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SHOULD SHAREHOLDERS HAVE A GREATER SAY OVER EXECUTIVE PAY?: LEARNING FROM THE US EXPERIENCE

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Executive pay arrangements in Britain's publicly quoted companies have been subjected to much criticism in recent years. Proposals that shareholders should have a greater direct say over managerial remuneration have been a by-product of the concerns expressed. Debate on this point, however, has been largely speculative. This is because there is little evidence available in the United Kingdom indicating how shareholders would exercise any new powers they might be given. This paper addresses the evidentiary gap by drawing upon the experience in the United States, where empirical work indicates that shareholder voting only operates as a potential check when pay arrangements deviate far from the norm. In a British context, these findings imply that implementing the shareholder-oriented reforms that have been canvassed recently would fail to address fully the concerns raised by critics of executive pay.

A. Introduction

Executive pay arrangements in Britain's publicly quoted companies have been subjected to much criticism in recent years. In 2001, the Secretary for Trade and Industry offered a response to such concerns, saying that the UK Government planned to make disclosure requirements more onerous.[1] He said, however, that no decision had been made to proceed with another reform option, namely enhancing shareholder participation in the setting of executive pay. The matter would instead be considered in light of recommendations brought forward as a result of a fundamental review of "core" company law currently being carried out under the direction of the Department of Trade and Industry (DTI).[2]

Bolstering shareholder involvement in the setting of executive pay is a reform option that has, in fact, already been canvassed widely in Britain. Debate on this point, however, has been largely speculative. This is because there is little evidence

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[1] DTI, "Byers to Strengthen Link Between Pay and Performance", Press Release P/2001/132 (7 March 2001); R Shrimsley and S Targett, "Spotlight on Executive Pay Deals", *Financial Times*, 8 March 2001, 33.

[2] See sources cited *ibid.* On the launch of the review of company law and the "core" terminology, see DTI, *Modern Company Law for a Competitive Economy* (London, DTI, 1998), paras 1.1–1.5.

available in the United Kingdom indicating how shareholders would exercise any new powers they might be given. This paper addresses the evidentiary gap by drawing upon the experience in the United States, which offers much potentially valuable data. We will see that developments in the United States indicate that enhancing shareholder participation in the setting of managerial remuneration is unlikely to have major adverse consequences in the United Kingdom. At the same time, however, giving shareholders a greater direct say will probably not address fully the concerns that exist over executive pay in Britain.

B. Setting the scene

In UK companies, the standard practice is for a company's articles of association to empower the board of directors to appoint individuals to executive positions and set their remuneration.[3] Pay details are then usually dealt with in service contracts the executives enter into with the company. A pivotal aspect of this arrangement will be the salary, which will be determined on a periodic basis and will remain fixed between reviews. Indeed, for senior executives, their salary will probably be the most important component of their pay. According to 1997 figures, a typical chief executive in a British publicly quoted company earned £589,000 annually, and nearly 60% of this was in the form of base salary.[4]

While an executive's salary will be "fixed" between reviews, other aspects of a manager's pay will often be "variable" in the sense that entitlement to remuneration will depend on the company meeting or exceeding designated targets. Key examples of variable pay are share option plans, annual bonuses and long-term incentive plans (LTIPs), under which executives are rewarded for performance over several years rather than on a year-to-year basis.[5] On average, according to 1997 data, chief executive officers (CEOs) in major UK companies received 18% of their pay in annual bonuses, 10% in share options and 9% in LTIPs.[6]

Executive pay has, for some time, been the subject of debate in the United Kingdom.[7] In the mid-1990s, however, interest in the topic reached unprecedented levels. Articles appeared regularly in the press, sometimes with colourful headlines such as "Derailing the Gravy Train",[8] "Executive Gluttony Under

[3] P Loose *et al*, *The Company Director: Powers and Duties* (Bristol, Jordans, 7th edn, 1993), 390; DTI, *Directors' Remuneration: A Consultative Document* (London, DTI, 1999), 69.

[4] MJ Conyon and KJ Murphy, "The Prince and the Pauper? CEO Pay in the US and the UK" (2000) 110 *Economic Journal* F640, F645 6. For more recent statistics illustrating a similar pattern, see Pensions & Investment Research Consultants Ltd, *Corporate Governance 2000* (London, PIRC, 2000), 23 4.

[5] For more background, see BR Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press, 1997), 113 14.

[6] Conyon and Murphy, *supra* n. 4, F646.

[7] Cheffins, *supra* n. 5, 655.

[8] M Lynn, *Sunday Times*, 22 January 1995, Business, 3.

Attack",[9] and "Fat Cats in the Dock".[10] Politicians also weighed in. Leading figures from the Labour Party, then in opposition, raised the issue repeatedly and argued that legislative reform was required.[11]

Britain's executive pay controversy followed on the heels of a dramatic increase in managerial remuneration levels. The gross pay of chief executives in larger UK public companies rose nearly 600% between 1979 and 1994.[12] Correspondingly, while, as of 1981, such individuals earned on average approximately 11 times what a rank-and-file employee was paid, by the mid-1990s the ratio was more than 20:1.[13] Similarly, while, during the 1970s, British executives were paid less than their counterparts in all other major industrial countries, two decades later they ranked near the top of the list.[14]

Various factors served to bring this dramatic growth in executive pay into the public spotlight. One was that remuneration levels seemed to bear little relation to corporate performance.[15] For instance, executives in utilities privatised under Margaret Thatcher's Conservative Government were being awarded generous increases in pay when profits earned could be attributed more easily to privileged access to markets than to managerial effort.[16] Also contributing to the furore over managerial remuneration was the relative position of senior management and the workforce.[17] During the first half of the 1990s, many UK companies cut staff costs, and stories of rising executive pay contrasted starkly with this pattern of retrenchment. Finally, executive pay achieved prominence during the mid-1990s because of a backlash against alleged capitalist excesses that characterised the free-wheeling 1980s.[18] Since top managers were running key business enterprises and were well-paid, executive pay became a lightning rod for those disaffected with the market system.[19]

[9] D Cohen, *Financial Times*, 26/27 November 1994, Weekend Money, 3.
[10] *Economist* (US edition), 4 March 1995, 60.
[11] See, e.g. Gordon Brown, "Labour Will Halt Directors' Gravy Train", *Observer*, 9 April 1995, Business, 4.
[12] D Goodhart, "In Search of Wages that Work", *Financial Times*, 27 June 1994, 14.
[13] Cheffins, *supra* n. 5, 655, 658.
[14] See D Vagts, "Challenges to Executive Compensation: For the Markets or the Courts?" (1983) 8 *Journal of Corporate Law* 231, 252, n. 99; J Abowd and D Kaplan, "Executive Compensation: Six Questions That Need Answering" (1999) 13 *Journal of Economic Perspectives* 145, 146. For other sources illustrating the pattern, see "Where Bosses are Paid Most", *Economist*, 6 June 1987, 79; C Buckley and A Butcher, "Pack Your Suitcase, It's Time for a Pay Rise", *The Times*, 10 April 1999, 28; R Taylor, "Facts to Frustrate the Gurus", *Financial Times*, 8 September 2000, Recruitment, II.
[15] See, e.g. "A Racket in Need of Reform", *Economist* (US edition), 27 August 1994, 49.
[16] S Jenkins, "Taking the Rise Out of Us", *The Times*, 25 January 1995, 14; P Bassett, "Company Executives Pay the Price of Public Anger", *The Times*, 7 March 1995, 27.
[17] B Cathcart, "The New Wage Barons", *Independent on Sunday*, 25 January 1995, 15; J Plender, "Bang Go the Great Expectations", *Financial Times* (US edition), 27 December 1995, 9.
[18] On the backlash, see "Animal Spirits", *Financial Times*, 4 August 1995, 19; D Nicholson-Lord, "Contract at Breaking Point", *Independent on Sunday*, 22 October 1995, 21.
[19] Cathcart, *supra* n. 17; M Dickson, "Financial Fat Cats or Tigers", *Financial Times*, 28/29 January 1995, 8.

Because of the controversy over managerial remuneration, John Major's Conservative Government contemplated introducing statutory amendments dealing with executive compensation.[20] Ultimately, it opted not to, deferring instead to the work carried out by a panel set up in 1995 by the Confederation of British Industry.[21] The Greenbury Committee, named after chairman Sir Richard Greenbury, fulfilled its mandate by issuing a Code of Best Practice on executive pay accompanied by a supporting report.[22] The London Stock Exchange then provided backing for the reform effort by adding the key elements of the Greenbury Code to the Exchange's Listing Rules.[23] The current version of the Listing Rules, which the Financial Services Authority now administers in its capacity as the UK Listing Authority (UKLA), contains a somewhat modified version of the provisions of the Greenbury Code in an appendix referred to as the Combined Code.[24]

The reform campaign carried out in the mid-1990s yielded significant dividends. Larger listed companies typically adopted the Greenbury Code fully, and their smaller counterparts generally implemented most of the provisions.[25] Moreover, Greenbury's primary aim—full disclosure—was largely achieved as publicly quoted companies divulged a much wider range of information than had been the case previously.[26] In addition, while in the United Kingdom executive remuneration has traditionally been linked only very weakly to corporate performance, survey evidence compiled subsequent to Greenbury indicated that incentive-oriented remuneration was growing in importance.[27]

[20] K Brown and J Blitz, "Dodging Through the Executive Pay Field", *Financial Times*, 2 March 1995, 10.

[21] Cheffins, *supra* n. 5, 375, 656.

[22] The Study Group on Directors' Remuneration, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (hereafter "*Greenbury Report*") (London, Gee Publishing, 1995).

[23] Cheffins, *supra* n. 5, 656.

[24] See Financial Services Authority, Listing Rules, Combined Code, Code of Best Practice, Section 1, paras B1–B3, Schedules A, B. The provisions dealing with executive pay were amended in 1998 as a result of recommendations made by the Committee on Corporate Governance, *Report of the Committee on Corporate Governance* (hereafter "*Hampel Report*") (London, Gee Publishing, 1998), paras 4.1–4.20. On the Financial Services Authority's status as the administrator of the Listing Rules, see Official Listing of Securities (Change of Competent Authority) Regulations 2000 (SI 2000/968); Financial Services Authority, Listing Rules, "Introduction".

[25] *Hampel Report, supra* n. 24, para. 1.10. See also "Pay is Not a Matter for Whitehall", *Sunday Business*, 18 July 1999, 19; C Arthur, "The Fat Cats are Back", *Independent*, 25 July 2000, 3. For a less-optimistic appraisal, see S Targett, "Most Companies 'Flout Code on Corporate Governance", *Financial Times*, 20 December 1999, 2.

[26] Conyon and Murphy, *supra* n. 4, F643; *Hampel Report, supra* n. 24, para. 1.9.

[27] On current trends, see Pensions & Investment Research Consultants, *supra* n. 4, 22; D Bölger, "Fit Cats Get the Cream", *Financial Times*, 15 August 2000, 15; R Wachman, "Bosses' Pay Hits New High", *Sunday Business*, 1 October 2000, 2. On traditional patterns, see P Gregg *et al*, "The Disappearing Relationship Between Directors' Pay and Corporate Performance" (1993) 31 *British Journal of Industrial Relations* 1, 5–7; M Conyon and P Gregg, "Pay at the Top: A Study of the Sensitivity of Top Director Remuneration to Company Specific Shocks" (August 1994) *National Institute Economic Review* 83, 83–4, 86–7, 90.

Despite the changes that occurred after the Greenbury Report, executive remuneration remained a topical issue in the United Kingdom.[28] One reason was that pay levels continued to rise, with increases in managerial remuneration significantly outpacing inflation.[29] The Labour Party's election in 1997 was an additional factor that served to keep executive pay in the limelight. Since Labour had eagerly made political capital from news of big pay rises in the boardroom when it was in opposition, there were expectations that it would introduce more stringent regulation while in power.[30]

Various "high-profile" incidents also served to keep executive pay in the news.[31] For instance, in 2000 Vodafone Airtouch plc sparked a furore when it proposed making a £10 million "one-off" bonus payment to the chief executive who had orchestrated acquisitions that resulted in the company becoming the world's largest mobile telephone concern.[32] Controversy also plagued Vodafone in 2001 when it announced its intention to award the same CEO potentially lucrative share options.[33]

Labour, despite its stance prior to 1997, in fact proved to be cautious on the executive pay front. Admittedly, in 1999, coincident with the release of a DTI consultation paper on managerial remuneration, the Trade and Industry Secretary promised "to regulate fat cat pay".[34] Still, the Labour Party, which had acquired new-found allies in the business community in its rise to power, was keen not to alienate this constituency.[35] Hence, the Secretary of State for Trade and Industry qualified his promise to regulate by saying "that in a global economy, world-class performers must be rewarded with world-class pay".[36] Consistent with such market-oriented rhetoric, the basic theme in the DTI's 1999 consultation

[28] Pensions & Investments Research Consultants, *supra* n. 4, 22.

[29] Arthur, *supra* n. 25; T Jackson, "The Fat Cats Keep Getting Fatter", *Financial Times*, 1/2 August 1998, 7; P Thornton, "Executive Pay Increase Set to Revive Row", *Independent*, 23 October 2000, 15. On how executive pay rose in comparison with other benchmarks, see P Bassett, "Directors' Pay Rises at Twice Rate of Workforce", *The Times*, 6 November 1996, 26; C Buckley, "Free-for-all on Pay in the Boardroom", *The Times*, 28 October 1999, 37; C Batchelor, "Britain's Top CEOs See Pay Soar 20%", *Financial Times*, 6 November 2000, 1.

[30] M Prescott, "Labour U-Turn on 'Fat Cat' Salaries", *Sunday Times*, 16 May 1999, Section 3, 1; "Keep on Purring", *Economist*, 24 July 1999, 25.

