Is Say on Pay An Effective Governance Tool?

Analysis and Recommendations

Report submitted to the Institute for the Governance of Public and Private Organizations

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Executive Summary

This report examines whether Say on Pay is a useful tool to ensure that executive compensation plans are designed in a way that is consistent with the firm's best interests. It addresses five related questions: 1) What is Say on Pay? 2) What does Say on Pay imply about governance? 3) What means are available to provide shareholders with Say on Pay? 4) What is the impact (the impact on whom or what?) of providing shareholders with Say on Pay? 5) Should Canada consider Say on Pay?

What is Say on Pay? Say on Pay is a commonly used expression to reflect the concept that shareholders have an opportunity once a year to hold a vote on the pay of a firm's executives. The vote can either be non-binding (Australia, U.K., Canada and the U.S.) or binding to directors (Netherlands, Sweden).

What does Say on Pay imply about governance? Say on Pay implicitly implies that the underlying governance, most notably the board of directors, is ineffective. Say on Pay may then be useful if one assumes that shareholders are more adept than the board of directors in dealing with executive pay issues, and have less conflict of interests then the directors in doing so. However, if shareholders make worse decisions than directors and/or have more conflicts of interests than directors, then Say on Pay may undermine the effectiveness of the pay decision-making process. However, Say on Pay does raise several legal and economic concerns regarding its impact on directors' role and duties.

What means are available to provide shareholders with Say on Pay? Say on Pay can be implemented in two forms: either it is adopted voluntarily following a shareholder proposal to that effect, or it is required by law, with government mandating that firms adopt Say on Pay and specifying its terms. There are very few instances of voluntary adoption of Say on Pay through successful shareholder proposals to that effect. Say on Pay is mandatory in the U.K., Australia, the Netherlands and Sweden. The U.S. House of Representatives has just adopted a similar measure, but it has yet to pass the Senate.

What is the impact of providing shareholders with Say on Pay? The U.K. and U.S. experience with shareholder voting on executive pay suggests the following four conclusions. First, shareholders rarely disagree with the executive pay plans proposed by boards of directors. Second, shareholder dissent with proposed executive pay plans is strongest when shareholders are initially given the opportunity to vote on executive pay plans, and then declines over time. Third, Say on Pay has the largest impact on firms with poor performance, and on firms where executive compensation is high compared to their peers' executive pay. Fourth, Say on Pay leads to lower compensation growth for these firms and less rewards for failure, i.e., compensation becomes more sensitive to poor performance. While Say on Pay may lead to more pre-Annual General Meeting dialogue between institutional investors and directors as the latter attempt to enhance the potential

for a vote that supports the executive compensation plan proposed in the executive compensation report, it may be also translate into more homogenization of executive compensation into perceived best compensation practices.

Should Canada consider Say on Pay? We conclude that mandated Say on Pay does not seem to bring many benefits and that it may actually be costly from a societal perspective. However, voluntary Say on Pay may have merits, assuming that its implications on the fiduciary duty of directors are well defined and that shareholders have the ability and incentives to make decisions that are in the firm's best interests.

1. What is Say on Pay?

The purpose of this report is threefold: (1) provide an overview of the debate surrounding Say on Pay, (2) discuss the effectiveness of Say on Pay as a governance mechanism, and (3) offer some recommendations and thinking points regarding Say on Pay to board members, regulators and investors.

Say on Pay is a commonly used expression to reflect the concept that shareholders have an opportunity once a year to hold a vote on the pay of a firm's executives.

We do not intend to analyze the underlying premise of Say on Pay that executive compensation plans are not consistent with the firm's best interests. Such executive pay plans are henceforth referred to as "bad" executive compensation plans. For example, a bad executive compensation plan is one that provides executives with excessive pay (i.e. pay not justified by the executive's effort, skill or risk preferences). For a discussion on the much debated topic of whether executive pay plans are bad or not, one can refer to Bainbridge (2008), Gordon (2006), Core et al. (2005) and Bebchuk et al. (2002). Rather, in this report, we assess whether or not Say on Pay is an effective tool to remedy a given bad executive pay plan.

We also do not discuss shareholder proposals on executive pay, which are different from Say on Pay. Such proposals are submitted by one or more shareholders who take the initiative to suggest a specific executive pay plan to the company's board of directors (Johnson and Shackell-Dowell, 1997). In contrast, Say on Pay implies that shareholders formally approve (or not) an executive pay plan proposed by the board of directors.

While we focus our discussion on the merits of Say on Pay in a Canadian context, we do review and analyze relevant evidence from other countries' experience with Say on Pay, in particular the U.K. Moreover, we rely on evidence from the U.S. experience with shareholder proposals on executive pay to make inferences about Say on Pay.

