

Say on Pay

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Introduction

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter Dodd-Frank Act).¹ One provision of the Act mandates that, beginning with annual meetings on or after January 21, 2011, US publicly traded firms allow shareholders a nonbinding vote on executive pay, known as “say on pay” (hereafter SOP).²

The purpose of this chapter is to present key insights from the academic research on the economic consequences of SOP. The chapter is organized around five parts. Section I provides a brief history of SOP, highlighting its role in the broader context of a gradual shift toward greater shareholder empowerment. The rich set of legislative events accompanying the adoption of SOP in many countries has provided fertile ground for empirical studies. Section II and Section III review the evidence in such studies, focusing on the effect of SOP, respectively, on executive pay and firm value, followed by some concluding remarks in Section IV.³

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §951, 124 Stat. 1376, 1899 (2010) (“Dodd-Frank Section 951”). Dodd-Frank Section 951 amended the Securities Exchange Act of 1934 by adding Section 14A (codified as amended at 15 U.S.C. §78n-1) (“Exchange Act Section 14A”).

² Dodd-Frank Section 951 also mandates a non-binding vote on the frequency of future say on pay votes (known as say-when-on-pay vote), with a choice between an annual, a biennial or a triennial frequency. This vote on the frequency of future SOP votes must be held every six years. At most firms, shareholders overwhelmingly favored an annual frequency. For an analysis of determinants and consequences of say-when-on-pay votes, see Ferri and Oesch (2013).

³ Some of the studies on SOP also examine the determinants of SOP votes. Since by and large these studies show that the key determinants are the same as for other types of shareholder votes (e.g. proxy advisors’ recommendations, ownership composition, performance), I devote little time to this topic and refer the reader to the Chapter on the Theory and Practice of Corporate Voting by Paul H. Edelman and Randall S. Thomas.

A caveat: the academic research on SOP is growing rapidly, as more data become available over time and across countries. As a result, many studies cited here are in the form of working papers and their findings should be viewed as preliminary. Also, I may have missed some of the most recent studies. Finally, I apologize if I do not discuss in equal depth all the studies and tend to focus instead on the work I am more familiar with, including my own.

I. A Brief History of Say on Pay

While CEO pay has made headlines and captured the attention of politicians and policy makers for many decades (Murphy 2012), it has arguably received even greater scrutiny over the last two decades. During the New Economy of the 1990s, the growing use of stock options as incentive tool (favored by a benign accounting treatment) led to a rapid increase in CEO pay, with the average CEO-to-worker pay ratio peaking at more than 400 in 2000, up from 18 in 1965 (Mishel and Sabadish, 2012). As the dot-com bubble began to burst and a series of accounting and governance scandals unfolded (e.g. Worldcom, Enron), stock options and executive pay were blamed for providing perverse incentives to manipulate financial reports and the stock price. At the same time, these governance scandals led many institutional investors to take a more active role in monitoring corporations, spurring a wave of shareholder activism. A whole new industry of governance experts and intermediaries (governance ratings agencies, proxy advisors) emerged, while influential academic studies documented a large impact of governance quality on firm value (Gompers, Ishii and Metrick 2003; Bebchuk, Cohen and Ferrell 2009). Calls for policy reforms empowering shareholders became louder and corporate governance took center stage in the policy debate (Bebchuk 2005). Like other institutional investors, union pension funds began to take a more active role. Because union pension funds tend to be well diversified,

holding very small stakes in thousands of firms, they could not exert their influence by buying large stakes in firms. Hence, they resorted to 'low-cost' tools of activism (Ferri 2012), such as shareholder proposals and shareholder votes on uncontested director elections. Tellingly, the percentage of shareholder proposals filed by union pension funds increased from 13.6% in 1997 to 43.6% in 2003, when union pension funds surpassed individual investors in terms of number of proposals, and continued to grow thereafter (Ertimur, Ferri and Stubben 2010). Not surprisingly, executive pay became a central focus of unions' governance activism. Between 2003 and 2010, led by union pension funds' efforts, the frequency of, and voting support for, compensation-related shareholder proposals and compensation-related 'vote-no' campaigns against directors up for election increased quickly. For example, Ertimur, Ferri and Muslu (2011) report that, among S&P 1500 firms, there were approximately 66 proposals per year in the 1997-2002 period (averaging 16.2% votes in favor) compared to about 160 proposals per year in the 2003-2007 period (28.9% votes in favor). New types of shareholder proposals emerged, (e.g. proposals to introduce performance-based vesting conditions in equity grants, expense stock options, subject severance payments to shareholder approval), gaining higher voting support. While these votes were nonbinding, firms began to respond, particularly when votes were withheld from compensation committee members up for re-election (Del Guercio, Seery and Woidtke 2008; Cai, Garner and Walkling 2009; Ertimur, Ferri and Muslu 2011).

