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Say on Pay's Bundling Problems

Andrew C.W. Lund

The newly enacted federal Say on Pay rule will require public firms to periodically provide shareholders with an opportunity to cast an advisory vote regarding its most recent year's executive compensation. Like other efforts to increase shareholder power, Say on Pay has attracted criticism from those who fear that so empowering shareholders will harm firms. There may be much to be said for those criticisms, but this Article instead offers a critique of Say on Pay internal to the shareholder empowerment movement. The problem with Say on Pay is that its ex post nature neuters its ability to influence executive pay at high-performing firms. This hypothesis has been borne out by the experience with Say on Pay in the UK where a mandatory version has been in effect for seven years. There, Say on Pay resulted in compensation-related discipline at poorly-performing firms, but not at high-performing firms. This disparity appears to be not entirely or even significantly driven by shareholder preferences or monitoring costs. Alternatively, this Article suggests that Say on Pay suffers from the bundling of perceived collateral costs insofar as shareholders reasonably fear offending executives via an adverse Say on Pay vote. Those problems are naturally more significant at high-performing firms where the potentially offended executives are believed to be more valuable. This Article suggests that the bundling problems can be mitigated by switching from an ex post to an ex ante vote and provides a first attempt at a CEO Compensation Plan approval requirement.

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INTRODUCTION

As executive compensation practices have become more controversial, many have called for a larger shareholder role in pay decisions at public firms. That increased power was officially granted through a federal law requiring public companies to submit to shareholder “Say on Pay”—a non-binding vote by which shareholders may register their disapproval of the previous year’s executive pay arrangements—no less frequently than once every three years. To this point, Say on Pay has been subjected to a moderate amount of criticism, the majority of which reflects the fault lines in the more general debate over increasing shareholder power. This Article offers a different kind of critique, contending that Say on Pay is a relatively unattractive structure for establishing that power. The ex post nature of the Say on Pay vote engenders significant bundling issues that distort shareholder decisionmaking regarding optimal pay structures, resulting in too little discipline at high-performing firms. Those who want shareholders to play an advisory role with respect to executive pay, should want such power to be exercised prior to the pay being decided and awarded. While remaining agnostic about the propriety of increasing Say on Pay, this Article develops

2 See Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951(a)(1), 12 Stat. 1376, 1899 (2010). Section 951 of Dodd–Frank also requires firms to submit to a non-binding shareholder vote on the frequency of the Say on Pay vote, e.g., once every either one, two or three years, with that vote occurring no less frequently than once every six years. Id. § 951(a)(2). Say on Pay has been required for all Troubled Asset Relief Program (TARP) participants since its inception. See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 519-20 (2009). All Say on Pay iterations subject to shareholder vote the compensation of the executives named in the firm’s proxy statement. For exposition purposes only, this Article limits its discussion of the affected executives to the CEO.

3 See infra Part I.B.

one version of such an _ex ante_ device: a requirement that shareholders periodically cast an advisory vote on a standing “CEO Compensation Plan” applicable to future CEO compensation arrangements.

Say on Pay reallocates power over a certain group of firm decisions, giving public shareholders more influence over compensation matters than ever before.\(^5\) Although the vote is non-binding, experience with Say on Pay in the UK—where it has been mandatory for the better part of a decade—and the US—where it has been adopted piecemeal, either voluntarily or via industry-specific legislation—indicates that advisory shareholder votes can constrain pay decisions.\(^6\) Consequently, those who would oppose increased shareholder power more generally have an obvious complaint and have tended to argue most forcefully against Say on Pay.\(^7\) Others less fundamentally opposed to increased shareholder power nevertheless have worried that compensation decisions may be a bad candidate for an increased shareholder role, largely because of their relatively complicated, firm-specific nature.\(^8\) In all events, the debate to this point has centered (and understandably so) on the merits of allocating more authority to shareholders vis-à-vis executive compensation.

Less frequently discussed is the question of how to empower shareholders assuming they are to be empowered. This Article details the problems created by the timing of the Say on Pay vote. Because the vote occurs after the compensation decision is made and the relevant executives are employed, Say on Pay is subject to potentially serious bundling issues. That is, the specific package to be voted on—the appropriateness of pay packages—is intertwined with other, sometimes conflicting considerations, making the vote less indicative of voters' preferences than it might initially seem. Shareholders who might otherwise use Say on Pay to disapprove of past compensation arrangements must discount the expected gains from disciplining pay by the collateral costs that such discipline might impose on shareholders.

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6 See infra Part I.A (Say on Pay in the UK) and notes 15-16 (advisory votes in the US).

7 See, e.g., Stephen M. Bainbridge, _Is ‘Say on Pay’ Justified?_, _Regulation_, Spring 2009, at 42, 42. In addition to the threat it poses to board authority, Bainbridge criticizes Say on Pay for solving a nonexistent problem, see id. at 42, 44, and for improperly federalizing corporate law, see id. at 44–46. See also infra note 70.

managerial performance. These collateral costs are more significant because of the ex post nature of Say on Pay and the resulting potential for offending managers through an essentially executive–specific adverse vote. As a result, shareholders who are upset with a firm’s pay practices may nevertheless accede to objectionable compensation for fear of offending a CEO they believe to be prospectively valuable. To the extent that shareholders “fall in love” with CEOs, the perceived potential of a particular CEO to increase firm value is likely to outweigh all but the most extravagant pay packages. The magnitude of this bundling effect will naturally differ based on the expectation of future CEO performance, meaning that we should expect Say on Pay to more heavily discipline CEOs at low-performing firms than those at high–performing firms where the cost of potential CEO deviation from past practice will be believed to be highest.

Perhaps mandatory Say on Pay’s greatest advantage as a device for increasing shareholder power over compensation decisions is that it has been tried in other jurisdictions, and on a voluntary basis in the US, and it has yet to produce significant negative consequences. The evidence is decidedly mixed, however, as to how much Say on Pay has actually improved pay practices. In fact, the clearest consequence of Say on Pay in the UK has been a significant shift in pay only at poorly performing firms.

Admittedly, the devil one knows may be better than the alternative one does not. This perhaps explains the near–universal acceptance of Say on Pay as the sole vehicle through which shareholder power over compensation is to be increased. This Article proposes a different sort of mechanism—an ex ante CEO Compensation Plan approval requirement. Happily, this mechanism also has a non–disastrous historical analog—the current exchange listing requirements mandating that all equity compensation plans be pre–approved by shareholders. Under a CEO Compensation Plan approval rule, public firms would be required to obtain shareholder approval of the parameters within which future CEOs could be paid. Shareholders would be free to impose as many or as few limitations
on prospective pay arrangements as they felt prudent. Finally, the approval would be advisory—just like Say on Pay—to mitigate any pathologies inherent to shareholder voting.

Part I discusses Say on Pay as recently enacted. It describes the experience with a similar Say on Pay rule enacted in the UK and voluntary Say on Pay votes in the US. Part II describes the problems created by Say on Pay’s *ex post* nature, and concludes that a significant number of firms will not be disciplined by the measure. Part III develops the CEO Compensation Plan approval rule as an alternative mechanism that would provide discipline in many of the cases where Say on Pay would not. This Article concludes that most participants in the debate over increased shareholder power in the compensation arena should prefer the *ex ante* mechanism to the *ex post* mechanism.

I. SAY ON PAY

In recent years, some institutional shareholders and shareholder advocates in the US have pushed for firm-by-firm adoption of Say on Pay. Their efforts were met with increasing but marginal success. At the same time, Congress was sporadically working on legislation that would make Say on Pay mandatory. In 2007, Representative Frank introduced a Say on Pay measure that passed in the House. The companion bill in the Senate was introduced by then-Senator Obama, but failed. As part of the legislative response to the financial crisis in early 2009, all TARP participants were required to hold a Say on Pay vote. Later that year, Senator Schumer introduced a Shareholder’s Bill of Rights containing mandatory Say on Pay at all public companies. Thereafter, Frank, as part of a more global financial reform package (titled the Corporate and Financial Institution Compensation Fairness Act of 2009), introduced a similar Say on Pay provision. In December 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 mandating Say on


20 S. 1074, 111th Cong. § 3 (2009).

Pay at all public firms. In May 2010, the Senate approved its own version of that bill (including the Say on Pay provision), and re-titled it as the Restoring American Financial Stability Act of 2010. Finally, both houses agreed to the Dodd–Frank Wall Street Reform and Consumer Protection Act (commonly referred to as “Dodd–Frank”) and President Obama signed Say on Pay into law.

Under Say on Pay as enacted, firms will be required to hold a non-binding vote whereby shareholders will either approve or reject the previous year’s compensation arrangements for the handful of executives whose compensation was otherwise disclosed in the Summary Compensation Table of the firm’s proxy statement. Under current rules, these include the principal executive officer, principal financial officer, and a firm’s other three most highly compensated executive officers. Therefore, Say on Pay usually requires shareholders to vote on the prior year’s compensation arrangements for the five most highly paid executives at a firm. The vote could be held each year, every two years, or every three years, at the board’s discretion. However, the board must submit the question of frequency to shareholders for another non-binding vote at least once every six years.

Say on Pay votes provide a discrete means to coordinate shareholder dissatisfaction over compensation matters. Yet, because it is an advisory vote, Say on Pay can be an effective tool for shareholders only by threatening some sort of secondary harm on boards and executives. This threat is largely reputational, though it may include an implicit threat to subsequently remove or vote “no” with respect to directors who have agreed or continue

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23 S. 3217, 111th Cong. § 951 (2010) (this bill was eventually added to H.R. 4173 as an amendment).
25 The Say on Pay vote would cover the entire compensation-related disclosure in the proxy statement, including the firm’s Compensation Discussion and Analysis. See id.; see also 17 C.F.R. § 229.402 (2010) for executive compensation disclosure rules generally.
26 17 C.F.R. § 229.402(a)(3) (2010). Item 402 (a)(3) also requires disclosure with respect to up to two former officers if such officers were only excluded because they were no longer serving in that capacity. Id. at § 229.402(a)(3)(iv).
27 There may be more highly paid non-officers who would not be covered by Say on Pay. See 17 C.F.R. § 240.3b–7 (2010) (defining “executive officer”).
28 Dodd–Frank, § 951 at 1899.
29 See Cai & Walkling, supra note 15 (manuscript at 6–7).
to agree to objectionable pay practices.\footnote{31 See Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, \textit{Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals}, 16 J. CORP. FIN. 53, 57 (2010).}

The leverage gained by shareholders through Say on Pay could theoretically come into play at two distinct points in time. Most obviously, shareholders could cast or threaten to cast an adverse Say on Pay vote. This exertion of shareholder power would necessarily take place around the time of the vote, i.e., after the compensation package has been awarded and a performance period has concluded. The consequence to a director from the negative vote would be embarrassment, perhaps coupled with a shareholder effort to remove the director via a concurrent or subsequent proxy fight or "vote no" campaign against the director. Similarly, the consequence to compensation-receiving executives would be reputational, although any employment-related consequence would be indirect given the inability of shareholders to hire and fire executives.\footnote{32 Shareholders could of course impose discipline on the executives \textit{qua} directors, to the extent they were board members.}

Second, the threat of potentially adverse votes at future shareholder meetings might cause boards (and executives) to consult with shareholders prior to the establishment of executive pay arrangements. This pre-arrangement influence could be direct in the sense of discrete shareholder-board negotiations over pay parameters, or it could be indirect if the board feels compelled to comply with compensation guidelines adopted by shareholder groups or proxy services firms.\footnote{33 \textit{See}, e.g., Gordon, supra note 8, at 347-48 (suggesting that the indirect sort of \textit{ex ante} influence is more likely than the former given the costs of firm-specific negotiations).} Interestingly, Say on Pay's proponents accord this \textit{ex ante} type of leverage equal importance relative to actual shareholder voting (or specific voting-related threats).\footnote{34 \textit{See}, e.g., Stephen Davis, \textit{Does "Say on Pay" Work? Lessons on Making CEO Compensation Accountable} 10-12 (Millstein Ctr. for Corp. Governance & Performance, Policy Briefing No. 1, 2007), available at http://millstein.som.yale.edu/Policy%20Briefing%20No%201%20'Say%20on%20Pay'.pdf.} This raises the obvious question: Why rely on \textit{ex post} discipline to force \textit{ex ante} negotiations? Why not simply establish a formal \textit{ex ante} disciplinary mechanism that encourages the same sort of negotiation? The question becomes especially salient when, as discussed below, the \textit{ex post} aspect of Say on Pay reduces its ability to discipline pay decisions in certain circumstances.