Say on Pay has received increasing attention and support in recent years. For example, governance bodies such as the Canadian Coalition for Good Governance and the Council of Institutional Investors as well as shareholder advisory services such as the RiskMetrics Group and Glass Lewis & Co. express support for Say on Pay. There are currently no legal requirements in Canada and the United States (U.S.) to let shareholders vote on executive pay plans. However, some firms have implemented Say on Pay on a voluntary and individual basis. In the U.S., in 2007, Aflac was the first firm voluntarily adopting Say on Pay, followed by around 25 other firms. Besides Aflac, firms such as Apple, IBM and Intel now allow Say on Pay. In Canada, Manulife, the Royal Bank of Canada, the Bank of Montreal, The Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, and the Toronto-Dominion Bank in Canada will allow Say on Pay at their next Annual General Meeting in 2010.[1]

[1] Most Canadian firms adopt Say on Pay as a result of shareholder votes on proposals promoting such a mechanism. A similar situation has prevailed in the United States

Say on Pay is now moving into the political arena. On July 31st, 2009, the U.S. House of Representatives voted in favor of requiring firms to implement Say on Pay (Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269). However, it remains to be seen if the U.S. Senate will follow through with Say on Pay: various Say on Pay measures have been introduced but it is not clear if they will be adopted and successfully reconciled with the House measure. If this act becomes law, it would mandate firms to hold annual advisory shareholder votes on their executive compensation reports. Moreover, advisory shareholder votes would also have to be held for golden parachutes. This measure is similar to one that passed the House of Representatives in 2007, but that subsequently stalled in the Senate, despite Senator Barak Obama's support. Moreover, U.S. companies that receive funding from the Troubled Asset Relief Program (TARP) are required to implement Say on Pay during the period when they have outstanding obligations under TARP.

If the U.S. mandates a non-binding shareholder vote on executive compensation reports, it would follow the footsteps of the United Kingdom (2002), Sweden (2006) and Australia (2004) (Davis, 2007) (See appendix A for a background on the adoption of Say on Pay in the U.K.). As in these countries, the proposed U.S. legislation would let the board of directors have the ultimate word on executive compensation, since shareholders only provide an advisory input that the board may or may not act on. In contrast, the Netherlands (2004), Norway (2007) and Spain (2008) have adopted Say on Pay legislation requiring a vote that is binding for the board of directors. Under these conditions, shareholders acquire decision-making powers, and impose their will on the board of directors.

Despite the media attention surrounding Say on Pay, there have been few instances of shareholders overturning a board's recommendations regarding executive compensation (which are provided to shareholders in the firm's executive compensation report). Among U.S. companies allowing Say on Pay, there is no record of negative votes. Overseas, the cases of two U.K. firms stand out. In 2003, 50.7% of GlaxoSmithKline's shareholders voted against a compensation report disclosing a golden parachute that would pay then CEO Jean-Pierre Garnier an estimated £22 million in bonus salary and stock if he were to resign or be dismissed at any time through 2007 (Timmons, 2003). Another example is Royal Dutch Shell. In 2009, 59% of the shareholders rejected the compensation report disclosing that its executives would receive a share award even though Shell had failed to achieve the required benchmark of outperforming three of its peers. Shell had actually finished fourth among the top 5 oil companies (Pagnamenta and Power, 2009). However, beyond these two well-publicized cases, negative shareholder votes occur only a few times every year so that is a relatively marginal phenomenon.

It may be useful to point out that, if it were to happen in North America, Say on Pay would not be the first instance where shareholders vote on corporate practices that affect executive compensation. In the U.S., the Securities and Exchange Commission (SEC) approved new rules on June 30, 2003 requiring any company listed on NASDAQ or the New York Stock Exchange to obtain shareholder approval before adopting any new equity compensation plan or materially amending an equity compensation plan. Prior to

2003, such votes were needed only when changes or proposals were deemed “non-routine”. In Canada, the Toronto Stock Exchange requires listed companies to seek shareholder approval of the number of shares which may be issued under stock option plans on a three year cycle. While Say on Pay votes and shareholder votes on equity and option compensation plans do share some similarities, they exhibit also major differences. In both cases, shareholders are asked to expressly vote on an issue that relates to executive compensation. However, while Say on Pay votes are non-binding (i.e., advisory), votes on equity compensation plans are binding: without a positive shareholder vote, the plan cannot be offered. Moreover, Say on Pay votes are ex-post as they typically relate to a directors’ report on the previous year actual executive compensation and current compensation philosophy. In contrast, votes on the approval of equity plans are ex-ante as they occur before the actual compensation contract is signed or designed. Finally, Say on Pay concerns specific individual executives, for whom compensation details are being provided and discussed (typically, the executive compensation report provides details on the compensation of the firm’s most highly paid executives). Votes on the approval of equity plans are on the number of shares to be reserved or set aside for future issuance under stock option or other equity plans. At the time of the vote, there is no mention of an explicit allocation scheme among employees and executives. Hence, Say on Pay is a more focused measure that relies on more detailed data than votes on equity plans.

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2. What does Say on Pay imply about governance?

While our purpose is not to assess the effectiveness of executive compensation policies and plans, an analysis of Say on Pay must address the question as to why it is needed in the first place. In other words, why add another governance mechanism to an existing set that is already quite comprehensive if one includes all regulatory or legal requirements? In that regard, two viewpoints can be put forward.