[31] For summaries, see J Plender, "What a Performance", *Financial Times*, 27/28 March 1999, 11; S Targett, "Heat May Be Turned Up", *Financial Times*, 17 November 2000, FT Director Survey, 7; S Calian, "UK Shareholders Press Firms to Curb Executive Pay Raises", *Wall Street Journal Europe*, 30 July 2001, 1.

[32] J Waples, "Boardroom Bonanza", *Sunday Times*, 16 July 2000, Business, 9; M Dickson, "Vodafone Rings the Wrong Numbers on Executive Pay", *Financial Times*, 29/30 July 2000, 15; S Targett, "Phone Number Salaries Have Changed the Public Mood", *Financial Times*, 15 September 2000, FT Director, 7.

[33] P Wheatcroft, "There is No Option, Rules Must Change", *The Times*, 3 July 2001, 23; M Dickson, "Pay at Vodafone: Now We're Talking Telephone Numbers", *Financial Times*, 21/22 July 2001, 15.

[34] "No Answers in Executive Pay Debate", *Independent*, 20 July 1999, 19. The paper in question was DTI, *Directiors' Remuneration*, *supra* n. 3.

[35] A Murray, "Hampel Throws a Fat Cat Among Labour Pigeons", *The Times*, 20 January 1998, 31.

[36] "Keep on Purring", *supra* n. 30. See also "No Answers in Executive Pay Debate", *supra* n. 34.

document was that shareholders, not government, should impose sensible limits on managerial remuneration.

Critics of executive pay felt shortchanged by the approach the DTI suggested, and charged that its proposals were "thin stuff".[37] Indeed, the reform package was labelled "a textbook example of how New Labour has managed to exploit populist, old Labour issues without damaging its business-friendly image".[38] Still, while the DTI's recommendations fell short of demands from critics, Labour proved reluctant to follow through on the Department's suggested reform package. The Secretary of State for Trade and Industry had been expected to announce during 2000 how the Government would proceed.[39] Instead, there was "stoney silence".[40]

In 2001, Labour finally offered a partial response to the DTI's 1999 report. The Trade and Industry Secretary declared that while UK companies "must be able to attract and retain the best executives in the world", the linkage between pay and performance was "also rightly a matter of concern to shareholders".[41] He correspondingly announced that disclosure regulation would be restructured, reasoning that shareholders need to "have the necessary information to enable them to assess a company's policy on boardroom pay".[42]

In certain respects, the reforms the Trade and Industry Secretary outlined were consistent with the analysis in the DTI's 1999 consultation paper. The DTI had indicated that new disclosure regulations should be introduced to ensure that more information was available on the relationship between pay and performance.[43] The Trade and Industry Secretary followed up on this when offering his response. He indicated that as a result of the reforms proposed by the Labour Government a publicly quoted company would have to divulge a wider range of information dealing with the link between pay and performance, including compiling graphs to highlight where matters stood.

In an important way, however, Labour proposed going further than the DTI had suggested in the 1999 consultation paper. The DTI acknowledged in this document that the current disclosure regime, which again is governed primarily by the UKLA Listing Rules rather than by legislation, had been subjected to some criticism.[44] The Department did not, however, recommend any sort of shift

[37] "Mr. Byers is Right Not to Skin the 'Fat Cats'", *Independent*, 19 July 1999, Comment, 3; see also "Keep on Purring", *supra* n. 30.

[38] D Wighton, "Byers' Crackdown on Executive Pay Amounts to Small Change", *Financial Times*, 20 July 1999, 8. For a similar appraisal, see "Mr. Byers is Right Not to Skin the 'Fat Cats'", *supra* n. 37.

[39] K Brown, "Boardrooms Under Seige", *Financial Times*, 2 June 2000, FT Director, 5.

[40] Targett, *supra* n. 31; Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (London, DTI, 2000), para. 3.109.

[41] DTI, *supra* n. 1.

[42] *Ibid.*

[43] DTI, *supra* n. 3, 22–3.

[44] *Ibid.*, 21–2.

towards statutory regulation. In contrast, the Trade and Industry Secretary said that the Government would replace the existing Listing Rules regime with a scheme set out in companies legislation.

While Labour indicated in 2001 that it was prepared to restructure the regulation of disclosure, it refrained from indicating whether shareholders should be given new powers that would involve them more directly in the setting of executive pay. Instead, the Trade and Industry Secretary said that final decisions on improving accountability on remuneration issues would be taken after the completion of a fundamental review of UK company law launched by the DTI in 1998 and which will conclude with the publication of a White Paper.[45] Subsequently, however, DTI officials intimated that wholesale reform on the executive pay front was unlikely.[46]

Since Labour was planning to call an election subsequent to offering its 2001 response to the DTI's 1999 report, the postponement offered potential political advantages. As one newspaper columnist observed, "(t)he effect of the half-hearted fudge is to shunt a potentially embarrassing issue for the government into the promised land beyond the general election".[47] It is somewhat ironic that the Labour Government deferred announcing its position on shareholder participation in the setting of executive pay until after the company law review is complete. This is because the Company Law Review Steering Group, which co-ordinated the review on the DTI's behalf, generally steered clear of managerial remuneration during its deliberations. This was done in deference to the executive pay consultation exercise that culminated in the Department's 1999 report.[48]

The only instance where the Steering Group sought to deal directly with executive pay concerned the duration of managerial services contracts. The UK Companies Act 1985 currently provides that shareholders must endorse, by resolution, agreements with a term of longer than five years.[49] The Steering Group indicated in a discussion paper published in 2000 that the permitted duration should be cut to one year, with longer contracts being prohibited unless they were approved at a general meeting of the shareholders.[50] However, the Steering Group retreated somewhat from this proposal in a final report issued in 2001. It recommended that, with contracts of between one and three years in length,

[45] On the launch, see *supra* n. 2. On the plans to publish a White Paper, see Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure* (London, DTI, 2000), para. 1.10.

[46] C Buckley, "Review Leaves Fat Cats Unscathed", *The Times*, 27 July 2001, 30.

[47] J Plender, "An Assault on Boardroom Excess", *Financial Times*, 14 March 2001, 23. The election was held in June 2001 and Labour returned to power with an commanding majority.

[48] Company Law Review Steering Group, *supra* n. 40, para. 3.109; Company Law Review Steering Group, *supra* n. 45, para. 4.20, n. 60.

[49] Chapter 6, s. 319.

[50] Company Law Review Steering Group, *supra* n. 45, paras 4.19, 4.20. The Steering Group said that when a new executive was appointed the limit should instead be three years (*ibid.*, para. 4.19).

shareholders should have the option of using a "special" resolution requiring a three-quarters majority of the votes cast to displace the obligation to vote on each remuneration package.[51]

C. A RATIONALE FOR SHAREHOLDER PARTICIPATION IN THE SETTING OF EXECUTIVE PAY

Again, a key theme in the DTI's 1999 consultation paper was that shareholders, not government, should constrain executive pay abuses. Bolstering the contribution shareholders make in the setting of managerial remuneration is one of two themes that have monopolised discussions of reform in the United Kingdom.[52] The other is that remuneration committees dominated by directors who are not also full-time executives ("outside" or "non-executive" directors) should play a central and constructive role.

To understand the contribution remuneration committees can potentially make, it should be recalled that in UK companies authority for setting executive pay customarily rests in the hands of the directors.[53] By virtue of the composition of company boards, this can pose a problem.[54] Approximately half of the individuals who act as directors for publicly traded UK companies also serve as executives for the same firm.[55] The fact that full-time managers are well-represented in the boardroom implies that if directors set remuneration on a collective basis, executives may in effect be able to determine what to pay themselves. A potential solution to the problem is for the board to obtain guidance from a remuneration committee composed of outside directors. This will mean that pay issues will be dealt with by a group of people with a good knowledge of the company, but with no personal financial interest in the decisions they are taking.[56]

The logic supporting the use of remuneration committees has proved to be influential in the United Kingdom. As a result of recommendations made by the Greenbury Committee and by the Cadbury Committee, a panel that issued an influential report on corporate governance in 1992, the Combined Code currently says that a listed company should establish a remuneration committee.[57] A listed

[51] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report* (URN 01/942 (vol. 1), London, DTI, 2001), para. 6.13. On the nature of a special resolution, see Companies Act 1985, s. 378.

[52] Two additional possible approaches to reform—improving access to the courts and increasing taxes which executives would pay on their income—have received little attention. For background, see Cheffins, *supra* n. 5, 674–5; City Editor, "Byers Goes 'Fat Cat' Clubbing", *The Times*, 17 February 1999, 25.

[53] See *supra* n. 3 and accompanying text.

[54] Cheffins, *supra* n. 5, 661.

[55] Company Law Review Steering Group, *supra* n. 40, para. 3.147; S Targett, "Corporate Governance Body Hits at Boardroom Domination", *Financial Times*, 20 November 2000, 2.

[56] *Greenbury Report*, *supra* n. 22, para. 4.3.

[57] Financial Services Authority, Listing Rules, Combined Code, Code of Best Practice, para. B.2.1. On the recommendations made by the Greenbury Committee concerning remuneration

company is not obliged, as such, to comply with this stipulation. Instead, in line with the Combined Code's disclosure-oriented focus, a company must only divulge its failure to establish a remuneration committee in accordance with the guidance provided.[58] However, since the early 1990s, most UK companies with publicly traded equity have in fact fallen into line with the prevailing orthodoxy and created such a committee.[59]

While remuneration committees have beneficial features, they do not constitute an ideal response to existing concerns over executive pay. A key problem is that their objectivity is open to question. One potential difficulty is the composition of such committees. According to the Combined Code, a remuneration committee should be made up exclusively of non-executive directors who are independent of management.[60] This seems logical, since top managers can retain direct influence over the setting of their own pay if they are members. However, a substantial fraction of listed companies do not comply with the Combined Code guidelines and instead have one or more senior executives sitting on their remuneration committees.[61]

Even if outsiders in fact dominate on remuneration committees, bias remains a concern.[62] In most listed companies, a nominating committee will work together with the chairman of the board to select the individuals who ultimately serve as non-executive directors.[63] The recruits will usually have been chosen on the basis that they "fit in" with the company, in the sense that they identify with its goals and are compatible with the management team.[64] Such individuals, when they sit on a remuneration committee, may well be reluctant to antagonise their

committees, see *Greenbury Report, supra* n. 22, paras 1.14, 4.3–4.8. On the Cadbury Committee, see Committee on the Financial Aspects of Corporate Governance (chaired by Sir Adrian Cadbury), *Report* (London, Gee Publishing, 1992), para. 4.42. Certain refinements were made to the Listing Rules as a result of work undertaken by the Hampel Committee, which was assigned the task of reviewing the work carried out by the Cadbury and Greenbury Committees. See *Hampel Report, supra* n. 24, paras 2.11, 4.11–4.12.

58 Financial Services Authority, Listing Rules, para. 12.43A.

59 On the pattern during the 1990s, see *Greenbury Report*, *supra* n. 22, para. 4.6; MJ Conyon, "Institutional Arrangements for Setting Directors' Compensation in UK Companies", in K Keasey *et al* (eds), *Corporate Governance: Economic and Financial Issues* (Oxford University Press, 1997), 103, 111. On the current situation, see Targett, *supra* n. 55.

60 Financial Services Authority, Listing Rules, Combined Code, Code of Best Practice, para. B.2.2.

61 See A Jameson, "UK Companies Under Fire from NAPF for Code Violation", *The Times*, 10 October 2000, 27; Conyon, *supra* n. 59, 112–13. For a more optimistic appraisal, see DTI, *supra* n. 3, 11–12, 51.

62 Cheffins, *supra* n. 5, 668–9; SJ Stabile, "Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform" (2000) 35 *Wake Forest Law Review* 153, 174–6.

63 Pensions & Investment Research Consultants, *supra* n. 4, 13, 20; Cheffins, *supra* n. 5, 610.

64 JD Cox and HL Munsinger, "Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion" (1985) 48 *Law and Contemporary Problems* 83, 91–8; I Fraser, "The Growing Power of Non-Executives", *Director*, November 1998, 74, 76.

managerial colleagues by speaking out strongly against generous executive pay.[65] The fact that the CEO is frequently present at remuneration committee meetings on an advisory basis probably reinforces any such tendency.[66]

If company boards and their remuneration committees are not ideally suited to the task of dealing with executive pay issues, seemingly shareholders should be motivated to step forward. For instance, when executives receive exorbitant salaries, there will be, at least in some measure, a dissipation of profits otherwise available to shareholders.[67] Moreover, if management receives a substantial number of shares under option plans and/or LTIPs, the consequent dilution of existing equity will mean that other shareholders will end up with significantly less voting power and could have appreciably lower earnings per share.[68]

Also noteworthy is that managerial remuneration can potentially be structured so as to align the interests of shareholders and managers.[69] Establishing a link between executive pay and shareholder return will be potentially appealing for investors because executives are less likely to impose managerial "agency costs" on shareholders if there exists a direct financial incentive to maximise shareholder value.[70] The upshot is that shareholders have various reasons to pay attention to managerial remuneration. As we will see next, however, under current UK law they have little direct influence over the setting of executive pay.

D. The current regime in the United Kingdom

A publicly quoted company's articles of association will, in all likelihood, provide the board with the power to deal with executive remuneration

[65] The problem may well be compounded if the outside directors are also executives at other companies since indirectly they will be setting their own pay. See Brown, *supra* n. 39; Fraser, *supra* n. 64, 75; City Editor, "Squaring the Closed Circle", *The Times*, 15 October 1998, 33. Survey evidence suggests, however, that fewer than one in four British non-executive directors act in a managerial capacity for another company. See N O'Sullivan, "Managers as Monitors: An Analysis of the Non-executive Role of Senior Executives in UK Companies" (2000) 10 *British Journal of Management* 17, 23; K Peasnell *et al*, "Who are They?", *Accountancy International*, March 1999, 106; JW Hunt, "Exposure of the Non-Executive Directors", *Financial Times*, 27 October 2000, 17.