Meanwhile, an important development had taken place in the United Kingdom (UK), where in 2002 the UK government had introduced a mandatory annual advisory vote on executive compensation, known as "say on pay", largely in response to a perceived increase in US-style, 'fat cat' executive pay packages among UK firms. During the first say on pay proxy season, a

failed say on pay vote at Glaxo SmithKline (with 50.7% of the votes cast against approval of the remuneration report) made headlines around the world. Shareholders had objected to an estimated £22 million severance arrangement for the CEO (reflecting a two-year notice period), lack of challenging performance targets, and the presence of a retesting provision in the stock option plan.⁴ Glaxo SmithKline's board responded to the vote by launching an extensive consultation process with shareholders and adjusting the compensation package accordingly (Ferri and Maber 2013).

In the United States, the American Federation of State, County and Municipal Employees, a union pension fund, took notice of the UK experience and rallied other activist investors to submit shareholder proposals requesting the adoption of SOP (Ferri and Weber 2009). Between 2006 and 2010, SOP proposals were submitted and voted upon at hundreds of US firms, averaging more than 43% votes in favor and often winning a majority vote, with increasing success over the years (Cuñat, Gine and Guadalupe 2013). High-profile executive pay scandals (e.g. option backdating, the large severance package awarded to Nardelli at Home Depot) helped activists in making their case for more “say on pay” among investors and policy makers. While submitted at individual companies, the objective of the SOP proposals was to induce widespread adoption of SOP, either via voluntary adoption (which turned out to be rare), a listing standard, or regulatory intervention. Policy makers took notice and on April 20, 2007, the House of Representatives passed a bill requiring a nonbinding annual shareholder vote on executive

⁴ Retesting provisions in the performance-based vesting conditions of equity grants allow to reevaluate in subsequent years performance targets not achieved during the initial measurement period, rather than allowing the equity grant to lapse. As such, they were criticized in the UK as a form of ‘reward for failure’.

compensation (hereafter SOP Bill).⁵ On the same day, then-Senator Barack Obama introduced a companion bill in the Senate (S.1181).

But it was the financial crisis of 2007-2008 to accelerate the path toward mandatory adoption of SOP. Growing income inequality, public outrage over Wall Street excesses (e.g. the large bonuses paid at AIG) and banks' bailouts, and the perception that executive pay played a role in inducing excessive risk-taking pressured policy-makers to take action with respect to executive pay. Many of the legislative proposals discussed in the House and Senate in 2008 and 2009 contained a SOP provision (see Table 1 in Larcker, Ormazabal and Taylor 2011). Also, holding a SOP vote was a mandatory condition for firms to receive funds under the Troubled Asset Relief Program (TARP). During the 2008 campaign, both Presidential candidates expressed support for SOP. As these events unfolded, the debate on merits and drawbacks of SOP heated up. Critics of SOP argued that, at best, SOP votes would be ignored (because nonbinding) and, at worst, would cause directors to pander to shareholders with special interests or lacking the required expertise and sophistication, ultimately resulting in the adoption of suboptimal pay practices (Kaplan 2007; Bainbridge 2008).⁶ They also cautioned that the high

⁵ House Bill 1257: Shareholder Vote on Executive Compensation Act.

⁶ Analytical studies have also raised questions on the informativeness of SOP votes. Ozbas and Matsusaka (2013) note that SOP votes only reveal shareholder preferences for the current compensation plan compared to the alternative plan that will be adopted if the current plan is rejected, but such alternative plan is unclear in practice, casting doubts on whether the shareholder votes on SOP may be truly informative. Levit and Malenko (2011) further suggest that shareholder votes may not be informative about shareholder preferences when shareholders ignore their own information and vote strategically, conditioning on the chance of casting a pivotal vote.

cost of analyzing executive pay at thousands of firms would lead shareholders to outsource voting decisions to proxy advisors, who, in turn, would minimize their own costs by promoting one-size-fits-all compensation practices which would hurt firm value. Finally, SOP opponents noted that shareholders had already tools to express their views on compensation matters, such as the ability to submit shareholder proposals on compensation and withhold votes from directors responsible for compensation packages. Supporters of SOP argued that enhanced shareholder voice (as formalized in a SOP vote) and reputation concerns would help boards overcome psychological barriers to negotiating with CEOs on behalf of shareholders, resulting in more efficient compensation contracts and more dialogue between boards and shareholders (Bebchuk 2007). They also pointed out to growing evidence of shareholders' sophistication in casting informed votes. Finally, they argued that SOP would be more effective than shareholder proposals (limited to a single issue) and less disruptive than a confrontational vote against an otherwise valuable director. More fundamentally, critics and supporters of SOP disagreed on whether existing compensation contracts were the result of an efficient labor market for talent or, instead, the expression of management power over captive boards.