On one hand, existing corporate governance structures can be regarded as being effective (i.e. they are in the best interest of the firm). Hence, it is doubtful that there is then any role for Say on Pay, since effective governance implies that executive pay plans are efficient (i.e., in the best interests of the firm). Under these conditions, Say on Pay is likely to be a costly additional governance mechanism that may distract directors. On the other hand, existing corporate governance structures can be regarded as being ineffective (i.e. they are not in the best interest of the firm). Say on Pay can then be viewed as a governance mechanism that may improve on ineffective corporate governance.

We focus our attention on one very specific governance mechanism: the board of directors. We next provide a discussion about the board of directors, in order to determine whether or not existing boards in Northern America are likely to be effective or not. This discussion examines the board from three perspectives: 1) a legal perspective, 2) an economic perspective or 3) a political perspective.

2.1 The Legal Perspective

Absent Say on Pay, decisions about executive compensation are taken by the board of directors, upon a recommendation issued by the compensation committee of the board. Directors are subject to various legal requirements when deciding about executive compensation. Most publicly-traded U.S. firms are incorporated in the State of Delaware (Delaware Division of Corporations [2009]), while in Canada, most firms and incorporated under the Canada Business Corporations Act (CBCA) (Democracy Watch [2007]).

According to U.S. state laws (most notably, Delaware state law), the board of directors has a fiduciary duty to act on their shareholders' behalf. As part of this fiduciary duty, directors have the duty of care to act on an informed basis and the duty of loyalty to serve the corporation and its shareholders to the exclusion of all other interests. The duty of care can be seen as including the design and implementation of executive pay plans. The Delaware jurisprudence has interpreted the directors' fiduciary duty to be the maximization of shareholder value (the "shareholder primacy" model), especially in change of control situations (the Revlon doctrine). The jurisprudence has also stressed that this fiduciary duty cannot be delegated to shareholders: directors are not exonerated by a shareholder vote (such as the one that may be obtained under Say on Pay) from exercising their own business judgment in fulfillment of their fiduciary duty (Brownstein and Kirman, 2004). In fact, directors do not have to follow the wishes of shareholders, since they alone are vested with managing the firm (Brownstein and Kirman, 2004). A mechanical application of Say on Pay resolutions may therefore result in a violation of the board of directors' fiduciary duty, if directors were to believe that the resolution is not in the firm's best interest (Brownstein and Kirman, 2004).

In Canada, the responsibilities of the board of directors are slightly different than in the United States. The fiduciary duty of the board is toward the firm itself, not solely the shareholders. This fiduciary duty was recently reaffirmed by the Supreme Court of Canada in its judgment in the *BCE* case (Supreme Court of Canada, 2008), where the Supreme Court relied on the "stakeholder" model of directors' duties that it had affirmed previously in the *Peoples* case (Supreme Court of Canada, 2004). According to this "stakeholder" approach, acting in "the best interests of the corporation" requires directors to consider the interests of all stakeholders and not to equate the interests of the corporation with the interests of shareholders alone. In the BCE decision, while the Supreme Court of Canada did not explicitly reject the "shareholder primacy" model derived from Delaware jurisprudence, it has clearly stated that the law in Canada requires a broader focus, even in a change of control context (Chapman et al., 2008). Within that mandate, directors must exercise duty of care, that is, "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." (Canada Business Corporations Act).

Directors who act in a manner consistent with the duty of care obligation are protected by the business judgment rule. Courts will not typically reevaluate their decisions ex-post, including those on executive compensation. The Supreme Court of Canada reaffirmed the business judgment rule in the *Peoples* decision: *Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known (Supreme Court of Canada. 2004, supra note 1,).* However, there are exceptions to the rule that board decisions are not reevaluated ex-post. For instance, in the so-called *Repap* decision from 2002, which was maintained by the Ontario Court of Appeal, the Superior Court of Ontario ruled that the business judgment rule did not apply as the management compensation contract was deemed excessive. More importantly, the Supreme Court of Canada assessed that the process followed by the board was deficient, as was the contract itself (Superior Court of Ontario, 2002, *UPM-Kymmene Corp.v. UPM-Kymmene Miramichi Inc.*).

Boards of directors are considered to have followed due process if they adhere to good governance practices and ensure a significant review process for significant corporate decisions (Reiter and Emes, 2009). If one is willing to accept the premise that boards of directors follow due process, then Say on Pay can be viewed from two perspectives. On one hand, Say on Pay can provide directors with additional input into their decision-making process, thus allowing them to acquit their legal obligations. On the other hand, Say on Pay may undermine the due process that the board of directors has put in place to make executive compensation decisions. The legal rulings that we have previously discussed suggest that courts would most likely view Say on Pay as undermining due process. For example, U.S. jurisprudence argues that directors are not exonerated by a shareholder vote (such as obtained under Say on Pay) from exercising their own business judgment in fulfillment of their fiduciary duty (Brownstein and Kirman, 2004). Similarly, in Canada, the Supreme Court has stressed the board's business judgment in the *People's* case.