[66] Conyon, *supra* n. 59, 117–18. The Greenbury Committee explicitly acknowledged and endorsed this practice (*Greenbury Report*, *supra n.* 22, para. 4.14).

[67] GS Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York, WW Norton, 1991), 172–3, 212, 254. The amounts involved are, in fact, quite small in comparison with other aspects of corporate activity. See Bölger, *supra* n. 27.

[68] On problems arising from dilution, see RS Thomas and KJ Martin, "The Determinants of Shareholder Voting on Stock Option Plans" (2000) 35 *Wake Forest Law Review* 31, 35–6; D Leonhardt, "Will Today's Huge Rewards Devour Tomorrow's Earnings?", *New York Times*, 2 April 2000, Section 3, 1.

[69] On this philosophy, see, e.g. CM Yablon, "Bonus Questions—Executive Compensation in the Era of Pay for Performance" (1999) 75 *Notre Dame Law Review* 271, 278–80; RAG Monks and N Minow, *Corporate Governance* (Oxford, Blackwell, 2nd edn, 2001), 221–2.

[70] On the concept of agency costs, see, e.g. FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA, Harvard University Press, 1991), 9–11, 14–15, 91–2, 217–18.

matters.[71] Such an arrangement, in turn, largely precludes shareholders from playing a direct role in the area of managerial pay. It is well-established under UK company law that whenever the articles of association authorise the board of directors to make decisions on a company's behalf, the general meeting cannot dictate to the board how to exercise its powers.[72] Hence, shareholders in UK companies are, in a general sense, excluded from exercising control over managerial remuneration.

While the general rule in the United Kingdom is that shareholders do not have a direct say over executive pay, the pattern is subject to exceptions. For instance, companies legislation and the UKLA Listing Rules both offer investors some control over managerial remuneration.[73] On the legislative front, as we have seen, the Companies Act 1985 stipulates that a company's shareholders must consent by resolution before the company can enter into a contract of employment with a director for a term of more than five years.[74] With the Listing Rules, they stipulate that shareholders in a listed company should approve share option schemes and most LTIPs.[75]

In circumstances where legislation and the UKLA Listing Rules do not provide shareholders with a vote on executive pay, those owning equity may still have the opportunity to express their views on the topic. Under section 376 of the Companies Act 1985 a shareholder who complies with various procedural requirements can propose a resolution to be voted on at a company's next annual general meeting (AGM).[76] Since the Act does very little to regulate the subject-matter of such resolutions, a shareholder is free to make proposals concerning executive pay.[77] If investors want to raise remuneration issues but prefer not to wait until a company's next AGM, they may be able to have an extraordinary

[71] See *supra* n. 3 and accompanying text.

[72] *Automatic Self-Cleansing Filter Syndicate v Cunninghame* [1906] 2 Ch 34.

[73] For an overview, see DTI, *supra* n. 3, 33. An additional theoretical possibility is that a company's shareholders could amend the articles of association to provide them with authority to deal with executive pay issues. On the process involved, see PL Davies, *Gower's Principles of Modern Company Law* (London, Sweet & Maxwell, 6th edn, 1997), 116–17.

[74] See *supra* n. 49 and accompanying text. The statute also stipulates that shareholders must give their approval before a company can provide *ex gratia* payments to a director when the director is leaving office or when a company is undergoing a change in control. See Companies Act 1985, ss 312–14. However, a "golden parachute" awarded after premature termination of a director's executive services contract does not require shareholder approval because the director will have a contractual entitlement to this amount. See *Lander v Premier Pict Petroleum Ltd* [1997] SLT 1361, Outer House.

[75] Financial Services Authority, Listing Rules, para. 13.13. With share options, the right to vote in fact extends to any scheme under which employees may receive newly issued shares. On LTIP exceptions, see para. 13.13A of the Listing Rules as well as the definition of "long-term incentive scheme". If a listed company fails to obtain shareholder approval in accordance with the Listing Rules, it can be censured or have its listing cancelled (Financial Services Authority, Listing Rules, para. 1.9).

[76] On the procedural requirements, see Companies Act 1985, s. 377 and discussion *infra* nn. 80 and 114 and accompanying text.

[77] On the circumstances where a company is not bound to circulate a resolution, see *infra* n. 186 and accompanying text.

general meeting (EGM) called to deal with the matter. For instance, section 368 of the Companies Act 1985 indicates that shareholders who meet the requirements set down in this provision can request that the board of directors arrange such a meeting.[78]

While in theory a shareholder can raise executive pay issues by proposing a shareholder resolution or by calling an EGM, significant practical obstacles exist. For instance, a shareholder who steps forward may well incur costs which the company will not reimburse. To illustrate, with shareholder proposals under section 376 of the Companies Act 1985, the company can oblige those making the request to tender a sum which is reasonably sufficient to pay the costs of the circulation of the resolution and any accompanying statement.[79]

Also pertinent are statutory ownership thresholds. Under section 376 of the Companies Act 1985 an individual shareholder or small group of investors must own 5% or more of the voting rights of a company in order to make an AGM proposal.[80] In relation to section 368, those requesting an EGM must own between them more than 10% of the voting shares.[81] In a typical listed company in the United Kingdom the largest shareholders will be institutional investors (e.g. pension funds, insurance companies and unit trusts).[82] Only a tiny handful of these institutions will control enough votes, acting alone, to make a shareholder proposal at an AGM under section 376, and in many companies there will not be a single investor that owns enough equity to call an EGM under section 368.[83]

If shareholders can rely on section 376 or can arrange to have an EGM held and then manage to secure passage of a resolution, enforceability could still be a problem. Again, a company's directors will typically have the authority to set managerial remuneration. Correspondingly, the board will potentially be free to

[78] Section 370 may also be available, but a company's articles of association can displace the provision and the shareholders calling the meeting must bear the costs of doing so themselves (s. 370(1), (3)).

[79] See s. 377(1)(b). Under s. 368, if those who have called an EGM want to distribute an explanatory circular to shareholders, they will have to do so at their own expense. See Davies, *supra* n. 73, 569; E Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999), 263, n. 135.

[80] See s. 376(2). If the 5% threshold cannot be met, a resolution can still be brought forward by 100 or more shareholders who have paid up capital averaging not less than £100 per shareholder. Applications of this nature are rare in the United Kingdom but have caused some controversy in Australia. See "New Rule Proposed for Shareholders to Call Company Meetings", *Corporate Law Electronic Bulletin* 41, January 2001, 3.

[81] See s. 368(2)(a).

[82] GP Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford, Clarendon Press, 1996), 108–12.

[83] *Ibid.*, 112 (indicating that in a sample of UK publicly quoted companies, the largest institutional stake was 9.6%, the second largest was 6.0% and the third largest was 4.8%). See also L Morse, "Shareholders Sharpen Claws", *Financial Times*, 2 May 1997, FT Survey on Accessing US Capital Markets, 4 (indicating that UK institutional investors were concerned about the ownership hurdles). For somewhat different figures and for a more optimistic appraisal of the availability of s. 368, see Ferran, *supra* n. 79, 261.

ignore a resolution passed at a general meeting on executive pay.[84] Overcoming this problem may require reliance on the articles of association. For instance, some companies have articles which stipulate that the general meeting can provide directions to the board by a special resolution.[85]

There are two additional means by which investors in a listed company can express concern over executive pay. The first is to vote against the company's accounts when these are presented at the AGM.[86] This can function as a protest against the company's policy on executive pay because the directors of a listed company must prepare a report on remuneration that will be presented to the shareholders as part of the accounting documentation.[87]

The second is to decline to approve the re-election of directors who were members of a company's remuneration committee.[88] For instance, in 2001 the National Association of Pension Funds (NAPF)—whose members own approximately 25% of the UK Stock Market—urged shareholders to register a protest in this fashion. It did so after the Royal Bank of Scotland awarded a bonus to executives for orchestrating the acquisition of another bank.[89]

While shareholders can signal their dissatisfaction with executive pay arrangements by voting against the annual accounts or the re-election of a director, neither method is particularly popular. For instance, few investors will decline to approve the accounts merely because they have concerns about executive pay. Instead, they will need to have serious reservations about how the directors are running the company.[90]

With respect to voting against directors, one potential problem with this strategy is that the individuals most associated with an unpopular remuneration strategy may not be standing for re-election.[91] Instead, they may be in the middle of a three-year term in office; in UK companies the corporate constitution ordinarily

[84] See *Automatic Self-Cleansing v Cunninghame* [1906] 2 Ch 34. For a case involving s. 368 that offers some support for this proposition, see *Rose v McGivern* [1998] 2 BCLC 593, 604. In relation to s. 376, if the resolution would not be binding on the board, the directors could probably refuse to circulate it. See *Rose v McGivern* [1998] 2 BCLC 593, 605; AJ Boyle (ed.), *Gore-Browne on Companies* (Bristol, Jordans, 44th edn, 1986), para. 21.15, n. 2.

[85] Table A in Companies (Table A to F) Regulations 1985 (SI 1985/805) (hereafter "Table A"), art. 70.

[86] *Greenbury Report, supra* n. 22, para. 5.30; *Hampel Report, supra* n. 24, para. 4.21; F Guerrera, "SKB Faces Shareholder Revolt Over Bosses' Pay", *Independent*, 8 April 1999, 16. Although it is conventional at listed companies' AGMs for there to be a resolution which "receives" the company's annual report and accounts, technically no such resolution is required. See *Hampel Report, supra* n. 24, para. 5.20; R Smerdon, *A Practical Guide to Corporate Governance* (London, Sweet & Maxwell, 1998), 147 8.

[87] On the remuneration report generally, see *infra* nn. 97–9 and accompanying text. On its inclusion as part of the accounting "package", see Financial Services Authority, Listing Rules, para. 12.43A(c).

[88] DTI, *supra* n. 3, 35; *Greenbury Report, supra* n. 22, para. 5.30.

[89] S Targett, "Funds Furious Over RBS Bonuses", *Financial Times*, 27 March 2001, 1.

[90] DTI, *supra* n. 3, 31.

[91] *Ibid.*

provides for the retirement by rotation of one-third of the board each year.[92] Moreover, even if directors serving on the remuneration committee stand for re-election, shareholders may be reluctant to vote against an individual whose contribution to the company they otherwise value.[93] Certainly, the Royal Bank of Scotland directors who were the target of the NAPF's protest campaign in 2001 prevailed easily.[94]

E. Giving shareholders a greater direct say over executive pay

Since shareholders in UK companies might want to exercise influence in the controversial area of executive pay but have limited scope for doing so, it is not surprising that reform has made its way onto the agenda. For instance, the Greenbury Committee, in its deliberations on executive pay, considered the role shareholders should play. The Committee acknowledged in its 1995 report that investors could and should use their power and influence to make a constructive contribution in the area of executive pay.[95] When it recommended reform, however, it did not place the primary emphasis on giving shareholders a direct say. Instead, it focused on disclosure.

The Greenbury Committee, reasoning that investors need to have sufficient information to evaluate whether a company's approach to remuneration issues is a sound one, attached the "highest importance" to disclosure and urged a "philosophy of full transparency".[96] As mentioned, a listed company's board of directors must compile an annual report for shareholders on executive pay.[97] This requirement was added to the Listing Rules on the Greenbury Committee's recommendation.[98] The disclosure that occurs as a result is thorough in nature. Consistent with suggestions made by the Greenbury Committee, the remuneration report must discuss in a general way the company's policy on managerial remuneration and set out full details of all elements of each executive director's compensation package.[99]

[92] See Table A, arts 73, 74. See Cheffins, *supra* n. 5, 99; DTI, *supra* n. 3, 35 6, which indicated that directors should perhaps stand for re-election each year. See also *Hampel Report*, *supra* n. 24, paras 2.8, 3.21; Financial Services Authority, Listing Rules, Combined Code, Principle A6 (indicating that directors should stand for re-election at least every three years).

[93] DTI, *supra* n. 3, 36.

[94] M Nicholson, "RBS Chief Unapologetic Over Bonuses", *Financial Times*, 12 April 2001, 27.

[95] *Greenbury Report*, *supra* n. 22, para. 3.4 (focusing on institutional investors).

[96] *Ibid.*, paras 5.2, 5.3.

[97] See *supra* n. 87 and accompanying text.

[98] *Greenbury Report*, *supra* n. 22, paras 5.4–5.25. The Greenbury Committee recommended that a company's remuneration committee should compile the report, but the focus shifted to the board of directors as a result of recommendations made by the Hampel Committee (*supra* n. 24, para. 4.14).

[99] See Financial Services Authority, Listing Rules, para. 12.43A(c); Combined Code, Code of Best Practice, paras B.3.1–B.3.2, Schedule B.