\subsection*{A. The Experience in the UK}

The UK adopted its version of mandatory Say on Pay in 2002. That year, the UK Companies Act was amended to require a non-binding shareholder vote on the Directors' Remuneration Report, the UK analog to
the executive compensation disclosure required by Item 402 of Regulation S-K.\textsuperscript{35} The new rule affected all UK companies traded on UK exchanges, except for companies traded on the Alternative Investment Market.\textsuperscript{36}

As described above, Say on Pay in the UK promised both \textit{ex post} discipline in the form of actual adverse votes or vote-related threats and \textit{ex ante} discipline in the form of incentives for boards to consult with or avoid angering shareholders earlier in the process.\textsuperscript{37} Regarding the former, there have been eight adverse shareholder votes since Say on Pay’s adoption in the UK.\textsuperscript{38} During that period, one in nine firms has been presented with a significant minority – 20% or more – of shareholders voting in the negative in any one Say on Pay vote.\textsuperscript{39} Significant shareholder advisors have recommended negative votes in 10% and 13.4% of votes, respectively.\textsuperscript{40} This indicates that UK companies on the whole have received surprisingly negative responses to their pay practices under Say on Pay.\textsuperscript{41}

As far as the predicted \textit{ex ante} discipline via board consultation with shareholders, Stephen Davis reported anecdotal evidence of a marked increase in compensation-related communication between companies, on the one hand, and institutional shareholders and proxy services firms, on the other.\textsuperscript{42} For instance, a proxy services firm reported that it had received 20 compensation-related consultative calls per year from firms prior to Say on Pay’s enactment in the UK, increasing to between 130 and

\textsuperscript{36} See Companies Act, 2006, c. 46, \S 420(1) (Eng.); Companies Act, 2006, c. 46, \S 385(2) (Eng.).
\textsuperscript{37} See Davis, supra note 34 and accompanying text.
\textsuperscript{38} Id. at 10.
\textsuperscript{39} Id. (citing a Deloitte study to that effect).
\textsuperscript{40} Id. (referring to the practices of Glass Lewis and RiskMetrics’ British subsidiary, RREV); Gordon, supra note 8, at 343.
\textsuperscript{41} Interestingly, Gordon and Davis appear to take away different implications from these figures. Gordon writes that negative votes have generally been minimally supported, but “\textit{[n]evertheless, in recent years, the proxy services firms have recommended negative votes in ten to fifteen percent of cases . . . .}” Gordon, supra note 8, at 343 (emphasis added). Davis, on the other hand, writes:

Moreover, the proxy services themselves have \textit{largely exercised restraint in their advice.} Glass Lewis has recommended votes against at approximately 10% of UK companies covered. ISS, which operates in Britain through RREV, a wholly owned subsidiary linked to the National Association of Pension Funds, recommended votes against remuneration reports in 13.4% of cases (158 companies out of a universe of 1,183) in 2006.

Davis, supra note 34, at 10 (emphasis added).
\textsuperscript{42} Davis, supra note 34, at 10.
150 calls afterward. That there was more communication between boards and important shareholder interests indicates that Say on Pay afforded shareholders more leverage than they had previously enjoyed. But given the almost 1100 firms otherwise captured by the Say on Pay rule, it is not clear that Say on Pay granted them very much leverage.

After 2002, many shareholder groups in the UK scrambled to establish compensation-monitoring systems commensurate with their new voting power. Others simply outsourced the necessary monitoring to proxy advisors or industry coalitions. Those investors who chose to become more actively involved ran into several challenges. As a result, some opted to avoid the firm-specific analysis and instead adopt broadly applicable compensation principles or “best practices”.

Along with directly observable shareholder adaptations like these, Say on Pay had an effect on actual compensation patterns in the UK. Interestingly, it had no impact on aggregate CEO compensation, which continued to grow substantially. However, in the most significant empirical study of the UK experience, Fabrizio Ferri and David Maber did find increased sensitivity of CEO pay to poor performance after Say on Pay’s passage. While there had been no statistically significant relationship between negative returns measures and CEO pay prior to Say on Pay, those measures became correlated with CEO pay after its enactment. This change can be fairly attributed to Say on Pay and indicates that Say on Pay in the US may have a similar effect.

43 Id.
44 Gordon, supra note 8, at 350–51.
45 As expected, there is even less information concerning the frequency with which boards are simply complying with shareholder-imposed guidelines rather than engaging in a more substantive discussion with shareholder groups. Gordon suggests that this form of influence is likely to dominate the firm-specific sort, see Gordon, supra note 8, at 347, a view which is intuitively persuasive though certainly not yet demonstrated.
46 Davis, supra note 34, at 12.
47 Id.
48 Id. (describing an “arms race” between shareholders’ in-house compensation experts and boards’ compensation consultants).
49 Id.; see also Gordon, supra note 8, at 347 (internal quotation marks omitted).
51 See Ferri & Maber, supra note 50, at 19.
52 Id.
53 See Gordon, supra note 8, at 346 (dismissing the possibility that increased disclosure rather than Say on Pay drove Ferri and Maber’s findings).
54 But see Bernard S. Black & John C. Coffee, Jr., Hail Britannia?: Institutional Investor
Ferri and Maber further found that the increased sensitivity of CEO pay to poor firm performance is driven by increased sensitivity at firms they characterized as having "controversial CEO pay practices." They offered as proxies for this group high (greater than 20%) Say on Pay dissent in 2003 and high levels of "excess CEO pay," defined as CEO compensation above that predicted by commonly-used economic variables. Ferri and Maber found statistically significant differences between high dissent firms and low dissent firms in post-Say on Pay changes regarding the sensitivity of CEO pay to industry adjusted negative returns on assets. In fact, only high dissent firms experienced a statistically significant change in pay sensitivity to poor performance. Ferri and Maber found similar differences in post-Say on Pay sensitivity changes among firms with high levels (top quartile) of excess CEO compensation versus those with relatively low levels (bottom three quartiles). These findings indicate that Say on Pay's effect was limited to pay at poorly performing firms with poor prior pay practices, a degree of precision pointing in favor of increased shareholder power.

Finally, Ferri and Maber found no post-Say on Pay differences in the sensitivity of CEO pay to positive return measures. That is, CEOs at above-median performing companies were paid exactly as they had been before Say on Pay was enacted. This finding was consistent even with respect to those high-performing firms that otherwise had "controversial" pay practices represented by high voting dissent or high levels of excess CEO compensation. In short, Say on Pay had no disciplining effect on a firm's pay practices as long as that firm performed well.
Like other attempts to increase shareholder power,\textsuperscript{64} Say on Pay has been criticized on the grounds that the reallocation of authority will result in a net loss for firms. Some have suggested that certain shareholder groups might be able to use their newfound leverage to extract personal benefits from boards.\textsuperscript{65} Yet it is hard to see how Say on Pay would produce any real increase in shareholder extortion opportunities even if certain shareholders were so inclined. Those shareholders with ulterior motives have a number of other options at their disposal including “withhold the vote” campaigns and the increasingly likely ability to use companies’ proxies for nominating insurgent director slates.\textsuperscript{66} These alternatives may carry with them collateral consequences that make the extortion threat not particularly credible,\textsuperscript{67} but as discussed in Part III, collateral consequences make extortion based on Say on Pay even less credible.\textsuperscript{68}

Other arguments against shareholder empowerment commonly conclude that shareholders are apt to make honest but poor decisions with regard to compensation matters. Along this line, some critics proceed from a more general philosophical position that the board authority is valuable and worthy of protection, a construction that is readily transferrable to the particular authority/accountability issues in executive compensation.\textsuperscript{69}

\textsuperscript{64} See Bebchuk, \textit{Shareholder Power}, supra note 4, at 883 (citations omitted); Lipton & Savitt, \textit{supra} note 4, at 745–46.

\textsuperscript{65} Bainbridge, \textit{supra} note 7, at 47 (suggesting that union and public pension funds may use increased leverage granted by Say on Pay to extract private rewards including labor concessions and increased reputational benefits for fund managers); see also Ashwini K. Agrawal, \textit{Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting} 18 (N.Y. Univ., Stern Sch. of Bus., Working Paper No. Fin–08–006, 2008), available at http://w4.stern.nyu.edu/finance/docs/WP/2008/pdf/wp08006.pdf (demonstrating that union shareholders are less likely to support director nominees at corporations at which the union’s members are employed); Anabtawi, \textit{supra} note 4, at 575-77 (discussing private benefits that certain shareholders may seek to extract if given new power).

\textsuperscript{66} See Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024, 29027 (June 18, 2009) (to be codified at 17 C.F.R. 200). Moreover, Ferri and Maber’s findings indicate that only firms with problematic pay practices became targets, limiting the argument that shareholders were behaving opportunistically. See \textit{supra} notes 59–60 and accompanying text.

\textsuperscript{67} Additionally, the majority vote requirement for shareholder action may check rent-seeking shareholders’ ability to extort. See, e.g., Stewart J. Schwab & Randall S. Thomas, \textit{Realigning Corporate Governance: Shareholder Activism by Labor Unions}, 96 Mich. L. Rev. 1018, 1082–84 (1998). But see Anabtawi, \textit{supra} note 4, at 594–97 (arguing the majority vote rule may not successfully deter shareholders from seeking private benefits).

\textsuperscript{68} But see Gordon, \textit{supra} note 8, at 337 (suggesting that the director election route is likely to be a less credible tool for accountability than Say on Pay because of other issues bundled in any director vote).

\textsuperscript{69} See Bainbridge, \textit{supra} note 7, at 47 (“Whatever flaws board governance may have, they pale in comparison to the information asymmetries and collective action problems that lead most shareholders to be rationally apathetic.”); Stout, \textit{supra} note 4, at 792-97. Bainbridge, at
Increased shareholder influence over executive compensation would, on this account, diminish the gains produced by allowing a cohesive, informed, and centralized board to respond quickly to market events and negotiate the best deals possible with executives. Instead, empowered shareholders, facing intractable informational disadvantages may consider the wrong factors in making compensation–related decisions.  

The most exhaustive critique of Say on Pay of this sort was recently developed by Jeffrey Gordon. Gordon points out the tendency of institutional shareholders to rely on proxy service firms for guidance in deciding how to vote on Say on Pay.  

On the one hand, the use of proxy advisors alleviates concerns about dispersed shareholders' inability to become informed and coordinate their voting. But Gordon argues that this reliance on proxy services firms also has two distinct, and potentially harmful, effects. First, the proxy firms may have conflicts of interest. They have client companies that pay for advice on how to improve “corporate governance scores” compiled by the firms at the same time they are providing advice to investors regarding those companies. Gordon concludes:

In a mandatory ‘say on pay’ world ... 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 circumstances, and then, behind purported ethical and physical barriers, provide proxy voting advice to shareholders.  

Second, and more importantly, efficiencies as well as efforts to remove
the taint of those potential conflicts are likely to move proxy service firms toward adopting one-size-fits-all rules. Under Say on Pay, subject companies would be free to offer the proxy service firms any company-specific justifications for departing from established compensation guidelines. But given the costs of company-specific negotiation, proxy service firms may be difficult to persuade in non-extreme circumstances. The result is amplified once companies assume non-negotiability, leading them to never reach out to the proxy service firms in the first place.

