

SAY-ON-PAY: CAUTIONARY NOTES ON THE USE OF THIRD PARTY COMPENSATION GUIDELINES IN THE UNITED STATES

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ABSTRACT

Outrage over executive compensation practices has fueled calls to increase shareholder participation in the executive compensation process. Beginning January 20, 2011, the Dodd-Frank Act mandates shareholders receive nonbinding, advisory votes on the compensation of executives and any “golden parachutes” provided to executives.¹ However, the say-on-pay provisions of Dodd-Frank remain problematic, particularly in light of the United Kingdom’s experience with similar provisions. Despite greater disclosure of executive compensation plans, many shareholders continue to lack the incentives and ability to accurately evaluate the information given to make an informed decision regarding whether executive pay is reasonable.

The U.K.’s experience additionally generates a new concern: a third party certifier stepping into the say-on-pay process. In the U.K., two large institutional investors have put forth best practices guidelines for compensation, and shareholder approval hinges on whether the proposed plan complies with these guidelines. There is some concern that similar groups in the U.S. will take on the role of third party certifier with their own executive compensation guidelines. The risk with such guidelines is that power would vest in a select few groups that have incentives to collude with boards and/or have goals that do not maximize overall shareholder value.

Two proposals may alleviate these concerns. The first would require disclosure of executive pay to comparable firm executives to give shareholders a sense of the “market value” of executive pay. The second would encourage the creation of best compensation principles that better encapsulate what reasonable executive compensation should be. With one of these proposals in place, shareholders may make better use of the say-on-pay provisions such that only truly excessive pay is targeted and corporations may still properly tailor executive compensation packages to their CEOs.

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010) (to be codified at 15 U.S.C. § 78n-1).

I. INTRODUCTION

Executive compensation practices have raised citizen ire perhaps more than anything else in corporate governance—2006 proposals by the Securities and Exchange Commission (SEC) to increase executive compensation disclosure generated more than 20,000 comments and more interest than any other proposal in the SEC’s history.² As a result of those growing concerns, shareholders have now gained a new bargaining chip in the continuing fight over executive compensation: say-on-pay votes. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), shareholders now must receive a periodic advisory vote on executive compensation plans (say-on-pay).³ While the vote is nonbinding, its results still carry a significant message to the board and to the market. Even though the vote is based on the extensive executive compensation disclosure provided to shareholders,⁴ Dodd-Frank does little to identify what the disclosed information means in the market at large.

This Note unfolds in five parts. Part I briefly discusses past efforts to rein in excessive executive compensation and identifies what Dodd-Frank now mandates with regard to executive compensation. Part II then details the results of similar efforts in the United Kingdom. However, such schemes still manifest a number of problems as identified in Part III. One issue that has arisen in the U.K. is that two “certifying agents” have dominated the conversation on executive compensation, and Part IV considers the likely entities in the U.S. to take on such a role. Any form of guidelines overtaking the conversation of executive compensation in the United States is troubling because of special interest involvement and related conflicts of interest. Part V then suggests two potential solutions to these problems in the new say-on-pay regime: (1) mandating that executive compensation disclosures include data on pay given to top executives at peer firms, and (2) mandating that all actors in the process, including the SEC, cooperate to create nonbinding compensation principles to guide shareholders in exercising the say-on-pay vote.

A. *Past Efforts to Curb Excessive Executive Compensation*

The provisions of Dodd-Frank are only the latest in a long line of efforts to curb excessive executive compensation. Many of the efforts have centered on more closely tying executive compensation to the performance or conduct of the company. For example, since 1992 ex-

2. Christopher Cox, Chairman, SEC, Address to the New York Financial Writers Association (June 8, 2006), *available at* <http://sec.gov/news/speech/2006/spch060806cc.htm>.

3. § 951, 124 Stat. at 1899-1900.

4. 17 C.F.R. § 229.402(a)(2) (2010) (calling for tabular disclosure “of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers”).

executive compensation of more than one million dollars per year is not tax deductible unless it is performance-based.⁵ Top executives may face clawbacks⁶ of bonus or incentive payouts if their firm engages in certain accounting misconduct under the Sarbanes-Oxley Act of 2002.⁷ Some efforts have sought to distance the board of directors from determining manager pay; for example, stock exchange listing rules require the creation of a compensation committee comprised entirely of independent directors to focus specifically on CEO compensation.⁸

Other efforts have focused on increasing shareholder awareness of their company's executive compensation practices. SEC Regulation S-K Item 402 is the current executive compensation disclosure mechanism, wherein corporate boards report the amounts of compensation their top executives make. This is also the information shareholders will consider when exercising their say-on-pay vote under Dodd-Frank. In Item 402, the corporate board must report all compensation given to its top five executives.⁹ Item 402 includes the Compensation Disclosure and Analysis (CD&A), which "is intended to be a narrative overview that puts into context the executive compensation disclosure provided elsewhere in response to the requirements of Item 402."¹⁰ In the CD&A, the board must "[d]iscuss the compensation awarded to, earned by, or paid to the named executive officers," including "all material elements" of the compensation.¹¹ Such material elements include the company's compensation program objectives, why the company chooses to pay each element, how each amount or formula is determined, and the structure of long-term and short-term compensation and how they relate to the company's performance.¹² The CD&A was created with the intended goal of rousing

5. Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 280-81 (1999).

6. A "clawback" has been defined broadly to mean a method "for recovering benefits that have been conferred under a claim of right, but that are nonetheless recoverable because unfairness would otherwise result." Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 371-72 (2009); see also *id.* at Part I (discussing clawback provisions in the context of excessive executive compensation).

7. Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002) (codified at 15 U.S.C. § 7243(a) (2006)). However, the benefits of their use have been somewhat limited. See Jeffrey N. Gordon, "Say on Pay": *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323, 334 & n.41 (2009).

8. Gordon, *supra* note 7, at 335; see, e.g., THE NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.05, http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=/lcm/sections/lcm-sections/ [hereinafter NYSE LISTED COMPANY MANUAL].

9. See § 229.402(a)(3).

10. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010, 6015 (Feb. 2, 2011).

11. § 229.402(b)(1).