While the *Greenbury Report* focused primarily on disclosure when dealing with shareholders, voting arrangements were also canvassed. The Greenbury Committee indicated that investors should have a direct say over executive pay in certain circumstances. For instance, when the Listing Rules were amended to give shareholders the right to vote on various types of LTIPs, this was done in response to a recommendation by the Committee.[100] The *Greenbury Report* also suggested that each year those setting executive pay on a listed company's behalf should consider whether to invite the AGM to vote on the matter.[101] The Combined Code currently directs boards of listed companies to conduct this annual exercise.[102]

While the Greenbury Committee was content to permit investors to vote on managerial remuneration under certain conditions, it was not prepared to endorse direct input on a regular basis. Instead, it said that investors should not have a vested right to vote on the annual report on executive pay or otherwise have to signify their concurrence with a company's approach to managerial remuneration.[103] Committee members reasoned that in most years shareholders would want to focus on the company's general progress and the board's overall performance, not executive pay.[104] The Hampel Committee, a panel assigned the task of reviewing the work undertaken by the Cadbury and Greenbury Committees, endorsed the Greenbury Committee's stance in a 1998 report. According to the Hampel Committee, it was inappropriate that shareholder approval should be required for a single aspect of company policy.[105]

When the DTI issued its 1999 consultation paper on executive pay, it departed from the views the Greenbury and Hampel Committees had put forward on shareholder voting. The DTI acknowledged that the board of directors, acting on the recommendation of a remuneration committee, should establish a company's general policy on executive pay and determine the remuneration packages for individual executive directors.[106] It suggested, however, that increased dialogue between a company's board and its shareholders might be beneficial, and indicated that such dialogue would be more effective if it was underpinned by a framework which facilitated voting on resolutions relating to executive pay.[107]

The DTI offered two justifications for its recommended approach.[108] One was that, despite the setting-up of remuneration committees, bias continued unduly to

[100] *Greenbury Report*, *supra* n. 22, paras 5.33, 6.33; on the Listing Rules, see *supra* n. 75 and accompanying text.

[101] *Greenbury Report*, *supra* n. 22, paras 5.31, 5.32.

[102] Financial Services Authority, Listing Rules, Combined Code, Code of Best Practice, para. B.3.5. On the extent to which this guidance is followed, see *infra* nn. 111, 133–4 and accompanying text.

[103] The Combined Code reflects this. See Financial Services Authority, Listing Rules, Combined Code, Code of Best Practice, para. B.3.5.

[104] *Greenbury Report*, *supra* n. 22, paras 5.28, 5.29.

[105] *Hampel Report*, *supra* n. 24, para. 4.21. On the Hampel Committee's mandate, see *ibid.*, Annex; Smerdon, *supra* n. 86, 2 3.

[106] DTI, *supra* n. 3, 31.

[107] *Ibid.*

[108] *Ibid.*, 31, 35–6.

taint the setting of executive pay in UK publicly quoted companies.[109] The DTI's implicit assumption on this count was that shareholders could, under appropriate circumstances, act as an objective check on potential abuse.

The other justification the DTI offered for giving shareholders a greater direct say over executive pay was that those who are unhappy about a company's remuneration policy currently do not have adequate means available for expressing their concerns. For instance, the DTI indicated that shareholders who might have misgivings about executive pay were unlikely to find it worthwhile to protest by voting against a company's accounts or by opposing the re-election of directors who had served on the remuneration committee.[110] The Department also made its point by drawing attention to the guidelines in the Combined Code which indicate that a company's board of directors should assess each year whether shareholders should be invited to vote on the company's stance on managerial remuneration. As the DTI noted, only a very small number of companies consult investors in this fashion.[111]

The DTI, in its 1999 consultation paper, canvassed various options for increasing shareholder power over directors' remuneration, and endorsed two. One was to make it easier for shareholders to make a proposal at an AGM.[112] On this count, the DTI was apparently unconcerned that the 5% ownership threshold in section 376 of the Companies Act 1985 might be too strict.[113] Instead, it focused on timing. Currently, shareholders seeking to have a resolution circulated at an AGM must submit the relevant documentation at least six weeks before the meeting is held.[114] Reasoning that investors seeking to comply with this requirement may well not have received the annual report on remuneration from the directors, the DTI suggested that the time period be reduced to one week. This change, it was said, would allow shareholders to develop an informed view of a company's remuneration policy before making a proposal.[115] An alternative approach, as the DTI noted, was simply to give shareholders the right to propose resolutions on executive pay at the AGM.

The other reform option endorsed by the DTI was to give shareholders the right to vote on the board's remuneration report each year.[116] The primary advantage

[109] It is not alone in staking out this position. See, e.g. Lex Column, "Executive Pay", *Financial Times*, 27 September 1996, 28.

[110] See *supra* nn. 90–93.

[111] DTI, *supra* n. 3, 34. On the guidelines in question, see *supra* n. 102 and accompanying text. See further Dickson, *supra* n. 32; Pensions & Investment Research Consultants Ltd, *supra* n. 4, 26.

[112] DTI, *supra* n. 3, 37–8.

[113] The Company Law Review Steering Group has, in fact, specifically endorsed retention of the current ownership requirements. See *Completing the Structure, supra* n. 45, paras 5.33, 5.35; *Final Report, supra* n. 51, para. 7.12.

[114] Companies Act 1985, s. 377(1)(a).

[115] The company must send the annual accounts, of which the report on remuneration will be a part, to shareholders at least 21 days prior to the AGM (Companies Act 1985, s. 238(1)).

[116] DTI, *supra* n. 3, 36–7.

offered by an annual vote, according to the DTI, was that concerns over executive pay would be addressed directly rather than via an indirect method, such as voting against the accounts.[117] The consultation paper indicated, however, that the significance of the annual remuneration policy resolution should be qualified in an important way: it should be advisory rather than binding in nature.

As the DTI acknowledged, requiring an advisory vote would be novel under UK law. Moreover, it did not dismiss out-of-hand the possibility that the executive pay resolution should be made binding.[118] However, perhaps because the DTI was concerned about the effect a binding vote would have on remuneration arrangements established prior to an AGM, it preferred to endorse the more cautious option.[119] Certainly, fears about implementation led the DTI completely to reject the possibility that shareholders should have a veto over all individual executive service contracts.[120] Practical difficulties the DTI cited on this count included the recruitment of managers who would not know their salary until the next AGM and the substitution of different pay arrangements if shareholders rejected a contract on the agenda.

The fact that serious practical problems can arise if investors vote on individual executive service contracts draws attention to an important feature of the contribution the Company Law Review Steering Group made on the executive pay front. As we have seen, the Steering Group suggested that executive service contracts of greater than one year in duration should be prohibited unless they were endorsed at a general meeting or the shareholders had used a special resolution to authorise the use of longer agreements.[121] According to 2000 data, in UK listed companies more than one in four director service contracts had terms exceeding one year.[122] Correspondingly, implementation of the Steering Group's proposal on shareholder voting seemingly would expand the scope for shareholder participation in the setting of executive pay considerably.

Appearances, however, are potentially deceiving. If the law were amended in accordance with the recommendations made by the Steering Group, investors would probably not vote much more frequently on individual pay packages than they do at present. Since various difficulties can arise if executive services contracts

[117] For a similar argument, see MJ Loewenstein, "Reflections on Executive Compensation and a Modest Proposal for (Further) Reform" (1996) 60 *Southern Methodist University Law Review* 201, 222 (arguing in favour of annual vote on CEO compensation).

[118] DTI, *supra* n. 3, 37. The DTI is not alone in suggesting that a mandatory annual vote on executive pay should be advisory rather than binding. See Loewenstein, *supra* n. 117, 221–2.

[119] On the dangers involved if the vote were binding, see "Pay is Not a Matter for Whitehall", *supra* n. 25; D Wighton, "Business Welcomes Minister's Comments on Remuneration", *Financial Times*, 20 July 1999, 8 (quoting the Director-General of the Institute of Directors); City Comment, "Curdling the Cream for the Fat Cats", *Telegraph*, 20 July 1999, 29.

[120] DTI, *supra* n. 3, 36. On support for this approach, see, e.g. Lex Column, *supra* n. 109; C Lorenz, "Time for Cadbury to Tackle High Pay", *Financial Times*, 3 June 1993, 14; "Investors Must Have a Voice", *Independent*, 6 December 1994, 29.

[121] *Supra* nn. 50–51 and accompanying text.

[122] Pensions & Investment Research Consultants Ltd, *supra* n. 4, 25.

are contingent upon shareholder approval, companies would probably respond to a change in the law by refraining from offering packages with a term of more than one year[123] or by seeking authorisation to offer contracts with a longer duration.

F. ASSESSING THE CONTRIBUTION REFORM MAY MAKE: THE RELEVANCE OF VOTING PATTERNS

The proposals made by the DTI in 1999 for increasing shareholder power over directors' remuneration elicited a mixed response. Some were concerned that investors would meddle in an unhelpful way. Fears were expressed that UK companies would have difficulty recruiting talented executives because shareholders would be prepared to vote against the highly lucrative packages required to attract and motivate top people.[124] Most, however, doubted whether giving shareholders additional powers would make much difference. Optimists suggested that adoption of the DTI's recommendations would not do much harm and might even do some good.[125] Others indicated, on the other hand, that the suggested changes to the law might well be pointless.

Those who suggested that giving shareholders additional powers would not have a significant practical impact made their point in a variety of ways. One line of argument focused on the idea that investors would not vote to destroy shareholder value. The thinking was that shareholders would not oppose potentially lucrative, performance-oriented pay packages since these can serve to align the interests of executives and investors.[126] Alternatively, generous remuneration might be necessary to recruit and retain talented managerial personnel.[127]

Others made their point about the futility of giving shareholders extra powers by focusing specifically on institutional investors. The institutional emphasis was not surprising: such investors can dictate the outcome of most shareholder votes

[123] The Steering Group in fact recognised that implementation of its one-year proposal would typically cause companies to shorten the length of executive services contacts. See *Completing the Structure*, *supra* n. 45, para. 4.20 (noting that the change to the law would mean that a dismissed executive's claim for damages for breach of contract would normally be a maximum of one year's remuneration).

[124] "Pay is Not a Matter for Whitehall", *supra* n. 25; R Griffin, "Investors Will Have Veto on Fat-Cat Pay", *Sunday Business*, 17 October 1999, 31. See also "Shareholder Involvement may be Unwise" (Letter), *Financial Times*, 19 February 1999, 18.

[125] "Mr. Byers is Right Not to Skin the 'Fat Cats' ", *supra* n. 37; D Wighton, "Byers Rules Out Curbs on Top Managers' Pay", *Financial Times*, 20 July 1999, 1; "Conflicts Over Directors' Pay", *Financial Times*, 20 July 1999, 19.

[126] "Cheer Good Directors from the Rooftops" (Letter), *Financial Times*, 19 February 1999, 18 (commenting on the proposals before they had been finalised). For survey evidence indicating that UK fund managers support higher executive pay if there is a strong performance link, see *infra* n. 245 and accompanying text.

[127] Cheffins, *supra* n. 5, 700; Waples, *supra* n. 32; R Gribben, "Investors Champion Boardroom Pay Rises", *Telegraph*, 19 July 1999, 27.

since they control, collectively, more than 70% of the equity in the UK's listed companies.[128] The basic sentiment was that the institutions would, despite occasional complaints about the setting of executive pay, inevitably acquiesce when matters came to the crunch.[129] One explanation offered was that institutional investors do not have sufficient company-specific knowledge to take a "hands-on" role in the setting of executive pay. As one observer pointed out, "(h)ow do they know what Joe Bloggs should be paid?".[130] A more cynical view was that self-interest would influence the people who make decisions on behalf of institutional investors, such as pension fund managers and insurance company executives. The basic argument was that such individuals would opt for passivity because of their own financial self-interest: they benefit personally from the executive pay "gravy train".[131]

A common theme that linked the predictions concerning the impact of the DTI's proposals was that each hinged implicitly on assumptions about shareholder attitudes toward collective decision-making. Those who suggested that reform would have a detrimental impact were taking it for granted that shareholders would vote against executive pay arrangements on a sufficiently regular basis to affect corporate policy. On the other hand, those who argued that changing the law was unlikely to make much difference, and might even be pointless, were assuming that investors would rarely rely on resolutions and general meetings to influence decisions on managerial remuneration. In order to evaluate which of these predictions is more likely to be accurate, a helpful way to proceed is to take into account existing evidence concerning resolutions dealing with executive pay.

The available data from the United Kingdom is, unfortunately, fragmentary. With shareholder proposals that raise managerial remuneration issues, the only points which are clear are that such resolutions are rare, and are defeated when they come to a vote.[132] Various interesting questions therefore remain unanswered. For instance, it is unknown whether those making shareholder proposals

[128] *Hampel Report*, *supra* n. 24, para. 5.1 (stating that domestic institutions own 60% of the shares and that most of the 20% owned by foreigners are held by institutional investors); L Colby, "Investment Militants", *Institutional Investor*, April 1999, 28.

[129] M Fagan, "How Not to Skin a Fat Cat", *Sunday Telegraph*, 18 July 1999, 21; S Patten and J Ashworth, "UK 'Fat Cats' Look on in Envy at Their American Cousins", *The Times*, 15 July 2000, 29. The fact that a substantial majority of UK fund managers oppose the DTI's 1999 proposals lends credence to this view. See C Oldfield, "Investors Want American-Style Pay", *Sunday Times*, 13 August 2000, Section 3, 1; N Cope, "Marconi Revives City Anger Over Boardroom Pay Excesses", *Independent*, 21 June 2001, 21.

[130] Quoted in "Keep on Purring", *supra* n. 30. See also "Cheer Good Directors from the Rooftops", *supra* n. 126; K Hamilton, "Fat-Cat Pay Battle Breaks Out Again", *The Times*, 21 February 1999, 7 (setting out views expressed by fund managers).

[131] Plender, *supra* n. 31; City Editor, "Look Out, There's a Monster Coming to Your Annual Meeting", *Telegraph*, 25 July 2000, 27. For further background, see J Plender, "When Winner Takes All", *Financial Times*, 13 August 1998, 18; J Plender, "Instant Gratification in the Boardroom", *Financial Times*, 23 June 2000, 23.

