YALE SCHOOL OF MANAGEMENT

THE MILLSTEIN CENTER
FOR CORPORATE GOVERNANCE AND PERFORMANCE

Testimony of
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On

"Empowering Shareholders on Executive Compensation: H.R. 1257, the 'Shareholder Vote on Executive Compensation Act'"

Before the Committee on Financial Services
United States House of Representatives

March 8, 2007

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Chairman Frank, Ranking Member Bachus and Members of the Committee, the Millstein Center for Corporate Governance and Performance at the Yale School of Management is in the process of producing a white paper on the practice of annual advisory votes on compensation policy. The aim of *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable* is to assess the track record in Britain and provide analysis on whether the advisory vote tool may be adapted to the United States environment. While we expect to issue draft and final versions later this spring, as director of the project I wanted to provide the Committee herewith a preliminary summary of principal findings for the record, as members deliberate on H.R. 1257. Note that conclusions are those of the author and do not reflect the opinion of the Millstein Center as an institution.

First, a word of background on the Millstein Center. The Center is an international resource providing active support for research in corporate governance. It disseminates its work to the world's academic, policy-making and professional communities. We produce and sponsor scholarly research, policy-oriented white papers and a unique online platform of databases on global corporate governance. The Center's affiliated faculty and fellows comprise leading scholars and practitioners from a variety of disciplines. Our advisory board includes leaders in the business and financial communities. A forum for interdisciplinary research, the Millstein Center for Corporate Governance and Performance brings together scholars from the School of Management, the Yale Law School, the Yale Economics Department, and other graduate and professional programs within Yale University to study governance mechanisms in a global context. For this white paper project, the Center sourced information and conducted roundtables and interviews in London in February 2007 with cooperation from the Association of British Insurers, Institute of Chartered Secretaries and Administrators, Institute of Directors, International Corporate Governance Network, Deloitte and others.

The overall conclusion of the *Does 'Say on Pay' Work?* white paper is as follows.

Advisory votes on executive pay policies are rational, timely, road-tested and practical for use in the United States. Based on reviews of the UK track record, we find that advisory votes represent an important lever that could strengthen both boards and shareholders in the quest to better align top corporate pay with performance. A surprisingly broad consensus of corporate directors, shareholders and government in Britain sees 'say on pay' acting as a driver of corporate value, making public corporations more competitive and, by raising confidence in governance integrity, lowering risks for investors. Experience shows that advisory votes on compensation are likely to serve as a potent stimulus to dialogue between boards and shareholders. Moreover, advisory votes can go hand-in-hand with new SEC-mandated rules on pay disclosure. The tool is no panacea on its own. While constructive in and of themselves, advisory votes on compensation policy generate best outcomes when fitted with other measures, such as majority-rule director elections. Further, to best tether pay to performance, boards, shareholders and service providers face the challenge of hard-wiring material changes in their operations to handle advisory votes. In this respect, market players in the United States have an opportunity to take steps to avoid shortfalls evident in Britain.

Underpinning the summary conclusions above are seven principal findings from the UK which can inform the process of adapting 'say on pay' to the United States environment. They are as follows.

1. *Votes on compensation policy resulted in a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other. This transformed the way compensation policies are constructed.* The introduction of 'say on pay,' and in particular the GlaxoSmithKline board's jolting defeat in 2003, produced a virtual overnight increase in the level of dialogue between companies and funds. Directors have shown a strong interest in avoiding the prospect of individual and collective reputational damage resulting from significant shareholder opposition. "Beforehand, we paid the CEOs what we wanted to and told investors who objected 'too bad,'" recalled one former board member. But the Glaxo loss "concentrated the mind wonderfully. Now the board must base remuneration on performance and be scrupulous about it." The Association of British Insurers (ABI) estimates that contacts initiated by companies before they finalize compensation plans tripled. And an arm of the National Association of Pension Funds (NAPF), which had recorded an average 20 such outreach efforts by companies each year prior to 'say on pay,' engaged in 150 instances of dialogue in 2005 and 130 in 2006. These consultations ranged from a simple phone call to multiple high-level meetings. In many cases such dialogue resulted in boards changing corporate plans to strengthen performance triggers in ways that met shareholder objections. Critics have raised concerns about minority shareholders abusing a 'say on pay' system to enhance their sway over boards of directors. In Britain, anxiety over a tide of investor uprisings proved misplaced. In four years only Glaxo, among major companies, has seen its remuneration report rejected in a non-binding vote. Proxy advisors have exercised restraint. Between 2004 and 2006 RREV, the UK arm of Institutional Shareholder Services (ISS), urged votes against at less than 13% of 1,817 annual meetings. Investors have come to view a vote against board pay policies as an option of near-last resort. Just 64

companies out of 596 reporting voting results between 2002 and 2007 experienced combined dissent ('no' votes plus abstentions) of more than 20%, according to Deloitte.

