Say on Pay: a Review of the Evidence

Fabrizio Ferri – Columbia University

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SOP Voting Patterns

1. “Failed” SOP votes (votes against >50%) rare in all countries
   - UK (2003-2004): ~2% of sample firms
   - US (2011): ~2% of sample firms
2. Substantial dissatisfaction (>20%) more frequent
   - UK: about 26% (16%) of firms in 2003 (2004)
   - US: about 15% firms in 2011
3. Proxy advisors’ recommendations key “determinant”
   - US: ISS (GL) negative recommendations > 25% (13%) more votes against
   - International evidence on role of PA less clear
4. What do these voting patterns imply? (more on this later)

1. Effect of SOP on Executive Compensation

A. Effect of SOP on (target) levels of pay:
   - E.g. does the adoption or SOP (or a high vote against SOP) result in lower levels of executive pay (after controlling for economic determinants, such as performance)

B. Effect of SOP on pay-performance sensitivity (PPS)
   - E.g. does the adoption or SOP (or a high vote against SOP) result in greater sensitivity of annual pay to performance (or to poor performance)?

C. Effect of SOP on specific compensation practices
   - E.g. does the adoption or SOP (or a high vote against SOP) result in removal/introduction of certain compensation practices?
   - Note: complementary to PPS analysis

>>> Challenge: how to establish causality?

1. Effect of SOP on Executive Compensation

Effect of SOP adoption in UK in 2002 (Ferri and Maber 2013)

- Greater likelihood of removal of controversial practices ('rewards for failure') after negative SOP votes relative to a propensity-matched sample of firms experiencing low voting dissent
  - E.g. severance (notice periods of 24 months), retesting provisions
  - Often consultation with major institutional investors
  - For responsive firms, voting approval increases the subsequent year
  - Many low dissent firms removed those provisions *before* the vote
- Greater sensitivity of pay to **poor** performance post-SOP, particularly:
  - In firms facing high voting dissent and firms with "excess" CEO pay pre-SOP
  - No effect for firms listed on AIM (not subject to SOP)
  - Consistent with casual interpretation
- No effect of SOP on "target" levels of pay

1. Effect of SOP on Executive Compensation

US evidence: effect of SOP on compensation practices

- Ertimur, Ferri and Oesch (2013): 55% of firms facing substantial voting dissent respond by making changes to compensation contracts, often in consultations with major institutional investors
  - Examples: 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.
- Frequency of changes jumps from 32% to 72% when voting dissent is higher than 30%. Why? ISS threat of 'withhold' recommendation for compensation committee members
- Responsive firms rewarded by large decrease in voting dissent
- Some evidence of changes made *before* the vote to obtain favorable ISS recommendations (Larcker et al. 2013)

1. Effect of SOP on Executive Compensation

Evidence from US: before mandatory adoption of SOP

- Cunat, Give and Guadalupe (2013): examine sample of 250 firms targeted by shareholder proposals to adopt SOP (2006-2010)
- Regression discontinuity design:
  - Compare changes in CEO pay at firms where proposals received slightly more than 50% of the votes and firms where they received slightly less than 50% of the votes. That is, otherwise similar firms, but with large difference in the probability of adopting SOP.
- Finding: <u>no effect</u> of SOP adoption on the level and composition of pay (mix of cash/equity, equity incentives, perks, deferred pay)
- Caveats:
  - Generalizability?
  - Does not examine changes in compensation practices or in PPS.

1. Effect of SOP on Executive Compensation

Evidence from US: effect of mandatory adoption of SOP

- Iliev and Vitanova (2013): SEC exempted 'small firms' (public float below $75) from SOP for two years
- Regression discontinuity design:
  - Compare changes in CEO pay at firms above and below the SEC-imposed threshold. That is, otherwise similar firms, but with large difference in the probability of adopting SOP.
- Finding: <u>no effect</u> of SOP adoption on the level and composition of pay (mix of cash/equity, golden parachutes)
- Caveats:
  - Focus on small firms, where CEO pay may not be a material issue
  - Does not examine changes in compensation practices or in PPS

1. Effect of SOP on Executive Compensation

International evidence: effect of mandatory adoption of SOP

- Correa and Lel (2013): examine CEO pay trends in 39 countries, including 12 countries adopting some version of SOP
- Post-SOP adoption increase in PPS in SOP countries relative to non-SOP countries
- Post-SOP adoption decrease in CEO (only) pay levels in SOP countries relative to non-SOP countries (mostly due to lower equity awards).
  - But in country-by-country analysis, no change in CEO pay levels
  - Hence, effect is driven by comparing SOP and non-SOP countries
- Study does not examine if findings are driven by firms with excess CEO pay prior to SOP adoption and/or firms with high votes against SOP
- No analysis of changes to compensation practices

1. Effect of SOP on Executive Compensation - Summary

Key findings:

1. SOP “works, in the sense that firms respond to adverse votes
   - Most compensation changes involve provisions perceived as affecting the pay-performance link
2. Some evidence of an increase in pay-performance sensitivity
3. No evidence of SOP impact on target levels of pay

How to interpret? Disappointing? SOP Ineffective?

- Say on pay is a neutral tool, its impact depends on how it is used
- Institutional investors seem to have chosen not to interfere with target levels of pay and focus instead on certain comp features

2. Effect of SOP on Firm Value

Event studies around regulatory events: mixed findings

- Ferri and Maber (2013): small, positive reaction to SOP regulation in the UK, particularly in firms with excess pay and controversial compensation practices
- Cai and Walkling (2011): small positive reaction to House approval of SOP bill in 2007, particularly in firms more likely to be affected
- Larcker et al. (2011): no effect for firms with excess pay around various SOP-related regulatory events
- Iliev and Vitanova (2013): no reaction for firms around the $75 million SEC-threshold

2. Effect of SOP on Firm Value

<u>Event studies around SOP shareholder proposals:</u>

- Cai and Walkling (2011): no reaction around proxy filing dates and annual meeting dates
- Cunat, Gine and Guadalupe (2013): 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).
  - They estimate the 'full' value of SOP at 4.6% (after taking into account the increase in the probability of SOP implementation).
  - However, hard to reconcile this magnitude with their finding of no effect on CEO pay levels and mix.

2. Effect of SOP on Firm Value

Event studies around SOP-induced compensation changes:

- Larcker, McCall and Ormazabal (2013): compensation changes made ***before*** the vote (presumably to avoid a negative ISS recommendation and, thus, a negative SOP vote) are associated with a negative abnormal return of -0.44%
- Ertimur, Ferri and Oesch (2013): no stock price reaction around compensation changes made **after** the vote explicitly in response to SOP votes, even for the subset of compensation changes that resulted in a positive recommendation and low dissent in the subsequent year (and, thus, were presumably perceived to be adequate and material by proxy advisors and voting shareholders).

What to make of the evidence?

- SOP “works”! Boards “listen” to SOP votes and change compensation contracts accordingly.
- But modest impact overall…why?
- Weak tool or powerful tool used weakly?
  - What do institutional investors have to “say on pay”?
- Executive problem overstated?
  - Bad apples, but largely driven by market forces?
- Did SOP arrive too late?
  - Vote no-campaigns, HF activism…
- Low-cost response to public opinion pressure?
- Side benefit: stimulating discussion on “optimal” pay and PfP
- Certainly good for researchers!