As a result, Say on Pay may tend to homogenize compensation practices across public firms. This tendency to conform to proxy firm guidelines could be value-decreasing for firms facing idiosyncratic compensation issues or if the executive compensation market is operating inefficiently. Consider stock option repricing under equity-compensation plans. If a company’s share price falls far enough below the exercise price of executives’ options, the options either begin to lose their ability to incentivize behavior, or, alternatively, encourage the executives to undertake exceptionally risky projects, the only ones with a chance of driving the options into the money. Thus, in cases where executive motivation is particularly in question, options are deeply underwater and the equity plan has few shares remaining for distribution, repricing the existing options to a lower exercise price may be the sensible thing to do. On the other hand, the potential for repricing options clearly diminishes the initial pay-for-performance aspect of the option. Thus, shareholders should be expected to generally object to option repricing while nevertheless reserving judgment in the particular case described above. Yet, experience with equity-compensation plans indicates that shareholders avoid permitting the latter sort of discretion. Since 2003, shareholders have been required to approve any compensation plan at companies listed on the NYSE and Nasdaq that would pay in equity, including stock options. In general, the plans approved by shareholders

76 See Gordon, supra note 8, at 347 (observing the efficiencies gained by establishing general guidelines); id. at 353 (noting RiskMetrics’ adoption of a non-negotiation policy to avoid the potential for conflict). Again, this phenomenon has apparently been experienced in the UK. See Davis, supra note 34, at 13. Moreover, the phenomenon is not limited to proxy firms’ clients. Even those institutional shareholders who keep Say on Pay analysis in-house will feel the economic pressure to adopt one-size-fits-all rules regarding voting on their portfolio companies.

77 See Gordon, supra note 8, at 352.


79 BECHUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 5, at 166.

80 Id. at 165–66.

81 Lund, supra note 78, at 126–27 (citations omitted) (describing the rules and noting that they exempted plans that only granted equity as inducements to potential employees
have set our basic ground rules, leaving the granular detail of the actual equity grants to firm discretion.\textsuperscript{82} However, shareholders have insisted, as one of these ground rules applicable across firms, that option repricing be prohibited.\textsuperscript{83}

Of course, whether homogenization is really harmful depends on the level of compensation–related idiosyncrasy across firms. This may very well be underwhelming.\textsuperscript{84} Moreover, economy–wide, the disciplining effect of shareholder–imposed rules on otherwise non–idosyncratic companies may outweigh the costs imposed on outlier firms. Ultimately, the issue turns on empirical questions regarding the amount of heterogeneity one would expect with respect to the decision class and the value of a potentially constraining influence on the homogenous group.\textsuperscript{85}

Finally, another criticism has recently surfaced in relation to the concerns about risk–taking, particularly in the financial sector. Many scholars and policymakers have laid responsibility for the recent financial crisis at the doorstep of bankers' pay structures.\textsuperscript{86} While some have

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\textsuperscript{82} See Bebchuk & Fried, Pay Without Performance, supra note 5, at 196; see also Gordon, supra note 8, at 337 (describing shareholder say over equity compensation plans as “general” rather than “specific”).


\textsuperscript{85} Gordon attempts to solve the problem he diagnoses, in part, by requiring an opt–in vote by shareholders to establish a Say on Pay requirement at any particular firm. See Gordon, supra note 8, at 356. But the opt–in device seems to simply push the difficult issue to an earlier stage. That is, the vote to opt–in or out would seem to fall prey to exactly the kind of homogenizing effect that Gordon attributes to the Say on Pay vote. Gordon observes that the opt–in mechanism would allow shareholders to target only those firms “whose pay practices (or their boards' justifications for them) raise the most serious questions.” Id. It is hard to see why the same investors would not make the same distinction when determining how to cast their Say on Pay vote. Investors who would otherwise rely on their own guidelines or those of proxy firms with respect to Say on Pay would have to establish (or receive) similar guidelines with respect to opting in to the Say on Pay regime.

focused their criticism on short-term incentives,"87 others have pointed to the divergence of risk preferences between executives (as equityholders through option and restricted stock awards) and debtholders.88 At least for the latter camp, it is key to make executives think less like shareholders, or worse, optionholders.89 But shareholders will obviously prefer managerial incentives to be more closely aligned with their own. Thus, empowering shareholders to influence pay may lead to a greater reliance on equity-based pay structures, thereby increasing incentives to take excessive amounts of risk.90

Suffice it to say that the criticisms of mandatory Say on Pay are strong and sophisticated. Notably, some of the fiercest critics of executive compensation practices seem reluctant to embrace the rule. For better or worse, however, increased shareholder power over compensation will be a fact for the foreseeable future.

II. HAVING A SAY ON PAY AFTER THE FACT

The foregoing criticisms of Say on Pay derive from a view of the merits of increasing shareholder power over compensation decisions. They say little, though, about the merits of Say on Pay as an alternative among different mechanisms for effecting that increase. In particular, none of the critiques addresses the disadvantages of presenting shareholders with a disciplinary device hinging on an ex post vote rather than an ex ante one. If Say on Pay's disciplinary effect occurs at the time of the ex post vote, then having a shareholder vote after the compensation decision and the performance period makes it vulnerable to bundling problems. Even if Say on Pay's discipline is found in the ex ante negotiations entered into because of potential ex post discipline, bundling problems remain because the base
threat of a future adverse vote is not credible for the same bundling-related reasons.

The most salient implication of these bundling problems is that Say on Pay will fail to discipline high-performing firms where bundling problems are greatest. In fact, the evidence that we have on Say on Pay’s effects in the UK confirms that high-performing firms are likely to be under-disciplined by a US version. Pay-performance sensitivity only increased for firms with negative earnings results, indicating that shareholders were unable to discipline high-performing firms even when those firms had questionable pay practices.91 Thus, there seem to be two independent and necessary conditions for Say on Pay’s discipline—poor pay practices92 and poor firm performance—when the former should be sufficient.93

A. Pay-for-Performance and Discipline of High-Performing Firms

The remainder of this Part argues that the timing of the Say on Pay vote helps explain the UK data and, indeed, that it would be surprising for Say on Pay to have turned out any other way. However, there is an alternative explanation for the UK phenomenon to address first. It may be that Say on Pay’s singular effect on poorly-performing firms derives from shareholders’ discipline preferences: they may simply care much more about pay–for–failure than they do about overpayment–for–success.94 On this view, Say on Pay in the UK did not increase pay–performance sensitivity at high performing firms because shareholders cared less about linking the two (or any other governance issue, for that matter) once a threshold level of performance was certain. If this is true, the failure to discipline high-performing firms simply reflects a general fact about shareholder activism, a fact that stands regardless of the structure of Say on Pay.

The explanation from bifurcated pay preferences is hard to square with theory or evidence, however. Today, almost all participants in the debate over executive compensation are committed to pay–for–performance.95

91 See Ferri & Maber, supra note 50, at 23–25, 53–54 tbls.6 & 7.

92 This first condition is slightly problematic in that it lumps together as objectionable practices both excess CEO compensation and past negative Say on Pay votes. One potential problem with the latter, for present purposes, is that it begs the question of what caused shareholders to cast adverse votes in the past — something about the packages themselves or general firm performance? Nevertheless, Ferri and Maber did find that even high–performing firms with excess CEO compensation did not experience discipline as a result of Say on Pay. Ferri & Maber, supra note 50, at 53–54 tbls.6 & 7; see supra note 61 and accompanying text.

93 See infra Part II.A.

94 Gordon, supra note 8, at 345 (“[The distinction] is consistent with avoiding pay for failure, certainly a major theme, if not the preoccupation, of the reform impulse behind the [Director Remuneration Report requirement including Say on Pay].”).

95 The minority, on the other hand, ranges from those who doubt the ability of executives to greatly influence firm performance, see, e.g., Khurana, supra note 10, at 22, to those who
Pay-for-performance implies a level of pay contingency across all performance outcomes, not merely the rejection of pay-for-failure. In its most simplified form, making compensation contingent on performance may incentivize executives to increase shareholder value when they might otherwise be expected to shirk. Indeed, the argument implies a rejection of the view that there is an aggregate amount of compensation that is per se objectionable. For instance, Kevin Murphy and Michael Jensen famously titled a paper, in part, “It’s Not How Much You Pay, But How.” They concluded that increased sensitivity of pay to performance would likely lead to increased total compensation for CEOs, but that such an increase would be more than offset by the gains to shareholders produced by the more productive managers. As long as executive pay is encouraging behavior that increases firm value and executives are not extracting rents greater than those gains, shareholders should be neutral to bullish regarding total compensation, even at otherwise extraordinarily high levels.

But even if increased pay encourages executives to make more wealth-maximizing decisions, that does not mean that all wealth-maximizing decisions are the result of increased pay or any particular pay structure. A firm’s success does not ensure that pay was structured optimally. It is possible that different pay practices could have improved firm performance or less pay could have resulted in similar performance. Shareholders should believe that a pay-for-performance framework harms non-pecuniary executive incentives, see James McConvill, The False Promise of Pay for Performance: Embracing a Positive Model of the Company Executive 49 (2005).

97 See Berchuk & Fried, Pay Without Performance, supra note 5, at 8 (admitting that their aim was to link pay and performance rather than limiting pay more generally).
98 Jensen & Murphy, supra note 96, at 138.
99 Id. at 139 (“These increases in compensation--driven by improved business performance--would not represent a transfer of wealth from shareholders to executives. Rather, they would reward managers for the increased success fostered by greater risk taking, effort, and ability. Paying CEOs ‘better’ would eventually mean paying the average CEO more. Because the stakes are so high, the potential increase in corporate performance and the potential gains to shareholders are great.”).
100 This position rests on at least two controversial propositions. First, firm performance must always have room to improve by way of better management. However, it is notoriously difficult to separate CEO performance from other factors leading to firm performance. See, e.g., Khurana, supra note 10, at 21–23 (describing the debate between the “leadership” and “constraint” schools of thought regarding CEO effects on firm performance). Second, CEOs must be thought to only supply that marginal-wealth-generating management when they are further compensated for doing so. This would require ever-increasing marginal levels of managerial productivity, i.e., that CEOs always hold back some effort or skill. But there is necessarily a saturation point with respect to incentives beyond which CEOs either cannot be more productive or have become immune to further remunerative incentives. Moreover, as Jensen and Murphy note, the threat of potential dismissal provides a base level of incentives. See Jensen & Murphy, supra note 96, at 142.
only want additional amounts paid when doing so produces greater benefits
than the compensation costs.\textsuperscript{101}

Payments in excess of this point may, of course, be less harmful to
shareholder value than payments that provide too few incentives, given
the differences of magnitude between compensation and firm value. When
pay exceeds the optimal amount, the total cost to shareholders equals the
excess compensation cost that is not offset by any marginal increase in firm
value. When pay does not provide enough incentives, the cost may be a
decrease in firm value that cannot be offset by the reduced compensation
cost. Faced with the uncertain location of the optimal balance, shareholders
committed to a strong pay–for–performance preference might be expected
to err on the side of providing too many incentives. But it nevertheless
seems bizarre that rational shareholders would consistently leave money on
the table in a Say on Pay world when realized pay is apparently excessive.\textsuperscript{102}

Along this line, significant institutional investors explicitly highlight the
need to constrain pay even in cases of exceptional firm performance.\textsuperscript{103}