2. *While top executive pay in the UK continues to exceed inflation and average workforce wage increases, advisory votes have been an important contributing factor in taming the rate of increase, curbing opportunities for 'pay for failure', and linking compensation dramatically closer to performance.* As elsewhere, fuller disclosure of compensation in Britain has proven a contributing factor in rising pay levels among top executives. Advisory votes do not appear to have reversed that trend. Absolute numbers continue to climb, though at a more measured pace (the average annual increase has slowed in the last four years to between 5 and 10%, say various sources). However, advisory votes are credited by virtually all parties with producing "dramatically better alignment between incentive pay and shareholder value." For instance, the latest Deloitte study concluded that the level of variable pay has increased significantly with meaningful performance conditions attached to incentive compensation. Stock option plans are being replaced by share grants tied to significant performance triggers advocated by shareholder bodies. Payouts for average performance have dropped significantly in response to investor pressure. New limits cap the amount of options any one executive may be granted. Golden parachute packages, swelled to three times final salary before a drive to curb them began in 1999, have steadily shrunk to the equivalent of one year's wage. The quality of reporting on pay has improved substantially. In short, "the level of transparency and disclosure and explanation today can't be compared to before," contends one service provider.

3. *Advisory votes are seen by government as having succeeded not only in handing investors a voice on compensation, but in contributing to the competitiveness of the British economy and the attraction of London as an international capital market.* British lawmakers may have initiated advisory votes "as a negative push to correct scandals on pay," asserted a key official the UK Department of Trade and Industry (DTI), the agency which crafted and now oversees 'say on pay' legislation. But London now perceives them as part of strategic measures that "enhance the competitiveness of the UK economy." The DTI has concluded that advisory votes result in "better planning by corporations, fewer surprises, better dialogue with investors." They are "a prophylactic against poor management," the official said in an interview, keeping UK companies in fighting trim. Advisory votes are among "appropriate steps to reduce risk…and we have had no big scandals among quoted companies" in recent years. Public authorities and the London Stock Exchange have touted the UK corporate governance regime, including

'say on pay' voting rights, as equipping the City with a competitive edge for attracting capital, especially in comparison to New York. Echoing that perspective, four of the world's largest funds recently wrote to the Securities and Exchange Commission asking for advisory votes to expand shareholder rights and, thereby, to improve the attraction of the US for foreign capital.

4. *Corporate board compensation committees have retooled the way they design and communicate about executive pay plans so as to draw support from institutional shareholders.* Before advisory votes came into force, the typical compensation committee had to produce a package aimed at persuading the board. After advisory votes, the board compensation committee had to design packages capable of persuading shareholders. The difference has proven significant. Pay panels now meet more frequently; engage in design-stage consultation with key investors, investor trade organizations and/or proxy service advisors; utilize more information; and hire more independent outside advice. Directors "demonstrate more awareness that their work will be subject to broad scrutiny" and are "more diligent" about crafting policies that allow them "to defend decisions taken," according to corporate secretaries at a Yale roundtable in London. Moreover, compensation committees "are much more constrained" in shaping generous severance terms, since UK shareholder guidelines on CEO employment contracts are prescriptive and relatively strict. Chairs of compensation committee, in particular, have welcomed advisory votes as they supply leverage in standing up to potential insider pressure. However, corporations are on a learning curve. Some initiate early, high-level dialogue with investors and produce fulsome disclosure documents considered best in class. Others make only token efforts at consultation and rely on boilerplate in reporting.