12. *Id.* § (b)(1)-(2).

shareholder reactions to the firm's executive compensation policies,¹³ including "private shareholder interventions with management and directors, precatory resolutions, and 'withhold vote' campaigns against compensation committee directors."¹⁴

However, more direct shareholder participation through votes on pay has also grown. Under the New York Stock Exchange rules, shareholder approval has been required for equity-based compensation plans since 2003.¹⁵ A number of companies, including AFLAC, Verizon Communications, and Hewlett-Packard, have already agreed to advisory shareholder votes on executive compensation.¹⁶ Further, financial firms receiving federal bailout money are required to provide shareholders with say-on-pay votes and abide by certain limits on executive salary.¹⁷

Whether shareholders deserve this greater role in the process is the subject of much debate. The ever-increasing amount of executive compensation is arguably already tied to shareholder pressure, as the increase in stock option components of compensation plans resulted from calls for executive pay to be more closely tied to shareholder returns.¹⁸ Some blame the heavy hitter shareholders—the institutional investors. "Short-termism . . . is bred in the trading rooms of the hedge funds and professional institutional investment managers who control more than 75% of the shares of most major companies."¹⁹ Say-on-pay provisions may very well increase shareholder power and further encourage the same "[s]hort-termist pressure" that contributed to the excessive executive compensation practices complained of today.²⁰

However, if one assumes the problem of excessive executive compensation exists, there is also evidence to suggest increased shareholder power works: companies targeted with shareholder proposals tend not to increase CEO pay the next year as much as comparable

13. See Gordon, *supra* note 7, at 337-38; see also, e.g., Cox, *supra* note 2.

14. Gordon, *supra* note 7, at 338.

15. NYSE LISTED COMPANY MANUAL, *supra* note 8 § 303A.08.

16. Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does It Create Value?* 46 J. FIN. & QUALITATIVE ANALYSIS 299, 304 (2011).

17. Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay—Firms that Get Bailout Funds Face \$500,000 Salary Cap, Must Disclose Luxury Purchases; A Move to 'Claw Back' Bonuses*, WALL ST. J., Feb. 5, 2009, at A.1.

18. Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 8 (2000).

19. Martin Lipton et al., *A Crisis is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake 1* (May 12, 2009) (unpublished manuscript), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16657.09.pdf>.

20. *Id.*; see also *id.* at 3 (opining that proposals to enhance shareholder power are "a serious mistake, especially when the government has done nothing to either encourage (or require) that money managers—the real 'stockholders' today—think and act on a long-term basis").

firms untargeted by such proposals.²¹ At the very least it would appear such increased shareholder power provides some benefit. In a 2007 study, Professors Cai and Walkling found that the U.S. House of Representatives' passage of a say-on-pay bill resulted in a positive market reaction for firms with the most highly paid executives.²²

B. *Dodd-Frank and SEC Regulations*

The Dodd-Frank Act, a massive overhaul of financial regulations in the U.S., was passed July 15, 2010.²³ Under Dodd-Frank, executive compensation will be submitted to a mandatory, nonbinding advisory vote by shareholders at least once every three years.²⁴ Additionally, a "say-on-frequency" vote will be implemented at least once every six years in which shareholders will decide whether the say-on-pay vote will occur every one, two, or three years.²⁵ Moreover, under the recently adopted SEC regulations authorized by Dodd-Frank, the CD&A will be expanded to include how the company previously considered shareholder advisory votes and how those votes have impacted compensation practices.²⁶

In addition to the say-on-pay vote for regular executive compensation, golden parachutes will be subject to shareholder vote. In proxy materials asking shareholders to approve an acquisition, merger, consolidation, or sale of all or most of the assets of the company, the proxy must disclose any agreements with executive officers concerning any compensation that relates to the acquisition, merger, consolidation, or sale.²⁷ Such agreements are then submitted to the shareholders for a nonbinding, advisory vote to approve or disapprove such an arrangement.²⁸

Dodd-Frank also provides further rules to increase the independence of compensation committees and compensation consultants.²⁹

21. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1022 (1999). The composition of executive compensation in the year after such a proposal "shifts toward more cash, and less long term incentive compensation," though the study found that this change was not statistically significant. *Id.*

22. Cai & Walkling, *supra* note 16, at 18.

23. Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST, July 16, 2010, at A01.

24. Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (to be codified at 15 U.S.C. § 78n-1).

25. *Id.*

26. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010, 6043 (Feb. 2, 2011) (to be codified at 17 C.F.R. § 229.402(b)(1)(vii)).

27. § 951, 124 Stat. at 1899-1900.

28. *Id.* at 1900.

29. See Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900-01 (2010) (to be codified at 15 U.S.C. § 78j-3); see also *infra* Part IV.C on the problems identified with compensation consultants, including various conflicts of interest.

Pursuant to Dodd-Frank, the compensation committees of public companies must be composed solely of persons who are “independent” and members of the board of directors.³⁰ The SEC in defining “independence” must require the securities exchanges to consider the source of the committee member’s compensation (including any consulting fees received from the committee’s firm) and whether the member is an affiliate of the company or its subsidiaries.³¹ Furthermore, if the compensation committee uses consultants or other advisors, the independence of the consultants must also be evaluated. The SEC must identify by rule the factors that will affect the independence of consultants, including the extent to which the consultant’s firm provides other services to the committee’s company and the amount of fees received by the consultant’s firm for such services.³² Companies must then disclose in their annual proxy statements whether the compensation committee retained a compensation consultant, the existence of concerns over consultant conflicts of interest and, if any exist, how the company addressed those concerns.³³

II. THE UNITED KINGDOM’S EXPERIENCE WITH SAY-ON-PAY

While not an exact approximation of what will happen in the U.S., it is useful to consider the U.K.’s experience with say-on-pay. In 2002 the U.K. adopted similar provisions regarding a firm’s executive compensation practices.³⁴ This legislation expanded disclosure beyond the requirements of London’s stock exchange and required an advisory shareholder vote on the Directors Remuneration Report, a company’s disclosure report of executive compensation.³⁵ A few high-profile negative votes have occurred; for example, GlaxoSmithKline’s shareholders rejected a large golden parachute (estimated by shareholders at \$35 million) for the firm’s CEO.³⁶ In the main, however, U.K. “shareholders invariably approve the Directors Remuneration Report,” with only eight reported negative votes since say-on-pay’s implementation.³⁷ Furthermore, executive compensation in the U.K. has

30. § 952, 124 Stat. at 1900.

31. *Id.* at 1901. The SEC has authority, however, to establish exemptions for certain kinds of committee member/company relationships in consideration of factors such as the firm’s size. *Id.*

32. *Id.* The Act does affirm that the decision of whether to retain compensation consultants is within the sole discretion of the compensation committee. *Id.* at 1901-02.

33. *Id.* at 1902.

34. Gordon, *supra* note 7, at 338. Similar rules were adopted in Australia, the Netherlands, Norway, and Sweden. Fabrizio Ferri & David Maber, Say on Pay Vote and CEO Compensation: Evidence from the UK 1-2 (June 2008) (unpublished manuscript), <http://69.175.2.130/~finman/Reno/Papers/FMASayOnPay.pdf>.