[132] On the evidence, see DTI, *Shareholder Communications at the Annual General Meeting* (London, DTI, 1996), 30–31.

are targeting companies with potentially problematic remuneration arrangements, such as firms that pay well despite lacklustre financial results. In addition, it is unknown whether voting patterns vary depending on the nature of the proposal that has been made.

In terms of companies seeking approval for executive pay policies at AGMs, it is widely acknowledged that this occurs only rarely.[133] Moreover, the available evidence indicates that when this does occur, levels of opposition and abstention are typically very low.[134] However, not much more is known. The DTI, in its 1999 consultation paper, speculated that the lack of dissent meant that the companies with contentious policies were not the ones allowing shareholders to vote.[135] Events occurring at Vodafone in 2000 and 2001 cast doubt, however, on this hypothesis. As mentioned, in both years the company announced controversial remuneration arrangements for its CEO.[136] Each time, the board of directors voluntarily put an executive pay resolution before the AGM, and a substantial fraction of the votes cast were either intentional abstentions or "no" votes (nearly 30% in 2000 and 40% in 2001).[137]

Turning to share options and LTIPs that require approval under the Listing Rules, there has been some research carried out on voting patterns. Pensions Investment Research Consultants (PIRC), a firm that provides advice to pension funds, has found that the level of support exceeds 90% for both share options and LTIPs.[138] This implies that shareholders are content to adopt such incentive schemes without subjecting them to critical analysis. Such an inference should not, however, be drawn too hastily. The PIRC data indicates that "oppose" votes and abstentions are considerably higher for share option and LTIP resolutions than they are for other issues.[139] Moreover, investor dissatisfaction with undemanding performance conditions in an executive share option plan proposed by Cable & Wireless, a large telecommunications company, was sufficient to elicit a 29% "no" vote at the company's 2001 AGM.[140] Perhaps, then, executive pay issues do receive some special scrutiny from shareholders.

A helpful way to ascertain how seriously investors approach votes on share options and LTIPs would be to determine whether specific features of these schemes affect the level of support the various resolutions receive. Unfortunately,

[133] See *supra* n. 111 and accompanying text; Targett, *supra* n. 25; Targett, *supra* n. 31.

[134] DTI, *supra* n. 3, 34–5.

[135] *Ibid.*, 35.

[136] *Supra* nn. 32–3 and accompanying text.

[137] On 2000, see D Blackwell, "Vodafone's Cage Rattled at AGM", *Financial Times*, 28 July 2000, 22; S Calian, "Vodafone Shareholders Protest Executive's Hefty Cash Bonus", *Wall Street Journal*, 28 July 2000, A13. On 2001, see Calian, *supra* n. 31; D White, "Vodafone Bows to Shareholder Revolt", *Telegraph*, 26 July 2001, 33.

[138] See Pensions & Investment Research Consultants, *supra* n. 4, 43–4; DTI, *supra* n. 3, 34.

[139] See Pensions & Investment Research Consultants, *supra* n. 4, 42–4.

[140] D White, "Relaxed Wallace Rides Revolt on Pay", *Telegraph*, 21 July 2001, 27; "Common Sense Needed on Options", *Sunday Business*, 22 July 2001, 17.

however, such data have apparently not been compiled. Instead, as with other aspects of shareholder participation in the setting of executive pay, the available evidence does not provide much guidance on how investors use their existing powers. This, correspondingly, makes it difficult to predict the impact of possible reform.

G. LEARNING FROM ABROAD: WHY EVIDENCE FROM THE UNITED STATES IS POTENTIALLY INSTRUCTIVE

Since the data from Britain is fragmentary, examining evidence from the United States potentially can provide helpful guidance on whether it would be worthwhile for UK policy makers to give shareholders greater influence over managerial remuneration. As we will see, due allowance should be made for potentially relevant differences between the two countries.[141] However, the similarities are strong enough to suggest that comparative analysis will be valuable.

An important common starting point is a shared legal heritage encompassing the common law and principles of equity.[142] In addition, both countries have a "shareholder economy" where private enterprise is about maximising profits for those who invest and shareholders occupy the central position with respect to companies.[143] Moreover, in contrast with other major industrial countries, the United States and the United Kingdom share an "outsider/arm's-length" system of ownership and control.[144] The "outsider" typology is used to describe the situation that exists because most big firms do not have "core" shareholders who own enough equity to exercise "inside" influence.[145] Instead, share ownership is

[141] See, e.g. *infra* nn. 242–4 and 256 and accompanying text.

[142] DA DeMott, "The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions" (1999) 3 *Company Financial and Insolvency Law Review* 190, 191.

[143] F Bolkestein, "The High Road that Leads Out of the Low Countries", *Economist*, 22 May 1999, 115; LA Cunningham, "Commonalties and Prescriptions in the Vertical Dimension of Global Corporate Governance" (1999) 84 *Cornell Law Review* 1133, 1136–9. Others have used somewhat different terminology to make the same point. See, e.g. E Berglöf, "Reforming Corporate Governance: Redirecting the European Agenda" (1997) 24 *Economic Policy* 93, 105–6 ("company based system"); M Bradley *et al*, "The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9, 37–8, 48 ("contractarian").

[144] BR Cheffins, "Current Trends in Corporate Governance: Going From London to Milan via Toronto" (1999) 10 *Duke Journal of Comparative and International Law* 5, 7, 11–13, 31; E Berglöf, "A Note on the Typology of Financial Systems", in KJ Hopt and E Wymeersch (eds), *Comparative Corporate Governance: Essays and Materials* (Berlin, Walter de Gruyter, 1997), 152. On why the categorisation might matter in the context of executive pay, see SJ Stabile, "My Executive Makes More than Your Executive: Rationalizing Executive Pay in a Global Economy" (2001) 17 *New York International Law Review* 63, 83–4.

[145] On the impact that controlling shareholders have on the use of shareholder proposals, see BR Cheffins, "*Michaud v National Bank of Canada* and Canadian Corporate Governance: A 'Victory' for Shareholder Rights?" (1998) 30 *Canadian Business Law Journal* 20, 58–60.

typically dispersed among a large number of institutional and individual investors rather than being concentrated in the hands of family owners, banks or affiliated firms. The term "arm's-length" signifies that investors in the United States and the United Kingdom are rarely poised to intervene and take a hand in running a business. Instead, they tend to maintain their distance and give executives a free hand to manage.

Another important similarity between the United States and the United Kingdom is that executive pay is set in much the same way. Again, in British companies the board of directors is typically vested with authority to appoint executives and set their remuneration.[146] By virtue of a combination of provisions in corporate legislation, case law principles and the by-laws of individual corporations, the situation is the same in the United States.[147] Moreover, as is the case in Britain, the prevailing orthodoxy is that directors of a publicly quoted company should delegate decisions concerning executive pay to a remuneration or "compensation" committee made up of outside directors.[148] The vast majority of America's publicly listed corporations in fact conform with this prescription.[149] Just as in Britain, however, fears exist that remuneration committees do not approach their assigned task with sufficient detachment.[150]

One additional commonality is the presence of controversy concerning executive pay. As mentioned, the topic has been widely debated in the United Kingdom in recent years.[151] In the United States, interest in executive compensation grew considerably during the early 1990s when a wave of corporate "downsizings" left managers who were enjoying significant increases in pay vulnerable to criticism.[152] One by-product of the controversy was that the federal Securities and Exchange Commission (SEC) toughened up regulations governing disclosure of managerial remuneration considerably.[153] In addition, in 1993 President Clinton fulfilled a campaign pledge to halt "excessive executive pay" by spurring changes to the Internal Revenue Code which meant that a corporation that paid an executive more than $1 million annually could treat the expenditure as deductible for tax purposes only if the additional amount was paid pursuant to a "performance-based plan".[154]

[146] See *supra* n. 3 and accompanying text.

[147] TP Bjur and D Jensen, *Fletcher Cyclopedia of the Law of Private Corporations* (Deerfield, Ill, Clark, Boardman Callaghan, 1995), vol. 5, §§2120, 2126, 2127.

[148] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St Paul, ALI Publishers, 1994), §3A.05(a), §3A.05, Comment, ¶¶ a, c.

[149] *Ibid.*, §3A.05, Reporter's N 1.

[150] See, e.g. MJ Loewenstein, "The Conundrum of Executive Compensation" (2000) 35 *Wake Forest Law Review* 1, 14–18 (casting doubt, however, on the concerns that exist). On the United Kingdom, see *supra* nn. 62–6 and accompanying text.

[151] See *supra* nn. 7 and 28 and accompanying text.

[152] IM Stelzer, "Are CEOs Overpaid?" *Public Interest*, Winter 1997, 26, 26–7.

[153] KJ Murphy, "Politics, Economics, and Executive Compensation" (1995) 63 *University of Cincinnati Law Review* 713, 714, 729.

[154] *Ibid.*, 714, 738. See 26 USC §162(m)(4)(C) (1998).

Throughout the remainder of the 1990s the American economy enjoyed the longest continuous expansion in its history, and many people were too optimistic about their personal economic future to be very concerned about executives getting rich.[155] However, the issue did receive attention in academic circles, and executive compensation stories were a media favourite.[156] Moreover, with the United States beginning to experience an economic slowdown in 2001, managerial remuneration may be assessed more critically over the next few years. There is already some evidence that union pension funds and other shareholders are relying on the changing conditions to argue that executive pay arrangements are unduly lavish.[157]

H. Powers which US shareholders have over executive pay

Given the similarities between the United States and the United Kingdom, the manner in which American shareholders (or "stockholders") have voted on executive pay issues may help to reveal how British investors would use additional powers in this area. The first point to consider as part of an appraisal of the American evidence is the extent to which shareholders in the United States have a direct say on remuneration issues. Since America's corporate boards are vested with the authority to appoint managers and make the consequent contractual arrangements, those owning equity do not participate in the setting of executive pay in the ordinary course of events.[158] Nevertheless, as is the case in the United Kingdom, there are situations where those owning equity in publicly quoted corporations do vote on aspects of managerial remuneration.

An important situation in which US stockholders get a direct say is where a corporation is awarding share options (commonly referred to as stock options).[159] To start, state corporation laws may require shareholder approval of stock option plans, with the New York Business Corporation Law constituting a significant example.[160] On the other hand, the many states that follow the guidance provided by the Model Business Corporations Act on corporate legislation do not impose

[155] D Leonhardt, "Executive Pay Drops Off the Political Radar", *New York Times*, 16 April 2000, Week in Review, 5.

[156] Stabile, *supra* n. 62, 153 5.

[157] A Hill, "How Executives May Avoid Worst Effects of Downturn", *Financial Times (Asia)*, 16 March 2001, 14; E Wine, "Union Funds Turn Up the Heat Over Executive Pay", *Financial Times (Asia)*, 23 March 2001, 29.

[158] See *supra* n. 147 and accompanying text. On the possibility that statutory measures can require shareholders to vote on the salaries of certain executives, see Bjur and Jensen, *supra* n. 147, §§2020, 2024.

[159] For an overview of the law, see Thomas and Martin, *supra* n. 68, 46–51; RH Wagner and CG Wagner, "Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors" (1997) 3 *Stanford Journal of Law, Business and Finance* 5, 11 15.

[160] §505(d). See further Wagner and Wagner, *supra* n. 159, 13.

such a requirement.[161] The position is the same under the Delaware General Corporation Law, which governs the affairs of many of America's largest corporations.[162]

American tax laws create a second reason to put stock option plans to a vote by stockholders since certain shareholder-approved schemes yield tax benefits to corporations.[163] Consider, for instance, the provision in the IRC that allows companies to deduct annual executive compensation in excess of $1 million.[164] As mentioned, to qualify for the deduction, the remuneration has to be awarded under a "performance-based plan". According to the IRC's definition, a plan can be "performance-based" only if the shareholders ratify the scheme.[165] Hence, if a corporation wants to avail itself of the deduction when it introduces a stock option scheme, those owning equity must be given a say.

For companies that have their equity traded on a major US stock exchange, stock exchange rules provide a third reason to submit stock option plans to a shareholder vote. The New York Stock Exchange, the NASDAQ Stock Market and the American Stock Exchange all have listing rules which, subject to some exceptions, oblige listed companies to obtain shareholder approval before introducing a stock option plan.[166] Indeed, the New York Stock Exchange and NASDAQ are contemplating changing their listing rules to address a loophole which allows companies to bypass the shareholder approval process where plans include a substantial number of employee participants as well as corporate executives.[167]

Even where there is no need to obtain shareholder approval for a stock option plan, US corporations may still seek such authorisation so that the board of directors gains protection from shareholder litigation. In both the United States and the United Kingdom, executive remuneration can potentially be challenged in the courts on the basis that pay has been determined in a manner constituting a breach of the duties of care, loyalty and good faith owed to a company by its directors. In the United Kingdom, this course of action has only rarely been pursued.[168]

[161] *Ibid.*

[162] *Ibid.*; on the significance of the Delaware legislation, see Cheffins, *supra* n. 5, 424.

[163] See Wagner and Wagner, *supra* n. 159, 14–15. In the United Kingdom, certain share option schemes receive favoured tax treatment but performance conditions are not a prerequisite. See D Tankel and A Udale, "Executive Share Options: Choosing Performance Conditions", *Practical Law for Companies*, November 1993, 17, 20.

[164] See *supra* n. 154 and accompanying text.

[165] 26 USC §162(m)(4)(C)(ii) (1998). See also Wagner and Wagner, *supra* n. 159, 14.

[166] *Ibid.*, 12–13.

[167] J Labate, "SEC Closer to Proposing Tougher Stock Option Rules", *Financial Times*, 13 December 2000, 13. For background on this type of exception, see Thomas and Martin, *supra* n. 68, 48–9.