5. *Institutional investors have stepped up scrutiny of executive pay packages but continue to search for effective methods of monitoring compensation.* "There is no question that investors changed dramatically after introduction" of advisory votes, observed one market player in Britain. Before them, institutions generally devoted fewer resources to systematic analysis of compensation structures except in egregious cases brought to special attention through media or other circumstances. The onset of universal voting on pay at FTSE All-Share companies generated fresh demands on both the time and skills of fund professionals as corporate boards sought input on plans, and as complex incentive policies required analysis for ballot decision-making. Funds have experienced mixed success in facing challenges posed by the introduction of advisory votes. Some funds responded by relying almost entirely on outsourced agents, the proxy advisory services, to conduct

such analysis and consultation. Leading funds, however, sought to participate directly in engagement with companies over pay practices. They report having had striking success in persuading boards to tie incentive pay directly to performance. However, institutional investors also worry that they have entered into something of an arms race, where they are struggling to match expertise with corporations' remuneration consultants who produce ever more complex arrangements. Said one investor: "we risk getting lured into tweaking; of thinking we've achieved objectives when we might be missing the big picture." UK funds are only beginning debate about whether to ease their own prescriptive guidance on pay practices in favor of broader principles that can be adapted to individual companies. They are also assessing at what level of detail they must engage when reviewing compensation plans.

6. *Advisory votes have proven particularly effective in a context of measures that provide for substantial board accountability.* Advisory ballots on compensation appear to carry particular weight in the UK because of a related power. Investors retain authority under corporate law to oust directors by majority vote. If members of a remuneration committee fail to be responsive to shareholder concerns over pay policies, investors have the real, but rarely exercised, option in an annual meeting—or by a mid-term special meeting—of supporting their ejection from a board. Therefore, directors choosing to ignore significant dissent in an advisory ballot face the risk of practical consequences. The 'teeth' of majority rule may be seen as another reason why both corporations and investors in Britain have come to endorse the concept of advisory votes on pay. Boards see the measure as a way of channeling dissent away from elections so that members can isolate and resolve a specific problem over pay rather than risk stinging levels of opposition, or outright defeat, for a director candidate. For their part, investors back votes of confidence on remuneration because the tool allows them to register dissent over pay without exercising their power to overthrow board members they might otherwise support.

7. *Providers of proxy analysis and recommendation services have found their role enhanced.* Investment funds in Britain expect proxy service providers affiliated with their trade associations to vet remuneration plans with companies and to engage in dialogue with boards in search of improvements before plans are finalized. Other funds appear to rely on service providers solely for guidance in voting. Either way, market concerns center on two questions: First, whether too many investors follow service provider voting advice automatically and, second, whether such providers apply a "one-size-fits-all" framework instead of evaluating compensation plans according to a company's specific circumstances. The services themselves have

confronted other challenges. They experienced intense new demands on internal resources in the wake of advisory votes on compensation. Ventures providing recommendations had to re-examine guidelines on pay as such best-practice advice now related directly to a voting item. The two most influential UK services (ABI's IVIS and the NAPF's RREV, owned by Institutional Shareholder Services) reported a substantial rise in outreach by corporate boards and representatives, such as compensation consultants. Services faced needs to improve the sophistication of their analysis of compensation packages.

It follows from the observations above that 'say on pay' is a demonstrated propellant of healthier corporate-shareholder relations with a meaningful record of strengthening performance links to CEO compensation. Further, insights from the UK experience illuminate variables US players should address in the course of Americanizing advisory votes on pay. Some involve legislation; others adaptation of market practices. Among them:

- Advisory votes on pay are best introduced on a legislative basis. The history of UK experience before votes on pay became law makes clear that companies already engaged in market-leading pay practices tended to be early voluntary adopters. But companies deemed most in need of greater accountability shunned the tool, despite significant government and investor pressure.

- Advisory votes are constructive in and of themselves. However, they can reach their full potential when operating at companies which conduct director elections according to the majority vote standard. Ongoing efforts to install majority voting as the electoral standard at US companies can be an important parallel development in the drive to better align executive pay with performance.

- Corporate boards can readily develop effective proactive strategies to secure investor loyalty in advisory votes. New SEC disclosure rules on pay are more comprehensive than those in Britain. Compensation committees can oversee design-stage consultation exercises with investors and/or their agents, and road shows on pay policies in advance of the annual meeting.

- Investors can prompt entities such as the Council of Institutional Investors to develop advanced collective guidance on best-practice compensation principles.

Thank you for the opportunity of contributing to the debate over advisory votes. Please do not hesitate to contact me should you have any questions or comments, or if the Millstein Center can be of any further assistance. We will of course provide the Committee with the full white paper report when it is completed. I look forward to answering your questions.

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