Finally, in 2010, a SOP provision found its way in the Dodd-Frank Act. Ironically, SOP, a provision designed to provide *more* alignment between shareholder and management was adopted as part of a financial reform package aimed at deterring 'excessive' risk taking (excessive from the point of view of social welfare), which may be the result of the alignment of interests between shareholders and management.

As of today, non-binding SOP votes (on the compensation report) have been mandated in Australia, Belgium, Denmark, Israel, Italy, Portugal, while Netherlands, Sweden, Norway, South

Africa and Switzerland adopted some version of a binding SOP vote (on the future compensation policy), which is now also being considered by the European Union.⁷

When putting SOP into its historical context, it is also important to appreciate that SOP has come to epitomize a broader movement toward greater shareholder democracy, beyond the issue of executive pay. For example, during the same period, shareholder activists have long (unsuccessfully) lobbied for a proxy access rule that would have made it easier for shareholders to oust corporate directors and nominate their own candidates. Hence, many observers often view the successes and failures of SOP as speaking to the potential effects of other reforms aimed at increasing shareholder power, making the academic research on SOP all more relevant.

II. The Effect of Say on Pay on Executive Compensation

A. Effect of SOP votes on level and composition of executive pay

As discussed earlier, United Kingdom was the first country to adopt SOP in 2002 for publicly traded firms. Ferri and Maber (2013) report that in most cases shareholders voted in favor of compensation plans. Failed SOP votes (i.e. greater than 50% of votes against) were rare (2% of the sample), though highly publicized in the press. However, about one-fourth of the sample firms received more than 20% of votes against.

To capture the overall effect of SOP on CEO pay, Ferri and Maber (2013) examine the sensitivity of CEO pay to its economic determinants over the 2000-2005 period (i.e. before and after the introduction of SOP regulation) and document a significant increase in the sensitivity of

⁷ Some countries have already modified their first SOP legislation. In 2013 the UK added to the non-binding, backward-looking SOP vote on the current compensation report a binding, forward-looking vote on the proposed compensation policy. In 2012 Australia modified the non-binding SOP vote to introduce the so-called “two-strikes” rule. Under the rule, if 25% of shareholders vote against a company’s remuneration report at two consecutive annual general meetings, the entire board may have to stand for re-election within three months. For more details about the international development of SOP, see Thomas and Van der Elst (2013).

CEO pay to poor performance. They also find that this increase does not occur for a subset of UK firms exempted from the SOP regulation (firms traded on the Alternative Investment Market, a sub-market of the London Stock Exchange with a more flexible regulatory system), suggesting that the result reflects the impact of SOP rather than a general trend affecting all firms. Besides, Ferri and Maber (2013) find that the increase is more pronounced in firms experiencing high voting dissent and firms with high abnormal CEO pay before the adoption of SOP, consistent with a causal impact of SOP. In contrast, they fail to find any effect of SOP on the level of pay. Correa and Lel (2013) examine the effect of SOP laws on CEO pay using a large cross-country sample of about 103,000 firm-year observations from 39 countries, including 12 countries that adopted some (advisory or binding) version of SOP. They essentially compare post-SOP CEO pay at firms of countries adopting SOP to a control sample which includes all non-SOP observations (that is, pre-SOP CEO pay in countries eventually adopting SOP as well as CEO pay in countries never adopting SOP). They find that firms in a post-SOP regime: (i) exhibit lower CEO pay levels (but only in countries adopting an advisory SOP vote), a finding driven by a relative decline in equity awards and limited to CEOs and not the other top executives; (ii) higher pay-performance sensitivity (the authors do not look at positive and negative performance separately). The current version of the paper does not examine whether these findings are more pronounced in (or driven by) firms with excess CEO pay before the adoption of SOP and in firms experiencing adverse SOP votes.

