Is Say on Pay (SOP) a useful initiative?

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Allowing shareholders to vote on executive compensation (SOP) has received a great deal of support from institutional investors as well as opportunistic political adhesion. SOP has thus become compulsory in the United States since 2011 and in the U.K since 2006.

While a number of Canadian corporations have chosen to voluntarily adopt a say-on-pay vote by shareholders, Canadian authorities do not (as yet) require public companies to hold advisory votes on compensation. However, the review of the Canada Business Corporations Act (CBCA) recently conducted by Industry Canada has queried respondents whether SOP should be made compulsory in Canada.

Some Canadian corporations are still resisting SOP but they have come under heavy pressure by institutional investors to get on board.

The thesis is thus: giving shareholders a direct, though non-binding, say on executive compensation would make boards of directors more circumspect, more receptive to the concerns of institutional investors about compensation matters. So stated, that thesis appears most reasonable, even incontrovertible.

But were there unintended consequences to the implementation of this “reasonable” initiative? What do studies carried out since 2010-2011 tell us about the impact of this initiative? This paper deals briefly with these issues.

Principles and logistics

SOP raises issues of principle and, as is often the case with well-intentioned initiatives, triggers the risk of unintended consequences:

- The SOP initiative represents a significant breach of the traditional concept of corporate governance, rooted in law and tradition, which grants to the board of directors, once elected by shareholders, the responsibility for making all decisions in the interests of the corporation. The board's responsibility and accountability are well defined in the statutes and covers, *inter alia*, the appointment of senior management.
and the setting of their compensation, the declaration of dividends, the nomination of candidates for election to the board, and the approval of the corporation's strategic plan and budgets. The Canadian Business Corporation Act famously states in its article 122:

“Every director and officer of a corporation in exercising their powers and discharging their duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.”

- While SOP is initially advisory in nature, there will be a tendency to give a binding effect to the shareholders' vote. This is precisely what happened in the U.K.

- Once this breach has been opened, some institutional investors will wish to submit for direct approval by the shareholders other decisions that have historically been the sole province of the board of directors. Once again, this came to pass as institutional shareholders now want the right to put forth their own nominees for the board. That «right» has now become almost a standard in the United States and some influential Canadian institutional investors have started championing this issue.

- Overwhelmed by the number of advisory votes on executive compensation and poorly equipped to review the long and complex explanations of the compensation programs, the smaller investment funds, and some large ones, have deferred to the recommendations of proxy advisory firms (essentially ISS and Glass, Lewis), giving these firms extraordinary influence over the governance of corporations.

- Also overwhelmed by the sheer number of opinions they must produce in a very short time span, these firms had to resort to simple evaluation grids based on easily accessible quantitative data. For instance, nearly 1,570 companies are listed on the TSX and 2,200 are listed on the TSX Venture Exchange in Canada. The fiscal year of about 84% of TSX-listed companies ends on December 31. For these companies, proxy advisory firms must produce their opinions in a very short period of time as investors have less than 50 days between the
date on which they receive the management information circular and the proxy vote deadline. (IGOPP research, 2012).

- Assessing a compensation program on the basis of quantitative indicators like «Total Shareholder Return» (TSR) is highly inappropriate, even misleading. Yet, that is the basis for the opinions of ISS on which many investors rely for their say-on-pay vote. Indeed, different quantitative and qualitative indicators are required to capture any particular company's performance; each company is different in this respect and cookie-cutter compensation programs are bound to be ineffective. Qualitative aspects of performance, such as values and ethics, the sense of belonging and fairness felt by the majority of the members of the organization, play a key role in the long run success of a company. Compensation should factor in some of these qualitative aspects of performance but SOP is not conducive, indeed is antagonistic, to these sorts of consideration.

- According to its supporters, the primary benefit of this advisory vote stems from the dialogue it establishes between institutional investors and the members of the board of directors; however, provided all precautions are taken to prevent disclosure of privileged information, institutional investors may easily continue with is already a widely prevalent practice of engaging in dialogue with the board members and executives of corporations of which they are significant shareholders. Displeased institutional investors should not hesitate to use the much more effective means at their disposal: voting (or withholding their vote) against members of the board responsible for what they consider indefensible levels of compensation.

What studies conducted since 2010-2011 reveal

The following studies reach conclusions that are not favourable to SOP showing a more favourable effect of SOP:

- A study from 2012 concludes as follows: Firstly, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes (this was also confirmed in a study by Ertimur et al. [2013]). Secondly, a substantial number of firms change their compensation programs in the time period before the formal shareholder vote in a
manner consistent with the features known to be favored by proxy advisory firms in an apparent effort to avoid a negative voting recommendation. Thirdly, the stock market reaction to these compensation program changes is statistically negative. (Larcker et al., 2012)

- According to Kay and Sinkular (2013), the combined effect of advisory votes on compensation and meticulous scrutiny by influential voting advisory agencies has unexpected consequences: a marked trend toward the uniformization of the compensation programs of executive officers. To minimize the risk of a potentially negative vote on SOP, many companies change their compensation practices by basing them more on external perceptions than on business needs or skills. This trend is particularly apparent in the design of stock-based compensation programs with a significant increase in the use of TSR (total shareholder return) as a measure of performance.

