Global Investors Laud Shareholder Votes on Executive Compensation

By Peter Moon, Keith Johnson and Phil Spathis[*]

Verizon, Par Pharmaceutical and Aflac became the first US companies over the last year to adopt policies requiring an advisory vote of shareholders on company executive compensation practices. We applaud them for being early US adopters of what is a common practice elsewhere.

A network of over 70 institutional and individual investors lead by AFSCME and Walden Asset Management announced in January that adoption of this 'say on pay' policy is expected to be put on proxies at more than 90 US companies this year. With majority shareholder votes having been cast for similar resolutions at seven companies during 2007, say on pay will be one of the hottest issues in the upcoming US proxy season. Experience with say on pay in other markets shows it could produce a number of benefits for both companies and shareholders.

Aligning Executive Pay with Performance

Three out of four US corporate directors see CEO compensation as high relative to performance, according to a recent National Association of Corporate Directors survey. Similarly, Watson Wyatt found that nine out of ten institutional investors believe corporate executives are overpaid and that this has hurt corporate America's image.

While the SEC's recent improvements in executive compensation disclosure were important, disclosure alone is unlikely to stop 'pay for failure' compensation practices. Movement toward a 'pay for performance' culture at US companies is most likely to occur where shareholders are given a voice.

A successful model for giving shareholders voice through advisory votes on company compensation reports already exists in the United Kingdom, Australia, the Netherlands, South Africa, Norway and Sweden. Experience with this model in our markets suggests it would produce significant benefits in the US.

British Experience with Shareholder Advisory Votes

Advisory shareholder votes on executive compensation plans were first required in the UK in 2003. Despite anxiety that it would result in a tide of shareholder uprisings, only a handful of boards have received a majority vote against their executive compensation report, with the 2003 vote at GlaxoSmithKline being the most significant. After that vote, the company undertook a consultation with its shareholders to identify their concerns and made adjustments to its compensation plan.

The UK advisory vote has substantially increased interaction between large investors and company compensation committees. In addition, a recent evaluation by Columbia University and Harvard confirmed that CEO compensation in the UK has become more

closely aligned with company operating performance. Positive changes were also documented in a study by Deloitte:

- Links between pay and performance have increased, with more meaningful performance conditions attached to incentive compensation;
- Stock option plans that dilute ownership of outside shareholders are being replaced by stock grants with performance triggers;
- Payout levels for achieving only average performance have declined;
- The quality of reporting on compensation has improved.

In addition, many compensation committee chairs now welcome advisory votes as an effective counterbalance to management pressures on compensation decisions. The UK Department of Trade and Industry has even said it views advisory compensation votes as having a positive impact on company strategic planning and on competitiveness of the UK economy.

Australian Experience with Advisory Shareholder Votes

A similar advisory shareholder vote process has been in place in Australia since 2005. Votes on Australian company compensation reports are now a major focus of proxy voting activity and have encouraged shareholders to consider each company's compensation report as a whole, rather than focus on one particular aspect of pay. Institutional investors are using the compensation vote process to:

- Better understand compensation practices at each company;
- Analyze alignment of compensation plans with company performance and strategic goals; and
- Communicate with companies about specific shareholder concerns.

The process has prompted a number of companies to reform their practices. The first majority negative vote was just cast at Telstra in November. Companies that received high negative votes have exhibited a range of compensation practice shortcomings that have became the focus of discussions between companies and shareholders, including:

- Lack of demanding hurdles for long term incentives;
- Excessive termination payments;
- Unexplained substantial pay increases;
- Bonus payments at odds with company performance; and
- Excessive performance target revisions with regard to long term incentive goals.

However, even with this increased shareholder input, boards remain firmly in control of compensation decisions. Shareholders and boards in both Australia and the UK recognize that it is in their mutual best interests to ensure that companies are able to recruit and retain quality executives who are motivated to deliver superior long-term performance.

Shareholder Support in the US

In the US, over 40 shareholder resolutions seeking an advisory shareholder vote on compensation were put forth during the 2007 proxy season. Support for those resolutions averaged 42 percent. A majority of shareholders backed the resolutions at Clear Channel Communications, Activision, Valero Energy, Blockbuster, Verizon, Ingersoll-Rand and Motorola, with votes as high as 69 percent. This is a surprisingly strong level of support for a new shareholder initiative. We expect many more resolutions to be offered at companies during 2008.

Based on experience in our markets, we believe that the adoption of an advisory shareholder vote could help produce substantial benefits in the US:

- Improved communication between directors and shareholders on compensation plans and company strategic goals;
- Stronger pay-for-performance compensation ties;
- Reduced influence of vocal, short-term activists, as a result of the voice being given to all shareholders;
- Fewer votes against director candidates, due to there being an alternative for expressing disapproval of compensation practices; and
- Better board resistance to upward pressure on compensation levels from enhanced executive compensation transparency.

There has been a global trend toward adoption of advisory shareholder votes on executive compensation. Creation of a similar requirement in the US could help to strengthen the links between compensation, company strategic plans and creation of long-term shareholder value. Without it, we fear that a potentially more draconian regulatory response to continued US executive compensation abuse is inevitable. Aflac and Verizon have found a preferable market-based solution that deserves replication at other companies.

Peter Moon is Chief Investment Officer at Universities Superannuation Scheme, the second largest pension fund in Britain, with $65 billion under management. Keith Johnson is Chair of Reinhart Institutional Investor Services and former Chief Legal Officer at the $95 billion State of Wisconsin Investment Board. Phil Spathis is Executive Officer of the Australia Council of Super Investors, the leading Australian shareholder rights organization which represents the interests of 42 Australian pension funds with over $200 billion in assets.