35. Gordon, *supra* note 7, at 338 n.56.

36. Gautam Naik, *Glaxo Holders Reject CEO’s Compensation Package*, WALL ST. J., May 20, 2003, at D8.

37. Gordon, *supra* note 7, at 341.

continued to increase, though some evidence indicates that boards' sensitivity to executive pay increased for its arguable targets: firms with excessive compensation or otherwise controversial pay practices.³⁸

Shareholder approval flows in part from the influence of the U.K.'s two largest shareholder groups: the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).³⁹ ABI and NAPF have exercised this influence through the creation of compensation guidelines,⁴⁰ which build on the best practices in the U.K. Corporate Governance Code.⁴¹ The basis of the shareholders' vote often hinges on whether the proposal complies with these guidelines.⁴²

The influence of these groups cannot be understated. "Because of the dominance of those two actors, . . . [t]he tendency for firms to 'herd' in their compensation practices is very strong: follow the guidelines, stay in the middle of the pack, and avoid change from a prior year, when the firm received a favorable vote."⁴³ As a result, U.K. firm compensation practices have aimed for compliance and "stasis rather than innovation."⁴⁴ In evaluating the study of Professors Ferri and Maber on the U.K.'s experience with say-on-pay, Professor Gordon notes, while there is evidence that pay decreases as performance declines, "there is no evidence of the reverse. . . . If that is the result of a shareholder advisory vote, it seems an odd way to build a system that relies on entrepreneurial energy and the risk of failure."⁴⁵ Also concerning is the impact the say-on-pay regime may have had on CEO pay at the largest firms. "Since pay generally increases with the size of the firm, this suggests that [the U.K.'s say-on-pay] may have produced a decrease in the rate of compensation growth where pay was on average the highest" and "most visible," regardless of firm performance.⁴⁶

However, Ferri and Maber, in their own study, suggest that say-on-pay in the U.K. has had positive effects, with higher sensitivity to pay "most[] concentrated . . . in firms experiencing substantial voting dissent" against executive pay and "in firms characterized by 'exces-

38. *Id.*

39. Ferri & Maber, *supra* note 34, at 29.

40. *Id.*; see also, e.g., ASS'N OF BRITISH INSURERS, EXECUTIVE REMUNERATION—ABI GUIDELINES ON POLICIES AND PRACTICES (2009), available at <http://www.ivis.co.uk/ExecutiveRemuneration.aspx>.

41. See FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE 22-24 (June 2010), http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf.

42. Gordon, *supra* note 7, at 344.

43. *Id.* at 347.

44. *Id.* at 348.

45. *Id.* at 345 (citing Ferri & Maber, *supra* note 34).

46. *Id.* at 346.

sive' CEO pay" prior to say-on-pay's adoption.⁴⁷ Arguably, this means say-on-pay's effects were most pronounced for its intended targets: firms that were providing excessive executive compensation.⁴⁸ An updated study conducted by Ferri and Maber also confirms that say-on-pay votes have been used to successfully reduce rewards for failure.⁴⁹ However, as Ferri and Maber note, their findings rest on the assumption "that *on average* shareholders are able to identify sub-optimal compensation practices and recommend superior alternatives," an assumption they agree is up for debate.⁵⁰

However, transplanting the impact of say-on-pay in the U.K. into the U.S. is imperfect due to the differences between the systems.⁵¹ These differences likely allow for a stronger, more concentrated power exercised by U.K. institutional investors. While power is not as concentrated in the U.S., as discussed in Part IV, three groups are likely to take on the roles of the ABI and NAPF in a say-on-pay regime in the U.S. However, due to the recurring problems in any say-on-pay scheme, shareholders may need some aid in appropriately exercising their say-on-pay vote.

III. CONTINUING PROBLEMS

While say-on-pay has had positive benefits in the U.K., the concerns that have always plagued the shareholder-board power structure remain. These problems must be addressed before say-on-pay can have a beneficial impact on executive compensation practices in the U.S.

A. *The Agency Problem*

In negotiating CEO compensation, the consensus view in the U.S. has been that the board of directors should serve as the shareholders' agent.⁵² Under the shareholder primacy theory, shareholders are the

47. Ferri & Maber, *supra* note 34, at 2-3. "Excessive" to Professors Ferri and Maber means "excessive relative to [the pay's] predicted value based on economic determinants," separate from "high raw CEO pay." *Id.* at 3.

48. *Id.* at 3-4.

49. Fabrizio Ferri & David Maber, Say on Pay Votes and CEO Compensation: Evidence from the UK 4 (2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1420394>.

50. *Id.* at 4-5.

51. There are a number of differences, but a few are notable for purposes of this Note. Overall, the U.K. is more concerned with empowering shareholders, while the U.S. focuses on making the board of directors more independent. Gordon, *supra* note 7, at 349-50. Ownership also differs. Unlike the U.S., where corporations are "owned" by the shareholders, U.K. corporations are owned by institutional investors rather than retail investors. *Id.* at 349. Institutional investors in the U.S. are also greater in number and more diverse than in the U.K. *Id.* at 351.

52. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248 (1999).

principals while managers and directors are the shareholders' agents tasked with running the corporate firm.⁵³ In setting executive compensation, the board of directors must serve four goals often in conflict: (1) reward the executive for prior success; (2) provide incentives for future success; (3) keep and attract managerial talent; and (4) "align managerial and shareholder interests."⁵⁴ However, a structural bias exists whereby directors often defer to the wishes of managers.⁵⁵

For advocates of increased shareholder voice in setting executive compensation, "the objective is not to substitute the shareholders' business judgment for the board's, but rather to buttress boards' independence-in-fact by making them more accountable" to their principals.⁵⁶ The concern remains that even the independent compensation committee may be captured by compensation consultants.⁵⁷ Say-on-pay may alleviate these problems to some extent, giving shareholders a more direct way to express their dissatisfaction with the actions of their agents in setting executive pay. However, as discussed in Part IV, some shareholders may have goals other than maximizing overall shareholder value, and these shareholders may wield the say-on-pay vote as a weapon to force the board to bend to their will. Furthermore, increasing shareholder voice in compensation practice may actually jeopardize the board's role as agent: shareholders have designated the board as the ultimate decisionmaker, and say-on-pay votes—where there is relatively little cost for a shareholder to make an uninformed decision—undermine the board's authority to make decisions regarding compensation.

While the vote is again nonbinding, it has important implications for the board. As a result, the board will take the vote seriously, while shareholders may not take it seriously enough due to the problems discussed next. At the heart of the agency problem is another: the very informational asymmetry that necessitates creation of the agency continues to exist under a say-on-pay regime and may further frustrate the goals of say-on-pay.

53. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power 2* (UCLA Sch. of Law, Law & Econ. Research, Paper Series No. 05-16, 2005), available at <http://ssrn.com/abstract=783044>.

54. Gordon, *supra* note 7, at 329.

55. Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 335 (2009) (noting that this structural bias may exist for a number of reasons, including the idea that directors may be beholden to corporate officers for their jobs).