There must be something else at play in the UK experience with Say on
Pay. Shareholders’ commitment to pay–for–performance might flow
from a sort of inchoate intra–firm populism, with shareholders essentially
making a claim that no executive should do too well unless the rest of the
firm is doing well enough.\textsuperscript{104} Alternatively, pay–for–performance may serve
as a hedging strategy for investors seeking to cut compensation expenses
in bad times.\textsuperscript{105} Finally, shareholders could simply be committing error by
failing to discipline high–performing firms in spite of their stated pay–for–
performance commitments, perhaps out of excessive hindsight bias.\textsuperscript{106}

\begin{footnotesize}
\begin{itemize}
\item[101] See, e.g., Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, \textit{Managerial Power and Rent Extraction in the Design of Executive Compensation}, 69 U. Chi. L. Rev. 751, 763–64 (2002) ("Under the optimal contracting approach, shareholders should continue to give value to executives until the incremental cost of doing so outweighs the incremental benefit of the incentives produced.").
\item[102] See id. at 764 ("A compensation plan designer . . . would consider alternative structures both in terms of their incentive benefits and their costs to the company. No scheme would be chosen, of course, if an alternative scheme could produce the same or better incentives at a lower cost to the company.").
\item[103] See \textit{Council of Institutional Investors, Corporate Governance Policies} §§ 5.1, 5.5d, http://www.cii.org (follow “Council Policies” hyperlink; then follow “Full Council Corporate Governance Policies” hyperlink) (last updated Apr. 13, 2010) ("While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid . . . . Performance measures applicable to all performance–based awards . . . should reward superior performance . . . at minimum reasonable cost. Such measures should also reflect downside risk.") (emphasis added).
\item[105] This position is weakened by the relatively small magnitude of executive compensation relative to most firms’ balance sheets.
any of these cases, the failure to constrain pay at high-performing firms would again reflect a characteristic of compensation activism generally rather than a structural flaw in Say on Pay.\textsuperscript{107}

Without completely dismissing those possibilities, there is little evidence that institutional shareholders or proxy services firms feel that pay-for-performance is conceptually limited to the avoidance of pay-for-failure.\textsuperscript{108} Of course, the absence of such a statement in proxy firms’ public statements does not definitively show that their view of pay-for-performance applies equally to high-performing firms as it does to poorly-performing firms. Nevertheless, it is perhaps telling in the light of the different explanations for the under-disciplining of high-performing firms developed hereinafter.

\textbf{B. The Problems with Say on Pay’s Timing}

The more plausible explanation for shareholders’ failure to discipline pay at high-performing firms is that implementing such discipline carries greater perceived costs than discipline at low-performing firms. These costs can be divided into process-related costs including monitoring and vote coordination efforts, and anticipated but unintended secondary costs related to the discipline. The remainder of this Part makes two related points. First, process-related costs in a world of scarce monitoring resources do not explain much about the experience with Say on Pay. Second, Say on Pay’s unintended collateral costs are likely to appear significant to shareholders. Together, these points indicate that Say on Pay’s bundling issues are a significant cause of the inability to fully discipline excessive pay.

1. \textit{Firm Performance and the Limited Resources of Monitors}.—The connection between firm performance and shareholder activism has been well documented.\textsuperscript{109} Traditionally, this link has been explained by reference to the incentives (or lack thereof) of shareholders to actively monitor firms.\textsuperscript{110}

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\textsuperscript{107} Though, in the case of error by virtue of hindsight bias, pushing the shareholder vote up in time would make it less likely for pay practices to be conflated with performance during the relevant performance period.

\textsuperscript{108} See infra Part II.B.1.


\textsuperscript{110} See, e.g., Ferri & Maber, supra note 50, at 19; Thomas & Martin, supra note 109, at 1055 (“Most researchers hypothesize that investors can be expected to be active monitors of
Activism may be costly, potentially unsuccessful, and even if successful, only minimally accretive to all but the largest shareholders. Consequently, institutional investors have been shown to be more likely to target poor-performing firms when making shareholder proposals and, once shareholder proposals are offered, high-performing firms have been shown to be less likely to face high levels of voting in favor of them. As just one example from the world of compensation activism, Randall Thomas and Kenneth Martin analyzed compensation–related shareholder proposals from the 1993 through 1997 proxy seasons and found that whether activists offered such proposals was inversely related to market–adjusted common stock returns over three– and five–year intervals.

Those findings are not surprising given that institutional investors, like everyone else, have limited resources to expend on firm monitoring. Consequently, they should be expected to adopt monitoring strategies that economize. As discussed above, they may respond to this reality by establishing one-size–fits–all guidelines and/or farming out much of the monitoring work to agents. To the extent they do make firm–specific determinations, scarcity of resources may cause them (or their agents) to limit the number of firms that they study or in which they ultimately make activism investments.

With respect to Say on Pay in the UK, however, proxy firms and institutional shareholders and advisors have tended to downplay the importance of firm performance to their analyses in their public statements. In the UK, the Association of British Insurers ("ABI"), whose members and subscribers represent approximately thirty percent of the UK equity market, has established executive pay guidelines that apply regardless of performance categories. Its IVIS service prepares reports for all UK firms with color-coded "tops" indicating significant, less significant, and managers when the benefits of such monitoring exceed the costs.

111 Thomas & Martin, supra note 109, at 1056–57 (citing research describing the behavior of CalPERS, the United Shareholders of America, the Council of Institutional Investors as well as economy–wide shareholder activism).

112 Id. at 1058–59 (citation omitted) (citing Johnson and Shackell's work demonstrating that firm performance was inversely correlated with shareholder support, while compensation plan design was not correlated with such support at all).

113 Id. at 1064.

114 See supra notes 71–77 and accompanying text.

115 See, e.g., Black & Coffee, supra note 54, at 2053 (discussing phenomenon as it relates to British institutional investors).

116 Telephone interview with representative, Ass'n of British Insurers (Apr. 27, 2010); see also Ass'n of British Insurers, Institutional Voting Info. Serv., Executive Remuneration—ABI Guidelines on Policies and Practices 4 (2009), available at http://www.ivis.co.uk/PDF/ABI_Remuneration_Guidelines_Dec_2009.pdf ("Executive remuneration should be set at levels that retain and motivate, based on selection and interpretation of appropriate benchmarks which should be used with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.")
no significant governance-related concerns. These reports go into a fair amount of compensation detail and explicitly consider excessiveness of pay even at highly-performing firms. Similarly, the RiskMetrics subsidiary involved with UK governance issues analyzes high-performing companies as well as poor-performing ones and has done so at least since Say on Pay became mandatory. The National Association of Pension Funds explicitly adopts the ABI guidelines in its own voting guidelines, and goes on to describe twenty practices that might trigger adverse Say on Pay votes. Most of these practices have little to do with firm performance, although at least one—a board’s resetting of performance goals—is more likely to occur at poor-performing firms. This practice of “moving the goalposts” is presumably less costly to observe than it is to judge the appropriateness of their initial placement, and thus provides some limited evidence that monitoring cost considerations might help explain the UK experience.

Interestingly, US proxy firm and institutional shareholder expressions of Say on Pay analyses are roughly similar to their UK counterparts. In the US, though, proxy firms are slightly more likely to explicitly link performance with recommendations more generally. RiskMetrics’ US group, for example, describes how it focuses its Say on Pay activism on firms with “sustained underperformance relative to peers,” assuming that the pay/performance link will be most attenuated in those companies. A finding of poor pay/performance sensitivity functions as one of the three stated primary grounds for RiskMetrics making a negative Say on Pay recommendation, and the other two primary grounds—“problematic pay practices” and “poor

118 For a sample report, see INSTITUTIONAL VOTING INFO. SERV., AGM FOR THE YEAR ENDING 26/11/2007 2 (2007), http://www.ivis.co.uk/PDF/IVIS_Plc_15112007.pdf (for a firm with an above-median 10-year TSR measure “[o]verall levels of remuneration do not appear to be excessive with an appropriate balance struck between fixed and variable pay [and] EPS targets attached to the exercise of options appear to be suitably demanding.”).
119 Telephone interview with representative, RiskMetrics Group (Mar. 30, 2010).
120 NAT’L ASS’N OF PENSION FUNDS, CORPORATE GOVERNANCE POLICY AND VOTING GUIDELINES 24 (Feb. 2009), http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx (follow the “C” hyperlink; then follow the “Corporate governance policy and voting guidelines” dated Feb. 6, 2009 hyperlink to download the PDF file) (“The NAPF anticipates that most institutional investors and issuers will use the ABI Guidelines as a benchmark for remuneration policies and has therefore chosen not to re-interpret them in detail here.”).
121 Id. at 24-25.
122 Cf. id. at 24 (describing IVIS’s close examination of performance metrics).
communication and responsiveness to shareholders'—do not obviously capture instances of excess compensation on Ferri and Maber's terms. As far as RiskMetrics's primary drivers of adverse Say on Pay votes, then, none would necessarily impose discipline on excess compensation at high-performing firms: pay/performance sensitivity because high-performing firms are screened out, and the other two factors because they do not address excess compensation specifically.

On the other hand, Glass, Lewis & Company explicitly states on its website that it applies a pay–for–performance test to all firms regardless of performance; that test is then used in its Say on Pay analysis. Moreover, even RiskMetrics issues negative Say on Pay recommendations based on excessive compensation at high-performing firms. In addition to the primary factors it lists in its voting guidelines, RiskMetrics also notes additional considerations including the propriety of performance metrics in incentive plans, benchmarking practices, and the balance between performance–based versus non-performance–based pay. The first two of these may catch much of excess compensation (as defined by Ferri and Maber) and do so without a performance filter. This alternative route to negative Say on Pay votes is more than illusory. In 2010, for instance, RiskMetrics recommended a negative Say on Pay vote (and an “Against” vote against the entire board) despite the fact that the firm had above–median performance over a three– and five–year term. The recommendations were not based on pay/performance sensitivity (presumably because the firm was not caught by the performance filter described above) and were instead generated by

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125 Id. at 38.
126 See supra note 59.

We closely review companies' compensation practices and disclosures as outlined in their CD&As and other company filings to evaluate [Say on Pay votes]. In evaluating these [votes], we examine how well the company has disclosed information pertinent to its compensation programs, the extent to which overall compensation is tied to performance, the performance metrics selected by the company and the levels of compensation in comparison to company performance and that of its peers.

Id.

130 RiskMetrics Company Profile (on file with author).
"pay magnitude, pay disparity, peer group disparity, and performance target issues." Thus, while proxy firms do have incentives to reduce costs by limiting their inquiry to poorly-performing firms, it appears that they do not, at least not to any significant degree.

Although it is difficult to say anything with certainty, recent research outside of the compensation context also indicates that proxy firms do not focus their monitoring energies specifically on poorly-performing companies. Evaluating proxy firm recommendations for director elections, Steve Choi, Jill Fisch, and Marcel Kahan studied the recommendations of the four leading US proxy firms with respect to director elections in 2005 and 2006. Their univariate analysis indicated that only Institutional Shareholder Services (now RiskMetrics) and Glass, Lewis & Company were less likely to issue a withhold recommendation for directors at high-performing firms, while PROXY Governance and Egan–Jones seemed to disregard firm performance entirely when making their recommendations. Their multivariate regressions, moreover, showed that high firm performance was not significantly inversely correlated with any proxy firm’s withhold recommendations other than at PROXY Governance where the correlation was only marginally significant. Finally, limiting the performance/recommendation inquiry to elections of CEOs and other inside directors who may be more likely to be blamed or credited for firm performance, Choi et al. found that top and/or bottom returns did not seem to affect the proxy firms’ “withhold” recommendations, contrary to their expectations. In short, US proxy firms at least do not generally shy away from recommending discipline even at high performing firms despite their limited resources. Although it is possible that shareholder advisors in the

131 Id.

132 Moreover, if Jeffrey Gordon is right and proxy firm vote recommendations are less firm-specific than claimed, the cost of inquiry is even lower and scarcity of monitoring resources explains even less of the different treatment of high-performing and poorly-performing firms. See supra notes 76–77 and accompanying text.

133 Given the relatively scarce adoption of voluntary Say on Pay measures, there is not enough data regarding proxy firm recommendations or US Say on Pay votes.