The drawback of the research design in Correa and Lel (2013) is that it is not clear whether the results reflect time-series changes within countries adopting SOP (pre vs. post) or difference between firms in SOP and non-SOP countries. For example, further tests in the paper suggest

that the lower CEO pay levels for post-SOP observations are not driven by a pay decrease relative to the pre-SOP period (in fact, country-by-country analyses indicate no change in CEO pay levels after the adoption of SOP) but by the comparison with non-SOP countries. Also, while the authors employ reasonable econometric solutions to deal with this issue, some concerns remains as to whether non-SOP countries can be a good benchmark for what would have happened in SOP countries had SOP not been adopted (in other words, if only countries with problematic CEO practices adopt SOP, it is possible that changes in CEO pay reflect factors leading to the adoption of SOP rather than the effect of SOP laws per se). Notwithstanding these concerns, these findings are intriguing and future versions of this recent study have the potential to provide more conclusive evidence on the effect of SOP.

While in the US SOP was mandated by the Dodd-Frank Act, its implementation was left to the Securities and Exchange Commission (SEC). The final rule, issued in January 2011, exempted 'small' firms (i.e. firms with a public float below \$75 million) from the SOP provision for two years. Iliev and Vitanova (2013) exploit this setting to estimate the effect of SOP on CEO compensation. In particular, using a regression discontinuity design, they compare changes in CEO pay of firms just above the SEC-imposed threshold to changes in CEO pay of firms just below the threshold (but otherwise quite similar). They find no differences in terms of level and composition of CEO pay and in terms of golden parachutes, concluding that SOP had no impact on CEO pay. While the identification strategy chosen by the authors has the benefit of reducing endogeneity issues, it comes with the price of focusing only on fairly small firms (those around the \$75 million public float threshold), where CEO pay may not be a problem in the first place

(in which case, the lack of impact of SOP would not be surprising, but would not speak to its impact at large firms, traditionally the target of compensation-related criticism).

Cuñat, Gine and Guadalupe (2013) also use a regression discontinuity design but in a different setting. In particular, they analyze nonbinding shareholder proposals to adopt SOP (250 proposals between 2006 and 2010). Comparing the changes in CEO pay for firms voluntarily adopting SOP in response to the proposals to firms not adopting SOP would be difficult, since the adoption decision is endogenous. Similarly, it would be difficult to compare changes in CEO pay between firms where the proposal is passed (and, thus, significantly more likely to be adopted) and firms where the proposal fails to be approved, since the voting outcome is endogenous as well.

Hence, Cuñat, Gine and Guadalupe (2013) use instead a regression discontinuity design that compares firms where the proposals receive slightly more than 50% of the votes (the threshold for approval) to otherwise similar firms where the proposals receive slightly less than 50%.

Using this approach, they conclude that the passing and adoption of SOP proposals is not associated with changes in the level of CEO pay, nor its composition and structure (mix of cash and equity, equity incentives, level of perks and deferred pay). In some sense, this finding complements the one in Iliev and Vitanova (2013), in that it is based on large firms (shareholder proposals are typically submitted at large, S&P 500 firms). However, both Cai and Walkling (2011) and Cuñat, Gine and Guadalupe (2013) show that firms targeted by SOP proposals do not exhibit excess CEO pay or weaker governance.⁸ Hence, the lack of an effect at these firms may

⁸ Activists submitting SOP proposals chose to focus on a broad sample of large firms, rather than target only firms with problematic CEO pay practices, to obtain visibility and show to policy-makers that investor's support for SOP was not limited to problematic firms (Ferri and Weber 2009).

not be surprising. More generally, the findings cannot be necessarily generalized to firms away from the 50% threshold or to firms not targeted by SOP shareholder proposals.

B. Effect of SOP votes on compensation practices

Analyses of the effect of SOP on level and composition of CEO pay may not capture a number of other changes to compensation contracts that may be induced by SOP votes but are not reflected in measure of CEO pay. For example, the introduction of performance-based vesting provisions is typically not reflected in the estimates of fair value of equity grants used by researchers in measuring CEO pay. Many other changes (e.g. terms of severance packages) will only be reflected in measures of CEO pay contingent upon the occurrence of certain events. Hence, it is important to complement the evidence in section II.A with an analysis of firms' disclosures of changes to observable provisions of compensation contracts. Another benefit of this approach is that it captures the changes that boards explicitly present as a response to SOP votes, and thus, it acts as a reality check on regression-based inferences. For example, a regression-based finding of, say, a decrease in CEO pay level would be more credible if supported by evidence that firms disclose a decision to reduce target levels of CEO pay in response to an adverse SOP vote (an action that presumably they have an incentive to disclose to get rewarded by shareholders in subsequent votes).