56. Gordon, *supra* note 7, at 337.

57. *Id.* at 336. *But see* Brian Cadman et al., *The Incentives of Compensation Consultants and CEO Pay*, 49 J. ACCT. & ECON. 263 (2010) (investigating and finding little evidence to support the proposition that compensation consultants' cross-selling of other services to firms has resulted in increased executive compensation packages).

B. Informational Asymmetries

As with most decisions facing shareholders, an informational asymmetry exists between the information held by the corporate board and the information held by the shareholder. Increased disclosure regarding a firm's executive compensation practices does not mean shareholders have all the necessary information or the ability to adequately process that information to make an informed decision in a say-on-pay vote.⁵⁸

First, the extensive disclosure as described in Part II.B does not provide all the necessary information to make an informed decision. Most importantly, it does not give shareholders a sense of the market for corporate executives. "[T]he 'market price' for a CEO is hardly self-defining, since the market for senior managerial services has no posted prices—hence the hunt for comparators."⁵⁹ In individual cases, executive compensation often becomes simply whatever results from the bargaining process between the firm and the executive.⁶⁰ In the absence of "comparators," it is understandable why shareholders may not be able to adequately assess the reasonableness of corporate pay.

Also contributing to the difficulty is the complexity involved in compensation plans.⁶¹ Many shareholders must attempt to understand the package before them without expert help.⁶² Moreover, shareholders must understand whether the package is *right for their firm*—this would require knowledge of alternative compensation plans or again, expert help. The same hindrances for any shareholder vote also exist—the benefits from gathering more information to make an informed vote will be relatively small, even for large investors.⁶³ Their efforts may be awarded with only a pro rata share of the gains, and other shareholders may free ride off their research efforts. Interestingly, shareholders are more supportive of proposals that simply restrict executive compensation than proposals to increase

58. Many academics have questioned the net benefits of mandated disclosures. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 687-92, 709-15 (1984) (finding little evidence that increased disclosure requirements by the SEC has resulted in any significant benefit to investors). Even with increased disclosure, shareholders may still have limited incentives to ensure they exercise their decision appropriately. See Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1057-65 (1998) (identifying conflicting interests and disparity of access to information of corporate constituents and finding shareholders may still lack the incentives necessary to make sound decisions on either operational or policy questions).

59. Gordon, *supra* note 7, at 335.

60. *Id.*

61. Thomas & Martin, *supra* note 21, at 1033.

62. *Id.* Even the Disney corporate board required the assistance of an executive compensation consultant to understand the terms of the infamous Michael Ovitz compensation package. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 38 (Del. 2006).

63. See Thomas & Martin, *supra* note 21, at 1034.

disclosure.⁶⁴ This has serious implications for the say-on-pay vote: perhaps shareholders will simply look at the compensation disclosed and vote dependent upon whether it represents a decrease or increase as opposed to considering the information disclosed on why the pay is reasonable or necessary.

This informational asymmetry may not exist as prominently for institutional investors, who are typically sophisticated in corporate governance affairs.⁶⁵ However, even for these investors, certain information may be missing from their evaluation in a say-on-pay vote. The most helpful information, to both individual and institutional shareholders, may be a comparison of the applicable firm's compensation package with other similar firms' pay packages. As far as Dodd-Frank and its accompanying SEC regulations go, this information is not included, but it may be a worthwhile disclosure to aid all shareholders in making good use of their say-on-pay vote.⁶⁶

1. *Misuse of Signals*

As it stands now, shareholders (even institutional ones) lack the necessary information and require aid to make sense of the compensation disclosure before them in a say-on-pay vote. This asymmetry must be overcome to ensure the say-on-pay vote is a credible signal to the market.

Say-on-pay, while nonbinding, acts as a threat: if executive compensation is too high in the minds of shareholders, shareholders will vote to disapprove the plan. The threat attached to an adverse voting outcome will likely include reputational costs to the board associated with negative public opinion.⁶⁷ As former SEC Chairman Christopher

64. See, e.g., *id.* at 1022 (“[S]hareholders statistically are more likely to support executive compensation proposals that attempt to restrict executive compensation than they are proposals that simply ask for more disclosure about executive compensation.”).

65. See K.A.D. Camara, *Classifying Institutional Investors*, 30 J. CORP. L. 219, 223-25 (2005) (finding that while institutional shareholders face the same informational obstacles to voting as individual shareholders, institutional investors are better able to overcome those obstacles). However, despite their ability to better participate in corporate governance, institutional investors may have motives other than general shareholder wealth. See generally *id.*; see also *infra* Part IV.B.

66. See *infra* Part V.

67. See Ferri & Maber, *supra* note 34, at 9; see also Diane Del Guercio et al., *Do Boards Pay Attention when Institutional Investor Activists “Just Vote No”?*, 90 J. FIN. ECON. 84, 85 (2008) (finding that directors that ignore “just vote no” campaigns suffer reputational penalties in the direct labor market); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 865-66 (1993) (while advisory votes are symbolic, symbols can have consequences through negative publicity and embarrassment). But see John E. Core et al., *The Power of the Pen and Executive Compensation*, 88 J. FIN. ECON. 1, 1 (2008) (finding that press coverage focuses on firms with higher excess compensation and greater executive stock option exercise but also finding “little evidence that firms respond to negative press coverage by decreasing excess CEO compensation or increasing CEO turnover”).

Cox once noted, executive compensation reform depends in significant part upon business and financial journalists' continuous scrutiny of corporate boards.⁶⁸ Shareholders, through this nonbinding vote, send a signal to the board, the media, and the market of either satisfaction or dissatisfaction with current compensation practices. Similarly to "just vote no" campaigns, this negative publicity then requires corporate boards to act to improve their reputation in the eyes of the public.⁶⁹ A negative say-on-pay vote may also send a signal to the market for corporate control that this firm is susceptible to a hostile takeover.⁷⁰ Further, a negative vote may also hurt directors' reputations in the corporate labor market.⁷¹ If the say-on-pay vote is an uninformed one (and one that votes against a good pay plan), then it is being misused and represents a noncredible threat. Due to shareholders' inability to appropriately use this threat, an incorrect signal (the firm's executives are unworthy of their compensation when in fact they are) may be sent, and the market will dangerously react to inaccurate information.

Some shareholders may use a say-on-pay vote as a threat unrelated to executive compensation and the motives underlying say-on-pay. There is no true unified shareholder group; shareholders have divergent interests and some of those interests (those of hedge fund investors, for example) may not be in the long-term interest of the firm.⁷² Instead of using the say-on-pay vote to signal dissatisfaction with executive compensation, certain large shareholders may wield the threat of an embarrassing say-on-pay vote to gain significant bargaining power to pursue objectives that may not serve the interests of the other shareholders.⁷³

68. Cox, *supra* note 2 (The success of the new SEC regulations "largely depend[s] upon business and financial journalists for its success. The degree to which [the media] publicize[s] this new information . . . will have a significant influence on corporate governance in general.").