134 Choi et al., supra note 72, at 651.

135 Id. at 669–70. Choi et al. classify firms as high or low-performing if they fall in “the top or bottom [five] percent of companies ranked based on abnormal holding period returns [over the prior three years], adjusted based on the CSRP value-weighted market index.” Id. at 662. Consequently, their findings may not conclusively demonstrate that a rougher “50% are high-performing, 50% are low-performing” approach has not been used by proxy firms. See supra notes 111–13 and accompanying text.

136 Choi et al., supra note 72, at 671–75. Poor performance was significantly correlated with Glass Lewis’ withhold recommendations, though not with any other firm’s. Id at 674–75.

137 Id. at 680–81. It should be noted, however, that PROXY Governance, the only firm to have a significant inverse relationship between high firm performance and withhold recommendations more generally, was omitted from these analyses. Id.
UK are different in this respect, it is more plausible that something else is causing the UK phenomenon.

Along this line, even if proxy firm recommendations regarding Say on Pay votes are not biased in favor of high-performing firms, shareholder voting might be. Proxy recommendations are one step removed from the actual shareholder vote. The ultimate decision as to whether or not to discipline firms by taking activist measures will usually be made by proxy firms' clients, the institutional shareholders. Accordingly, there may be leakage between proxy firms' recommendations and shareholder votes. To this point, researchers have analyzed when and to what extent mutual funds deviate from proxy firm recommendations. James Cotter, Alan Palmiter, and Randall Thomas found that ISS/RiskMetrics recommendations have a more significant correlation with mutual funds' voting decisions on management and shareholder proposals than do management recommendations. This is in line with the view that the leakage between recommendations and shareholder voting should be relatively small. After all, if shareholders' monitoring resources are scarce, it would be surprising to find them checking the work of their advisors. Interestingly, however, Cotter et al. still found significant mutual fund deviation from ISS/RiskMetrics recommendations on both shareholder proposals and management non-routine proposals. The deviation rates are even larger for shareholders as a whole. Whatever might cause this leakage, however, it is unlikely to be shareholder monitoring costs. Solely with respect to such costs, shareholders' most efficient strategy would be to mechanically follow their advisors recommendations, recognizing that the fees paid to those advisors are sunk while any independent monitoring activities would require additional resources.

If one looks to governance and voting policies promulgated by significant institutional shareholders themselves, one finds little evidence of a bias towards highly-performing firms. CalPERS, for one, does not apply any sort of performance test to filter out firms that do not need to be monitored.

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138 But see id. at 652 (some shareholders permit the proxy services firms to vote their shares). In conversations with representatives from both RiskMetrics' UK arm and the ABI, the advisors strongly asserted the independence of their members/clients regarding actual voting behavior. Telephone interview with representative, Ass'n of British Insurers (Apr. 27, 2010); Telephone interview with representative, RiskMetrics Group (Mar. 30, 2010).


140 Id. at 31, 32 tbl.2.

141 Id. at 48–50. Cotter et al. found that mutual funds deviated from the recommendation in 23% of instances involving shareholder proposals and 12.1% of instances involving non-routine management proposals. Id. at tbl.6, Panel B.

142 Id. at 88–89. Deviations in 34.8% of instances involving shareholder proposals and 24.7% of instances involving non-routine management proposals. Id. at tbl.6, Panel A.

143 See CAL. PUB. EMPS’ RETIREMENT SYS., GLOBAL PRINCIPLES OF ACCOUNTABLE
TIAA-CREF's overarching policy statement on the matter discusses the need to consider issues beyond firm performance. While these policies may overstate the breadth of institutional investors' compensation-related monitoring, it provides some indication that they would perform a Say on Pay analysis on most firms.

Finally, taking delegating shareholders and non-delegating shareholders together, evidence shows that investors have not generally avoided disciplining high-performing firms in other compensation-related contexts. With respect to compensation-related activism (including compensation-related shareholder proposals and vote-no campaigns where there was explicit mention in the soliciting materials of compensation issues), activist shareholders' voting decisions have not been particularly influenced by firm performance.

In sum, proxy firms and institutional shareholders generally take critical looks at even high-performing companies when making voting decisions, including compensation-related decisions. This finding cabins, but does not eliminate, the possibility that scarcity of resources can help explain the reluctance of shareholders to discipline pay at high-performing firms.

2. Bundling Say on Pay Discipline with the Perceived Costs of Offending Managers.—Shareholders may incur other costs when they discipline

In addition to being performance based, executive compensation should be reasonable by prevailing industry standards, appropriate to the company's size and complexity, and fair relative to pay practices throughout the company.

While equity-based compensation can offer great incentives to management, it can also have great impact on shareholder value. The need for directors to monitor and control the use of equity in executive compensation, particularly stock options, has increased in recent years.


146 Id. at 58, tbl.4. Their targeting decisions, on the other hand, were significantly related to firm performance, among other things. Id. at 14.

147 But see Ferri & Maber, supra note 50, at 3 ("[I]nstitutional attention is a scarce resource that is allocated mostly to problem firms.") (citation and internal quotation marks omitted).
managers, however. In particular, discipline may bring with it unintended consequences insofar as it affects the behavior of the disciplined. Firm performance becomes an important data point for discipline decisions if the discipline may lead managers to shirk or depart from the firm in response. If this is a non-trivial possibility, it may be best from the shareholder perspective not to rock the boat on compensation. Thus, shareholders will reintroduce (or perhaps shareholder advisors will include in the first place) firm performance as a voting consideration where the appropriate answer from an abstract compensation/governance perspective might have harmful indirect performance consequences.

Take, for instance, the shareholder proposals singled out by Cotter et al. in their study—declassifying the board, seeking shareholder approval of poison pills, requiring majority vote for director elections, and separating the CEO and chairman of the board positions. The first two are entirely meta-governance issues and a vote for or against is unlikely to affect a firm’s operational performance beyond reducing managerial slack by making the firm more open to the market for corporate control. The only reason to consider firm performance in regard to such a vote is that low-performing firms may benefit more from such a reduction than high-performing firms. Shareholder votes to declassify boards, request shareholder input over anti-takeover measures, or install a majority voting provision are commonplace, generally applicable across firms, and therefore difficult for managers to take personally. Accordingly, there are relatively few reasons for shareholders at high-performing firms to fear negative performance effects due to an activist vote.

CEO/chair separation proposals are also structural and have become generalizable across firms. But votes on such proposals are somewhat susceptible of being viewed as a referendum on the CEO to the extent the base concern driving the activism is the fear of a particular CEO not being monitored. As such, the votes may theoretically have confounding near-term performance implications if they were to offend the target CEO and cause his or her defection from past behavior. Interestingly, it is on those proposals that Cotter et al. find high rates of deviation from ISS recommendations.

144 Cotter et al., supra note 139, at 48–49 tbl.6, Panel A.
150 There may be reasons to refrain from taking the lead on such activism as the leader may incur significant proxy costs. The advantages of free riding by other shareholders, however, should wind up mitigating that aspect of activism costs when follow-on shareholders need only decide how to vote, guided by a proxy firm recommendation.
151 See supra Part II.B.1.
152 See Cotter et al., supra note 139, at 48–50 (all shareholders) and 50–52 (mutual funds). Cotter et al. also found high deviation rates from ISS recommendations involving majority voting. Id. at 48–50. Of course, as CEO/chair split votes become more commonplace it be-
Consider compensation–related activism more specifically. As discussed above, shareholders’ voting is surprisingly uncorrelated with firm performance.\textsuperscript{153} Much of the activism in question—proposals calling for greater compensation committee independence, greater compensation disclosure, shareholder approval of certain compensatory items, linking pay to social criteria, and the abolition of incentive pay\textsuperscript{154}—is a generalized sort that is not obviously bundled with confounding performance–related consequences.\textsuperscript{155} Thus, there may be little reason for shareholders to take anything other than the abstract and non–firm–specific governance question into account when voting. Furthermore, we should expect little leakage from proxy firm recommendations or generally–accepted principles at that level of abstraction.

Say on Pay is different because it is far more firm—and executive—specific. Thus, even if Say on Pay’s process–related costs are not great—the vote is mandatory and advisors are already heavily relied upon—costs created by the personalized nature of the subject matter may outweigh, or may be perceived by shareholders to outweigh, the benefits of compensation discipline.

Bundling issues in shareholder voting are not new. Shareholder veto power over certain transactions or governance adjustments may be limited by the ability of interested directors to bundle a value–decreasing proposal with a distinct proposal that is attractive to shareholders.\textsuperscript{156} In director elections, shareholders may have difficulty disciplining directors over particular non–preferred board actions because they recognize the potential costs—over the class of all other future board decisions—of losing the directors.\textsuperscript{157} The bundled costs here include the marginal decline in performance realized by switching from current senior management to the next best available candidates who would at least remedy the non–preferred action.\textsuperscript{158} If directors can anticipate shareholders’ evaluation of these bundled costs, they will have no cause to fear discipline up to the

\textsuperscript{153} See supra notes 145–46 and accompanying text (discussing the study by Ertimur, Muslu, and Ferri).
\textsuperscript{154} See Ertimur et al., supra note 145, at 9. Also included were performance–based vesting conditions for equity grants, which would seem to have performance–related effects. Id.
\textsuperscript{155} For more on firm–specificity and its effect on institutional investors’ willingness to engage in activism, see Bebchuk, Shareholder Power, supra note 4, at 881 (arguing that “rules of the game” decisions are generally not firm–specific and shareholders are therefore reasonably well–situated to exert influence over them).
\textsuperscript{156} Lucian A. Bebchuk & Ehud Kamar, Bundling and Entrenchment, 123 HARV. L. REV. F. 1549, 1555–57 (2010); see, e.g., Bebchuk, Shareholder Power, supra note 4, at 864–65.
\textsuperscript{157} K.A.D. Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 Wis. L. REV. 1425, 1450–54; see, e.g., Bebchuk, Shareholder Power, supra note 4, at 857–61.
\textsuperscript{158} See Camara, supra note 157, at 1450 (referring to the “loss of the incumbent senior–management team”).
admittedly nebulous point at which the costs of those actions equal the costs of dismissal.\textsuperscript{159}

Although Say on Pay does not relate directly to director elections or shareholder votes on management-sponsored proposals, it nevertheless creates bundling issues. An adverse Say on Pay vote, like a vote-no campaign against directors, is designed to send a message. Shareholder discipline in these cases will not directly cause firm performance to change, but may offend managers and cause them to change their managing behavior for the worse. On this score, Say on Pay has a high potential for giving offense. The Say on Pay vote is personal—there are at most five people’s compensation packages being judged, pay has significant ramifications to the executives, and the entire process is played out in a very public setting. At its heart, Say on Pay asks shareholders to decide whether executives deserved what they were paid, a criticism that strikes directly at the executive’s self-esteem. The potential for offense is only heightened if CEOs tend to be more narcissistic as a class than others,\textsuperscript{160} or if they have a deep-seated need for others’ admiration and, concomitantly, a deep-seated aversion to criticism.\textsuperscript{161} Losing a Say on Pay vote is humiliating to people who are not used to being humiliated.\textsuperscript{162}

Therefore, prior to casting a negative Say on Pay vote, shareholders may reasonably expect offended managers to slack or feel less loyalty towards the firm after such a vote. Fiduciary duties and performance-based compensation provide relatively weak constraints on that sort of deviation.\textsuperscript{163} But even if there were sufficient mechanisms in place to discipline offended managers who continue with the firm, managers may instead leave the firm. Their ability to do so will depend on the vagaries of the managerial labor market, but those managers at high-performing firms will almost certainly have the greatest exit opportunities.\textsuperscript{164}

\textsuperscript{159} Id.


\textsuperscript{161} See Alan Downs, Beyond the Looking Glass: Overcoming the Seductive Culture of Corporate Narcissism 17 (1997).

\textsuperscript{162} If Say on Pay votes were systematized according to one-size-fits-all structural rules, then some of the personal nature of the vote could be dissipated. Because the data indicates a bias against poor-performing firms, however, an adverse Say on Pay may not be seen by managers in this way.