Two studies collect data on specific changes made to compensation contracts explicitly in response to SOP votes in the UK and the US, using firms' disclosures in their proxy statements. Ferri and Maber (2013) examine the compensation reports of a sample of UK firms before and after the first SOP vote and find that firms experiencing higher voting dissent were significantly more likely to remove compensation provisions criticized by investors as 'rewards for failure'

relative to a matched sample of firms experiencing lower dissent. For example, they report that among firms with long notice periods (implying larger severance payments) the percentage of high dissent firms that shortened them after the vote (80.0%) was significantly higher than before the vote (20.0%) and also significantly higher than among low dissent firms after the vote (33.3%). They report similar findings for another controversial practice, namely, the presence of retesting provisions in the performance-based vesting conditions of equity grants. Most firms indicate that these changes were the result of consultations with their major institutional investors. Firms' responsiveness to SOP votes was 'rewarded' with a substantial increase in favorable SOP votes at the subsequent annual meeting. Ferri and Maber (2013) also find that many firms experiencing low voting dissent at the first SOP vote had removed these practices *before* the vote,⁹ highlighting the importance of accounting for ex ante effects when assessing the impact of a new regulation.

Ertimur, Ferri and Oesch (2013) examine the effect of SOP on compensation practices in the US in 2011 (first proxy season under mandatory SOP). Their key findings are generally similar to the evidence from the UK: (i) failed SOP votes are rare (about 2% of the sample), though cases of substantial dissent are more frequent; (ii) more than 55% of the firms experiencing significant voting dissent respond by making material changes to their compensation plan during the subsequent year (e.g. introduction of performance-based vesting conditions in equity grants, use of tougher performance targets, removal of perks and tax gross-ups, removal of controversial provisions from severance contracts, etc.), usually in consultation with major institutional

⁹ In their sample, 70.0% of low dissent firms shortened their notice periods during the year *before* the SOP vote.

investors, (iii) firms making changes to their compensation plans receive greater voting support at the following SOP vote.

Ertimur, Ferri and Oesch (2013) also highlight the strong influence of the recommendations released by proxy advisors (particularly Institutional Shareholder Services, ISS), with a negative recommendation being associated with 25% more votes against the compensation plan. Further evidence of the significant influence of ISS is the striking discontinuity in the relation between the extent of SOP voting dissent and firms' responsiveness to the vote: the percentage of firms making compensation changes in response to SOP votes jumps from 32% to 72% around the 30% voting dissent threshold. Why? After the 2011 proxy season, ISS had indicated that firms failing to "adequately" respond to SOP voting dissent above 30% would receive a negative recommendation in 2012 on the SOP proposal and on the election of compensation committee members.

Finally, similar to the UK experience, there is also anecdotal evidence of analogous compensation changes being made by US firms *ahead* of the SOP vote, to avoid a negative proxy advisor recommendation and an adverse shareholder vote (Thomas, Palmiter and Cotter 2013; Larcker, McCall and Ormazabal 2013).

III. The Effect of Say on Pay on Firm Value

In this section we examine the empirical studies on the overall effect of SOP on firm value.

A. Event studies around the adoption of Say on Pay regulations

As mentioned in the Introduction, on April 20, 2007, the House of Representatives passed a SOP Bill, by a 2-1 margin. On the same day, then-Senator Barack Obama introduced a companion bill (S.1181) in the Senate (which was then put on hold by the Senate Banking Committee).

While the SOP Bill's approval was expected (Democrats were in control of the House and supported the SOP Bill), the 2-1 margin was unexpected, suggesting some support for SOP among Republicans.

Cai and Walkling (2011) examine the market reaction to the House's approval of the SOP Bill for a sample of firms in the S&P 1500 index and document a positive reaction for firms more likely to benefit from greater shareholder voice over executive pay: namely, firms with high abnormal CEO *cash* pay (defined as the difference between actual CEO cash pay and the level predicted based on known economic determinants, such as size, performance, industry), firms with low pay-for-performance sensitivity, firms with a history of shareholders willing to vote against compensation-related management proposals and firms with a history of responsiveness to shareholder pressure on compensation issues. In other words, they find a positive reaction in firms where the compensation problems are more severe and a say on pay vote is more likely to trigger a response (e.g. more shareholders willing to vote against management and greater firms' propensity to respond to an adverse vote). Note, however, that they do not find a significant impact for firms with high abnormal *equity* and *total* CEO pay.