69. See Grundfest, *supra* note 67, *passim*.

70. See Anabtawi, *supra* note 53, at 8.

71. See, e.g., Yonca Ertimur et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 54 (2010) (finding that a corporate board's implementation of a nonbinding, majority-vote shareholder proposal is associated with a reduction in the probability of director turnover and a "reduction in the probability of losing directorships held in other firms").

72. See, e.g., Anabtawi, *supra* note 53, at 4 (arguing against the conception of shareholders as "a monolith with a single, overriding objective—maximizing share value").

73. Gordon, *supra* note 7, at 362. Professor Gordon also notes:

The question is, what are the checks and constraints? In the United Kingdom, these checks have historically arisen from a pattern of repeat interactions among a relatively small number of institutional investors of similar long-term payoff horizons concentrated geographically in London. In other words, behavior can be observed, and reputations gained or lost.

Id. (footnote omitted). That may not be the same in the U.S. See *id.* at 362-63.

Again, the nonbinding nature of a say-on-pay vote does not undercut its real impacts. In Ferri and Maber's study of the U.K.'s say-on-pay regime, most firms experiencing high voting dissent responded by deleting controversial pay provisions—even firms with low voting dissent proactively removed controversial provisions before the vote.⁷⁴ This may seem positive, but the implicit incentives attached to advisory votes may have simply resulted in directors pandering to shareholders and implementing suboptimal pay practices.⁷⁵

Hence, a condition for credible say-on-pay votes is that shareholders must “have the ability to discriminate between high-quality and low-quality compensation plans.”⁷⁶ Further, shareholders should only use the say-on-pay vote as a signal with regard to executive compensation practices. Otherwise, shareholders are misusing the signal of say-on-pay and jeopardizing the reputation of the corporate board and the firm. As discussed in the next section, shareholders may turn to a third party certifier to distinguish the good from the bad.

2. *Adverse Selection, Certification, and Herding*

An adverse selection problem arises because shareholders do not have the ability to distinguish the high-quality compensation plans from the low-quality compensation plans. This problem results both from a lack of necessary information and a lack of the ability to process the information disclosed. Something similar to a warranty may aid in that distinction; in the U.K. that warranty has been given by compensation guidelines promulgated by two institutional investors. These guidelines reduce costs for shareholders because they reduce the costs of verifying and processing the disclosure information before them in a say-on-pay vote.

However, the result of using a third party certifier may cement the “one size fits all” approach to executive compensation now found in the U.K. With a lack of information as to what a reasonable pay package is, firms may be overly cautious and seek the “middle-of-the-road” compensation plans approved by the guidelines.⁷⁷ In the con-

74. Ferri & Maber, *supra* note 49, at 33.

75. See generally, e.g., Ravi Singh, *Board Independence and the Design of Executive Compensation* (Harvard Bus. Sch. Negotiations, Organizations & Markets Unit, Working Paper No. 673741, 2006), available at <http://ssrn.com/abstract=673741> (arguing that corporate boards which are most responsive to shareholder pressure often engage in costly measures to appear more independent of management).

76. Ferri & Maber, *supra* note 34, at 9-10.

77. See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 28 (2002) (“Herding . . . can be a response to bounded rationality and information asymmetries. Under conditions of complexity and uncertainty, actors who perceive themselves as having limited information and who can observe the actions of presumptively better-informed persons may attempt to free ride by following the latter’s decisions.”).

text of merger guidelines in antitrust cases, “guidelines [have] become [unjustly] valued for more than the persuasive power of their ideas.”⁷⁸ In this context, the guidelines’ legitimacy increased even though their legitimacy had not been established, and often decisionmakers explained or reconciled their rulings with the guidelines after the fact.⁷⁹ Generally, any “standardization” may limit innovation.⁸⁰ This institutionalization effect has already been felt in the U.K., resulting in a “herding effect” by which applicable companies are using the compensation guidelines of ABI and NAPF to create their compensation packages.⁸¹ To receive an approving say-on-pay vote, companies effectively must comply with the guidelines.⁸² The fact that so few plans have been disapproved in the U.K. does not necessarily counsel against this concern; “[i]t is an even greater concern that the implementation of the guidelines may establish a standardized form of compensation practice across an entire economy.”⁸³

IV. LIKELY SOURCES FOR GUIDELINES IN THE UNITED STATES

In the U.S., several entities are heavily involved in the executive compensation process, and some have already put forth executive compensation guidelines. All of the groups discussed below have conflicts of interest when it comes to executive compensation; these conflicts should be addressed before any one group has significant sway over the say-on-pay vote. Dodd-Frank only attempts to address conflicts of interest for one of these groups, compensation consultants.

A. Proxy Advisory Firms

In the U.S., corporate governance decisionmaking is often delegated to proxy advisory firms, a market whose growth has been partially fueled by the increase in institutional investor holdings because institutional investors are the primary consumer of these services.⁸⁴ The most prominent is Institutional Shareholder Services/RiskMetrics Group, Inc. (ISS).⁸⁵ ISS advises on half the world’s

78. Hillary Greene, *Guideline Institutionalization: The Role of Merger Guidelines in Antitrust Discourse*, 48 WM. & MARY L. REV. 771, 776 (2006).

79. *Id.* at 811.

80. Standardized guidelines may have resulted in “what we now regret.” See Gordon, *supra* note 7, at 352 (explaining the “embrace of stock options in the 1990s resulted, in part, from institutional investor pressure on firms to adopt this ‘best practice’ method of enhancing managerial incentives”).

81. See Ferri & Maber, *supra* note 34, at 29.

82. Gordon, *supra* note 7, at 343-44.

83. *Id.* at 348.

84. Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 655 (2009).

85. *Id.* at 649.

common stock.⁸⁶ This group currently has compensation guidelines in place;⁸⁷ ISS possesses advanced computer models which evaluate executive compensation packages and “makes these models available to companies (for a fee) so that the companies can evaluate their pay plans before submitting them for shareholder approval.”⁸⁸

Potential conflicts of interest arise due to ISS’s infiltration into a number of corporate governance service markets. ISS is the only group that provides proxy analyses and voting recommendations to institutional shareholders, “offers corporate governance advisory services to public companies, and issues corporate governance ratings on public companies” that aim to aid investors in evaluating a company’s corporate governance practices.⁸⁹ A substantial number of mutual funds and other large institutional investors outsource their voting power and corporate governance decisions to this proxy advisory firm.⁹⁰ “Mutual funds rely on ISS’[s] advice in determining how to vote portfolio shares and 15-20% of mutual funds have even authorized ISS to automatically vote their shares however it sees fit.”⁹¹ Additionally, ISS publishes corporate governance ratings on a number of public companies; the rating, the Corporate Governance Quotient (CGQ), indicates to investors the quality of a company’s corporate governance structure.⁹² ISS’s clients have come to extensively rely on these services, and many will not act without ISS’s input.⁹³ As the first on the scene in the proxy advisor market, ISS continues to enjoy its “first mover advantage” and remains largely unregulated.⁹⁴

All proxy advisory firms have been subject to much scrutiny as of late because of perceived conflicts of interest, procedural opaqueness,

86. Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 384 (2009).