\textsuperscript{163} See, e.g., Robert B. Thompson & Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 VAND. L. REV. 1747, 1756–60 (2004). More controversially, the managerial labor market may discipline those who remain at the firm. See Cheng et al., supra note 90, at 6 (suggesting that executives may be incentivized to undertake risk based on the threat of turnover).

\textsuperscript{164} See Khurana, supra note 10, at 104–105; Bebchuk et al., supra note 100, at 776 ("[T]he ability to get another CEO job will depend on the CEO's overall performance at her current firm, not on the amount of rent extracted.").
Of course, even if CEO deviation from past behavior, up to and including departure, is a likely response to more personal forms of activism like Say on Pay, that will only give shareholders pause if they believe that such deviation could significantly affect firm performance. On this point, there is little doubt that shareholders perceive an extraordinarily high correlation between firm performance and CEO behavior.\(^{165}\) CEO retention—the focus of shareholders confronted with possibly bundled Say on Pay votes—is but the flip side of CEO recruitment. To the extent shareholders perceive the link between CEO and firm performance at the hiring stage, they surely do so at the retention stage. This is true even leaving aside any bargaining advantages sitting CEOs may otherwise receive by virtue of their incumbency. Incumbents may exert managerial power over pay negotiations,\(^{166}\) but that does not change the calculus for shareholders seeking to predict the marginal benefit to firm performance gained from having CEO, as opposed to CEO.

If one looks at the CEO hiring process, it is relatively well-settled that shareholders place a high value on that marginal difference. Since the 1980s, institutional shareholders have agitated for greater management responsiveness believing, necessarily, that managers mattered.\(^{167}\) After initial success, activist investors continued to press for corporate change through the dismissal of CEOs who were viewed as ineffective.\(^{168}\) The result was radically shorter CEO terms across the economy as a whole and, consequently, significantly greater CEO attention being paid to large investors.\(^{169}\) Rakesh Khurana summarized the state of affairs thusly: “All of the forms of pressure applied by investors, via corporate directors, to CEOs—but especially those aimed at achieving CEO dismissals—have revealed a distinctly CEO-centered view of the corporation.”\(^{170}\) Underlying
the pressure from institutional investors and governance activists is the fact that those groups think CEO behavior is critical.

Investor pressure for CEO turnover is not the only data point that demonstrates investors' belief in CEO importance for firm performance. As discussed earlier, tying CEO pay to firm performance has become a bedrock principle for shareholder activists. The vast majority of performance-based pay comes in the form of equity compensation explicitly linking a CEO's financial outcome with share price. Unless CEO behavior has a profound effect on firm value though, the relationship between share price and CEO performance becomes attenuated, and the case for awarding equity compensation largely falls apart.

Moreover, there is a broader set of anecdotal evidence showing the way in which CEOs' personal behavior—their traits, talents, and actions—has become the primary indicator of firm performance for shareholders and the public generally. Khurana, for instance, describes the rise of the cult of the charismatic CEO in recent years. In his account, CEOs are no longer seen as simply managers, but rather as "visionaries" and "evangelists." The rise of the business press, with its own set of incentives for easily digestible, sexy, and moralistic explanations for complex business issues, and the increasing importance of analysts hoping to be interviewed by that business press, has further focused attention on the personal characteristics of CEOs and the candidates to replace them. The more attention that is lavished on CEOs and potential CEOs, the more impact they seem to have on the firms they lead and, most importantly, the more that slight differences between CEO alternatives become magnified.

It is not even essential that institutional shareholders believe in the significance of firm performance effects among CEO alternatives. These investors need only to expect that other market participants hold such views and consequently that differences between CEO alternatives will drive firm value, at least in the short run. The best evidence that

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172 See supra notes 95–99 and accompanying text.
174 See Kevin J. Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 857 (2002) (questioning the basis for awarding equity compensation to employees who cannot affect share prices).
175 KHURANA, supra note 10, at 69–80.
176 Id. at 71.
177 Id. at 73–80.
178 For more on the view that investors are predicting the behavior of other investors

If shareholders perceive a strong link between CEO quality and firm performance, they will be reluctant to risk offending CEOs in a way that may harm firm performance. The costs of offending will obviously be higher at high-performing firms. A negative Say on Pay vote is therefore likely bundled with, and, at high-performing firms, dominated by its potential collateral effects on CEO behavior. A skeptic might note that this domination extends to compensation decisions more broadly.\footnote{But see discussion supra Part II.A for more on the case for disciplining pay at high-performing firms.} That is, compensation cost concerns are always dwarfed by executive performance concerns even if the decision is made on an \textit{ex ante} basis. It is incontrovertible that shareholders prefer expensive stars to inexpensive mediocrities. As discussed in Part III, however, there are advantages in having an \textit{ex ante} mechanism even if shareholders’ preferences require that the discipline ultimately meted out is relatively modest.

3. **Say on Pay’s Discipline Prior to Determining Pay.**—The argument to this point has been that an \textit{ex post} Say on Pay vote will be distorted by bundled collateral costs at high-performing firms. Say on Pay’s proponents, however, do not place particular importance on shareholders’ \textit{ex post} voting decisions. Rather, they believe the measure’s promise lies in its ability to shape board behavior prior to entering into compensation arrangements with executives.\footnote{See supra notes 33–34 and accompanying text.} In order to avoid the embarrassment and complications created by an adverse vote in the future, boards and executives should comply with shareholder demands in shaping pay packages at the outset. This compliance could involve actual communication with shareholders or their advisors or adherence to whichever generalized guidelines they promulgate. If true, shareholders are never forced to use their Say on Pay voting power and are therefore not truly faced with the bundling issues described above.

Even in this idealized case, however, bundling will pose a problem because it makes less credible the base threat that animates boards’ willingness to negotiate with shareholders ahead of time. The less credible the ultimate voting threat is, the less reason managers (and boards and
the executives with which they are negotiating) have to comply with shareholder demands early in the process.

The threat of an adverse vote will be less credible *ex ante* in at least two cases given the vote’s bundled costs.182 First, if managers are optimistic about the firm’s prospects, they will assume the firm will be among the high performers and therefore discount the likelihood of future adverse Say on Pay votes.183 Second, even more conservative managers will nevertheless be able to discount the shareholder threat that yields *ex ante* shareholder influence. The structure of compensation contracts allows boards and executives to allocate compensation rewards among different performance scenarios. By doing so, they can enforce discipline in downside scenarios, where the potential for later shareholder discipline is high. But in the upside scenarios, boards and executives will be unconstrained by any shareholder influence because they anticipate the significant bundling problems facing shareholders in the high–performance situation. Bundled collateral costs are thus able to fully explain the inability of Say on Pay to impact pay at high–performing firms during both periods in which discipline might otherwise be meted out.184

### III. *Ex Ante* Shareholder Approval of CEO Compensation Plans

The bundling problem described in Part II is a result of the timing of the Say on Pay vote. Largely because the vote occurs after a performance period and after a CEO has been chosen, Say on Pay will struggle to constrain pay at high–performing firms. The solution, obviously, is to push the discipline mechanism to a period prior to the point at which a vote could offend managers. One possibility along this line would be to require shareholders to approve a CEO Compensation Plan ahead of the process in which a firm recruits and hires its new CEO.185

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182 Additionally, if the CEO-to-be is aware of the shareholder demands at this *ex ante* stage, he or she may be offended. For more on this point, see *infra* Part III.A.

183 For more on managers’ excessive optimism, *see*, e.g., Barnard, *supra* note 160, at 413–15.

184 The later timing of the Say on Pay vote may also permit shareholders to defect from commitments they made to managers at the *ex ante* stage. This inability to bond shareholders could cause managers to discount the benefit of getting *ex ante* shareholder approval. If so, the discounting would not necessarily lead to less discipline at high–performing firms than poor–performing firms. Instead, the ability to defect caused by the time lag between shareholder promise and shareholder vote would call into question the ability of Say on Pay to impose any discipline at all. But the data from the UK indicates that Say on Pay has had an impact on poor–performing firms, arguably the firms most likely to fear shareholder defection. *See supra* Part I.A.

185 This proposal could easily be expanded to a “Top 5 Executive Compensation Plan,” and there is no reason to necessarily limit its purview to CEO pay. This Part does so only for ease of exposition.
set out compensation-related terms for anyone hired to the post for some period of time following its adoption, and the plan vote could not be shifted to an earlier time to exploit the bundling effects described above. The remainder of this Part develops this mechanism and suggests that it is largely preferable to Say on Pay.

A. Starting from the Equity Compensation Plan Listing Requirements

A point in Say on Pay's favor is that it has already been adopted in the UK and proposed at a number of US companies and, in both cases, has not led to disastrous results. Although proposals to adopt Say on Pay at individual US firms seem to be driven by firm size rather than quality of pay practices, those proposals have generally not been approved by shareholders. In the UK, where Say on Pay is mandatory at most firms, it seems to have affected only those with poor pay practices. Even if Say on Pay is limited to affecting only firms with poor pay practices and poor performance, the fact that it has not wreaked havoc elsewhere is not to be dismissed lightly given the doubts surrounding increases to shareholder power.

Fortunately, a CEO Compensation Plan approach is similarly situated in that an analogous rule has been adopted—in the US, no less—and has not caused significant damage to firms. Since 2003, the NYSE and Nasdaq, as well as other exchanges, have required traded firms to submit equity compensation plans for shareholder approval. This rule covers any plan under which options, restricted stock, or restricted stock units are

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187 Cai & Walkling, supra note 15 (manuscript at 31–33).

188 Id. at 33.

189 See Ferri & Maber, supra note 50, at 21–25.

190 See supra Part I.A (Say on Pay's benign effects); supra Part I.B (concerns over increased shareholder role).

191 While it is important not to overstate the advantage of using a US example as precedent, there are differences between US and UK corporate governance which may militate in favor of a tried–and–true domestic approach. See supra note 54.

192 Lund, supra note 78, at 126. Prior to 2003, firms only had to receive shareholder approval under listing standards if the plans were not "broadly–based." Id. at 124. For more on the history of the equity compensation–related listing standards, see id. at 124–27.

Those equity-related components of pay make up a sizable portion of the annual compensation paid to top executives, though the rules apply even to plans that pay all or most of the equity to lower-level employees. By prohibiting equity compensation from being paid under non-approved plans, the rule effectively makes the shareholder vote binding and gives shareholders significant authority over a large portion of executive compensation.

This reallocation of authority has not produced particularly terrible consequences. The rule proposed in this Part would be broader than the equity plan-related listing requirements in that it would cover all compensation paid to CEOs rather than just equity-based compensation. On the other hand, it would be narrower than the current listing requirements in that compensation approval would only be required for the CEO or a small group of executives.

Building on the ex ante equity compensation approval example would largely avoid the bundling issues described in Part II. Pushing the discipline decision forward would make its application unlikely to offend any potential CEO and should therefore allow shareholders to express their true compensation preferences. To ensure this depersonalization, the CEO Compensation Plan would have to be proposed and approved prior to the onset of a CEO search process. If it occurred later, the potential for offending candidates would become higher as the vote could still be seen as candidate-specific. The likelihood of offense in such situations would depend on the public information regarding candidates, but could be

are covered only to the extent the value of such units can be paid out in shares. Id.

194 Excepted from the approval requirement are (1) inducement awards; (2) conversions, replacements, or adjustments of outstanding options or other equity compensation awards when necessary to reflect an acquisition and post-acquisition grants using shares available under acquired plans; and (3) 401(a) plans (e.g., ESOPs), 423 plans, and parallel excess plans. Id.


196 In this way, the rules differ from historical rules that exempted broad-based plans. For more on the history of the listing requirements, see Lund, supra note 78, at 124–30.

197 See Cai & Walkling, supra note 15 (manuscript at 35–36) (showing that pay–performance sensitivity and abnormal CEO pay drive shareholder voting on equity compensation plans).