[168] Directors' duty arguments were advanced but were unsuccessful in a series of cases stemming from the same facts. See *Smith v Croft* [1986] 1 WLR 580; *Smith v Croft (No. 2)* [1988] 1 Ch 114; *Smith v Croft (No. 3)* [1987] BCLC 355. Shareholders in the United Kingdom can, however, potentially challenge executive pay arrangements on the grounds that the relevant transactions are *ultra vires* or constitute unfairly prejudicial conduct under Companies Act 1985, s. 459. See Cheffins, *supra* n. 5, 666.

On the other hand, in the United States derivative litigation has been used in numerous instances to challenge directors' decisions about executive pay.[169] These suits are more frequently successful at closely held corporations, but even in publicly quoted firms they provide something of a check on managerial remuneration.[170]

For corporate decision-makers in the United States, the fact that executive pay litigation is a realistic possibility provides them with an incentive to turn to the shareholders. For example, if a board of directors which approves a stock option plan is comprised largely of individuals who also serve as executives, the board will typically bear the burden of proof to justify the fairness of the arrangement in the event that there is a legal challenge.[171] If boards in this position get the shareholders to ratify their conduct, the directors will typically be protected against claims for breaches of the duties of care and loyalty.[172]

As is the case in the United Kingdom, shareholders in the United States have scope to put executive pay on the agenda in circumstances where they might not otherwise have a say. Rule 14a–8, implemented pursuant to section 14(a) of the Securities Exchange Act 1934,[173] sets out the framework which governs the submission of proposals by US corporations that have distributed their shares to the public.[174] Under this rule, as with section 376 of the UK Companies Act 1985, a shareholder can deliver a resolution to a corporation and request that management circulate the proposal to other investors. Carrying out this exercise ensures that the resolution can be put to a vote at a subsequent meeting of the shareholders.[175]

Management, when confronted with a Rule 14a–8 proposal, can decline to circulate it on the grounds that the proponent has breached prescribed eligibility

[169] See RS Thomas and KJ Martin, "Litigating Challenges to Executive Compensation: An Exercise in Futility?" (2001) 79 *Washington University Law Quarterly* (forthcoming).

[170] *Ibid.* (finding that the plaintiffs' success rate in pursuing at least some portion of executive compensation cases at close corporations was approximately 50%, while at public corporations this dropped to roughly 30%).

[171] See EJ Wittenberg, "Underwater Stock Options: What's a Board of Directors to Do?" (1988) 38 *American University Law Review* 75, 85–6. Where the board is disinterested in the transaction, and satisfies its other fiduciary duties, a principle known as the business judgment rule will normally protect a decision to approve a stock option plan from being second guessed by the courts. For background on the business judgment rule and the protection it offers to directors, see JD Cox *et al, Corporations* (Gaithersburg, New York, Aspen, 1998), §§10.2, 15.7.

[172] *Lewis v Vogelstein* 699 A 2d 327 (Del Ch, 1997). To be precise, the burden of proof will shift to the plaintiff to show that the actions of the board constitute waste and thus should not be protected by the business judgment rule.

[173] 15 USC §78n.

[174] 17 CFR (Code of Federal Regulations) §240.14a–8. On which corporations are governed by federal securities regulation, see RC Clark, *Corporate Law* (Boston, Little, Brown, 1986), 366, n. 1. For further background on Rule 14a–8, see RS Thomas and CT Dixon, *Aranow and Einhorn's Proxy Contests for Corporate Control* (New York, Aspen, 3rd edn, 1998), §§16.01–16.05.

[175] Rule 14a–8, unlike Companies Act 1985, s. 376, permits shareholders to make shareholder proposals at EGMs as well as AGMs (Rule 14a–8(a), introductory paragraph).

criteria, procedural conditions or substantive content restrictions.[176] When a corporation follows this course, typically it will advise the federal SEC and provide legal authority to try to demonstrate that exclusion is justified.[177] If staff at the SEC agree with the position taken, they will issue a "no-action" letter advising that they will refrain from recommending that the Commission take proceedings if the proposal is excluded.[178] The practical effect of such a letter most often is to preclude circulation of, and voting upon, the proposed resolution. However, the proponent retains the option of filing a suit in federal court seeking to force management to reverse its position.[179]

Among the various substantive grounds upon which a corporation can refuse to circulate a resolution[180] an important category encompasses proposals that pertain to the ordinary business operations of the corporation.[181] The primary purpose of the "ordinary business" exception is to preclude investors from meddling in day-to-day operating issues, thereby preserving management's prerogative to make decisions respecting a corporation's profit-making activities.[182] Prior to 1992, US companies could successfully oppose a Rule 14a–8 proposal concerning executive compensation on the grounds that it raised matters of "ordinary business". According to the SEC, compensation questions fell within the exclusive province of the board and could therefore not be challenged by shareholders.[183]

In 1992, the SEC reversed its interpretation of executive pay and ruled that the ordinary business exception did not preclude the submission of shareholder proposals dealing with the topic.[184] In doing so, the SEC noted that executive compensation issues had become the focus of widespread public debate and thus were no longer in the realm of ordinary business matters. It therefore concluded that shareholders were entitled to raise such matters under Rule 14a–8, assuming that the resolution in question did not seek to dictate how the board must proceed and was instead only "precatory" (i.e. advisory) in nature.[185]

[176] Thomas and Dixon, *supra* n. 174, §§16.01–05.

[177] *Ibid.*

[178] These letters are usually quite short and provide only minimal guidance on the SEC's reasons for permitting exclusion.

[179] See, e.g. *Roosevelt v EI duPont de Nemours & Co* 958 F 2d 416 (DC Cir, 1992) (concluding that a private cause of action exists to enforce Rule 14a–8).

[180] For example, a corporation can refuse to distribute a resolution which is not significantly related to the company's business (Rule 14a–8(i)(5)), which relates to election to an office (Rule 14a–8(i)(8)) or which deals with an issue that is not a proper subject for action by shareholders under the state laws under which the corporation is incorporated (Rule 14a–8(i)(1)).

[181] Rule 14a–8(i)(7), formerly Rule 14a–8(c)(7).

[182] See Thomas and Dixon, *supra* n. 174, §16.04[G]; RS Thomas and KJ Martin, "Should Labor Be Allowed To Make Shareholder Proposals?" (1998) 73 *Washington Law Review* 41, 59.

[183] KW Waite, "The Ordinary Business Exception to the Shareholder Proposal Rule: A Return to Predictability" (1995) 64 *Fordham Law Review* 1253, 1268–70.

[184] JE Heard, "Executive Compensation: Perspective of the Institutional Investor" (1995) 63 *University of Cincinnati Law Review* 749, 754–5.

[185] See Thomas and Martin, *supra* n. 182, 76.

The manner in which the SEC recast the "ordinary business" exception has served to align, in an important way, America's shareholder proposal regime with its UK counterpart. While those running a US publicly traded corporation can refuse a request to circulate a resolution on various substantive grounds specified in Rule 14a–8, those managing a UK company rarely have this option. Section 377(3) of the Companies Act 1985 does say that a company is not bound to circulate a statement if the rights in question "are being abused to secure needless publicity for defamatory matter". Otherwise, however, a resolution must go forward, assuming that those making the request satisfy the numerical criteria and timing requirements we have considered.[186] Since the SEC now takes the view that resolutions dealing with managerial remuneration do not constitute "ordinary business", the scope which US corporations have to refuse to circulate an executive pay resolution on substantive grounds is not much greater than that available to their British counterparts.[187]

I. THE US EXPERIENCE WITH SHAREHOLDER PROPOSALS

As mentioned, in the United Kingdom the fact that available evidence does not provide much guidance on how investors use their powers over the setting of managerial remuneration makes it difficult to evaluate proposals for reform.[188] Examining the experience in the United States provides a way to address this evidentary gap. Let us start by considering shareholder proposals. Again, in the United Kingdom, shareholders rarely seek to raise executive pay issues by asking management to circulate resolutions.[189] In contrast, each year, shareholders in the United States rely on Rule 14a–8 to submit a substantial number of proposals annually, and executive pay is a common topic.[190]

Legal rules perhaps explain why shareholder resolutions dealing with managerial remuneration are less common in the United Kingdom than they are in the

[186] On the procedural requirements, see *supra* nn. 76, 79–80 and 114 and accompanying text.

[187] Note, however, that corporations do retain some scope for excluding executive pay proposals on substantive grounds under Rule 14a–8. See, e.g. MJ Connell, "Shareholder Proposals", *Preparation of Annual Disclosure Documents 2001*, issued as part of the Corporate Law and Practice Course Handbook Series prepared by the Practising Law Institute (available on Westlaw database), 471, 485 (discussing a compensation proposal excluded under Rule 14a–8(i)(4) on the grounds that the proponent was seeking to redress a personal grievance).

[188] See *supra* text following n. 132.

[189] See *supra* nn. 111 and 133 and accompanying text.

[190] During the "proxy season" in 2000, stockholders in 1,000 of America's leading publicly quoted corporations filed 578 corporate governance proposals, 83 of which dealt with executive pay issues (source: interview with Drew Hambly, senior research analyst at the Investor Responsibility Research Center). See also J Scott, "Buzz Like a Gadfly, Sting Like a Flea", *Plain Dealer* (Cleveland), 7 December 2000, 1C (confirming that investors file about 500 corporate governance proposals a year); G Morgenson, "Holding Executives Answerable to Owners", *New York Times*, 29 April 2001, Section 3, 1 (indicating that the number of proposals dealing with executive pay is rising).

United States. For instance, a recommendation made by the DTI in its 1999 consultation paper on executive pay implies that timing requirements deter proposals on remuneration. As we have seen, the DTI advocated relaxing, specifically for remuneration issues, the current statutory requirement that a shareholder submit a proposal at least six weeks before a company's AGM.[191] The DTI justified its recommendation on the grounds that the change would serve to improve accountability to shareholders.[192]

While the DTI specifically flagged the timing issue as being important, it is in fact unlikely that the notice requirements in the Companies Act 1985 account for the comparatively low number of shareholder proposals in Britain. This is because the UK's six-week rule is already much less stringent than the equivalent deadline under Rule 14a–8.[193] It follows that if Parliament implements the change proposed by the DTI, this will probably not do much to bridge the shareholder proposal "gap" that currently exists between the United States and United Kingdom.

Rules governing cost constitute another possible explanation for the comparative unpopularity of shareholder resolutions in the United Kingdom. On this count, in contrast with timing, the US regime is more liberal than its British counterpart. As noted above, a UK company can oblige those making a request under section 376 of the Companies Act 1985 to tender a sum which is reasonably sufficient to pay the costs of the circulation of the resolution and any accompanying statement.[194] In contrast, once a proponent has established compliance with the procedural and substantive requirements of Rule 14a–8, the American system places the cost of printing and distributing the proposal on the company.[195]

Following on from work carried out by the DTI in a 1996 consultation paper, the Company Law Review Steering Group has recommended that the law should be amended to require companies to circulate section 376 resolutions at their own expense.[196] If cost considerations in fact account for the comparative unpopularity of shareholder proposals in Britain, such a change might cause more investors to submit resolutions dealing with executive pay. It is unclear, however, whether expense in fact is a major deterrent in the United Kingdom. This is because most companies are already prepared to circulate a shareholder proposal free of charge, assuming that sufficient notice has been provided to allow the resolution to be included with

[191] See *supra* n. 115 and accompanying text.

[192] DTI, *supra* n. 3, 38.

[193] In the United States when a shareholder is submitting a proposal to be voted on at an annual meeting, the relevant documentation typically must be filed not less than 120 days before management solicits proxies for that event (Rule 14a–8(e)(2)). With other meetings, a "reasonable time" is sufficient (Rule 14a–8(e)(3)).

[194] Section 377(1).

[195] Rule 14a–8(a), introductory paragraph.

[196] See Company Law Review Steering Group, *supra* n. 51, para. 7.12; DTI, *supra* n. 132, 9; Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication* (London, DTI, 1999), para. 49.

[197] DTI, *supra* n. 132, 9.

documentation that must be distributed to shareholders prior to AGMs.[197]

While rules governing timing and cost probably do not account for the low number of shareholder proposals in the United Kingdom, minimum ownership thresholds may well be a culprit. Again, an individual shareholder or small group of investors must own 5% or more of the voting rights of a company in order to rely on section 376 of the Companies Act 1985.[198] The American system is considerably more liberal since a shareholder needs to hold only $2,000 in market value, or 1%, of a corporation's securities in order to make a proposal under Rule 14a–8.[199]

The experience in the United States suggests that this difference is of considerable importance in the context of executive pay. While American shareholders submit a substantial number of proposals dealing with the topic, institutional investors have not taken a leading role. Instead, to the extent that they have sought to influence executive compensation policies in the corporations in which they own equity, they have generally opted not to resort to shareholder proposals as part of their efforts.[200] Individual shareholders, on the other hand, have proved keen to step forward, making proposals ranging from linking executive pay to a company's stock price to restricting company pay to a low multiple of employee salaries.[201]

While in the United States individual shareholders have made numerous proposals dealing with executive pay, the ownership threshold requirements in section 376 of the Companies Act 1985 essentially foreclose input from their UK counterparts. This is because, as we have seen, the 5% rule effectively restricts use of this provision to a handful of institutional investors.[202] It follows that if those responsible for reforming UK company law want shareholders to circulate more proposals concerning executive pay, they should relax the ownership threshold in section 376.[203] Change of this type, however, is apparently not currently on the agenda.[204] Unless there is a reversal on this count, the US experience suggests that shareholder proposals dealing with executive pay are not going to be common in Britain in the foreseeable future.