This discussion of the legal perspective illustrates that the issue of how Say on Pay maps into directors' duties is critical and needs to be addressed more explicitly should Say on Pay become more widespread.

2.2 The Economic Perspective (Say on Pay infringes upon market-driven processes)

A commonly held view is that executives evolve in a global market, in which firms seek the best talent. Within that view, executive compensation represents the market price that is paid for talent. For example, Fama (1980) argues that competitive executive and director labor markets induce directors to act in the firm's best interest. Hence, there is already a strong governance check as the talent market provides a benchmark to gauge executive compensation practices (Kaplan, 2008). Moreover, other markets, such as the market for corporate control, provide similar checks on executive compensation: firms with bad executive compensation plans which result in suboptimal performance may become underpriced and thus easy targets for takeovers.

The view that executive compensation is optimally set (through the influence of various markets) by informed parties (the executive and the board of directors whose members are voted for by rational shareholders) is consistent with an economic perspective of the firm. According to this view, boards of directors are best positioned to negotiate with executives as they are likely to have 1) the best information on the qualities and competencies of the executive, 2) incentives to implement compensation plans that are consistent with the firm's interests, 3) the best understanding of what the firm needs, as a result of their involvement and of their knowledge of internal resources (financial as well as human), 4) knowledge and understanding of the firm's strategic objectives.

Thus, within such an economic perspective, Say on Pay has the potential to lead to inefficient decisions (i.e. decisions that are not in the firm's best interest) as shareholders may not have as much information, incentives, and knowledge as directors to assess what is an optimal executive compensation plan. Moreover, not being privy to strategic and operational decisions, shareholders may have difficulty in assessing how executive pay plans affect the executives' behavior (and hence the firm). Although the details of executive pay plans are provided to shareholders in the executive compensation report, these reports are sometimes boilerplate and difficult to understand for the non-expert shareholder.

Even if shareholders were to have the same information about the firm and its executive pay plans as the board of directors, they may lack the ability to correctly interpret this information as they may have a biased judgment (Thaler and Sunstein, 2008).[2] Hence, pay plans preferred by shareholders would not necessarily be in the firm's best interest. An example of such a biased judgment is anchoring, which occurs when shareholders assess executive pay based on their own situation or experience. Many individual shareholders could find executive compensation levels unreasonably high if compared with their own, thus leading them to vote against compensation reports. As a result the firm would offer an executive pay plan with a level of pay that is too low to attract an executive of a given skill level. Boards of directors are less likely to be subject to such biased judgment, as they are better informed about the pay packages necessary to attract executives with a desired skill, effort and risk preference profile.

Furthermore, shareholders may not have incentives that are as strong as those of the board of directors to act in the firm's best interests. The individual board members have

[2] It should be noted that the economic perspective also rests on the assumption that shareholders are rational. In particular, rational shareholders vote for the members of the board of directors. If shareholders are not rational, they may vote for board members that are subject to the same information, ability and incentive problems that they themselves are subject too. As a result, the argument of the market view would fall apart.

strong incentives to act in the firm's best interest from various sources, including their reputation, litigation (especially in the light of the legal perspective discussed above), and the market for corporate control. Individual shareholders are less constrained by such factors, and may thus seek to further their own welfare at the expense of the firm or of other shareholders. Some shareholders may have an agenda and leverage their investment in a particular firm to achieve other objectives or goals. For example, shareholders may push the firm for certain types of capital investments, or for investments in certain countries, based on how these investments benefit them personally rather than based on the firm's best interests.

Furthermore, it is costly for the individual shareholder to become informed about executive pay and its implications for the firm. These costs include information collection costs, information processing costs, influence costs which are incurred by shareholders who try to influence other shareholders' voting, voting costs, the cost imposed on other shareholders of incorrect voting and the opportunity cost of lost time (Camara, 2004). The direct benefits to the individual shareholder from participating in Say on Pay are low, and directly proportional to her investment. For example, a shareholder who own 1% of the firm's shares bears 100% of the costs of becoming informed about executive pay and voting, but shares the benefits with the other shareholders in the sense that she only receives 1% of the benefits of becoming informed and voting. There may not even be any benefits to share between the shareholders. Hence, for small shareholders, the costs of keeping informed over time with respect to underlying executive compensation is likely to be much larger than any benefit to be derived from voting, thus potentially leading to lower participation. The U.K. experience, which we will discuss later, does suggest that attention with respect to Say on Pay wanes over time. In contrast, while large institutional investors do have the resources to stay informed, they may also take advantage of Say on Pay, voting in favour of compensation practices that they deem bad in exchange for economic benefits (e.g., portfolio or pension fund management contracts, investment banking business, financing, etc.).

