'Say on pay': What the market thinks

By Ralph A. Walking

Spencer Stuart / DirectorS & Boar DS Director S r oSter 18 directors & boards B oth presidential candidates support what has been termed “say on pay.” In general, say on pay gives shareholders an advisor y vote on CEO compensation. Heated arguments have been made on both sides of the issue, yet to date there is little actual evidence about the market’s reaction to say on pay. You can imagine three pos- sible outcomes of say on pay legislation. First, it’s possible that the initiative could create value by better aligning the interest of owner and managers. Second, since the vote is ad- visory only, it could have little impact on firm value. Firms n e e d n o t t a k e a ny a c t i o n regardless of the outcome. Academic research generally finds little market reaction to advisory vote initiatives. Third, the legislation could be disruptive. A strong case can be made that the author- ity for executive compensa- tion must remain inside the boardroom and that attempts to alter this authority will destroy value. Recently, the chair- man of Directors and Boards, Rob- ert Rock, wrote eloquently about say on pay, making this very point: “Should shareholders have the right to an advi- sory vote on executive compensation? With the exception of where pay is egre- gious, I don’t think so.” [“Say on Pay Is a Populist, but Misguided, Notion,” Third Quarter 2008.] In a recent Drexel University working paper, “Shareholders’ Say on Pay: Does It Create Value?” (available at http://papers. ssr n.com/sol3/pap ers.cfm?abst r ac t_ id=1030925) my co-author, Jie Cai, and I examine the market’s reaction to cur- rent say on pay legislation and related shareholder-sponsored initiatives. Here are some of our results. O n A p r i l 2 0 , 2 0 0 7 , t h e House passed the Sharehold- er Vote on Executive Com- pensation Act (H.R. 1257) by a two-to-one margin. The same day, Barack Obama in- troduced a companion bill in the Senate. Neither bill limits CEO pay but requires a non-binding shareholder vote on executive compensation. To examine the market’s rea c t ion to the say on pay l e g i s l a t i o n , w e c a l c u l a t e d risk-adjusted rates of return for over 1,200 firms ranked by level of “abnormal” CEO compensation. Our results indicate that, after control- ling for market movements and other confounding fac- tors, firms with the highest level of unexplained CEO compensa- tion and lowest pay for performance ex- perienced significantly positive returns when the bill passed the House. This re- sult is consistent with the market believ- ing that say on pay legislation improves value for these firms. It is also consistent with Robert Rock’s suggestion that say on pay would be useful only where pay is egregious. Presumably, firms with the lowest level of unexplained compensa- tion (underpaid executives, if you pre- fer) don’t need say on pay. Indeed, these firms experienced small (statistically in- significant) market-reaction losses. We also found that the highest market returns were earned by firms responsive to shareholder proposals in the past and by firms with higher levels of activist shareholdings. All of these results may understate the impact of say on pay legislation. But the results indicate gains to firms that could benefit if say on pay were to be imple- mented. One argument against say on pay is that if it were beneficial, firms could adopt it voluntarily. Blockbuster, Apple, and Aflac are among the companies that have done just that, and activists have pressured many other companies on say on pay. We found about 50 companies in the 2005-2006 period that were indi- vidually targeted by shareholder propos- als related to say on pay. However, our results indicate that the firms targeted by these proposals appear unlikely to benefit from say on pay. In general, their market performance was superior, their CEOs did not have higher levels of unexplained compensation, and their governance was not abnormal. At the announcement of say on pay propos- als for these firms, value was destroyed. On average, these firms exper ienced significantly negative abnormal returns when the proposals were announced. The subject of executive compensa- tion is certain to remain a hot topic. Our results provide objective evidence for the current debate on say on pay. Say on pay can create value in firms with egregious pay, but blanket application to all firms can destroy value. As with much legisla- tion, one size does not fit all. As an alternative to say on pay, Robert Rock suggests in his above-cited article that shareholders could withhold votes for members of the compensation com- mittee. Guess what? In my next Direc- tors & Boards column I will discuss the issue of director elections and present evidence that links lower votes for com- pensation committee members to future reductions in excessive pay. ■ The author can be contacted at rw@drexel. edu. Dr. Ralph A. Walkling is executive director of the Center for Cor- porate Governance at Drexel University’s LeBow College of Business (www. lebow.drexel.edu). This is his first in a series of columns. ‘Say on pay’: What the market thinks We did the ‘reaction’ calculations to the passing of legislation and related shareholder-sponsored proposals. By ralph a. Walkling