'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

Both presidential candidates support what has been termed "say on pay." In general, say on pay gives shareholders an advisory 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 possible 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 advisory only, it could have little impact on firm value. Firms need not take any action 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 authority for executive compensation must remain inside the boardroom and that attempts to alter this authority will destroy value. Recently, the chairman of Directors and Boards, Robert Rock, wrote eloquently about say on pay, making this very point: "Should shareholders have the right to an advisory vote on executive compensation? With the exception of where pay is egregious, 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.ssrn.com/sol3/papers.cfm?abstract_id=1030925) my co-author, Jie Cai, and I examine the market's reaction to current say on pay legislation and related shareholder-sponsored initiatives. Here are some of our results.

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On April 20, 2007, the House passed the Shareholder Vote on Executive Compensation Act (H.R. 1257) by a two-to-one margin. The same day, Barack Obama introduced a companion bill in the Senate. Neither bill limits CEO pay but requires a nonbinding shareholder vote on executive compensation.

To examine the market's reaction to the say on pay legislation, we calculated risk-adjusted rates of return for over 1,200 firms ranked by level of "abnormal" CEO compensation. Our results indicate that, after controlling for market movements and other confounding factors, firms with the highest level of unexplained CEO compensation and lowest pay for performance experienced significantly positive returns when the bill passed the House. This result is consistent with the market believing 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 compensation (underpaid executives, if you prefer) don't need say on pay. Indeed, these firms experienced small (statistically insignificant) 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 implemented.

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 individually targeted by shareholder proposals 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 proposals for these firms, value was destroyed. On average, these firms experienced significantly negative abnormal returns when the proposals were announced.

The subject of executive compensation 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 legislation, 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 committee. Guess what? In my next Directors & Boards column I will discuss the issue of director elections and present evidence that links lower votes for compensation committee members to future reductions in excessive pay. ■

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