook and Ian Katz, "House Gives Regulators Incentive Pay Role; Senate Prospects Dim," *Bloomberg*, August 1, 2009.

H.R. 3351 (Kilroy) would

- require a non-binding shareholder vote on executive pay;
- require the disclosure of any agreements or understandings that a person involved in a possible acquisition of a target firm has had with the target firm's principals;
- require a non-binding shareholder vote on the awarding of golden parachutes; and
- that hedge funds, pension funds and other large institutional investors make public how they voted on any shareholder vote.

Some Potential Critical Responses to Various Provisions in the Bills

There are a number of potential critical responses to provisions in the aforementioned bills. Several are discussed below:

Providing proxy access for shareholders to nominate directors (S. 1074 and H.R. 2861)[41]

- Most shareholders do not have sufficient holdings to justify the necessary opportunity costs needed to educate themselves on rival director candidates from contending slates (reasoning that their votes will have little effect on the outcome). This deliberately uninformed "rational apathy" is actually a calculated response to the perception that the expected benefits of adequately educating themselves on the matter will not exceed its costs. Thus, the argument goes that for the vast majority of shareholders (excluding a few activist institutional investors), the level of consideration and thought given to such proxy contests may be expected to be quite low.
- Over the past several years, some criticism has been leveled at the behavior of activist hedge funds who allegedly have tried to force firms to focus on short-term stock gains rather than long-term value by pushing measures such as share buybacks or special dividends to create quick shareholder profits. Some concerns are that proxy access would better position such hedge funds to succeed at these agendas by giving them greater opportunity to place supportive members on boards.
- Additional concerns are that proxy access would also enhance the ability of activist institutional investors to push for what some deride as wasteful corporate agendas that add nothing to a firm's financial viability (such as environmental projects or socially responsible investing).

Requiring that the board chair be an independent director (S. 1074 and H.R. 2861)

- It has been argued that the growing use of the lead director, the voice and the leader of independent directors, has helped to provide a sufficient counterweight to the combined CEO-chairman structure.

[41] Some contend that if the SEC's proxy access proposal is adopted, a federal law authorizing proxy access would lower the odds of a successful challenge to its constitutionality.

- Evidence from a number of statistical studies shows that whether the CEO and the chair are combined makes little difference to a company's financial performance.[42]

Prohibiting compensation consultants from performing other consulting in which they report to company management (H.R. 2861)

- It has been argued that there are some statistical studies that have found little evidence that firms with compensation consultants who play other roles tend to award comparatively higher pay packages to their executives.[43]

Requiring annual elections to replace staggered boards (S. 1074)

- Over the last several years, there has been a significant conversion to annual voting (according to one estimate, between 2004 and 2008, among the largest 100 U.S. firms, the number of staggered boards shrank from 54 to 27). Given this trend, the necessity of federally mandating annual elections may be questioned.
- It is also argued that the term of office for directors is more clearly a subject for state corporation laws than federal law.

Requiring board elections to involve majority voting (H.R. 2861 and S. 1074)

- By some estimates, 60% of the firms in the S&P 500 have adopted majority voting, a number that continues to grow. Given this trajectory, some question the necessity of a federally-mandated policy.

Requiring boards to have a dedicated panel that addresses issues involving risk (H.R. 3262 and S. 1074)

- Some argue that in many cases, concerns over risk-related matters are already being structurally addressed in corporate boards. Many boards combine the risk function in their audit committees, while many financial firm boards already have risk committees.

Requiring that compensation committees be solely composed of independent directors (H.R. 3262)

- It could be argued that federally mandating fully independent compensation committees is unnecessary because NYSE and Nasdaq rules for listed companies (the vast majority of the nation's publicly-trade firms) already do this.

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[42] For example, see the general discussion of such studies in: "Splitting Up the Roles of CEO and Chairman: Reform or Red Herring," *Knowledge@Wharton*, June 2, 2004, available at http://knowledge.wharton.upenn.edu/article.cfm?articleid=987.

[43] For example, see Brian Cadman, Mary Ellen Carter, and Stephen Hillegeist, "The Incentives of Compensation Consultants and CEO Pay," February 1, 2009, available at SSRN: http://ssrn.com/abstract=1103682.

