New Federal Initiatives Project

Executive Compensation

By
J.W. Verret**

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The Corporate and Financial Institution Compensation Fairness Act of 2009 ("The Act"), H.R. 3629, passed the House of Representatives on July 31, 2009. That Act included substantial components from the Treasury Department's compensation proposals released on July 16, 2009. The Act includes four provisions. It mandates publicly traded companies give their shareholders an opportunity to conduct a non-binding, advisory vote on annual executive compensation (known colloquially as "Say-on-pay"). It also mandates that the Compensation Committees of the Boards of Directors of publicly traded companies consist of independent directors. The act further requires financial institutions with over $1 billion in assets provide enhanced disclosure about their incentive-based compensation and requires the banking regulators to set minimum standards for incentive-based compensation at those financial institutions. Senator Schumer's Shareholder Bill of Rights, currently under consideration by the Senate Committee on Banking, Housing, and Urban Development, also includes a provision requiring an annual advisory vote on executive compensation.

The say-on-pay requirement would entail a vote on standard executive compensation as well as an advisory vote on golden parachutes, or provisions which require an executive receive a fixed sum upon a change of control in the company or termination without cause.[1] Proponents of say-on-pay urge that it is required to maintain executive compensation practices that properly align executive focus with maximizing the long term health of publicly traded companies. Proponents of say-on-pay also highlight that the proposal is non-binding, and would not constitute undue interference into company decision-making. Critics argue that it will limit publicly traded companies in their competition for talent with overseas firms. They also claim that say on pay would hinder golden parachutes from encouraging efficient takeovers of companies, by giving executives an incentive not to block new buyers of a corporation who intend to manage a struggling company more effectively. Finally, they argue against intervention by the Federal Government into matters of corporate governance, traditionally the realm of state governments.

Severance packages linked to changes in control, also known as golden parachutes, are designed to minimize any incentive executives may otherwise have to resist takeover proposals that may result in their being replaced at the helm. Evidence suggests that golden parachutes are very effective at encouraging efficient takeover activity, to the benefit of shareholders.[2] Lucian Bebchuk, one of the more notable say on pay advocates, does not support initiatives to regulate severance packages. In his book *Pay Without Performance, The Unfulfilled Promise of Executive Compensation*, he goes so far as to support payments in excess of pre-approved golden parachute arrangement when we writes that "Providing the target CEO with a gratuitous payment may benefit shareholders. When such sweetening is necessary to obtain board approval a beneficial acquisition, shareholders are likely to be better off with both the gratuitous payment and the acquisition than with neither....prohibiting such payments is unlikely to be desirable."

Many institutional investor groups, such as the Council of Institutional Investors and the AFL-CIO, have expressed support for say-on-pay votes. Some institutional investors, like the United Brotherhood of Carpenters, have expressed concern about the compliance costs they will face with an annual vote and instead favor say-on-pay votes every 3 years.[3] The Business Roundtable, an association of CEOs of publicly traded companies, has expressed concern with the effects of say-on-pay.

The act includes little detail on the parameters of the minimum compensation standards that banking regulators would be required to establish for large financial institutions. One proposal, which was presented in testimony before the House Financial Services Committee hearing on the bill as well as at the Treasury Department's roundtable on executive compensation, is to require bank executives' pay be linked more strongly to the institutions bonds than to the institution's stock price.[4] Proponents of that provision assert that it would limit executives' incentives to take excessive risk; critics argue that it would limit incentives to take any risk and would limit any penalty in compensation for poor executive performance.

Senator Schumer's Shareholder Bill of Rights, like the recently passed House Bill, includes a provision requiring an annual say-on-pay vote. Say-on-pay is the element of the House Bill with the highest likelihood of passage in the Senate. The administration has expressed its support for say on pay and compensation committee changes in a recent white paper from the Treasury Department[5], and indeed one of the few bills President Obama introduced as a Senator was a say-on-pay bill. Whether the compensation committee, compensation consultant, and incentive compensation provisions for large financial institutions will obtain sufficient support in the Senate remains more uncertain.

***J. W. Verret is an Assistant Professor of Law at George Mason University School of Law. He is also a Senior Scholar at the Mercatus Center Working Group on Financial Markets.*

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[1] For a summary of the policy arguments on both sides of this issue, See Stephen Bainbridge, Is 'Say on Pay' Justified?, Regulation, Vol. 32, No. 1, pp. 42-47, Spring 2009, available at http://ssrn.com/abstract=1452761.
[2] See, e.g., Nadarayam and Sundaram 1998.
[3] http://www.shareholderforum.com/sop/Library/20090722_Reuters.htm.
[4] See Bebchuk, Lucian A. and Spamann, Holger, Regulating Bankers' Pay. Georgetown Law Journal, Forthcoming; Harvard Law and Economics Discussion Paper No. 641. Available at SSRN: http://ssrn.com/abstract=1410072.
[5] http://www.ustreas.gov/press/releases/tg163.htm

Related Materials:

Congressional House Oversight Committee Hearing:
http://www.cspan.org/Watch/Media/2009/05/13/HP/R/18523/Congress+Questions+AIGs+Progress+Accountability.aspx

Written testimony by J.W. Verret to Congressional House Oversight Committee:
http://oversight.house.gov/documents/20090512175538.pdf

Press Release by Ranking Member Darrell Issa based on testimony by J.W. Verret available here:
http://republicans.oversight.house.gov/News/PRArticle.aspx?NewsID=542