198 For example, shareholders could be required to approve a plan every two years with the newly-approved plan becoming effective six months after the approval in order to prevent bundling in the event of a contemporaneous CEO search.

199 In addition to avoiding bundling problems, this point distinguishes the CEO Compensation Plan proposal from others that would require shareholder approval of an already negotiated but not yet effective CEO employment contract. Gordon, for instance, criticizes such proposals as unworkable because a company’s “inability to offer a definitive contract would significantly impair the recruitment efforts, both because of the uncertainty and the possible embarrassments of a negative shareholder vote.” Jeffrey N. Gordon, Executive
effectively negated by requiring approval well ahead of time.

B. The Continuing Problem of Internal Candidate Favorites and Incumbents’ Contract Extensions

Before discussing potential problems in replacing Say on Pay with an ex ante shareholder approval requirement, the latter’s limitations should be made clear. The CEO Compensation Plan approval requirement would not always solve the bundling problems discussed above. Ex ante approval avoids those distortions only if the voting shareholders are ignorant of potential CEO candidates. Otherwise, they may anticipate that their actions could be taken personally by any candidate who eventually becomes an actual candidate. The advantages of ex ante shareholder approval are largely dissipated, then, if there is no way to effectively shield the identity of the future CEO.

This will be the case most often where internal succession is anticipated, given the obvious problems created by publicly telegraphing the candidacy of someone external to the firm. Whether the arrangement involves re-upping with incumbent CEOs or promoting heirs apparent, shareholders will experience the same kind of concerns about executive offense and subsequent deviation that they would under Say on Pay. Of course, those issues will not be worse under an ex ante approval than under Say on Pay.

Still, if CEO overcompensation is largely a function of managerial power, then the inability to effectively constrain incumbent renegotiations or heir apparent elevations at high-performing firms—instances where the manager-to-be would be expected to have the most power over the board—would be troubling. At the very least, it would tend to reduce the importance of switching from an ex post voting mechanism to an ex ante one. In fact, however, there is good reason to think that the internal CEO compensation market is less in need of shareholder discipline than the external one. Increased hiring of CEOs from outside the firm is correlated with increased CEO pay, as external hires are generally paid more than

Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,” 30 J. Corp. L. 675, 699 (2005) [hereinafter Gordon, CD&A]. Needless to say, the CEO Compensation Plan would not disable a board from reaching a definitive contract with a CEO candidate but would merely set the parameters of such a contract. These constraints may nonetheless impair recruitment efforts by disabling the board from attracting candidates, a point that is addressed in more detail below. See discussion infra Part III.D.

For instance, the external candidate’s current employer would likely penalize the candidate during his or her remaining time with that firm. Consequently, the external candidate will not want his or her interest in the position becoming public such that the hiring firm’s shareholders would develop an expectation. For more on the external CEO hiring process, see Khurana, supra note 10, at 44–48.

See, e.g., Bebchuk & Fried, Pay Without Performance, supra note 5, at 61.
Of even greater concern than relatively high absolute levels of compensation, "pay-for-luck" is more prevalent in industries with greater levels of external CEO hiring. Thus, while there is certainly the potential for internal hires to be excessively compensated, a discipline mechanism that fails to constrain that excess may nevertheless significantly improve economy-wide pay practices if it were able to effectively constrain compensation for external hires.

A more difficult version of this problem starts from the proposition that it is difficult, during a CEO's tenure, for shareholders to anticipate anyone else being named a CEO. Despite the increased volatility of CEO employment, there may be a natural tendency to assume every CEO Compensation Plan that one is asked to approve will ultimately be applied to the sitting CEO. If so, there would be little advantage, in terms of the bundling problem, of switching to an ex ante as opposed to ex post plan. This may mean that the plan approved by shareholders should be explicitly inapplicable to a sitting CEO's future compensation. To the extent a CEO remains in office for an extended period, this would make discipline via the CEO Compensation Plan relatively infrequent.

202 Kevin J. Murphy & Ján Zábojník, Managerial Capital and the Market for CEOs 26-28 (Queen's University, Dept. of Econ., Working Paper No. 1110, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376 [hereinafter Murphy & Zábojník, Managerial Capital] (finding that increasing the level of external hiring from 15% of all hires to 25% of all hires results in a 13% wage increase for CEOs and that external hires earn 15.3% more than internal hires). Murphy and Zábojník hypothesize that an increase in the importance of general managerial ability, as opposed to firm-specific managerial ability, has lead to both a greater demand for external candidates and a greater ability of CEOs to obtain the lion's share of the rents created by their ability. Id. at 3-4. There are other plausible explanations for the increased prevalence of external hires and elevated CEO compensation. See, for example, supra notes 178-79 and accompanying text in which the importance of the business press and securities analysts and their respective incentives for focusing on a CEO's personal traits is described. Murphy and Zábojník admit that "[t]esting our propositions directly requires a proxy for the relative importance of general managerial skills [but] we cannot currently construct such a proxy." Murphy & Zábojník, Managerial Capital, supra, at 24. Regardless, their analysis does show that external hires are generally paid more than internal hires. For other research demonstrating the correlation between external CEO hiring and CEO compensation, see Martijn Cremers & Yaniv Grinstein, The Market for CEO Talent: Implications for CEO Compensation 17-18 (3rd Annual Conference on Empirical Legal Studies Papers, Yale ICF Working Paper No. 09-11, 2010), available at http://ssrn.com/abstract=1108761; Murphy, supra note 174, at 853-54.

203 See Cremers & Grinstein, supra note 202, at 1. Cremers and Grinstein, similar to Murphy and Zábojník, conclude that this represents rents extracted by external hires based on their superior bargaining position. Id. at 29. It stands in stark contrast, therefore, to Bebchuk and Fried's managerial power hypothesis. Id. Cremers and Grinstein further conclude, similarly to Murphy and Zábojník, that this position is a function of CEOs' non–firm–specific skill levels. Id.

204 Kaplan & Minton, supra note 169, at 1.

205 Conceivably, a CEO Compensation Plan could complement Say on Pay, with the former presenting an unbundled choice and the latter presenting more frequent, if imperfect.
C. Would CEO Compensation Plans be Too Constraining?

Although an *ex ante* approval mechanism might be preferable to Say on Pay for bundling reasons, there may be other ways in which it falls short. For instance, an *ex ante* approval requirement might shift too much power to shareholders. This would be particularly troubling for those who already have concerns about increasing shareholder power through Say on Pay.\(^\text{206}\) Equity plan approvals are binding on firms under the exchange rules. If it were better to limit shareholder power and retain board authority, then a binding *ex ante* vote would certainly be worse than an advisory *ex post* one. Adopting an *ex ante* mechanism like a CEO Compensation Plan approval requirement, however, does not require adoption of every feature of the equity compensation plan rules. The CEO Compensation Plan vote could be advisory just like Say on Pay. In addition, a non-binding CEO Compensation Plan approval requirement would be no worse than a non-binding Say on Pay vote in terms of inappropriately tying boards' hands.

Take one argument against increased shareholder involvement in the compensation process: time and resource-strapped investors (or their agents) may resort to one-size-fits-all guidelines that will likely prove inefficient for some set of firms.\(^\text{207}\) Wary of this outcome, Jeffrey Gordon advocates for allowing shareholders to opt in to Say on Pay.\(^\text{208}\) While allowing shareholders to opt in or out of disciplinary measures like Say on Pay is probably advisable,\(^\text{209}\) a CEO Compensation Plan approval requirement obviates much of the need for an opt-out device. Shareholders can “opt-out” of compensation micromanagement by limiting the requirements they impose on CEO pay packages. Shareholders reluctant to constrain board behavior could allow liberal plans while those wishing a greater say over compensation could be relatively stricter.

As discussed in Part II, Say on Pay can impose discipline at two distinct points in time: at or around the time of the *ex post* vote or prior to pay decisions (but based on the threat of *ex post* sanctions). Regarding discipline at the time of the vote, the ability to implicitly opt-out under a CEO Compensation Plan approval rule is more effective because it allows shareholders to tailor the scope of their opting out. Under Say on Pay with an opt-out provision, shareholders are always faced with a series of imprecise binary choices between opting in and out and, if the former,

\(^{206}\) See *supra* Part I.B.


\(^{208}\) Gordon, *supra* note 8, at 326.

discipline and no discipline.\textsuperscript{210}

The problem is softened if one assumes \textit{ex ante} negotiations under a Say on Pay rule. Shareholders could tailor their \textit{ex ante} demands as appropriate, wielding the threat of ultimately voting against the package at the \textit{ex post} point.\textsuperscript{211} Yet even compared with these \textit{ex ante} negotiations, the CEO Compensation Plan approval rule should be preferred by those in favor of private ordering. First, the CEO Compensation Plan requirement simply formalizes the favored negotiation process.\textsuperscript{212} Second, the reliance on an informal \textit{ex ante} negotiation permits defection by shareholders at the time of the later Say on Pay vote. Shareholders who privately agreed that a particular arrangement was appropriate at $T_1$, retain the ability under Say on Pay to condemn the arrangement later on. Moreover, given any significant level of shareholder turnover between the time of \textit{ex ante} informal approval and the \textit{ex post} vote, a new shareholder base may not feel constrained by their predecessors' informal approval. In this way, shareholders are arguably more capable of mucking up compensation arrangements under Say on Pay, even assuming shareholder influence ahead of the vote.

In sum, an advisory CEO Compensation Plan approval requirement would be no more constraining on board authority than Say on Pay. If anything, \textit{ex ante} approval should be comforting (relative to Say on Pay) to those who are skeptical of increased shareholder power. The only exception to this general point is that some of those who would resist shareholder power may be willing, in the face of its inevitability, to settle for a version vulnerable to the bundling effects described herein. That is, Say on Pay may be favored by those that want as little shareholder discipline as possible because it only affects a subset of firms.

\textbf{D. Would CEO Compensation Plans be Constraining Enough?}

Similarly, an advisory CEO Compensation Plan approval requirement should not be \textit{less constraining} than Say on Pay. Most obviously, the bundling improvements occasioned by the move to an \textit{ex ante} vote should encourage more discipline on compensation matters at high-performing firms than under Say on Pay. But that does not necessarily mean that \textit{ex post} discipline will be more significant than \textit{ex ante} discipline across all firms.

For instance, the rule requiring shareholder approval of equity compensation plans -- largely the model for this Part’s proposal -- has been

\textsuperscript{210} There are reasons to doubt the ability of proxy firms to make firm-specific Say on Pay decisions. \textit{See supra} notes 71–77 and accompanying text. But the difficulty also exists with firm-specific decisions on whether to opt-in to Say on Pay. \textit{See supra} note 85.

\textsuperscript{211} \textit{See, e.g., Davis, supra} note 34, at 20.

\textsuperscript{212} The CEO Compensation Plan approval mechanism becomes more compelling when one considers the bargaining and bundling problems with contemporaneous trilateral negotiations.
criticized as not being tough enough on pay practices. Bebchuk and Fried point to three problematic aspects of equity compensation plan approval. First, they note the level of generality at which the proposed plans operate. The equity plans approved by shareholders, as a rule, do not include details about particular executives’ payouts and therefore “[s]hareholders cannot reject or approve a particular executive’s pay package.” Second, Bebchuk and Fried note that shareholders who might like to disapprove of proposed plans are caught between a rock and a hard place. Although they may not like some of the terms of the proposed equity plans, approving a “bad” plan is still better for shareholders given the consequences—managerial departures, less performance-based compensation, adverse tax effects—of a defeated plan. Finally, Bebchuk and Fried observe the structural problems attendant to shareholder voting.

Of course, the important question for present purposes is whether these problems, assuming they are significant, are made worse because equity plan approval is given ex ante. On this count, Bebchuk and Fried support giving shareholders a binding vote over certain “suspect” compensation features. Given the logistical problems of an ex post binding vote, the approval for which they advocate must be ex ante. Thus, Bebchuk and Fried’s criticism of equity compensation plan approval is not a criticism of its timing but rather of other features.

