House Passes ‘Say on Pay’; Advocates, Opponents Continue Fight

Sidebar: Reining in comp committees

8/4/2009 By Stephen Miller

The U.S. House of Representatives approved legislation on July 31, 2009, to give shareholders greater say over executive pay and to expand the powers of financial regulators to limit compensation packages that they deem improper. Similar legislation was before the Senate.

The so-called "say on pay" bill, the **Corporate and Financial Institution Compensation Fairness Act** (HR 3269), would give shareholders the right to a nonbinding proxy vote on corporate pay packages. The bill, part of a broad push to tighten banking and market regulation, would impose new standards on corporate compensation committees and compensation consultants, requiring them to be independent of management.

In addition, financial institutions (excluding those with assets of less than $1 billion) would face increased regulation of incentive-based pay, intended to curtail short-term risk taking in pursuit of annual bonuses — referred to in the bill as "perverse incentives." The appropriate federal regulators would prescribe regulations that prohibit any incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine "encourages inappropriate risks by covered financial institutions that could threaten the safety and soundness of covered financial institutions, or would have serious adverse effects on economic conditions or financial stability."

Financial institutions would face increased regulation of incentive-based pay deemed to encourage "inappropriate risks."

Supporters argue that these measures are long overdue, but opponents contend that shareholders lack the knowledge and perspective to help determine compensation packages and that the legislation would draw the government too deeply into the internal decision-making of U.S. corporations.

‘Yea’ on ‘Say on Pay’

“We applaud the House of Representatives for taking this first action toward making our financial system more accountable and transparent, and we urge them to continue on this path of reforming our financial system and cleaning up abuses on Wall Street," said a statement by Heather Booth, director of the shareholder advocacy group Americans for Financial Reform. "We implore the Senate to take swift action on this legislation,” she added.

A June 2009 **national survey** by ShareOwners.org, another advocacy organization, found that more than four out of five U.S. investors (83 percent) agreed that “shareholders should be permitted to be actively involved in CEO pay and other important issues that may bear on the long-term value of a company to their retirement portfolio or other fund,” according to the group. The survey found that more than three out of four American investors (79 percent) wanted to “see strong action taken to correct the problems that exist today” in the financial markets.

Others Say ‘Nay’

But the reforms are opposed by others. "Say on pay is just one of an array of proposals for empowering shareholders. In that context, it is part of an ongoing effort by a handful of activists

to shift substantially the locus of decision-making authority," writes UCLA law professor Stephen Bainbridge in a Spring 2009 report, "**Is Say on Pay Justified?**," for the libertarian Cato Institute, a not-for-profit policy institute that supports free-market principles. "The trouble is that shareholder involvement in corporate decision-making seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the vesting of 'authoritative control' in the board of directors," Bainbridge contends.

"Effective corporate governance requires that decision-making authority be vested in a small, discrete central agency rather than in a large, diffuse electorate," he adds. "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."

Sidebar:

Reining in Compensation Committees

U.S. House approval of the Corporate and Financial Institution Compensation Fairness Act on July 29, 2009, followed the disclosure one day earlier that nine of the biggest U.S. banks, which are receiving billions of dollars in federal bailout aid, paid individual bonuses of $1 million or more to nearly 5,000 employees.

"This situation was clearly the case of compensation committees not paying attention to the overall amount of money that was being paid out, and the blame falls squarely upon them," comments Jack Dolmat-Connell, president and CEO of DolmatConnell & Partners Inc., a compensation consulting firm. "When bonuses are greater than the profitability of the company, the situation is clearly wrong, regardless of the claims that they needed to do this to be 'competitive.' Tthis is simply not good business judgment. These banks looked only at what a very insular peer group of firms were doing to define their compensation levels and practices, and lost sight of broader market trends and best practices."

Compensation committees and their hired consultants need to be "independent both in perception and reality," Dolmat-Connell adds."Better oversight by truly independent boards who think like owners would be a huge step in the right direction to curtailing outlier executive compensation practices in the largest financial services companies."

A Pay for Performance Disconnect

Adding fuel to the fire, top executive compensation at banks receiving Troubled Asset Relief Program (TARP) funds did not change in statistically meaningful ways despite the banks' poor financial performance, according to a new study by Presidio Pay Advisors.

The compensation consulting firm analyzed changes in executive compensation and measures of financial performance among 115 banks holding total assets of $11.9 trillion, with each receiving a minimum of $50 million in TARP investments. From 2006 through 2008, more than 90 percent of these banks generated negative shareholder returns.

"There seems to be a disconnect between stated performance philosophies and pay decisions," says Dave Bisson, a senior consultant at Presidio Pay Advisors.

"As performance deteriorated in 2007 and 2008, many compensation committees reset performance targets, paid discretionary bonuses, excluded unusual or one-time charges from bonus calculations, or increased long-term incentive grants for retention purposes. These actions are inconsistent with paying for performance," Bisson notes.

The Presidio Pay study also found compensation committees approved increases in the size of equity grants to offset lower stock prices:

- **Total stock options granted to CEOs** increased from 6.5 million in 2006 to 11.1 million in 2008, more than offsetting a drop in restricted stock grants from 2.6 million shares to 1.8 million over the same period.

- **Total stock options granted to CFOs** increased from 2.2 million in 2006 to 3.5 million in 2008, combined with an increase in restricted stock grants from 0.42 million shares in 2006 to 0.65 million in 2008.

In response to public dissatisfaction with bank compensation practices, Congress imposed significant pay restrictions on banks with TARP investments. Absent the passage of new legislation such as the bill described above, these restrictions will be lifted once TARP funds are repaid in full.

"As the debate surrounding executive compensation continues in Washington and elsewhere, thoughtful bank compensation committee members should use this 'time-out' to fix their compensation programs," Bisson says. "Otherwise, regulators and politicians may well do it for them."

Stephen Miller is an online editor/manager for SHRM.

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