A dissatisfied shareholder who wants to modify the existing executive compensation plan would need a sufficient number of other shareholders to also vote against the existing compensation plan in order for it to be rejected. We know from existing evidence that shareholders only rarely reject executive pay plans. Hence the costs to a dissatisfied shareholder from participating in Say on Pay may well exceed his or her benefits. This is particularly the case since shareholders can chose alternative actions rather than participating in Say on Pay if they are not satisfied with the executive compensation plan, such as selling their shares, or directly negotiating with the board of directors.

The board of directors does not face the same cost-benefit issues regarding executive compensation as the individual shareholders, for various reasons. First, regarding the costs, they likely are less high for boards than for individual shareholders, since board members face less information collection and processing costs (being more familiar with the firm and executive pay plans), and since boards act as a group. Second, regarding the benefits, boards work on executive pay plans as part of their duty of care, and their own compensation (as well as any gains in their reputation) can be viewed as the benefit from working doing so.

Overall, the market perspective thus suggests that the board of directors is in a better position to set executive pay policies than shareholders, since shareholders may not have sufficient information, may lack the ability to interpret this information, may lack the incentives to act in the firm's best interests and to invest their time into voting for executive pay plans.

2.3 Political Perspective (Say on Pay helps align executives' interests with those of shareholders)

Bebchuk and Fried (2004) argue that the executive compensation decision-making process is broken. Reviewing many cases and analyzing the different components of compensation contracts, they contend that executives have taken over the compensation process, with directors merely playing a passive role. In other words, contrary to the economic perspective that executive compensation is determined by market conditions, corporate boards do not bargain at arm's length with executives because of social and incentive links between directors and executives. Consequently, executives have power over boards, which they use to influence their own pay. Therefore, executives earn "rents", which represent the difference between the pay package that they negotiate in their power position and the pay package they would have received under arm's length bargaining (and which would be determined only by their effort, skill and risk preferences). Within this political perspective, Say on Pay is likely to provide many benefits to shareholders, for various reasons.

First, Say on Pay provides a check on potential problems in executive pay plans (Cheffins and Thomas, 2001). When shareholders vote on the executive pay plan, they signal to the board whether or not they agree with the plan's details and provide the board. with their position regarding the proposed executive pay plan (Brownstein and Kirman, 2004; Cheffins and Thomas, 2001). Furthermore, a shareholder proposal forces the board of directors to prepare a response, and thus to consider the reasons for its own position (Brownstein and Kirman, 2004). Boards may partially or entirely implement an executive pay resolution that is formally adopted (Brownstein and Kirman, 2004). Boards may also reconsider executive pay plans that fail to be adopted. Board members have incentives to consider the outcome from Say on Pay, because they may not be reelected to the board if shareholders feel that their opinion regarding executive pay is ignored.

Second, boards may even become more proactive and consult directly and behind the scenes with major shareholders when structuring executive pay (i.e. before even putting them to vote), as they have done in countries where Say on Pay is already required, such as the U.K. (Davis, 2007; Brownstein and Kirman, 2004). Shareholders most likely to play an influential role in this process are institutions, which have more access to the board and to management, and thus may be better able to negotiate with them

(MacIntosh, 1989). Boards have an incentive to engage in such direct negotiations, because negative press coverage from a "No" vote on an executive pay plan damages the firm's reputation as well as the reputation of the individual board members. In fact, boards of directors may use Say on Pay as a form of leverage when negotiating with executives, who can pressure the board to implement bad executive pay plans (Davis, 2007). The shareholders' voice via Say on Pay may increase the board's legitimacy when justifying their decisions to executives.

Hence, according to the above arguments, Say on Pay may be beneficial to shareholders and, even to directors by altering the power relation between the board of directors and the executives. Implicitly, Say on Pay then would assume that the board-executive power relation cannot be changed by market or regulatory actions. However, if the view of Bebchuk and Fried (2004) concerning the board's lack of power in setting executive pay is not a fair reflection of reality, then Say on Pay may represent a costly and, potentially, hurtful, intrusion into proper governance processes. For instance, Gordon (2008) argues that mandated Say on Pay may lead to the homogenization of executive compensation in what are perceived to be "best practices". The problem, according to Gordon (2008), is that most investors rely on a few governance assessment services to orient their vote (e.g., ISS). Since these services typically have a standardized approach to executive compensation and rely on similar models, it may lead to the imposition of practices that are consistent with a particular firm`s specific interests or strategy. Various researchers have indeed questioned the view of Bebchuk and Fried (2004), such as Core, et al. (2005).

3. **What means are available to provide shareholders with Say on Pay?**

Say on Pay may be introduced in a firm through two modes: either the government uses regulation to impose Say on Pay on firms (the regulatory mode), or shareholders vote for introducing Say on Pay on a firm level (the shareholder proposal mode). For instance, in the U.K., Say on Pay was introduced by the government as a regulation that was supplemental to the Companies Act. In the U.S., there is currently (as of August 2009) a law making its way through Congress; all existing instances of Say on Pay in the U.S. have followed shareholder proposals introducing Say on Pay that formally passed. We discuss both the shareholder proposal mode and the regulatory mode in more detail next.