87. See RISKMETRICS GROUP, U.S. CORPORATE GOVERNANCE POLICY 2010 UPDATES (2009), <http://www.issgovernance.com/files/RMG2010USPolicyUpdates.pdf>.

88. Thomas & Martin, *supra* note 21, at 1035.

89. Belinfanti, *supra* note 86, at 390-91.

90. *Id.* at 385.

91. *Id.* at 386.

92. *Id.*

93. See, e.g., *id.* at 387 (The Chairman of 3M’s board told the SEC that “[m]any of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines.” (quoting Letter from W. James McNerney, Jr., Chairman of the Board and CEO, 3M Corp., to Jonathan G. Katz, Sec’y, U.S. Sec. & Exch. Comm’n (Dec. 5, 2003), available at <http://www.sec.gov/rules/proposed/s71903/3m120503.htm> (internal quotation marks omitted)); see also, e.g., *HP, Compaq Merger Now in Hands of Shareholder Adviser*, REUTERS (Dec. 11, 2001), <http://www.rediff.com/money/2001/dec/11hp.htm> (detailing efforts by both sides to obtain ISS’s support in the HP-Compaq merger vote and observing that “[m]erging companies typically place a great deal of weight” on meetings with ISS analysts).

94. Belinfanti, *supra* note 86, at 411-15.

and questionable validity with regard to some services.⁹⁵ In June 2007, the U.S. Government Accountability Office conducted a study to evaluate conflicts of interest that may exist with proxy advisory firms and the steps that the SEC should take to oversee these firms.⁹⁶ More recently, the SEC has increased its oversight of the use of proxy voting services in compliance examinations of registered investment advisers and mutual funds. In a Compliance Alert issued in July 2008, the SEC highlighted a number of deficient practices across corporate boards and proxy advisory firms alike.⁹⁷ One complaint found the board oversight of use of proxy service providers appeared weak; “[i]n some instances, the funds had neither established controls to confirm that the proxy service providers’ recommendations were consistent with the funds’ policies and procedures nor requested information regarding conflicts of interest at the proxy service providers.”⁹⁸ Examining four proxy advisory firms, including ISS, one study found that each firm tended to focus on a single corporate governance issue and created recommendations depending upon that issue.⁹⁹ When the proxy advisory firm’s focus is known, institutional investors may choose an advisory firm that is tailored to their shareholders’ needs.¹⁰⁰ However, when those differences are not known, the proxy advisors may lack accountability and could pursue their own agenda.¹⁰¹

There is every reason to be wary of overreliance on the guidance offered by proxy advisory firms. These are groups that currently face little accountability, and as Professor Gordon notes particularly for a group like ISS:

In a mandatory “say on pay” world in the United States, it is easy to imagine that a single entity could create guidelines, establish rating systems for good compensation, consult with firms on how to improve their compensation ratings in light of their particular

95. See, e.g., *id.* at 419 (“Although the *development* of its proxy voting policies is not opaque, precisely how those policies are *implemented* remains unclear.”).

96. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING (2007), available at <http://www.gao.gov/new.items/d07765.pdf>.

97. See U.S. SEC. & EXCH., COMM’N, COMPLIANCE ALERT JULY 2008, available at <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

98. *Id.*

99. See Choi et al., *supra* note 84, at 675.

100. *Id.* at 696-97.

101. See *id.* at 697 (“To the extent that investors are not aware of these factors, however, the fact that the different advisors employ substantially different methodologies in making recommendations suggests that investors may not accurately perceive the information content associated with a [proxy advisor’s recommendation]. This could lead investors to follow blindly the recommendation of a proxy advisor, even when that recommendation is based on factors that the investors would not consider relevant. . . . The result would be to reduce the effectiveness of the shareholder franchise because shareholders would not be voting their true preferences.”).

circumstances, and then, behind purported ethical and physical barriers, provide proxy voting advice to shareholders.¹⁰²

B. Institutional Investors

Another concerning faction is the very group that ISS advises: institutional investors. Any increase in shareholder voice will give even greater influence to institutional investors, “the predominant shareholders of record in modern corporate society.”¹⁰³ The phrase “institutional investor” covers a number of different institutions including “corporate pension plans; public pension plans; mutual funds; commercial banks; insurers; [and] investment banks.”¹⁰⁴ No institution is entirely indebted to corporate managers, but “no institution is conflict-free.”¹⁰⁵ Corporate pension plans, for example, are often controlled by corporate managers, and while public pension plans may not solicit corporate business, they remain responsive to political pressure.¹⁰⁶ These are sophisticated groups that can and do have the resources and knowledge to better utilize the say-on-pay vote; however, their divergent interests may mean these groups are less likely to have interests aligned with shareholder wealth.¹⁰⁷

Institutional investors, especially public pension funds, have become active in corporate governance affairs.¹⁰⁸ Due to a diminishing ability to exit, institutional investors have turned to more active participation in corporate governance affairs to revive underperforming companies in their investors’ portfolios.¹⁰⁹ For instance, after frustration with CEO pay at some of its holdings, the American Federation of State, County and Municipal Employees (AFSCME) began targeting companies in 2006 with shareholders’ proposals to impose say-on-pay votes.¹¹⁰

102. Gordon, *supra* note 7, at 353.

103. Belinfanti, *supra* note 86, at 393.

104. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815 (1992).

105. *Id.* at 827.

106. *Id.* at 826-27.

107. See generally Camara, *supra* note 65, at 226-42 (finding unpersuasive arguments that institutional investors will choose only shareholder-wealth maximizing initiatives instead of initiatives that benefit their sectional interests). But see, e.g., Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1023 (1998) (arguing that regardless of the specific interests of activist labor union shareholders, such shareholders require the support of nonactivist shareholders to enact corporate change).

108. Black, *supra* note 104, at 828.

109. James P. Hawley, *Political Voice, Fiduciary Activism, and the Institutional Ownership of U.S. Corporations: The Role of Public and Noncorporate Pension Funds*, 38 SOC. PERSP. 415, 419-20 (1995), available at http://www.stmarys-ca.edu/fidcap/docs/The_Role_of_Public_and_Noncorporate_Pension_Funds.pdf.