Larcker, Ormazabal and Taylor (2011) also examine the market reaction to the House's approval of the SOP Bill (in addition to other regulatory events related to executive pay and other governance provisions). Similar to Cai and Walkling (2011), they fail to find a significant impact for firms with high abnormal *total* CEO pay (they do not examine the price reaction for firms with abnormal cash CEO pay or firms with lower pay-performance sensitivity).

A concern with both studies is that the House's approval of a bill does not guarantee passage in the Senate and approval by the White House. In fact, the press at the time reported that the

prospects of the bill in the Senate were uncertain (New York Times, 2007) and the Bush White House openly opposed the Bill (Associated Press, 2007). Hence, it is not clear the extent to which this event increased the likelihood of a say on pay legislation. Arguably, as noted in Section I, the only ‘event’ that substantially increased the likelihood of say on pay legislation was the financial crisis and the related perception of compensation abuses (e.g. outrage over AIG bonuses).

Ferri and Maber (2013) argue that the announcement of the submission of SOP regulation to the Parliament in the United Kingdom in June 2002 offers a more powerful setting for an event study, since it was largely unexpected and increased substantially the probability of SOP adoption (Parliament’s approval was virtually guaranteed). Using this event, they document positive abnormal returns for firms with excess CEO pay combined with poor performance, and for firms with controversial pay practices that weaken the penalties for poor performance (those practices were often removed in response to SOP votes, as discussed earlier in Section II.B). They interpret their findings as consistent with shareholders perceiving SOP as a value enhancing monitoring mechanism for firms with low pay-to-poor-performance sensitivity. Finally, a recent study by Iliev and Vitanova (2013) examines the market reaction around the announcement of the SEC final SOP rule that on January 25, 2011 exempted small firms (i.e. firms with a public float below \$75 million) from adopting SOP for two years (press reports at the time noted that the exemption could become permanent). An appealing feature of this setting is that the SEC decision was an unexpected reversal from the rule proposed in October 2010 rule, under which no publicly traded firm would be exempted.

Iliev and Vitanova (2013) compare the market reaction to this announcement for firms just above the SEC-imposed threshold, and thus, subject to the SOP rule, and firms just below the threshold (but otherwise quite similar), and, thus, exempted from SOP. While they find not significant abnormal returns for either group, the abnormal returns for exempted firms are significantly more negative, a finding that the authors interpret as evidence of a positive value effect of mandatory SOP. While the setting is an interesting one, some concerns remain, as exempted firms are fairly small and the magnitude of the executive pay problem (if any) is unlikely to be large enough to explain the differential market reaction. Also, the same study finds no effect on CEO pay level and composition (see Section II.A). Hence, the reason for the differential stock price reaction remains unclear. It would be helpful to know if the event study result is driven by (or stronger for) exempted firms with excessive pay or problematic pay practices.

B. Event studies around Shareholder Proposals to Adopt Say on Pay

Starting in 2006, shareholder activists led by union pension funds submitted shareholder proposal to adopt SOP at hundreds of US firms, in an attempt to induce voluntary or mandatory widespread adoption of SOP.

Cai and Walkling (2011) examine the market reaction to proxy filings and annual meetings of 113 firms targeted by nonbinding shareholder proposals to adopt SOP between 2006 and 2008. On average they find insignificant returns around both the submission of the proposal (proxy filing date) and the vote on the proposal (annual meeting date). But they also find that when the proposals are filed by union pension funds the abnormal returns (still insignificant) are more negative than when filed by other activists and that when the proposal is defeated the abnormal returns (while insignificant) are more positive than when the proposal is passed (it is not clear

whether this result is driven by union-sponsored proposals). They interpret these findings as evidence that the market views SOP proposals filed by union pension funds are driven by special interests rather than value maximization.¹⁰ However, caution is required in interpreting this evidence. Virtually all activists filing SOP proposals were coordinated by a group of investors (mostly, but not only, union pension funds) who made available to other activists a template for SOP proposals and a list of target firms (Ferri and Weber 2009). Hence, the distinction between union and non-union proponents in the context of SOP proposals may be only apparent. More importantly, the list of target firms was publicly available months before the proxy filing dates, so it is not clear whether the proxy statements contained any new information. Similarly, the voting outcome of the SOP proposals may largely be anticipated (based on the composition of institutional owners, proxy advisors' recommendations, etc.). Finally, the analyses do not control for other (potentially new) information contained in proxy statements (e.g. executive compensation report, other items up for a vote at the annual meeting) or other events occurring at the annual meeting (e.g. shareholder votes on other items).