In the shareholder proposal mode, there are two stages necessary to implement Say on Pay. First, what we call a "Say on Pay proposal" is submitted by one or more shareholders for vote in order to institute an annual advisory vote on the executive pay plan proposed by the firm's board of directors in the firm's executive compensation report (see Appendix B for DuPont's proposal regarding Say on Pay that was rejected by 53% of its shareholders in April 2009). This proposal may fail or pass, depending on the votes required for a formal pass as defined in the corporate charter (Maug and Rydqvist, 2009). If the proposal passes, the firm is required to hold an annual advisory vote on executive pay (henceforth referred to as the "Say on Pay vote"). This annual advisory vote is a vote that either accepts or rejects the executive compensation report proposed by the board of directors. Firms have to publish this executive compensation report because the SEC requires them to do this. Thus, Say on Pay involves two connected concepts: (1) the Say on Pay proposal, and (2) the Say on Pay vote. Appendix C contains the agenda for Aflac's 2009 Annual General Meeting of its shareholders as well as the executive compensation report submitted for shareholder approval. Aflac was the first U.S. firms to voluntarily adopt Say on Pay.

One problem with the shareholder proposal route is that firms that have bad pay plans are often the ones with the least efficient governance and, hence, the least likely to facilitate and/or implement Say on Pay proposals. In contrast, most firms that have so far voluntarily adopted Say on Pay exhibit reasonably efficient governance structures (e.g., major Canadian banks, IBM). These firms are also the least likely to need Say on Pay since their executive compensation plans likely are not bad given their reasonably efficient governance structures.

In the regulatory mode, government regulations or laws require firms to provide an executive compensation report that shareholders are obligated to vote on. As an example of the regulatory mode, we discuss the U.K. experience. The U.K. Regulation from 2002 requires listed firms to: 1) publish a directors' compensation report as part of their annual reporting, 2) disclose individual directors' compensation in such report, 3) state the firm's executive compensation philosophy, 4) define the compensation committee and board respective roles in matters of executive compensation and, 5) put the compensation report to a non-binding shareholder vote at the Annual General Meeting of the firm. The principles contained in 2002 Regulation were incorporated into the new UK Companies Act, which took effect in 2006 and is the longest ever legislation adopted by the UK Parliament. The Act contains two chapters that deal specifically with executive compensation: **Chapter 6 (**Quoted Companies: Directors' Remuneration Report) and **Chapter 9 (**Quoted Companies: Members' Approval Of Directors' Remuneration Report). Appendix D contains the text of both Chapters.

Two examples of compensation reports subject to Say on Pay under a regulatory approach are presented in the appendices. Appendix E contains the 2009 Royal Dutch Shell remuneration report that was voted down by its shareholders. Appendix F contains the Westpac directors' report on compensation which was submitted for shareholder approval. Westpac is a large Australian bank.

4. What is the impact of providing shareholders with Say on Pay?

We now review the limited evidence on the U.K. and U.S. experiences with Say on Pay from the following four angles: 1) Say on Pay dissent, 2) Impact on board processes, 3) Impact on compensation, 4) Impact on firm value.

4.1 Say on Pay Dissent

The U.K. evidence suggests that firms facing higher shareholder dissent have the following two characteristics (Alissa, 2008; Carter and Zamora, 2009): (1) their executive compensation (mostly bonuses and stock options) exceeds that of their industry peers, and (2) they have poor stock market performance

Moreover, shareholder dissent is typically quite low and decreasing over time. After a peak following the enactment of Say on Pay in the U.K., shareholder dissent has averaged 4-5% in recent years.

4.2 Impact on Board Processes

There is some direct and indirect evidence that Say on Pay leads directors to engage in dialogue with major institutional shareholders prior to a vote, thus reducing the probability of dissent (Alissa, 2008; Ferri and Maber, 2009). Remuneration reports are rarely defeated at shareholders' meetings: while some high-profile cases such as Royal Dutch Shell have attracted much attention, they do not reflect widespread dissent. A small proportion of firms (less than 10% of listed firms) experience dissent votes exceeding 20%. This low level of dissent provides indirect evidence suggesting that boards engage in negotiations prior to the AGM, mostly with key institutional investors, to attenuate tension with them (Davis, 2007). Such negotiations allow institutional investors to take advantage of the upcoming vote to express their viewpoint

4.3 Impact on Compensation

The impact of Say on Pay on compensation practices is difficult to assess as other concurrent factors could affect a board's decision. Hence, caution is warranted before reading too much from the U.K. experience. Our discussion looks at the evidence of whether and how Say on Pay affects executive compensation levels, mixes, and the link with performance.