110. Barbara Kiviat, *Giving Investors a Say on CEO Pay*, TIME (Apr. 9, 2008), <http://www.time.com/time/printout/0,8816,1729480,00.html>.

Two other public pension funds soon followed suit; the California Public Employees Retirement System (CalPERS) and the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) have also been a significant part of the activist shareholder wave in the area of executive compensation. TIAA-CREF has distributed to boards its policy statement emphasizing the use of performance-based pay and listing ten principles that it believes boards should apply to executive compensation.¹¹¹ CalPERS has adopted similar executive pay guidelines.¹¹² However, these guidelines are “fashion[ed] with only limited company-specific accommodation.”¹¹³

Extensive reliance on guidelines promulgated by any of these groups is problematic due to the groups’ conflicts of interest. While perhaps not as strong a concern for public pension funds, corporate pension funds may feel less free to oppose executive compensation due to their close ties to corporate managers.¹¹⁴ In addition, these groups may reap other benefits from their close association with corporate boards, such as gaining employment consulting corporate boards.¹¹⁵ Public pension funds, like CalPERS, may not engage in such dealings with corporate boards, but these funds are subject to political pressure.¹¹⁶ Moreover, as touched upon previously, these are groups that may be less inclined toward maximizing shareholder wealth and more inclined to promote their own objectives. Mutual and hedge fund investors are geared toward short-term gains as opposed to the presumptive goal of shareholders for long-term gains.¹¹⁷ “Social” shareholders like public pension funds or labor union funds may choose to push their own social or political agenda even at the expense of overall shareholder wealth.¹¹⁸

High ownership levels, long-term ownership, and strong voting authority have made institutional investors like CalPERS formidable

111. Thomas & Martin, *supra* note 21, at 1044; see TIAA-CREF, EXECUTIVE COMPENSATION POLICY (2010), http://www.tiaacref.org/ucm/groups/content/@ap_ucm_p_tcp/documents/document/tiaa01007957.pdf.

112. See CalPERS, GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE (2010), <http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf>.

113. Gordon, *supra* note 7, at 351.

114. See Grundfest, *supra* note 67, at 918-20; see also Thomas & Martin, *supra* note 21, at 1035 (“Many shareholders, such as mutual funds, care about the liquidity of their investments and their short term performance. They are unwilling to invest substantial resources in bringing about corporate governance changes that have uncertain immediate returns and may create substantial ill will from management.”).

115. See, e.g., Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 231-32 (2001) (noting that a top official in CalPERS left the fund and joined a law firm that advises management on takeover defenses).

116. Black, *supra* note 104, at 827; see also *id.* at 859 (“Public funds are highly vulnerable to political counterattack if they misuse their power.”).

117. See Anabtawi, *supra* note 53, at 22-23.

118. *Id.* at 32-34.

voices in corporate governance.¹¹⁹ However, due to their divergent interests and potential conflicts of interest, guidelines imposed by these groups may be a questionable source of aid to shareholders in exercising say-on-pay votes.

C. Compensation Consultants

Compensation consultants are often hired by corporate boards and independent compensation committees to craft or evaluate executive compensation plans. Compensation consultants are helpful in structuring executive compensation due to their knowledge and “access to detailed, proprietary information about pay practices.”¹²⁰ The CD&A requires disclosure of the use of compensation consultants,¹²¹ and Dodd-Frank will increase the requirements of disclosure.¹²²

Compensation consultant firms may provide other services to companies, such as advice on employee pension plans and benefit plans as well as compensation advice on nonexecutive employees. The involvement of a compensation consultant’s firm in various services for the same company prompts similar conflicts of interest as found with groups like ISS.¹²³ Further, while the compensation committee often has the exclusive authority to hire compensation consultants, the hiring decisions for noncompensation services lie with the CEO. Thus, compensation consultants may attempt to curry the CEO’s favor by recommending excessive pay packages to secure other services for the consultant’s company.¹²⁴ Some studies indicate that these conflicts of interest do not factor heavily into excessive CEO pay.¹²⁵ However, a congressional study on the topic identified significant conflicts of interest, as companies that employed compensation

119. See Hawley, *supra* note 109, at 423. Other arguments have arisen that SEC Regulations also unjustly gives greater power to these institutional investors at the expense of “mom and pop investors.” See, e.g., *Alinsky Wins at the SEC*, WALL ST. J., Aug. 30, 2010, at A14.

120. Cadman et al., *supra* note 57, at 264.

121. Item 407(e)(3)(iii) of Regulation S-K requires firms to disclose:

Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, . . . identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement

17 C.F.R. § 229.407(e)(3)(iii) (2010).

122. See *supra* notes 29-33 and accompanying text.

123. However, in one study of such consultants, little evidence was found to indicate that these conflicts result in higher CEO pay. Cadman et al., *supra* note 57, at 264.

124. Gretchen Morgenson, *House Panel Finds Conflicts in Executive Pay Consulting*, N.Y. TIMES, Dec. 6, 2007, at C1.

125. See, e.g., Cadman et al., *supra* note 57, at 280.

consultants that supplied both compensation-related and noncompensation-related services had larger compensation packages.¹²⁶

Dodd-Frank attempts to address these issues. Notably, shareholders will see in their annual proxy statement whether the compensation committee retained a compensation consultant, whether conflicts of interest existed, and if they existed, how the committee addressed those conflicts.¹²⁷ The SEC is given rulemaking authority to strengthen the independence of compensation consultants, with emphasis on whether the consultant provides other services or maintains other business relationships with the company.¹²⁸ These provisions will likely make shareholders more aware of the conflicts created by compensation consultants.

While the above is a step in the right direction, the proposals in Part V attempt to address the concerns created by compensation consultants, proxy advisory firms, and institutional investors alike: that a potentially “conflicted” group will have too great an influence over the say-on-pay vote. In fact, any one group’s sway may lead to the “herding” and stagnation found in executive compensation practices in the U.K. Thus, it should be considered whether a more objective “third party certifier” may be employed to aid shareholders in deciding how to vote on say-on-pay while downplaying any potential herding effect. Part V offers two possible solutions.

V. PROPOSED SOLUTIONS

A. *Disclosure of Comparable Executive Pay at Other Firms*

One way to enhance the ability of shareholders (particularly unsophisticated ones) to process and make appropriate use of say-on-pay votes is by increasing the disclosure considered in the vote to include the pay of executives at similar companies. The current Regulation S-K Item 402 is limited to information regarding the applicable firm’s top five executives.¹²⁹ Comparable executive pay information would give shareholders invaluable context: this information arguably indicates to shareholders the market price of executive pay. More than the breakdown of what is being offered in a pay package, this demonstrates to some extent what the executive is worth in the market of similar companies and gives a baseline of what is reasonable pay.