Cuñat, Gine and Guadalupe (2013) also examine the market reaction to the voting outcome of nonbinding shareholder proposals to adopt SOP, but to alleviate these concerns they employ a 'fuzzy' regression discontinuity design (RDD), essentially comparing the stock price reaction to SOP proposals that pass by a small margin to the reaction to SOP proposals that fail by a small

¹⁰ Consistent with this interpretation, the authors also find that SOP proposals generally targeted larger firms, rather than firms with excessive pay or lower pay-performance sensitivity. However, as noted by Ferri and Sandino (2009), activists typically submit shareholder proposals aimed at promoting policy reforms at a broad sample of large firms rather than the firms that would most benefit from the proposals, because they believe that showing widespread support for the proposal across all types of firms enhances its credibility with policy makers.

margin (Cuñat, Gine and Guadalupe 2012; Ertimur, Ferri and Oesch forthcoming). The underlying idea is that firms around the threshold are likely to have similar characteristics (indeed they do, as the authors show) but differ in the likelihood of implementation, which is typically much higher for proposals passing the threshold (Ertimur, Ferri and Stubben, 2010; Thomas and Cotter, 2007). Indeed, the authors show that the likelihood of subsequently adopting SOP is 48% higher when the SOP proposal passes by a small margin relatively to when it fails by a small margin. Besides, because in these close-call situations the voting outcome is uncertain, its resolution (pass or fail) is likely to convey new information about the likelihood of SOP adoption, making this setting suitable to an event study.¹¹

Using this RDD approach, Cuñat, Gine and Guadalupe (2013) find that on the day of the vote a SOP proposal that passes by a small margin yields an abnormal return of 2.4% relative to one that fails (after controlling for other proposals voted upon at the same meeting) and estimate the ‘full’ value of SOP at 4.6% (after taking into account the increase in the probability of SOP implementation).¹² Aside from the issues discussed in Section I.A (i.e. generalizability to other firms), this estimate seems too large to reflect the present value of future reductions in excess CEO pay (as noted by the authors, their estimate of the value of SOP is equivalent to the estimated value of removing two anti-takeover provision based on Cuñat, Gine and Guadalupe, 2012), particularly because (i) the authors find no evidence of subsequent changes in levels and composition of CEO pay for firms implementing SOP (see Section II.A) and (ii) the sample firms

¹¹ Consistent with this observation, the authors find no market reaction to the voting outcome of SOP shareholder proposals away from the threshold.

¹² Since the outcome of the vote is not binding, the 2.4% market reaction only reflects the expected increase in the probability of SOP adoption and, thus, understates the value of the SOP provision.

do not appear to be characterized by excess CEO pay. However, the authors also find significant improvements in subsequent operating performance and efficiency as a result of passing SOP proposals, and thus, conjecture that the SOP vote is viewed as a tool to express a vote of confidence in management performance more than a way to change compensation practices, and that the large, positive market reaction reflects expected performance improvements under this tighter monitoring regime. While this is an interesting idea, it remains unclear what additional “teeth” a SOP vote may provide over existing (non-compensation related) monitoring mechanisms: shareholders can express (and do often express) their dissatisfaction with management performance when voting on director elections (Cai, Garner and Walkling 2009).

C. Event studies around compensation changes induced by SOP

Two studies examine announcements of changes to compensation plans related to SOP. Larcker, McCall and Ormazabal (2013) examine the market reaction to (non-contaminated) compensation changes disclosed in 8-K filings by Russell 3000 firms in the U.S. during the year *before* the first SOP vote. They find that changes that appear to be made to avoid a negative proxy advisor’s recommendation and, thus, a negative SOP vote, are associated with a negative abnormal return of -0.44%, whereas other compensation changes are not associated with a significant stock price reaction. Ertimur, Ferri and Oesch (2013) perform a similar analysis, but focusing on compensation changes made *after* the first SOP vote (and explicitly in response to the vote) by firms receiving a negative recommendation and a high voting dissent in 2011. They fail to find significant abnormal returns, even for the subset of compensation changes that resulted in a positive recommendation and low dissent in 2012 (and, thus, were presumably perceived to be adequate and material by proxy advisors and voting shareholders).