Requiring the disclosure of incentive-based pay arrangements to federal regulators, who would determine the extent to which compensation schemes encourage officers and employees to take undue risks, etc. (H.R. 3269)

- Questions exist over the credibility of the basic underlying presumption that various financial firm executives and key operatives were knowingly involved in reckless risk taking.[44]
- Questions also exist over the legitimacy of the underlying presumption that the structure of executive compensation, particularly the incentive component, was a key factor behind the financial crisis.[45]
- Although phrases such as "excessive risks" and "undue risks" have become pejorative terms in the financial crisis, the potentially healthy nexus between taking outsized risks and the creation of innovative and corporate entrepreneurship may exist.
- Because financial firms are in the general business of taking risks, the concepts of excessive risk taking would need to be explicitly defined, arguably a formidable and contentious task.
- The regime could involve the federal government superseding the judgment of the compensation committees, who many believe, because of their proximity to the firm and its management (among other reasons), are in a much better position to oversee all aspects of executive pay.
- Some concerns are that such a selective disclosure regime could encourage an exodus of talent from subject firms to privately owned or foreign ones.
- Additional concerns are that such a disclosure regime could encourage problematic regulatory arbitrage in which firms opt to change their financial regulator to take advantage of less restrictive disclosure regimes.

Federal regulators would be authorized to prohibit incentive structures seen to encourage inappropriate risk-taking (H.R. 3269)

- Questions exist over the credibility of the basic underlying presumption that various financial firm executives and key operatives were knowingly involved in potentially reckless risk taking.[46]

[44] For example, a study of dozens of financial firms during the financial crisis of 2008 found that there was evidence that the vast majority of critical financial firm personnel such as CEOs and key securities traders did not understood the risks that were being taken. Among other things, the study's authors found that (1) there was no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence, actually performing worse in terms of stock returns and return on equity; (2) option compensation did not appear to have an adverse impact on bank performance during the crisis; and overall (3) that bank CEO pay arrangements were not to blame for the credit crisis or for the performance of banks during the crisis. Rudiger Fahlenbrach, Rene Stulz, and Rene M. Bank, "CEO Incentives and the Credit Crisis," *Charles A. Dice Center Working Paper No. 2009-13*, July 27, 2009, available at SSRN: http://ssrn.com/abstract=1439859.

[45] See the commentary in the footnote above.

[46] For example, a study of dozens of financial firms during the financial crisis of 2008 found that there was evidence that the vast majority of pivotal financial firm entities such as CEOs and traders did not understood the risks that were being taken. The study's authors also found that (1) there was no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence,
(continued...)

- Questions also exist over the legitimacy of the underlying presumption that the structure of the compensation, particularly the incentive component, paid to financial firm executives was a key factor behind the financial crisis.[47]
- Because subject financial firms are in the general business of taking risks, the concept of "undue risk taking" would need to be explicitly defined.
- A regime involving the outright proscription of certain kinds of compensation could greatly encourage an exodus of talent from subject firms to privately owned or foreign ones.
- A protocol in which individual financial regulators could devise different standards for what kinds of compensation should be proscribed is likely to encourage problematic regulatory arbitrage wherein firms opt to change their financial regulators to take advantage of less restrictive regimes.
- Some suggest that a regime in which government regulators centrally decide on what kinds of pay should be disallowed is incompatible with a free market system.

The aforementioned regulatory, Treasury, and legislative initiatives suggest that there is a significant groundswell of interest in corporate governance reform, following perceptions that qualitative shortcomings in the corporate governance at financial firms were at the heart of excessive risk taking seen by many as central to the financial crisis. This view, however, is by no means a universal one. A number of observers have questioned the notion that financial firm corporate governance was a major factor in the crisis. Among other things, they argue that

- it is hard to reconcile the idea that the firms consciously engaged in excessive risk-taking given the fact that "Wall Street" executives and key trading operatives often had large amounts of personal wealth in stock and stock options in their own firms. Such holdings resulted in large personal losses for top executives and key trading operatives at failed firms or surviving firms, many of which experienced tremendous drops in their share prices; and
- many financial firms and government financial regulators employed risk management models that generally provided (later proven to be erroneous) sanguine financial forecasts that did not suggest or warn about problematic risk taking.[48]