- Fund managers that invest in large-cap securities hold onto their shares for a median duration of about 17 months. This means that a significant proportion of the securities involved in an SOP vote will be held by different shareholders during a subsequent vote (Bachelder III, 2015). In such a situation, the influence of voting advisory agencies becomes appreciably stronger.

- SOP does not contribute to the development of high standards of compensation. On the contrary, in conjunction with the role played by voting advisory agencies, SOP leads to the uniformization of the practices, a one-size-fits-all solution for all companies, whereas compensation should take into account the particular characteristics of each organization and the specific challenges it must meet (Bachelder III, 2015).

- According to a study by Kronlund and Sandy (2015), when companies face an advisory vote, they reduce the salaries and golden parachutes of CEOs, but increase the stock-based compensation and pension plans. The net total compensation is higher (Alissa obtained a similar result [2015]). Shareholder scrutiny of compensation can therefore cause companies to focus on the
"appearance" of compensation, resulting in a higher aggregate compensation, contrary to the objectives sought by SOP.

• SOP votes have proven to be largely ineffective in reducing "excessive" executive compensation (but may have limited the growth of these "excesses") (Brunarski et al., 2015).

• A vote in favour of inefficient compensation (or an inefficient policy) can exacerbate the problem because the favourable vote legitimizes the poor compensation policy (Brunarski et al., 2015).

• Firms which have had to conform to the new regulation experienced both an increase in the aggregate compensation of the CEO and increased sensitivity to performance-based compensation. These results support the position that the SOP regulation has not had the desired effects, particularly of curbing the compensation of CEOs (Iliev and Vitanova, 2014).

• As compared with firms that were not subject to SOP, those that were did not significantly change the aggregate compensation of their CEOs once they complied with the regulation. However, the composition of the compensation has changed – monetary compensation was reduced in favour of greater incentive-based compensation. The same change was also observed in the composition of other executives' compensation (Burns and Minnick, 2013).

On the other hand, a few studies did find that there was an effect that could be described as "favourable":

• The results obtained by Lo et al. (2014) show that high levels of compensation for executive officers contribute to shareholder dissatisfaction, which is expressed in a negative vote; boards of directors take the results of SOP votes very seriously and revise compensation policies after unfavourable votes. Shareholder dissatisfaction subsides when boards react constructively to their concerns.

• Several U.K. firms reacted to a negative vote by eliminating aspects that were criticized, such as compensation clauses which seemed to "reward failure") (Ferri and Maber, 2013).
• Shareholders correctly identified firms that exhibit excessive and abnormally high compensation and express their dissatisfaction in the SOP vote, (however, Kimbro and Xu [2015] note that it is difficult to extract the influence of advisory agencies, which is still significant). Alissa [2015] draws similar conclusions in the context of the U.K., without however controlling for the influence of voting advisory agencies. Boards of directors react to this message by reducing the growth of executive officers' compensation (Kimbro and Xu, 2015).

It should be noted that the first two studies (Lo et al., 2014 and Ferri and Maber, 2013) focused on companies that obtained negative votes, and did not therefore measure the effect of SOP on other firms. While negative votes enable the situation to be corrected, an abstaining vote against the members of the human resources/compensation committee would very likely have just as much, if not a greater, impact in bringing about changes to poor compensation policies.

Among the so-called "favourable" studies, the last study referred to above (Kimbro and Xu, 2015) is possibly the strongest in support of SOP. However, the assessment of what constitutes "excessive" compensation in the study is based on statistical calculations that are complex and debatable from a methodological standpoint.

What's most perturbing about these studies is the acknowledged fact that corporations have a tendency to change their compensation policies to conform to the criteria determined by proxy advisory firms in order to avoid a negative recommendation from these firms. As a result, compensation systems become very similar from company to company, whatever the particular stakes and challenges they face, with great emphasis placed on stock market performance as the ultimate “judge” of a good compensation system.

This is a remarkable turn of events as that direct linkage between compensation and the stock price was never stronger than in the years preceding the 2008 debacle (as well as earlier ones) and was justly identified as one of the prime causes of this financial melt-down!
Main references


• Lo, Kin, Shuo Yang, Jenny Li Zhang, ““Say-on-pay” votes and compensation practices”, Canadian Academic Accounting Association (CAAA) Annual Conference, January 6, 2014.