213 BEBCIIUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 5, at 48-51.
214 Id. at 49.
215 Id. at 49-50.
216 Id. at 50-51.
217 Id. at 198 (“In our view, it would be desirable to permit shareholders to initiate and approve binding rules for executive compensation arrangements.”).
218 To elaborate, take two of the three sets of criticisms leveled by Bebchuk and Fried at equity compensation approvals. First, their general concerns regarding the efficacy of shareholder activism through voting are equally applicable to Say on Pay as they would be to an ex ante CEO Compensation Plan approval requirement. If shareholders rationally accede to management wishes as a result of the incentive structure created by dispersed shareholder voting in equity compensation plan votes, there seems little reason to expect more discipline via Say on Pay.

Second, Bebchuk and Fried’s acknowledgment of the collateral consequences of shareholder votes against equity compensation plans counsels in favor of an ex ante mechanism. If collateral consequences of adverse Say on Pay votes are significant because of bundling problems, see supra Part II.B.2, an ex ante approval mechanism would be preferable for the reasons stated earlier. Along this line, Bebchuk and Fried specifically point out the potential for managerial departures based on adverse equity compensation plan votes, which is much greater under Say on Pay than under a CEO Compensation Plan approval rule. While Bebchuk and Fried’s concern for managerial departures seems to be driven by the preclusive nature of an adverse, binding equity compensation plan vote, see BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 5, at 49 (“When shareholder ratification of a plan is essential to executive retention, vetoing the plan might well lead to a management crisis.”) (emphasis added), that does not detract from the potential for collateral damage occasioned by an advisory but more CEO-specific adverse vote.
Nevertheless, at least one of the criticisms of equity compensation plan approvals—the level of generality at which the matters to be approved by shareholders are specified in proposed plans—might apply more forcefully to \textit{ex ante} mechanisms like a CEO Compensation Plan rule than \textit{ex post} ones like Say on Pay. The former are more likely to need to operate at some level of generality given the impossibility of predicting every potential term demanded by future CEO candidates and the advisability of granting the board some flexibility in negotiation. Of course, the difference may not be appreciable if Say on Pay's most significant effect is to force boards to informally negotiate with shareholders in conjunction with or prior to the board's negotiations with a candidate anyway.

But the room for maneuvering required by an \textit{ex ante} mechanism need not be capacious. It would be surprising, for instance, if CEO Compensation Plans turned out to be as generalized as equity compensation plans. The most significant complaint about the generality at which equity compensation plans govern is that no plan specifies which employee gets what amount of equity compensation, leaving the vital matter of allocation up to the board.\textsuperscript{219} Shareholders are able to demand such specificity, but it makes no sense to do so, given the size of the class of recipients. CEO Compensation Plans, on the other hand, would be applicable to a much smaller group of executives, permitting shareholders to set position-specific terms if they so wished. Conceivably, shareholders might feel reluctant to give stringent guidance without greater information about the prospective CEO candidate so as not to prevent the firm from attracting him or her. It is hard to imagine this is a significant problem, however, given (a) institutional holders' and proxy advisors' willingness to promulgate one-size-fits-all guidelines in an \textit{ex post} environment and (b) the expectation that boards would approach shareholders and their advisors as necessary to negotiate deviations from the pre-approved plans.

Indeed, the evidence from equity plan approvals gives reason to expect shareholders would be reasonably aggressive in their demands for CEO compensation plans, both in respect of pay levels and other terms. Thomas and Martin conducted the most prominent study of shareholder behavior with respect to equity plan approval and they offer a relatively sanguine view of shareholders' ability to constrain behavior. Although the study found that less than 1\% of equity compensation plans were voted down by shareholders during the 1998 proxy season (with average shareholder opposition measuring 18.6\%),\textsuperscript{220} these relatively low numbers do not necessarily mean that shareholders were failing to discipline compensation. As with Say on Pay, firms may have adjusted behavior ahead of time for

\begin{footnotes}
\item[219] See \textit{Bebchuk & Fried, Pay Without Performance}, supra note 5, at 196.
\end{footnotes}
fear of a negative vote.221 Along this line, Thomas and Martin found 
that shareholder opposition was correlated with certain features of the 
plans—the level of dilution resulting from the plans, the ability of plans 
to automatically replenish themselves, their permitting option repricing or 
discounted options—suggesting that shareholders were able to coordinate 
their voting behavior in opposition to particular terms.222

Moreover, given the bargaining leverage gained by CEO candidates 
by the time the pay package is negotiated and the likely perception of 
shareholders that a skilled CEO is worth more than the marginal dollar 
(or million) in compensation cost, shareholders should recognize that 
any publicly announced advisory vote will likely become a floor for 
negotiations between the board and the candidate. The failure to impose 
constraints via the plan may be taken as a signal to boards and candidates 
that the shareholders have no preferences at all. Therefore, shareholders 
will have the incentive to set limits that are likely to be more restrictive 
than their reservation price (in terms of approving a pay package), with the 
understanding that boards will exceed those limits if necessary to attract 
a preferred candidate.223 While deviation from the shareholder-approved 
plan might therefore be relatively common, the shareholder advice could 
still have a salutary effect. By setting a baseline, boards would be given 
some leverage in CEO negotiations to avoid egregious deviations and any 
deviations would be publicly recognized as such and require explanation.

Proponents of Say on Pay contend that an adverse vote can provide 
a point of information for shareholder activists considering action against 
directors.224 A CEO Compensation Plan rule, by itself, does not accomplish 
this end, though this can be easily remedied. Because CEO compensation 

221 See, e.g., Lund, supra note 78, at 134-36.
222 Thomas & Martin, supra note 220, at 71. Interestingly, Thomas and Martin also 
found that shareholder voting was more positive for poorly-performing companies. See id. at 
61-62. This can largely be explained by shareholder desire to give increased incentives to 
poorly-performing managers, but it further indicates that an ex ante approach will not suffer 
from bundling concerns.
223 Investors, alternatively, could simply abstain from setting pay limits, recognizing 
their implicit expectation that the board would deviate from the limits. On the other hand, 
the absence of limits, given the shareholders’ new ability to set them, might signal to boards 
and candidates that absolute compensation does not matter to shareholders. To avoid this, 
shareholders would have to play the game of setting and enforcing limits as described.
224 See Cai & Walkling, supra note 15 (manuscript at 7). RiskMetrics’ voting guidelines 
anticipate such a process:

In general, the management say on pay (MSOP) ballot item is the 
primary focus of voting on executive pay practices—dissatisfaction with 
compensation practices can be expressed by voting against MSOP rather 
than withholding or voting against the compensation committee . . . . In 
addition, . . . if the board fails to respond to concerns raised by a prior 
MSOP proposal, then vote withhold or against compensation committee 
members (or, if the full board is deemed accountable, all directors).
arrangements are material contracts, they must be publicly filed on Form 8-K. To the extent that this normal disclosure might not serve to clearly signal a particular deviation from the shareholder-approved terms, disclosure rules could be amended to require firms to publicly state that they have deviated and offer reasons for doing so.

Similarly, Say on Pay may do more than signal something about firm governance. Adverse Say on Pay votes impose reputational costs on directors and executives at firms. Indeed, these reputational costs are the basis for the bundling problems described earlier. An advisory ex ante plan approval would differ insofar as it would not necessarily allow for a low-cost, high-humiliation vote. Because it is relatively easy to make violations of shareholder-approved plans public, however, the CEO Compensation Plan rule would provide at least some reputational sanctions for directors as Say on Pay.

The problem is admittedly exacerbated if the approved CEO Compensation Plan explicitly excludes the sitting CEO from its application to avoid bundling concerns. Even there, though, it is unclear that Say on Pay adds very much to the humiliation-inducing tools at hand for shareholders. In fact, the ability to shame via Say on Pay seems largely duplicative of the shaming capacity of “vote-no” campaigns in director elections. It may be that more opportunities for shareholders to express frustration are better than fewer, but it is at least worth wondering why shareholders need another alternative for embarrassing managers. Like Say on Pay, withhold the vote campaigns against directors are subject to bundling problems, with the bundled costs being the losses engendered by switching from one set of directors to another. In fact, some have suggested that Say on Pay has an advantage over director-election-related

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226 Jeffrey Gordon has previously analogized Say on Pay votes to “just vote no” campaigns against directors, though not specifically as catalysts for shareholder revolt. Gordon, CD&A, supra note 199, at 677.

227 See supra note 212, and accompanying text.

228 See Gordon, CD&A, supra note 199, at 701 (“If the goal is to provide a vehicle for broader mobilization of popular and elite opinion, the targeted ‘just vote no’ campaign may be almost as effective.”); see also RiskMetrics Grp., 2010 Guidelines, supra note 124, at 38 (“[I]f there is no [say on pay vote] on the ballot, then the negative vote will apply to members of the compensation committee. In addition, in egregious cases . . . then vote withhold or against compensation committee members (or, if the full board is deemed accountable, all directors).”).

229 Alternatively, Say on Pay proponents might argue that an ex post mechanism invites hindsight bias and that such bias is actually helpful insofar as shareholders might systematically err in favor of higher compensation packages if only presented with an ex ante choice.

230 See, e.g., Camara, supra note 157, at 1450–54.
activism in that it allows shareholders to express dissatisfaction while still retaining valuable directors. But this seems to get the bundling question backwards. While it may be true that Say on Pay creates fewer director–related bundling issues than resort to director elections, it seems extraordinary to think that shareholders are more concerned about the costs of losing directors than the costs of losing a CEO.

Finally, even if shareholders value directors at high-performing firms equally with CEOs, there is disciplinary value obtained by moving to an ex ante approval. The CEO Compensation Plan mechanism forces any board violation to be publicly acknowledged and declared as such. Any bundling concerns surrounding disciplining directors come after the public announcement, meaning that directors incur reputational costs even if bundling concerns ensure that shareholders will never remove them from office. Say on Pay, on the other hand, makes the event that would impose the reputational costs on directors—the Say on Pay vote—itself contingent on shareholder decisionmaking under the influence of the bundling effects such that there may never be an embarrassing moment.

**Conclusion**

Even before passage of Dodd–Frank, it was more or less apparent that executive compensation would be subjected to enhanced shareholder influence in the near future. The debate over this change’s merits is likely to prove intractable in the short term, though evidence from Say on Pay’s adoption in the UK indicates that increased shareholder power will not pose serious downside risks to US firms. Progress can be made, however, toward the optimal design of the mechanism for increasing shareholder power. Say on Pay has become the dominant version of increasing shareholder influence over compensation decisions, but both intuition and observed results in the UK show that Say on Pay is a limited disciplinary device, particularly with respect to high–performing firms.

Luckily, some of the problems with Say on Pay that lead to this skewing away from discipline for certain firms are mostly fixable via something like a CEO Compensation Plan rule. It is impossible to determine how powerful the bundling issues described above are relative to other plausible explanations, particularly the possibility that shareholders wrongly misperceive the cost of excess compensation in high–performance situations. But even if that misperception is more important to the observed phenomena than is argued here, it is still the case that an ex ante vote is preferable to an ex post one.

Ironically, the best argument in favor of Say on Pay is that it accidentally

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231 Ertimur et al., *supra* note 145, at 5 & n.2.

232 See *supra* notes 166–81 and accompanying text (describing the central role attributed to CEOs by shareholders).
limits discipline at high–performing firms. Needless to say, accidental mistakes are not particularly good candidates for saving. Perhaps the retention of Say on Pay, despite its problems, indicates that some of those pushing for greater shareholder power over executive compensation may not be entirely convinced that such an increase is a good idea. More likely, the laser–like focus on Say on Pay as the mechanism for introducing shareholder power is simply a mistake and one that should be remedied sooner than later.