(...continued)

actually performing worse in terms of stock returns and return on equity; (2) option compensation did not appear to have an adverse impact on bank performance during the crisis; and overall (3) that bank CEO pay arrangements were not to blame for the credit crisis or for the performance of banks during the crisis. Rudiger Fahlenbrach, Rene Stulz, and Rene M. Bank," CEO Incentives and the Credit Crisis," *Charles A. Dice Center Working Paper No. 2009-13*, July 27, 2009, available at SSRN: http://ssrn.com/abstract=1439859.

[47] See the commentary in the footnote above.

[48] For example, see Holman W. Jenkins Jr ., "The Financial Markets and Fear Itself," *Policy Review*, June/July 2009, and Patrick Honohan, "Risk Management and the Costs of the Banking Crisis" *National Institute Economic Review*, October 1, 2008, and "CEOs and Market Woes: Is Poor Corporate Governance to Blame," *Knowledge@Wharton*, December 10, 2008.

By contrast, in one of the few empirical attempts to quantify the qualitative role of financial firm corporate governance on the financial crisis, one study examined 300 financial firms across 31 countries, including the United States, and found that

- firms with more independent boards and institutional ownership experienced larger accounting write downs during the crisis;
- firms with more institutional ownership had higher default risk before the crisis;
- firms that awarded CEOs more compensation in the form of cash bonuses (instead of equity-based incentives) experienced higher losses.

The study's authors concluded that their findings underscored the "importance of governance mechanisms" in the regulatory reform of financial institutions.[49]

Say on Pay and Its Potential Benefits and Costs

Besides legislative and Treasury Department support for universally imposing say on pay to publicly traded firms, additional support comes from some academics, and a number of so-called "activist" institutional investors. Included in this group are the AFL-CIO and CalPERs, the California employee public pension fund. They are joined by the Council for Institutional Investors, an umbrella organization of institutional investors. Opposition to say on pay comes from some academics and various business groups, including the U.S. Chamber of Commerce and the Business Roundtable, an association representing CEOs of companies with more than $5 trillion in annual revenue. This section describes and examines major arguments marshaled by supporters and detractors of say on pay. CRS does not take a position with respect to any of the arguments.

Primary Arguments Offered in Favor of Say on Pay

- Say on pay could help address aspects of executive compensation that encouraged excessive risk taking. Particularly for financial firms, pay packages may have encouraged corporate executive maximization of short-term gains at the expense of their firms' longer-term financial viability.[50] As one observer noted before a congressional hearing:

  > There is little question that one contributing factor to the excessive risk taking that was central to the crisis was the prevalence of compensation practices at financial institutions that encouraged short-term gains to be realized with little regard to the potential economic damage such behavior could cause not only to those firms, but to the financial system and economy as a whole… Compensation structures that permitted key executives and other financial actors to avoid the potential long-term downsides of their actions discouraged a focus on determining long-term risk and underlying economic

[49] David Erkens, Mingyi Hung, and Pedro P. Matos. "Corporate Governance in the Recent Financial Crisis: Evidence from Financial Institutions Worldwide," July 12, 2009, available at SSRN: http://ssrn.com/abstract=1397685.

[50] More specifically, it has been argued that financial firms' senior managers were often rewarded even though (1) the company was not performing well or in some cases performing very poorly, (2) management was focusing on the short-term risk-reward profile and not sufficiently weighing the potential long-term downside risk of their decisions, and (3) management was not adequately assessing and modifying the overall risk management system.

> value, while reducing the number of financial market participants with an incentive to be a canary in the coal mine…[51]

It has been argued that say on pay could help address perverse incentives by helping to make management more mindful of the long-term consequences of their actions.