D. Other approaches: effect of SOP on Tobin's Q

In their cross-country study Correa and Lel (2013) also examine the effect of SOP laws on Tobin's Q and report a 3.6% increase in firm value following the adoption of the SOP laws (more precisely, a 3.6% higher firm value for post-SOP observations relative to a control sample that pools together pre-SOP and non-SOP observations). They acknowledge that this increase in firm value is too large to be justified by the relative decrease in CEO pay that they document and suggest (but do not test) that it may reflect better alignment of pay and performance.¹³ A key concern is that higher valuation in countries with SOP laws may reflect other governance changes introduced at the same time. While the study controls for other compensation-related laws, there may be other non-compensation regulations introduced with SOP and with a potentially larger impact on firm value.

IV. What have we learned?

Adoption of SOP in the US has been long advocated by those who contend that executive pay is a manifestation of, rather than a solution to, the agency problem and by those who favor great shareholder involvement in corporate decisions. A growing body of research is starting to investigate the effect of SOP on executive pay and firm value. It is premature to draw definitive conclusions, also because these studies differ in methodologies and settings, but three points seem to emerge. First, there is robust evidence that boards respond to SOP votes: when

¹³ They also find that the firm value increase is higher when the relative decrease in CEO pay results in a lower pay differential between CEO and other top managers (CEO pay slice) implying that a source of value creation may be the reduced pay inequality among the top management team. But this seems unlikely to explain the change in Tobin's Q, since the increase occurs for both firms with advisory SOP laws and firms with binding SOP laws and there is no change in CEO pay slice in firms subject to binding SOP laws.

shareholders use it, “voice” is heard”. Both in the US and UK studies show that not only firms failing to win the SOP vote, but also firms facing substantial dissent (20-30% of the votes against) make changes to their compensation plans in consultation with institutional investors and proxy advisors. Second, in both the US and UK, institutional investors appear to use the power of SOP votes to pressure firms into strengthening the link (or the perceived link) between pay and performance (particularly on the downside), but not to pressure firms to reduce target levels of pay, suggesting a reluctance of institutional investors to ‘regulate’ executive pay. Third, and consistent with the above, most studies examining the aggregate effect of SOP on CEO pay find some increase in pay-performance sensitivity but not effect on the level and growth of CEO pay. While some observers may interpret the lack of an effect on CEO pay levels as evidence of the failure of SOP, one should note that SOP per se is a neutral tool. Its impact depends on what investors choose to ‘say on pay’. Fourth, based on my interpretation of the existing research to date, there is little evidence of an effect of SOP on firm value. The studies documenting a positive price impact appear subject to alternative interpretations or not plausible in their findings (e.g. they fail to find an effect on CEO pay or the effect is too small to justify the documented price impact, hence it remains unclear what the source of value creation is). Also, there seems to be no stock price reaction to the SOP-induced compensation changes. Finally, given the nature of these SOP-induced changes, while some of them may be beneficial, it seems hard to believe that they will have a statistically detectable impact on firm value, except perhaps in a handful of firms where the compensation plan is subject to a complete overhaul.

Perhaps one explanation for the weak impact of SOP is that executive pay problems were overstated, or that, by the time SOP was introduced (more than a decade after the Enron-type

scandals that led to calls for greater shareholder voice), they had been already addressed via other mechanisms (hedge fund activism, monitoring by institutional investors, vote-no campaigns against compensation committee members, SEC-mandated pay disclosures).

Overall, though, based on the evidence to date, it does not appear that SOP had a major impact.¹⁴

Was the adoption of SOP an ‘optimal’ choice from a social welfare point of view? This is a difficult question to answer given the challenges of identifying and measuring all the potential costs and benefits associated with SOP (likely to change over time and differ across countries).

Perhaps the most positive view of SOP is that its introduction prevented the adoption of other more radical and intrusive regulatory measures (e.g. CEO pay caps). In that sense, it may be viewed as an ‘optimal’ answer (i.e. the lesser of two evils) to the political pressure to reform executive pay during the financial crisis.

¹⁴ This interpretation of the evidence is also consistent with the prediction of analytical studies. Ozbas and Matsusaka (2013) model the benefits and costs of shareholder empowerment distinguishing between the right to approve and the right to propose. They show that permitting shareholders to propose directors or policies can cause value-maximizing managers to take value-reducing actions to accommodate activist investors with non-value-maximizing goals. As for the right to approve, it is weakly beneficial: that is, approval rights (such as a SOP vote) are generally beneficial for shareholders in that they limit the manager’s ability to pursue private benefits at shareholder expense; but they have minimal impact on managerial actions and firm value (because the manager in effect can threaten shareholders with an undesirable status quo if they do not approve the manager’s proposed action).

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