BRACEWELL

BLOG POST

Post-Election Update: Financial Services - Dodd-Frank "Say on Pay"

November 26, 2012

By: **George D. Felcyn**

One provision of Dodd-Frank that has flown largely under the radar since it took hold in 2011 is the "Shareholder Approval of Executive Compensation" provision, also known as "Say on Pay", meant to foster shareholder participation and promote accountability in executive pay packages. The provision was designed to give ordinary shareholders a chance to voice their approval - or disapproval - of a company's executive pay packages through non-binding votes required to occur at minimum once every three years. But the law is shaking out far differently than intended due to a number of problems.

First and foremost, institutional shareholders far outnumber individual shareholders in most companies, and generally hold hundreds or thousands of publicly traded companies in their portfolios. These hedge funds, pension funds, etc. are not about to allocate the time and resources necessary to determine whether each company they hold is shaping executive compensation appropriately. Instead, they outsource the job to "proxy advisory firms" who do the research for them, recommend how they should vote , and might even execute the voting on their behalf.

The proxy advisory industry is dominated by two companies: Institutional Shareholder Services (ISS), which controls 61 percent of market share, and Glass Lewis, which controls 37 percent. The work is highly seasonal, as most shareholder meetings are held in the spring. Yet the firms have staffs of only a few hundred full-time analysts to rapidly sort through thousands of analyses during the brief window between the time proxy statements are circulated and when votes are held.

As a result, they bolster their ranks with temporary workers, often located overseas, to process a tremendous amount of data and information in a very tight time frame. More generally, they apply uniform analytical models across thousands of companies that all but eliminate their ability to consider unique characteristics of any one company's business, regulatory or other circumstances, no matter how germane. Not surprisingly, companies have discovered a slew of errors in the analyses provided by proxy firms, yet any window to correct these errors before the recommendations become official is tiny.

In addition to promoting standardized work marked by a high occurrence of inaccuracies and flaws, the firms have an array of conflicts. Among the most egregious is a practice conducted by ISS, which also offers corporate governance consulting services – meaning that companies on the receiving end of a ‘negative' recommendation may be advised to improve their subsequent proposal by working with ISS' own compensation consultants. Beyond ISS' consulting practice, both firms are part of much larger financial entities, calling into question the quality of analyses they perform that involve other companies in which their parent organizations have direct interests or investments.

As Rep. Barney Frank himself put it in July 2009, "It's a question of empowering the shareholders to decide the appropriate level because it's their money…". Given that Say on Pay has instead provided an extraordinary windfall to a select few companies with a host of potential conflicts and questionable analytical performance records, look for reform-minded Members of Congress to take a second glance at the provision in the 113thCongress.