- The prospect of a public backlash after say on pay elections might lead to greater pre-vote communications between the a firm and key investors on executive compensation matters.
- Say on pay could help better align the interests of shareholders and senior managers. Among their primary responsibilities, a company's directors are supposed to monitor corporate managers and hold them accountable to shareholders.[52] Proponents of say on pay argue that many directors failed in this responsibility in part because they were "captured" by company management.[53] It has been argued that providing shareholders with say on pay could help lessen this kind of managerial influence on directors in the area of executive pay by publicly and directly confronting them with their constituents' views on such matters.[54]
- Say on pay could provide a counterweight to the potentially pro-management bias that compensation consultants may bring to compensation committees. Many firms hire compensation consultants to help advise compensation committees on the design of executive pay. While doing this, the same consultants are often contracted by company management to perform ancillary functions. Many think that this presents a problematic conflict of interest that may bias consultants in their advisory roles with compensation committees, particularly given the fact that fees earned by consultants for compensation work tend to be less than what they make on other business. Some have compared this phenomenon to concerns that surfaced after earlier accounting scandals: supposedly outside auditors simultaneously profited from additional management-arranged contracts. The revelations led to concerns over the improper influence of the other contracts on the integrity of the audits. SOX subsequently limited the ancillary roles that a firm's outside auditor may perform. It has been argued that say on pay could provide boards with an alternative perspective on executive pay that could serve as a counterweight to compensation committee-vetted pay packages that might have been influenced by biased consultants.

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[51] "Written Testimony of Gene Sperling before the House Committee on Financial Services on Compensation Structure and Systemic Risk," June 11, 2009.

[52] In theory, a key part of the director's duty is to help to minimize the principal-agent problem, a type of market failure that exists when a principal's (the shareholder in this case) interests are represented by an agent (the corporate executive in this case) whose goals or incentives diverge from those of the principal's. A principal-agent problem can result in agents squandering company resources on self-indulgent projects at odds with the firm's best interests.

[53] For example, (1) fear of financial retaliation (through not being re-nominated); (2) the prospect of removal from the board; and (3) and a reluctance of directors to disrupt the environment of loyalty, collegiality and team spirit between board members, and management—could all discourage directors from effectively overseeing a firm's managers.

[54] Critics argue that this undermines the traditional power of corporate boards, which have historically served our economy well. They also argue that say on pay would give more power to certain types of shareholders such as hedge funds, which may have little interest in a firm's long-term welfare.

- Some believe say on pay may help address bias to executive pay packages resulting from the selective use of peer groups. Part of the methodology that compensation consultants use to help advise on the design of executive compensation packages involves using other companies as benchmark "peer groups."[55] One study found that among high paying compensation peer groups, firms with executive salaries within a given company's range were often deliberately chosen to justify higher CEO compensation.[56]
- By not adopting say on pay, political pressure may grow for more intrusive corporate governance reforms. Some see the recent outrage over executive compensation for TARP recipients as a harbinger of the public outrage and political pressure that could come about later if no corporate governance reforms are adopted. Failure to adopt say on pay, considered by many to be a relatively moderate piece of reform, could result in support for more restrictive and intrusive governance reforms.
- There appear to have been benefits to the UK's experience with say on pay. In 2002, legislation was adopted in the UK, which mandated an annual, non-binding shareholder vote (say on pay) on executive pay. As is being argued currently in the United States, this legislation was designed to reduce the occurrence of "excessive" executive compensation. A recent study[57] examined the impact that say on pay had on executive compensation in the UK and reported several effects. Among them were (1) it appears as though the communication between companies' large shareholders improved; (2) there is some evidence that companies have become more responsive to shareholder views on executive compensation; (3) although shareholder rejections of executive pay packages have been rare, there is some evidence that firms receiving a significant negative vote in one year tend to receive a much higher positive vote in the following year;[58] and (4) long-term CEO employment agreements, which some in the UK felt gave rise to "pay for failure," appear to have been become less prevalent.[59]

[55] An additional explanation for why boards often award higher pay packages to executives whose companies have had one or several subpar years is that no firm wants to be the first to reduce executive pay for fear of being wrong or fear of possibly sending a negative signal to the stock market or key employees. This is known as a collective action problem.

