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Evidence on the outcome of Say-On-Pay votes: How managers, directors, and shareholders respond

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ABSTRACT

The economic value of the Say-On-Pay (SOP) provision of the Dodd–Frank Act has been a subject of debate. Proponents of this provision suggest these votes benefit shareholders by increasing investor influence over managerial compensation. Opponents of the SOP provision believe compensation contracting is better done by well-informed and unobstructed boards of directors. Our study provides direct evidence on the impact of the shareholder SOP votes by examining responses to the vote. We find that overcompensated managers with low SOP support tend to react by increasing dividends, decreasing leverage and increasing corporate investment. However, we find no evidence that management's response to the vote affects subsequent vote outcomes, nor do we find a subsequent change in firm value. Finally, we find excess compensation increases for managers that were substantially overpaid prior to the SOP vote, regardless of the outcome of the vote. Thus, it does not appear that the SOP legislation has had the intended effect of improving executive contracting.

1 . Introduction

Since the mid-1980s, the rate of salary increase for top managers in the U.S. has outpaced both inflation and pay increases of lower-level employees, mostly due to higher executive stock option awards (Murphy, 2012).[1] In recent years, executive pay has prompted much debate among academics, regulators and investors as to whether these salaries are justified. The debate on executive compensation entered the U.S. House of Representatives in 2007, largely due to bonuses paid to executives of Merrill Lynch and AIG during the height of the financial crisis. This resulted in a Say-on-Pay (SOP) Bill, which was passed by the U.S. Congress on April 20, 2007. The bill was subsequently made part of the *Dodd–Frank Wall Street Reform and Consumer Protection Act* (*Dodd–Frank*) that was signed into law on July 21, 2010. The resulting SOP provision went into effect for most firms in 2011.[2] This provision requires boards to submit their executive pay packages to a mandatory (but non-binding) shareholder vote at least once every three years. The SOP vote requires that shareholders indicate either approval or disapproval of executive salaries, and every six years shareholders are to be permitted to vote on the frequency of the SOP vote.

The economic value of shareholder involvement in corporate governance in general, and SOP votes in particular, has been the subject of much study (see, for example, Ferri and Maber, 2010). Proponents of SOP requirements contend that these votes benefit shareholders because they compel boards to function more efficiently to provide executive contracts that are better aligned with

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[1] Murphy (2012) notes that median CEO pay increases averaged 4.3% in excess of inflation between 1983 and 1991, and 15.7% between 1991 and 2001, before leveling-off since 2001.

[2] TARP fund recipients were required to subject their executive compensation to a SOP vote starting in 2009.

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shareholder interests (Deane, 2007). At a minimum, the input from shareholders can increase the lines of communication between shareholders and the directors, resulting in board decisions that are more aligned with shareholder expectations. Grundfest (1993) suggests that, even if SOP votes are non-binding, publicity surrounding negative vote outcomes should compel boards to improve executive contracting efficiency.

Opponents of SOP argue that allowing shareholders to provide input on executive salaries will impart economic costs, reducing shareholder wealth. Bainbridge (2008) and Mangen and Magnan (2012) suggest that compensation contracting is best left to the discretion of the better-informed board of directors. Shareholder input can reduce firm value by compelling boards to alter compensation contracts to placate the less-informed investors. Mangen and Magnan further note that SOP voting requirements give shareholders more power and transfer value from non-shareholder stakeholders to shareholders. Proxy advisory firms, such as Institutional Shareholder Services, provide vote recommendations on proxy proposals including SOP, and Ertimur et al. (2013) report advisory firm recommendations significantly influence SOP vote outcomes.[3] Larcker et al. (2012) and Larcker et al. (2013) find that the market reacts negatively to board-initiated changes to executive compensation contracts in response to proxy advisors, suggesting proxy advisors are, on average, incorrect in their assessments. Thus, as a result of the SOP requirements, proxy advisors provide input to the board that tends to reduce firm value.

Morgan et al. (2006) propose a less positive view of board efficiency than Bainbridge (2008) and Mangen and Magnan (2012). Morgan et al. suggest that boards can use their influence to convince shareholders to approve non-optimal provisions by launching a *public charm* offensive. Public charm campaigns prior to SOP votes could result in favorable vote outcomes that serve to legitimize non-optimal compensation. In other words, the SOP vote requirements could have negative economic consequences for firms that receive a largely affirmative SOP vote, but, in fact, should receive low support.

