Making (a Little) Progress on CEO Pay

By Graham Kenny

Since companies can't seem to solve the divisive problem of exorbitant CEO pay on their own, legislation may well turn out to be the best fix. Here's how it's starting to help in various parts of the world, though there's still a lot of work to do.

SEC registrants in the U.S. — public companies, mutual funds, investment advisers, transfer agencies, and broker dealers — are required by the Dodd-Frank Act (passed by Congress in 2010) to conduct shareholder advisory votes at least once every three years on compensation for board members and the highest-paid executives. Investors have used this process to voice their concerns, which is all to the good (it puts pressure on companies to change their practices), but the votes are nonbinding. In 2012, for instance, shareholders said no to almost $15 million in compensation for Vikram Pandit at Citigroup and to almost $6 million for Fernando Aguirre at Chiquita Brands. Even though both CEOs received their packages, *against* investors' better judgment, they've since been forced out for their disappointing performance.

Shareholders in the UK have had advisory votes on pay since 2002 — but the British government has tightened the rules even more. For a little more than a year, UK public companies have had to prepare an annual remuneration report, and shareholders' votes on the policy behind it are *binding*. If a company fails a vote, it can't implement any of the proposed compensation changes — it reverts to the last approved pay scheme.

While many European companies have their own say-on-pay regulations — Belgium, France, Germany, Italy, the Netherlands, and Switzerland, for instance — the European Commission has proposed increasing shareholder power across the board. If the legislation is adopted, all EU-listed companies' remuneration policies will be subject to binding shareholder votes every three years.

Australia has gone even further, with its "two strikes" policy: If 25% or more shareholders vote "no" on a company's remuneration report at two consecutive annual general meetings, that triggers a vote to spill the board. And if this second resolution is passed, all directors (except the managing director) must stand for re-election within 90 days. This legislation, among the strictest in the world, has helped shareholders not just find their voices but exercise their muscle.

Just a few months ago, there was a first strike against Newcrest Mining, Australia's largest gold miner. At its latest annual general meeting, 45% of shareholder votes went against the remuneration report for several reasons, including horrible performance on the share market and billions in write-downs on one of its mines. Here was the real clincher: Newcrest announced that the new CEO could, with bonuses, earn 62% more than his predecessor — and a larger base salary, at $2.3 million, than his counterparts at the much larger miners BHP Billiton and Rio Tinto.

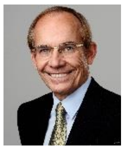
First strikes have also occurred at Uranium producer Paladin, company car fleet manager McMillan Shakespeare, Seven Group (which has major media holdings, among other diversified interests), and engineering services company UGL.

Shareholders are OK with turning a blind eye to CEO packages when the profits of their companies skyrocket. But when fortunes change, they hasten to put the brakes on executive remuneration. Government action has given them more power to do that.

No board wants to receive a “fail” from shareholders, whether that vote is advisory or binding. It hurts the company’s reputation not only with investors but also with suppliers, customers, and the general public. But legislation ratchets up the urgency, and a recent cross-country study for the U.S. Board of Governors of the Federal Reserve shows that it’s actually starting to work. From 2003 to 2012, growth in CEO compensation was much lower (5.5%, on average) at firms that were subject to say-on-pay laws than at those that weren’t (8.1%).

So, expect more laws.

Graham Kenny is the managing director of Strategic Factors, a Sydney, Australia-based consultancy that specializes in strategic planning and performance measurement. He is the author of *Crack Strategy’s Code* (President Press, 2013) and *Strategic Performance Measurement* (President Press, 2014).



HBR ARTICLE – FEBRUARY 16, 2015