[56] Michael W. Faulkender and Jun Yang, "Inside the Black Box: The Role and Composition of Compensation Peer Groups, *AFA 2008 New Orleans Meetings Paper*, March 15, 2007, available at SSRN: http://ssrn.com/abstract= 972197.

[57] Fabrizio Ferri and David Maber, "Say on Pay Vote and CEO Compensation: Evidence from the U.K.," *Harvard Business School*, March 2009.

[58] Jeffrey Gordon, "Say on Pay: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In," *European Corporate Governance Institute (ECGI)*, January 2009, p. 14.

[59] It should be noted that this information is primarily based on the findings of one study, which was conducted over three years with a select sample of firms. Therefore, the findings should not be taken as giving a definitive answer on the pros and cons of say on pay. Rather, it may be able to shed some light on the issue based on some of the evidence gathered to date. In addition, there are some significant differences between the financial systems in the UK and the United States, which could make it somewhat hard to compare the UK experience to what might happen in the United States if say on pay were adopted. For example, the stock market capitalization in the UK is much more concentrated than in the United States.

Primary Arguments Offered Against Say on Pay

- One concern about say on pay is that it would significantly alter the traditional roles and relationships between management, the board of directors and shareholders, a model that many believe has served U.S. businesses well. Critics fear that say on pay would distort shareholders' and directors' responsibilities by enabling shareholders to potentially undermine the proper managerial authority of directors to decide on executive pay.[60] It has also been argued that although say on pay merely provides for a non-binding shareholder vote, it could confront directors with the difficult decision of either accepting the vote or facing potential shareholder and public anger for going against their will.[61]
- Contemporary executive pay packages, which may use arcane performance metrics that may be hard to understand and tend to employ a mix of salary, long-term incentive pay and bonuses, can be exceptionally complex. Critics of say on pay contend that the disparate nature of corporate shareholders suggests that their views would diverge on what constitutes "good" performance versus "not good" performance. It has also been argued that because of time and resource constraints, shareholders would generally not be expected to do the "heavy lifting" necessary for a proper understanding of the pay packages.[62] One observer has commented:

  > For the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile…The key point is that effective corporate governance requires that decision making authority be vested in a small, discrete central agency rather than in a large, diffuse electorate.[63]

- Say on pay could impose additional costs on corporations and adversely affect the ones with no perceived executive compensation problems. Critics argue that there is no "one size fits all" approach to addressing say on pay and the current proposal being discussed is too broad sweeping. It has been argued that say on pay proposals would not only affect corporations with perceived compensation problems, but also those corporations that appear to have "reasonable" compensation practices. Findings from some recent research suggest that providing say on pay to shareholders of corporations that are perceived to have "reasonable" executive compensation practices may result in additional costs to the corporation.[64] According to the study, such increased costs from say on pay could come in several forms, including (1) a negative market reaction once say

[60] Katayun Jaffari and Mu'min Islam, "The Future of 'Say on Pay' in Current Economic Times," *The Legal Intelligencer*, October 30, 2008.

[61] Ibid.

[62] There may also be non-public information issues as well: a director may have access to certain information that public shareholders are not legally allowed to have.

[63] Stephen M. Bainbridge, "Is 'Say on Pay' Justified?," *Regulation*, Spring 2009, p. 47. In response, it could be argued that there are a number of large institutional investors with sufficient resources and holdings in various companies—to have the wherewithal and the economic incentive to undertake comprehensive examination of executive pay packages. Indeed, there are a few proxy advisory firms such as RiskMetrics that advise large investors on a variety of proxy matters, including pay issues, and provide analyses of executive pay packages.