With respect to compensation level and mix, Say on Pay does not appear to have much effect. Average total CEO compensation for a sample of large U.K. firms increased by 72% between 2002 and 2007, a sizeable rise under any condition. However, the average compensation mix did change, with the average value of long term incentives (deferred share units or restricted stock awards) increasing by 196% while the average value of stock option grants declined by 55% during the same period. One can argue that compensation growth was driven by performance improvements. However, such improvement may be deemed elusive. For instance, the FTSE 350 Stock Market Index doubled between January 2003 and December 2007. Since January 2008, the Index has declined by close to 40% and is now back at around the level it was in early 2002! Two reasons make it difficult to assess whether or not the changes in compensation level and mix over time are due to the enactment of Say on Pay. First, other events have taken place at the same time as the enactment of Say on Pay and could have produced the observed changes. Second, it is possible that without Say on Pay, alternative governance mechanisms that are already in place (such as the market for corporate control) would have lead to the same changes in compensation level and mix.

However, changes in the compensation level and mix appear to be affected by the level of dissent. Specifically, U.K. firms receiving a higher proportion of negative votes in a given year provide their CEOs with a lower change in year-to-year compensation relative to his/her peers, especially in terms of stock option grants and cash compensation (Carter and Zamora, 2009). However, the effect of the vote is very faint in economic terms, since the resulting change in year-to-year compensation is quite low.

With respect to the link between pay and performance, U.K. executive compensation became more sensitive to a firm's poor performance relative to its industry after the enactment of Say on Pay legislation (Ferri and Maber, 2009). Firms most likely to follow this pattern have the following characteristics: 1) they experienced higher voting dissent, 2) they granted their CEO higher compensation in the past and, 3) they are UK firms listed on the main market. However, these findings are subject to the caveat that they are relatively faint in terms of economic magnitude and relate to a small subset of poorly performing firms.

4.4 Impact on Value

In this section, we ask whether Say on Pay creates firm value, prevents firm value destruction, or, possibly, destroys firm value? Based on the U.K. experience, Ferri and Maber (2009), Carter and Zamora (2009) and Alassi (2008) cautiously argue that Say on Pay may reduce the instances of bad compensation plans. Therefore, they conclude that Say on Pay may prevent value destruction. However, their evidence is marginal at best and may be confounded by many other factors. Specifically, other events happened at the same time that make it hard to attribute any time trends in the level and mix of pay to Say on Pay. Moreover, we do not know how firms would have reacted in the absence of Say on Pay: it is possible that other governance mechanisms would have kicked in to prevent value destruction similar to what Ferri and Maber (2009), Carter and Zamorra (2009) and Alissa (2009) argued Say on Pay did.

More direct evidence is available from the United States, although not directly resulting from Say on Pay but reflecting investors' expectations regarding the effect of Say on Pay. As mentioned earlier, the U.S. experience with Say on Pay is rather limited. However, two sets of events allow us to glimpse at the implications that Say on Pay may entail for shareholders if it were to become law.

Cai and Walkling (2008) assess how investors react to news emanating from the debate and Congressional votes surrounding the evolution of the Say on Pay bill. Their sample comprises 1,270 firms that would likely be affected by the proposed legislation. They examine whether investors bid up or bid down a firm's stock price in reaction to Congressional developments regarding Say on Pay. If investors bid up (down) the stock price, this means that value is created (destroyed). Their findings provide some support that mandated Say on Pay may create value for firms whose CEOs' compensation 1) is higher than their peers or 2) has low sensitivity to performance (peers being defined on the basis of firm size and performance). More specifically, it appears that investors bid up the stock price of these firms on the announcement of the positive vote for the adoption of the Say on Pay bill, a view that is consistent with Say on Pay being beneficial to investors in firms with bad compensation plans. Moreover, firms with entrenched management and boards that are perceived to be less effective monitors (e.g., busy directors) are experienced positive stock market reactions to news about the eventual adoption of Say on Pay legislation. However, Cai and Walkling (2008) also document that firms that receive shareholder proposals for Say on Pay are likely to experience a value decline if the proposal is union-sponsored. Moreover, for the majority of firms, the passage of the bill did not seem to have any influence on their market value

Balachandran, Joos and Weber (2008) adopt an indirect approach to assess the merits of shareholder votes on executive compensation. They focus on the 1997-2002 period when boards of directors in the U. S. had the choice to submit or not new equity compensation plans to the approval of shareholders. They look at 976 equity plans that were implemented during that period, 768 of which were submitted to a shareholder vote (208 were not submitted to a shareholder vote). They show that firms submitting new plans to their shareholders for approval are typically better performing in the long run and exhibit stronger governance features. They conclude that their results are consistent with control mechanisms, such as shareholder voting, being associated with more efficient equity-based compensation plans. However, a major limitation of their findings is to know which way the causality goes. More specifically, do the firms perform better because of the equity plans that are submitted, or do firms submit new equity plans because they expect to perform better in the future? It is therefore hard to draw a strong conclusion with regard to Say on Pay.

5. Should Canada consider Say on pay?

Say on Pay has recently become a “hot balloon” and a representation of political correctness in the governance area. However, its enactment through regulatory or political means does raise several questions. First, in North America, Say on Pay is introduced in a context in which directors’ role and responsibilities are legally defined in very specific ways. Hence, the mapping between Say on Pay votes and the decision-making process at the board level is far from clear and is likely to require further analysis.