Research suggests both negative and positive implications of SOP. However, a final possibility is that, due to the non-binding nature of the U.S. SOP vote, the vote might have no effect on firm value. Many directors could feel little obligation to change their compensation contracts with managers. This can be especially true if directors assume that they are better informed than shareholders. Directors could also be loyal to managers with whom they have business ties or who supported their board appointments. Thus, these directors would be less likely to alter suboptimal compensation contracts to appease shareholders.

The empirical evidence on the economic value of shareholder SOP votes is mixed. Much of the evidence focuses on the effects of shareholder-initiated SOP provisions prior to 2008, or the stock price reactions to recent U.S. legislation on the SOP vote. Studies document that the announcement of shareholder-initiated SOP proposals has been met with largely insignificant wealth effects (e.g., Gillan and Starks, 2000; Thomas and Cotter, 2007) and results in no significant changes in CEO compensation (Thomas and Martin, 1999).

Larcker et al. (2011) examine firms' stock price reactions on dates where press releases suggested that SOP would be included in Dodd–Frank. They find evidence of a negative stock price reaction on these dates for firms with highly paid executives. The authors' results suggest that the market expects SOP will be ineffective in improving compensation contracting for these firms. Conversely, Cai and Walkling (2011) report a positive market reaction to the 2007 House of Representatives approval of the SOP bill for firms with overcompensated CEOs and for firms where CEOs have low pay-for-performance sensitivity. However, they find no wealth effect for firms with both overcompensated managers and the weakest category of corporate governance. This suggests that inefficient boards may be less influenced by SOP votes. Cai and Walking also examine the wealth effect of shareholder-initiated SOP proposals prior to 2011. Contrary to earlier studies, they find a significant negative wealth effect around these proposals. However, they also note that initiating shareholders tend to target large firms with high absolute values of CEO compensation. Interestingly, Cai and Walking find that targeted firms do not overcompensate managers, on average, when compensation models take firm size into account.

Our study provides direct evidence of the economic impact of the SOP vote aftermath by documenting management's response to the SOP vote outcome. We test several hypotheses to explain managerial responses to low SOP approval. The *self-interest hypothesis* implies that managers who receive low SOP support will seek to increase their influence on the board by weakening corporate governance. We expect this incentive will be particularly strong if the manager is, in fact, overcompensated. Such managers have strong incentives to preserve their compensation and positions with the firm. In this case, we expect increased compensation and/or managerial entrenchment after firms receive low SOP support. The *shareholder-alignment hypothesis* suggests that managers will react to low SOP support by taking actions to increase firm value. This can occur as a result of contract restructuring that better aligns manager and shareholder incentives. However, this hypothesis could hold even if low SOP support results from substandard firm performance and not excess compensation. Poorly performing managers have incentives to improve firm performance if they perceive that their job security or reputation in the labor market is negatively affected by the SOP vote. Finally, the *window-dressing hypothesis* contends that managers will respond to low SOP approval by attempting to appease dissatisfied shareholders without making substantive changes to the firm. For instance, managers could alter leverage and dividend payout policies to signal confidence in the firm's future profitability without affecting total cash flows, and thus without materially affecting firm value.

While our primary hypotheses focus on the effects of negative shareholder votes, it is also possible that some *positive* SOP votes could affect managerial incentives. As Morgan et al. (2006) suggest, firms with overcompensated managers receiving a high proportion of SOP approval might view the vote as a strong endorsement of the board of directors and/or their performance. The *unjustified*

[3] Although proxy advisory firms significantly influence votes, especially those of large institutional investors, only a small proportion of their recommendations to vote "no" on executive pay result in a negative vote by the majority of shareholders. For instance, Businessweek notes that as of 6/4/2012, Institutional Shareholder Services (a proxy advisory group) recommended voting against 265 of the 1,911 SOP proposals. Shareholders rejected only 36 of these by majority vote. (Brady, Diane, "Say on Pay: Boards Listen When Shareholders Speak" June 7, 2012.)