If the foregoing analysis is too pessimistic, and legal reform does foster increased

198 See *supra* n. 80 and accompanying text.

199 Rule 14a–8(b)(1).

200 See Heard, *supra* n. 184, 761. According to this author, institutions have preferred to use shareholder proposals for "structural questions, such as recommending the establishment of board-level compensation committees consisting entirely of independent outside directors". This observation is consistent with the data concerning the sponsors of shareholder resolutions. See Thomas and Martin, *supra* n. 182, 75, table 2.

201 Heard, *supra* n. 184, 761.

202 See *supra* n. 83 and accompanying text.

203 Some have indeed argued that relaxation of the law along US lines would be a positive step. See G Proctor and L Miles, "Neither Use Nor Ornament: Do We Really Need Annual General Meetings?", *Amicus Curiae*, February 2000, 21, 22–4.

204 See *supra* n. 113 and accompanying text.

use of shareholder proposals in Britain, would this make much difference in practice? Developments in the United States suggest that the answer is a qualified "no". The primary reason why major change should not be expected in the United Kingdom is the American voting pattern: shareholder proposals relating to executive pay do not garner majority support at the ballot box.[205] This lack of success is consistent with a more general pattern since few shareholder proposals are endorsed in this fashion. According to 1994 data, on average, 21.5% of shareholder votes were cast in favour of shareholder proposals.[206] This figure conceals some wide variations however. Proposals recommending that takeover defences be dismantled received the highest average percentage of favourable votes (53.7%).[207] In contrast, resolutions dealing with executive pay received relatively low average percentages of favourable votes (12.8%).[208]

With respect to executive pay proposals, the experience in 1994 was not an isolated one. According to the only detailed empirical study of voting on such resolutions, which covered the years between 1993 and 1997, the average percentage of votes cast in favour was 11.3%.[209] The pattern has apparently changed little in the past few years.[210] Various factors probably contribute to the low "yes" vote totals on executive compensation proposals. For instance, shareholders may find the issues involved to be too technical and complex to justify detailed analysis on a case-by-case basis. In addition, there may be a lack of consensus among investors over what the proper criteria are for evaluating executive compensation plans.[211]

While shareholder resolutions dealing with executive pay do not receive substantial backing from US investors, the effectiveness of this form of shareholder activism should not be dismissed out of hand. The empirical study covering the period 1993–97 found, for example, that proposals are not simply made on a random basis. Instead, the proponents target companies that pay executives more than competitors in the same industry and underperform in comparison with key stock market benchmarks.[212] This suggests that the shareholders who step forward and make proposals are seeking to remedy specific abuses rather than engage in a haphazard campaign against corporate executives.[213]

[205] RS Thomas and KJ Martin, "The Effect of Shareholder Proposals on Executive Compensation" (1999) 67 *University of Cincinnati Law Review* 1021, 1061 (taking into account proposals made from 1993–97).

[206] See Thomas and Martin, *supra* n. 182, 67, 76, table 3.

[207] *Ibid.* Such proposals are characterised in the study as "external corporate governance issues". On this terminology, see *ibid.*, 65; JM Karpoff *et al*, "Corporate Governance and Shareholder Initiatives" (1996) 42 *Journal of Financial Economics* 365, 371.

[208] Thomas and Martin, *supra* n. 182, 68, 76, table 3.

[209] Thomas and Martin, *supra* n. 205, 1060–61.

[210] J LoVoi and K Eppler, "Corporate Governance", in *Preparation of Annual Disclosure Documents, supra* n. 187, 421, 426; PS McGurn (ISS Monitor), "Attacks on Executive Pay Meet Mixed Response", *Corporate Governance Advisor*, Sept/Oct 2000, 25.

[211] Thomas and Martin, *supra* n. 182, 76.

[212] Thomas and Martin, *supra* n. 205, 1062–4.

[213] *Ibid.*, 1069.

For those who believe that shareholder proposals can function as a beneficial remedial device in the executive pay area, another aspect of the empirical analysis covering the 1993–97 period is encouraging. As noted previously, resolutions dealing with the topic do not receive enough votes for passage.[214] Nevertheless, according to the study, when such proposals are made they can have an impact on board decisions. In particular, in the two years after receiving a shareholder proposal, executive pay rose more slowly in a typical target company than it did in other firms in the same industry.[215] This pattern was more pronounced when proposals received substantial support than when the level of support was low.[216]

However, while the statistical evidence indicates that the shareholder proposal does have some impact on the setting of executive pay in the United States, the authors of the above-mentioned empirical study concluded that Rule 14a–8 does not provide a strong means for influencing executive compensation.[217] Instead, in light of the statistics available and conversations with corporate directors, they conceded that shareholder proposals are only one of a variety of factors that remuneration committees take into account. Proposals that drew a relatively high level of support admittedly could have a significant impact because they were viewed as a significant expression of shareholder discontent. On the other hand, even if the signal offered by a shareholder proposal was a strong one, it could often be outweighed by other concerns (e.g. the need to retain key employees and executives). From a British perspective, it follows that even if the law were reformed in a manner that significantly increased the number of shareholder proposals, the setting of executive pay would not be affected in a dramatic fashion.

J. VOTING ON STOCK OPTION PLANS IN THE UNITED STATES

Since shareholder proposals dealing with executive pay are not common in the United Kingdom, and since few listed companies take up the invitation in the Combined Code to consult investors on remuneration issues,[218] the primary situation where British shareholders vote on executive pay issues involves share option schemes and LTIPs. Typically, such arrangements are approved by large majorities, and there is insufficient data available to determine whether investors who vote "no" do so in any sort of discerning fashion.[219] Correspondingly, relying on the British experience with share options and LTIPs to ascertain whether there should be greater scope for shareholder voting on executive pay is necessarily a

[214] See *supra* nn. 208–10 and accompanying text.
[215] Thomas and Martin, *supra* n. 205, 1065–7.
[216] *Ibid.*, 1067–8.
[217] *Ibid.*, 1070.
[218] On s. 376 resolutions dealing with executive pay, see *supra* n. 132 and accompanying text. On annual votes, see *supra* nn. 111 and 133 and accompanying text.
[219] See *supra* nn. 138–40 and accompanying text.

speculative exercise. As we will see now, examining how shareholders vote on stock option plans in the United States fills the evidentary gap to a certain extent and does so in a manner that offers some encouragement for those who advocate changing the law.

Traditionally, when shareholders in US companies have been called upon to consider stock option plans, such schemes have been approved with almost no opposition.[220] This is not particularly surprising, given that US investors have generally been favourably disposed towards such arrangements.[221] Empirical studies indicate, for example, that the value of a corporation's shares typically rises after the introduction of a stock option plan.[222] Moreover, American institutional investors have urged boards to award stock options so as to align the interests of management more closely with those of shareholders.[223]

Those investors who are favourably disposed towards stock options have reason to be pleased with recent trends in the United States. According to data compiled by Conyon and Murphy, two experts on executive pay, the percentage of large publicly quoted corporations offering options to their CEOs grew from 82% in 1992 to 97% in 1997. The rise was even more dramatic with small and medium-sized public companies, with 55% having CEO option plans in 1992 and 96% doing so in 1997.[224] The result was that, by 1997, according to Conyon and Murphy, share option grants comprised a larger percentage of overall CEO compensation than base salaries (42% vs 29%).[225]

While stock options now constitute a pivotal type of managerial remuneration in the United States, it is possible to detect some signs of shareholder resistance to their use. For instance, some institutional investors now have guidelines in place stipulating that corporations should avoid replacing stock options that are "underwater" (i.e. the stock market price is below the price at which the options can be exercised) with new options of a lower "strike" price.[226] The dilution which outside shareholders can experience after options are exercised is also a serious concern. Institutional investors frequently set out dilution limits to which corporations

[220] Wagner and Wagner, *supra* n. 159, 5, 10.

[221] P Franson, "Minding the Store", *Electronic Business*, June 2001, 62, 68.

[222] R DeFusco *et al*, "The Effect of Executive Stock Option Plans on Stockholders and Bondholders" (1990) 45 *Journal of Finance* 617, 623–6; AG Morgan and A Poulsen, "Linking Pay to Performance: Compensation Proposals in the S&P 500" (1999), unpublished working paper, 17 21.

[223] See, e.g. TIAA-CREF, "Policy Statement on Corporate Governance" (2000), stating that "[s]tock-based compensation plans [are] a critical element of compensation programs, and can provide the greatest opportunity for the creation of wealth for the managers whose efforts contribute to the creation of wealth for shareholders". See <http://www.tiaa-cref.org/libra/governance/index.html>, under the heading "Five Fundamental Principles of Compensation Governance; 3. The Role of Stock".

[224] Conyon and Murphy, *supra* n. 4, F648–50.

[225] *Ibid.*, F646 7.

[226] Heard, *supra* n. 184, 759; CalPERS (California Public Employees Retirement System), *Domestic Proxy Voting Guidelines*, sections I.D, III.4000 (available at <http://www.calpers-governance.org/principles/domestic/voting/page01.asp>).

are supposed to adhere, with the underlying object being to regulate the potential transfer of wealth from outside investors to executives.[227]

Unease with stock option plans has also begun to manifest itself in voting patterns. By the mid-1990s, the trend had become evident. According to a paper published in 1997:

> "[w]here once there was an assumption that any plan presented by management and directors for approval would receive no more than token 3% to 5% disapproval, the 1995 and 1996 proxy seasons saw significantly stronger shareholder resistance to these plans, as votes against stock option plans in the range of 20–40% become more commonplace."[228]

The only systematic empirical analysis of shareholder voting on American stock option plans undertaken so far also highlights the growing unease with such schemes. This study, which was conducted by the same authors who carried out the empirical research on shareholder proposals discussed above, covered stock option plans voted on at AGMs held in 1998. It revealed that less than 1% of the plans put forward were defeated.[229] On the other hand, the average level of shareholder opposition was 19%, which is far from "token".[230]

The empirical study of voting on stock option plans revealed not only that shareholders are dissenting more often than they used to, but also that investors do not exercise their franchise in a haphazard manner. Instead, they take into account particular features of stock option plans when they vote.[231] Dilution constitutes a critical factor, with "no" votes in the study rising to almost 25% for schemes with a substantial dilutive effect.[232] This pattern is consistent with evidence indicating that, contrary to the norm with stock option plans, corporations that introduce highly dilutive schemes suffer negative stock price reactions.[233]

The empirical study of stock option plans indicates that certain other features in those plans prompt above-average opposition from shareholders. Explicit authorisations to "reprice" (i.e. lower the strike price) constitute one example. Others include the simultaneous awarding of restricted stock (shares given to directors

[227] *Ibid.* For further background on dilution, see *supra* n. 68 and accompanying text.

[228] Wagner and Wagner, *supra* n. 159, 10.

[229] Thomas and Martin, *supra* n. 68, 58.

[230] *Ibid.*, 58–9. By 2000, the average "no" vote had risen to almost 22%. See Morgenson, *supra* n. 190. Moreover, the percentage of votes cast in favour was probably inflated because under stock exchange rules brokers are permitted to vote in favour of stock option plans when their clients fail to vote shares. See JE Bethel and SL Gillan, "Corporate Voting and the Proxy Process: Managerial Control versus Shareholder Oversight" (2000), unpublished working paper, 5–7.

[231] Thomas and Martin, *supra* n. 68, 32–3.

[232] *Ibid.*, 60. Dilution can be measured in a variety of ways. Two common measures of dilution are total dilution and plan dilution. Total dilution is calculated as all future shares reserved for future grants of stock options plus the number of shares subject to outstanding options divided by the total number of voting securities. Plan dilution measures the amount of dilution created by the individual plan being voted upon. See *ibid.*, 59.

[233] See KJ Martin and RS Thomas, "Market Reaction to Highly Dilutive Stock Option Plans" (2001), unpublished working paper.

subject to restrictions on sale) and the provision of low interest loans to executives to facilitate the exercising of options.[234]

The fact that in the United States shareholder voting on stock options varies according to the features present should offer some encouragement to those in the United Kingdom who want investors to have a greater say in the area of executive pay. As we have seen, some have expressed fears that British investors would meddle in an unhelpful way if proposals which the DTI has made to increase shareholder power over managerial remuneration were implemented.[235] The American experience with stock option plans suggests that these fears are unfounded.

For instance, investors in the United States clearly do not exercise their powers in a highly disruptive fashion. Even though share option plans can be extremely lucrative—a majority of America's 200 largest corporations now annually grant their CEOs stock options valued at more than $10 million[236]—shareholders approve the vast majority of those schemes upon which they vote. At the same time, however, since American investors apparently take into account the features of a stock option plan when deciding how to cast their ballot, they seem capable of exercising the powers they have in a discriminating fashion. The point can, in fact, be made more forcefully. Since those owning stock vote in a discerning manner on executive pay issues, directors who want to ensure that shareholder concerns are being properly addressed will logically take into account features that are likely to provoke strong opposition.[237]

K. Putting the US experience into perspective

While stock option voting patterns in the United States offer some encouragement for those who argue that shareholders should have a greater say over executive pay, overall the American experience does not provide an endorsement for major reform. The authors who carried out the empirical studies of shareholder voting on stock options and on Rule 14a–8 proposals dealing with executive pay have observed that shareholder monitoring is only suitable for addressing occasional problems with executive pay practices.[238] They do believe that shareholder monitoring of compensation may be able to function as a potential check when arrangements deviate far from the norm. However, these experts reason that

[234] Thomas and Martin, *supra* n. 68, 33, 63–8. There is also an increase in the level of negative votes when plans contain "evergreen" features that allow boards to grant a certain portion of outstanding shares each year as options. See *ibid.*, 62–3. Note that under UK company law, the loans which US corporations make to executives to facilitate the exercising of options would be prohibited. See Companies Act 1985, s. 330.

[235] See *supra* n. 124 and accompanying text.