[64] Jie Cai and Ralph Walkling, "Shareholders' Say on Pay: Does It Create Value?," *Drexel College of Business Research Paper No. 2008-06*, August 2008, available at SSRN: http://ssrn.com/abstract=1030925.

on pay proposals were announced (particularly if the plans were supported by labor unions); (2) intensified special interest group pressure, which often leads to expensive proxy battles; and (3) expenditures for image enhancing corporate public relations campaigns.[65]

- Critics of say on pay also charge that adoption of say on pay could lead to top talent seeking alternative employment if they fear that it might usher in a regime that might deprive them of expected pay gains. As a consequence, publicly-traded firms with say on pay could arguably be harmed by a talent outflow to privately-held or foreign firms that would not be subject to it.[66]
- The SEC's 2006 executive pay disclosure rules enhance pay transparency, reducing the need for say on pay. As discussed earlier, in 2006, the SEC adopted additional corporate executive pay disclosure requirements. Among other things, firms must disclose information on their executives' total compensation, the value of their stock option grants, estimates of potential post-employment payments and benefits, and an explanation of the objectives and implementation of a company's executive pay program. Detractors of say on pay claim that this increased transparency significantly mitigates the need for pay reform.[67]
- Critics of say on pay also cite several developments that suggest that there has been a shift away from management biased boards**.** For example, one recent study found that "the prevalence of board chairs separate from the CEO continued a slow steady, climb, rising to 46% in 2008 from 37% in 2005."[68] In addition, another study reportedly found that the average U.S. CEO's tenure dropped from 9.7 years in 1999 to 8.3 years in 2006.[69]
- Some shareholders may use the potential leverage they gain from say on pay to try to extract corporate concessions potentially at odds with the interests of the company and other stakeholders. For example, short-term investors may push for changes such as such as larger dividends, stock repurchases, and the use of increased leverage that may conflict with the interests of long-term shareholders. Union pension funds may try to employ the leverage to lobby for "pet" reforms such as unionization, which many may perceive to not be in a company's best interest.
- Some argue that say on pay would undermine the state-based system for regulating corporate law and governance. U.S. corporate law, and the regulation of shareholder rights, is largely based on state law, a legal system that many believe has been a major contributor to the effective operation of the nation's

[65] Proponents argue that although this is a potential concern, the direct costs of excessive compensation and the consequences associated with it are likely to be greater.

[66] Say on pay's supporters, however, say that these concerns are exaggerated. Some argue that the controversy surrounding bonuses issued at firms receiving TARP money would result in a mass exodus of top talent to firms not subject to TARP scrutiny. However, reporting done in May 2009, suggests that this "mass exodus" had not yet occurred. For example, see Kate Kelly, "Bankers Huddle Under the TARP," *Wall Street Journal*, May 14, 2009.

[67] Say on pay proponents, however, argue that these other measures are not as explicit or as forceful as say on pay, and therefore do not provide the same level of protection against excessive executive compensation.

[68] Carol Bowie, "Independent Board Chairs: A Trend Picks Up Speed," *Aspen Publishers, Inc*, March/April 2009, p. 1.

[69] Reported in: Robert Weisman, "Being a CEO Has its Perks, but Tenure isn't One of Them," *Boston Globe*, May 11, 2008.

capital markets. Critics of say on pay contend that the reform would reduce traditional state oversight of corporate governance, harmfully expanding the federalization of power in this area.[70] One observer has commented:

> Basic economic common sense tells us that investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not lend to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers thus have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters should deter states from adopting excessively pro-management statutes.[71]

- Critics of say on pay cite a study on the UK experience with say on pay, which found that under it (1) companies reduced executive compensation when company performance declined; and (2) there was no evidence of executive compensation increasing when company performance improved. The latter observation has generated concerns over say on pay's possible impact on UK corporate efficiency. An attendant concern is that not rewarding executives when firm performance rises may also have broad and serious economic implications, such as undermining entrepreneurial energy and the appetite for risk taking in the UK.
- Say on pay would provide shareholders with a blunt and unsophisticated "yea or nay" response to executive pay packages, which is too simplistic an approach to complex and intricate compensation packages.

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[70] Conversely, proponents of federalizing corporate law often defend it through the "race to the bottom" theory. The theory postulates that in an effort to get the highest amount of state charters, which in turn will generate more tax revenue and job creation, states lower the bar on corporate governance and other regulatory issues as an incentive to attract corporations. In the end, they say that we are left with weaker corporate governance. Delaware is often cited as an example of a state that has historically employed this approach.

[71] Bainbridge, "Is Say on Pay Justified?" Say on pay's proponents would, however, counter that the reality is that the state of Delaware has a near monopoly on the chartering of the largest U.S. companies.