126. Morgenson, *supra* note 124, at C1 (“At 25 companies whose pay consultants came from firms that also had highly lucrative contracts to provide actuarial or employee benefit services, chief executives were paid a median salary of \$12.5 million last year. That was 67 percent higher than the median salary paid by companies that did not use consultants that were potentially biased.”).

127. Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1902 (2010) (to be codified at 15 U.S.C. § 78j-3).

128. *See id.* at 1901.

129. 17 C.F.R. § 229.402(a)(3) (2010).

The SEC would likely create levels, grouping similar companies (and thus executives) together for purposes of determining what other firms' executive pay should be disclosed in the say-on-pay vote. This information is already disclosed in each company's Regulation S-K; the SEC would only need to compile and publish in accordance with the level structure it creates. Companies would identify the applicable level and list briefly the compensation paid to comparable executives in the say-on-pay disclosure.¹³⁰ To handle situations in which the proposed compensation package does not align within the parameters of other comparable executive pay, the CD&A may be expanded to include narration on why the executive pay may deviate from the "norm" presented in the disclosure.

This proposal is subject to the same criticism already leveled at efforts to increase disclosures to shareholders. More disclosure does not necessarily mean that shareholders will appropriately process the additional information. However, the inclusion of this specific information may be one small distinction that allows unsophisticated shareholders to at least grasp the larger picture of executive compensation. Instead of being instantly outraged by the pay proposed, shareholders may more coolly understand why the company is paying their executive so much: to avoid losing that talent to similar companies. If the pay disclosed is out-of-sync with other executive plans, and the firm's explanation in their CD&A comes up short, shareholders may make a more reasoned decision to vote no on say-on-pay.

To be fair, this proposal does not fully address the concern of herding and may serve to exacerbate it. Shareholders may too greatly rely on the pay of comparable executives, and a say-on-pay vote may hinge on whether the proposed pay fits "the norm." However, even if say-on-pay does not wield the presumed influence this Note accords it, the problem of herding in executive compensation practices would likely arise. For example, companies may use the same compensation consultants, and those consultants may continually recommend a standard compensation package.

What may overcome the problem of herding exacerbated by this proposal is to emphasize use of the CD&A as a way to answer for deviations from the norm. In conjunction, the SEC should emphasize that pay deviations from the "norm" presented in the comparable executive pay disclosure are fine. The company would use the CD&A, however, to explain why the compensation proposed differs from that of comparable executives. Compensation consultants, when used,

130. This Note does not attempt to determine the level of disclosure required but simply argues that such information should be included. Although overly extensive disclosure may further obscure the necessary information, this Note assumes that the information disclosed would be concise yet extensive enough to convey to the shareholder the market for comparable executives.

would be encouraged to work with corporate boards to use the CD&A in this way and to avoid simply proposing “one-size-fits-all” compensation packages. This will allow shareholders to meaningfully evaluate the proposed pay in a say-on-pay vote, and companies will be able to tailor compensation packages without the overriding pressure to conform to any norms in pay when unwarranted.

B. SEC Guiding Principles of Executive Compensation

The SEC may also consider reevaluating and reissuing guiding (but nonbinding) principles of executive compensation. In 2009, Treasury Secretary Tim Geithner issued a general outline on principles of executive compensation in conjunction with the Troubled Asset Relief Program (TARP),¹³¹ but these should be expanded in light of Dodd-Frank and seek the input of compensation consultants, institutional investors, proxy advisory firms, and other relevant actors. These principles should also leave room for innovation: it should be emphasized in both the principles and the firm’s CD&A that each firm is different and may require a unique compensation plan. These principles will serve as a more objective third party certifier that shareholders may turn to in deciding how to act in a say-on-pay vote. It would also hopefully discourage shareholders from turning to less objective guidelines, such as those promulgated by ISS and institutional investors. The guidelines may even include language acknowledging the presence of such guidelines, but warning shareholders that such entities may have interests ill-suited to overall shareholder value. However, the SEC should seek input from all of the actors identified in Part IV in creating the compensation principles, as they are a continuing and experienced part of the U.S. conversation on executive pay.

Further, the SEC principles may also discourage annual say-on-pay votes in favor of exercising a say-on-pay vote every three years. Three years may give shareholders a better picture of firm health to determine whether the proposed compensation plan is justified. Allowing a shareholder vote every year may obscure subtle increases in pay and prompt less concern with shareholders than if the say-on-pay vote were conducted every three years.

This proposal also prompts criticisms. Herding might be exacerbated if shareholders come to extensively rely on compliance with the principles in determining how they exercise their say-on-pay vote. However, the SEC must both emphasize the principles’ nonbinding nature as well as the need for innovation in compensation packages.

131. See Press Release, U.S. Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx>.

This proposal would also impose costs upon the SEC, as the SEC would have to promulgate these principles. However, the costs would likely be no more than those associated with other rulemaking requirements imposed by Dodd-Frank.

The principles should be loosely drawn—though perhaps as not as loosely drawn as they are in the 2009 TARP guidelines—but provide enough guidance so that shareholders may evaluate compensation pay packages on their own terms. These principles should also address a number of industries' compensation practices. To emphasize the need for innovation and discourage any herding effect, the principles should also outline examples of “worthy” deviations from the norm: scenarios in which pay represented in a say-on-pay vote does not reflect the norm presented across the field of comparable executive pay but is still reasonable.

With such principles in place, shareholders will be less likely to turn to the guidance of conflicted groups like those discussed in Part IV. Instead, shareholders will turn to the SEC principles to aid them in deciding how to vote in a say-on-pay vote. This will ensure that the say-on-pay vote is a credible signal to the board and market. By ensuring credibility in the say-on-pay vote, the boards and market will be more trusting of its results; thus, shareholder voice is truly strengthened and the purpose of say-on-pay is realized.

VI. CONCLUSION

The U.K.'s experience with similar say-on-provisions reveals a troubling aspect to say-on-pay's implementation in the U.S.: the use of best practices compensation guidelines may result in opportunistic interjection by questionable U.S. groups, including proxy advisory firms, institutional investors, and compensation consultants. However, due to the informational asymmetry between boards and shareholders and the resulting adverse selection problem, some sort of certification may aid shareholders in making the say-on-pay vote a credible signal to the board and market. That in effect “warranty” on the proposed compensation plan may be given by either disclosure of (and comparison to) to the pay of other, similarly-situated firms' executives, or by the SEC's crafting of guidelines to aid shareholders in making the decision of whether to approve or disapprove compensation. Regardless of whether any of these solutions are considered, shareholders now have a significant bargaining chip in the Dodd-Frank say-on-pay vote; one hopes shareholders will use it wisely.