[236] Thomas and Martin, *supra* n. 68, 35 (discussing data from 1998).

[237] *Ibid.*, 74.

[238] Thomas and Martin, *supra* n. 205, 1071.

ascertaining how much corporate employees should be paid will typically constitute an exercise of business judgment best left to those with the responsibility for, and expertise in, making business decisions. Injecting shareholders too directly into this process, they submit, would foster the risk of undesirable micromanaging by investors. On this count, their views accord with those held by most US shareholders.[239]

As well as questioning whether close shareholder monitoring of executive pay is feasible, the authors of the above-mentioned empirical studies have echoed concerns expressed in Britain that giving investors significant additional powers will fail to address in a fundamental way problems alleged by critics of executive pay.[240] One stumbling block, according to these experts, is that investors may not be able to reach consensus on what reforms might be appropriate. Another difficulty they cite is that shareholders are unlikely to have sufficient information or expertise to identify problems in individual executive pay packages. Moreover, implicitly drawing attention to the "rational apathy" that afflicts those owning small holdings in public companies,[241] the authors suggest that investors who become aware of serious problems might not be able to mobilise concerted opposition to objectionable arrangements. Finally, the authors note that even when shareholders prove capable of voicing dissatisfaction on a co-ordinated basis, it cannot be taken for granted that the directors who make executive pay decisions will listen to the complaints.

It is important to put in context the doubts expressed by these authors. Their empirical analysis of shareholder proposals and stock options offers a guardedly optimistic appraisal of shareholder voting on executive pay since the evidence indicates that investors exercise their rights in a targeted fashion. Nevertheless, the authors have considerable doubts about the contribution which shareholders can realistically make with respect to managerial remuneration. It follows that those in Britain who have argued that it will be largely futile to give shareholders a greater direct say in the area of executive pay have raised an important and valid point.

However, while the experience in the United States suggests that reforming the law in the United Kingdom to foster shareholder participation in the setting of executive pay would not have a major impact, drawing inferences should be done with care. For instance, the evidence may understate the extent to which investors in British companies would take advantage of regulations that offered them scope to intervene. The United States, as a society, is more tolerant of income inequality, particularly if the inequality is driven by differences in effort, talent or entrepreneurial risk-taking.[242] Correspondingly, British shareholders might be more

[239] Franson, *supra* n. 221, 68.

[240] Thomas and Martin, *supra* n. 205, 1071–2. On the views expressed in the United Kingdom, see *supra* nn. 126–131 and accompanying text.

[241] See Cheffins, *supra* n. 5, 241.

[242] Conyon and Murphy, *supra* n. 4, F667–8; "Cheer Good Directors from the Rooftops", *supra* n. 126; W Rees-Mogg, "The Fat Cat is the Pensioner's Friend", *The Times*, 3 June 1996, 20.

prepared to take a stand against lucrative pay arrangements than American investors.[243] For instance, when various UK-based pension funds opposed the £10 million bonus awarded by Vodafone to its chief executive in 2000 and major US institutional investors did not, some speculated that the affair exposed geographical and philosophical differences concerning proper corporate governance.[244]

One should not be too hasty, however, in relying on "culture" to infer that UK shareholders, as compared with their US counterparts, would make more extensive use of powers that the law might make available. Survey evidence suggests that British fund managers are content to see executive pay rise substantially, provided increases are performance-related.[245] Also noteworthy is that even if UK shareholders have nationally oriented misgivings about lucrative managerial remuneration, the executive service contracts awarded by British companies are considerably less likely to cause offence. This is because US executives are much better paid than their UK counterparts. For instance, according to 1997 figures complied by Conyon and Murphy, chief executive compensation in publicly quoted US companies was more than five times greater than in comparable British firms.[246]

Even if UK shareholders do have a predisposition to intervene in the executive pay area, another distinction between investors in Britain and the United States may ensure that shareholder meetings will not be the venue in which the additional discontent will be expressed. Voter turnout statistics illustrate that investors in the United States pay closer attention to shareholder meetings than their counterparts in the United Kingdom. Whereas voting levels in the United States are around 80%, in the United Kingdom the voting rate is less than 50 per cent.[247] Various factors account for the comparative apathy in the United Kingdom. These include greater investor reluctance to get involved in a public fight, more complex voting procedures and the absence of rules equivalent to those in United States that impose duties on managers of pension funds to vote.[248]

243 G Dresser, "British Chiefs Toe the Line", *Sunday Business*, 16 July 2000, 5; see also S Barker, "Directors Play the Numbers Game", *Telegraph*, 29 July 2000, 20 (regretting the outcome).

244 Targett, *supra n.* 32; S Targett, "Funds Set to Oppose £10m Gent Package", *Financial Times*, 11 July 2000, 27.

245 Gribben, *supra* n. 127; Oldfield, *supra* n. 129.

246 Conyon and Murphy, *supra* n. 4, F646. For other survey evidence illustrating the point, albeit less dramatically, see Abowd and Kaplan, *supra* n. 14, 146; Buckley and Butcher, *supra* n. 14; Taylor, *supra* n. 14.

247 "Voiceless Masses", *Economist*, 31 October 1998, 104; S Shah, "Institutions Warned to Use Voting Rights", *The Times*, 6 July 1999, 26; S Targett, "The Institutional Investor Starts to Stir", *Financial Times*, 23 July 2001, 19.

248 On voting procedures, see Stapledon, *supra* n. 82, 88 92; "Voiceless Masses", *supra* n. 247. Legislative improvements could be on the way. See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, *supra* n. 196, para. 60. On the other factors, see P Myners, *Institutional Investment in the United Kingdom: A Review* (London, HM Treasury, 2001), 90 92. Myners has recommended to the UK Government that duties to vote should be imposed on managers of pension funds. See *ibid.*, 93.

One should not necessarily infer from the low voting rate in the United Kingdom that shareholders do not exercise influence over corporate governance issues such as executive pay.[249] One consideration is that there are institutional investors that fail to vote on "routine" resolutions, such as approving the accounts, but will vote on a potentially contentious issue such as executive share options.[250] It is also significant that companies are expected to follow, without facing any sort of resolution, various executive pay recommendations issued on behalf of institutional investors.[251] Such guidance can have a substantial impact, despite the absence of legal backing. For instance, guidelines issued by the Association of British Insurers (ABI), a representative of investors that own 55% of the UK equity market, have strongly influenced the content of share option plans adopted by publicly quoted companies.[252]

Also significant is that UK institutional investors are more likely to exercise collective influence "behind the scenes" than their American counterparts. In the United States, an institutional investor pursuing an activist agenda will almost always work as a "lone wolf" or "Lone Ranger".[253] In contrast, in the United Kingdom the formation of informal institutional coalitions does occur, particularly when a company is encountering serious difficulties.[254] For instance, in 2001 troubled telecommunications equipment maker Marconi plc announced a plan to reprice outstanding share options but institutional pressure caused the company to exclude executive directors from the proposal.[255] A comparatively hospitable legal environment helps to account for the higher level of "backroom" co-ordination amongst British shareholders, as do a more closely knit financial services community and higher levels of institutional ownership concentration within individual companies.[256]

[249] *Cf.* CA Mallin, "The Voting Framework: A Comparative Study of Voting Behaviour of Institutional Investors in the US and the UK" (1996) 4 *Corporate Governance: An International Review* 107, 118.

[250] *Ibid.*, 119; see also BS Black and JC Coffee, "Hail Britannia?: Institutional Investor Behavior Under Limited Regulation" (1994) *Michigan Law Review* 1997, 2038–9.

[251] See Smerdon, *supra* n. 86, 69–72 (quoting guidelines issued by major fund managers). Similar guidelines have been issued in the United States. See, e.g. TIAA-CREF, "Policy Statement on Corporate Governance", discussed *supra* n. 223; CalPERS, *supra* n. 226.

[252] Pensions & Investment Research Consultants Ltd, *supra* n. 4, 27–8, 30; BGM Main, "The Rise and Fall of Executive Share Options in Britain", in J Carpenter and D Yermack (eds), *Executive Compensation and Shareholder Value* (Dordrecht, Kluwer, 1999), 83, 84–6. For further background on the ABI, see M Conoley, "Moves to Halt Another Decade of Excess", *Financial Times*, 5 August 1999, 10.

[253] JC Coffee, "The Folklore of Investor Capitalism" (1997) 95 *Michigan Law Review* 1970, 1977–8; BS Black, "Shareholder Activism and Corporate Governance in the United States, in P Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (Basingstoke, Macmillan, 1998), vol. 3, 459, 461.

[254] Stapledon, *supra* n. 82, 121–2, 125–7; Black and Coffee, *supra* n. 250, 2050–53; J Holland, *The Corporate Governance Role of Financial Institutions in Their Investee Companies* (London, Certified Accountants Educational Trust, 1995), 34–6.

[255] C Mathieson, "Marconi Directors Back Down Over Options Plan", *The Times*, 29 June 2001, 28; J Plender, "Why Marconi Could Mark a Turning-Point", *Financial Times*, 3 July 2001, 21.

[256] On the significance of the law, see Stapledon, *supra* n. 82, 271–2; Colby, *supra* n. 128; Black, *supra* n. 253, 461. On the other factors, see Cheffins, *supra* n. 5, 638–9; Coffee, *supra* n. 253, 1983–4.

UK investors, it should now be clear, have means at their disposal to influence executive pay and other corporate governance matters. Regardless, the low voting rate in Britain indicates that when shareholders have the opportunity to exercise their rights at general meetings, they are more inclined to squander the chance than their US counterparts.[257] This implies that shareholders in Britain are less likely to take advantage of legal rules that offer scope to deal with remuneration issues by proposing and voting upon resolutions. Hence, even if UK investors are intrinsically less tolerant of lucrative pay schemes than American stockholders, the additional dissatisfaction may not be expressed at general meetings. Those advocating that the law should be amended to give British shareholders a greater say in the area of executive pay cannot therefore draw on cultural factors to refute evidence from the United States indicating that reform will have only a minimal impact in practice.

L. Conclusion

Executive pay has been a controversial topic in Britain for nearly a decade, and a byproduct of the consequent debate has been proposals that shareholders should have a greater direct say over managerial remuneration. Most notably, the DTI, in a 1999 consultation document, endorsed certain changes designed to give investors more scope to vote on executive pay. The UK Government has yet to indicate whether it will implement the DTI's recommendations, or otherwise seek to boost the role shareholders play in this area.

The analysis set forth in this paper suggests that the Government's hesitancy is not a cause for serious concern. Evidence from the United States indicates that UK investors are unlikely to use additional powers in a rash or irresponsible manner. On the other hand, British investors seem unlikely to use additional leverage to invoke substantial change on the managerial remuneration front. Indeed, the US experience suggests that at least one change suggested by the DTI—a proposal that shareholders be given additional time to make proposals concerning executive pay—would make no difference at all if it were implemented. If the desired objective is to generate more proposals dealing with managerial remuneration, relaxing the ownership thresholds that must be satisfied to proceed would be much more likely to yield results.

The points this paper raises do not refute in a conclusive way the case in favour of implementing the sort of changes the DTI discussed in its 1999 consultation paper. One consideration that should be kept in mind is that laws bolstering the role that shareholders play in the setting of executive pay might have an impact even if investors do not exercise their rights in an assertive fashion. For instance,

[257] *Cf* S Targett, "Shareholders Place Corporate Responsibility on the Agenda", *Financial Times*, 13 July 2000, 4.

the DTI indicated in its 1999 report that there should be an annual vote on executive pay. If this proposal were implemented, companies would need to justify more clearly and publicly the way they reward senior executives than they do currently.[258] Even if shareholders rarely dissented from what was proposed, this process might be beneficial. On the other hand, annual voting might, regardless of the final vote count, escalate disagreements over pay into public spectacles that would have an adverse impact on share prices.[259]

Although due regard should be had for the possibility that regulations giving investors a greater say over executive pay could foster change despite shareholder passivity, the essential lesson of this paper remains relevant. Evidence which indicates that investors are unlikely to exercise additional powers they might be given must undermine, in some measure, the case in favour of reform. Again, empirical studies from the United States suggest that shareholders exercise their powers in a responsible enough manner, but cannot be expected to take any sort of leading role with respect to the setting of executive pay. This, in turn, implies that implementing the shareholder-oriented reforms that have been canvassed recently in the United Kingdom will probably not address fully the concerns raised by the critics of "fat cat" pay.

M. POSTSCRIPT

Just as this paper was going to press, the Trade and Industry Secretary announced that the Government intended to enact a requirement that shareholders of publicly quoted companies vote each year on executive pay.[260]

Consistent with the recommendation the DTI made in its 1999 consultation paper,[261] the annual vote is to be advisory rather than binding. The investment director of the National Association of Pension Funds welcomed the proposed change to the law, describing it as "very good news for shareholders".[262]

The arguments advanced in this paper suggest that this verdict is probably overly optimistic.

[258] "Keep on Purring", *supra* n. 30; Brown, *supra* n. 39. With shareholder proposals, it can be argued similarly that liberalisation would have a beneficial impact, even if few additional resolutions were actually brought forward. See R Crête, "Some Comments on the *Michaud* Case" (1998) 30 *Canadian Business Law Journal* 73, 85.

[259] R Peston, "How Labour Learned to Love Cedric the Pig", 29 October 2000, available at <http://www.csquest.com >.

[260] R Shrimsley, "Investors Win Right to Vote on Directors' Pay Deals", *Financial Times*, 19 October 2001, 1; DTI Press Release P/2001/572, "Shareholders to Get Annual Vote on Directors' Pay", available on the DTI's website at <http://www.dti.gov.uk/>.

[261] See *supra* nn. 116–17 and accompanying text.

[262] Shrimsley, *supra* n. 260.