Second, extensive empirical evidence from the United Kingdom, a country where it has been mandated since 2002, does not suggest that Say on Pay has a major impact on executive compensation practices. More specifically, firms seem more likely to experience shareholder dissent and to react by reducing some aspects of compensation (especially stock options and severance arrangements) if their CEOs receive compensation that appears out of bound compared to their peers’ pay or to their stock market performance. There is also evidence that these firms enhance the relation between performance and CEO compensation. However, these findings relate to a small number of firms and are marginal in economic terms.

Third, mandated Say on Pay does impose some additional costs on all corporations (compared to voluntary Say on Pay) which may not be warranted considering the few benefits that most of them seem to derive from it, if any. These benefits seem to accrue to the shareholders of a small subsample of poorly performing firms with highly paid CEOs. Are these benefits high enough to compensate for the extra costs imposed on all other corporations? Furthermore, numerous alternative governance mechanisms already exist and may well address the problems in poorly performing firms with highly paid CEOs, even if there is no Say on Pay (e.g., market for control, election of directors). These alternative governance mechanisms are adapted to each firm's specific circumstances, which is not the case for mandated Say on Pay.

Therefore, we arrive at the following two conclusions:

1. Mandated Say on Pay does not seem to be a value-added governance measure. It is a one-size-fits-all solution to an ill-defined problem, thus imposing costs on all corporations, irrespective of their current governance and compensation practices. Its impact on firms with apparent high executive compensation practices is weak at best and, in any case, may be achieved through other means. In our view, it appears more fruitful to concentrate on reinforcing more comprehensive mechanisms that provide the board of directors with greater relevance and relative power vs. management. The board is the governance instance where the expertise should lie in deciding upon strategic issues such as executive compensation.

2. Say on Pay enacted as result of shareholder proposals does allow for customized flexibility in governance practices, provides boards of directors with an opportunity to make their case prior to the shareholder proposal vote and open the door to investors-directors dialogue. However, the evidence strongly suggests that the regulatory and governance frameworks surrounding shareholder proposals need to be well defined to prevent frivolous or value-destroying proposals from being submitted to shareholder votes.

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APPENDIX A

U.K. Institutional Background

One can say that the Cadbury report (1992) set in motion a series of fundamental changes in executive compensation practices in the United Kingdom. Enacted in 1993, the Report's code of best practices prescribed that 1) The total compensation of directors and of the chairperson be fully disclosed, 2) the fixed (salary) and performance-related (bonuses, etc.) components of compensation be disclosed separately and, 3) the compensation of executives who sit on the board be determined by a compensation committee comprising mostly directors who are not executives. By making public executive compensation, the Report's ultimate aim was to enhance transparency in governance practices and, ultimately, to potentially limit exaggerated compensation packages. However, subsequent evidence suggests that the disclosure of individual compensation did not necessarily slow down compensation increases. On the contrary, it appears that that it led to a subsequent bidding up process as firms whose executives were paid lower than their peers adjusted upward compensation levels to close the perceived gap (Ezzamel and Watson, 1998).

In the wake of the Cadbury report, and recognizing that governance regarding executive compensation needed more formal guidance, the Confederation of British Industry set up the Greenbury committee, to be chaired by Sir Richard Greenbury, then chair and CEO of Marks & Spencer. The overall principles guiding the Report's recommendations regarding executive compensation were: accountability, transparency and performance linkage. The most significant recommendations contained in the Greenbury committee report (released in 1995) include: 1) more disclosure about executive compensation, 2) an compensation committees entirely composed of independent non-executive directors, 3) a delegation of power to the compensation committee to set and implement compensation policy and individual compensation packages, 4) the company's annual report should include a report by the compensation committee which highlights its compensation philosophy and details individual compensation packages, 5) the objectives of the compensation committee should be to pay enough, but not more than enough, to "attract, retain and motivate directors of the quality required", 6) notices in executive compensation contracts should not exceed one year. The

Following the implementation of the Cadbury Code and the release of the Greenbury report, The Committee on Corporate Governance was set up and conducted a widespread consultation process on governance issues with key stakeholders. The committee was chaired by Sir Ronald Hampel, then chair of ICI. The Committee's mandate was very broad and it issued its report in 1998. Its recommendations, many of them echoing those issued in the Greenbury report, were initially adopted by the London Stock Exchange.

The basic principles and key recommendations from all three reports were ultimately consolidated into the 1998 Combined Code on Corporate Governance. The underlying philosophy guiding the Combined Code as well as the preceding reports was to guide the improvement in corporate governance without relying on government intervention.

Hence, consistent with that spirit, the Combined Code recommended standards for good governance were non-binding. However, if some standards were not applied by a firm, UK listing rules required an explanation for the non-compliance.

However, in the view of government, actual practices in corporate disclosure did not match the objectives sought and promoted in the three reports and in the Combined Code, especially the principles of accountability, transparency and performance linkage. Hence, by virtue of the powers conferred to him in the 1985 Companies Act, the Secretary of State for Trade and Industry enacted the Directors Remuneration Report Regulation 2002 (Regulation 2002).