"SAY ON PAY": SOME PRELIMINARY STATEMENTS FROM A EUROPEAN FINANCIAL ECONOMIST'S VIEW

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I. Introduction: What do investors expect "Say on Pay" to do for them, or for the marketplace?

"Say on Pay" is the street name for giving the annual shareholder meeting (AGM) the "power" to have an advisory, i.e., non-binding, vote on whether they agree with the compensation package of the top management.

In order the evaluate what SOP can do for investors or the marketplace, first of all, we have to clarify whether we care about total "pay levels" or "pay-for-performance sensitivity". While the general public clearly believes that the total level of executive pay has exaggerated to intolerable levels, from the perspective of the investors, the total level of compensation is irrelevant; instead, what is relevant is an understanding of the complete incentive structure of the top management and whether it is optimally designed in aligning its interests with those of the shareholders. Therefore, shareholders should and do care about pay-for-performance sensitivity and less so about the absolute level of compensation. Of course both are correlated to the extent that we can sometimes observe extremely high levels of executive compensation which are not justified by performance, i.e., very high levels of compensation go along with a low pay-for-performance sensitivity.

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II. Investor and regulatory reactions to executive compensation issues in Europe

The position of the responsible European Commissioner Charlie McCreevy (DG Internal Markets and Services) has always been that shareholders, as the owners of the company, should have a strong say on the remuneration schemes of board members.[2] While this is just a recommendation for the member states, there is no European-wide regulation such as a "Directive on executive pay" yet, but the issue is high on the political agenda and there is pressure to put more rules into national law. Public and political opinion – particularly after financial crisis – clearly against what is regarded as excessive compensation and "reward for failure".[3] So further regulatory action in the national jurisdictions is at the gate almost for sure.

Switzerland is even facing a popular vote driven by the "Federal popular initiative against rip-off salaries" to implement SOP and more far reaching measures to curb executive compensation.[4] As a response to this and heavy criticism by its shareholders, UBS - the Swiss bank which is most negatively affected by the financial crisis - has completely redesigned its compensation structure and is implementing from 2009 an advisory vote on the principles and fundamentals of compensation.[5] The UK experience on SOP is generally seen as a positive first step in right direction. In particular, SOP is seen as the measure least interfering with free market mechanisms and efficient contracting.

A. Developments in Germany

In Germany the general Public believes CEO to be overpaid and lacking personal accountability. All political parties now want to increase personal liability of top management. The Social Democrats want

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[2] SPEECH/08/518, Charlie McCREEVY European Commissioner for Internal Market and Services, Corporate Governance Institute Chartered Secretaries and Administrators (ICSA), EU Corporate Governance Summit , Brussels, 8 October 2008.
[3] *£750k Northern Rock payoff is "reward for failure"*. Liverpool Daily Post, 1 Apr 2008.
[4] *Gegenvorschlag zur «Abzocker-Initiative» Teil der Aktienrechtsrevision könnte beschleunigt behandelt werden*, 21 October 2008, Neue Zürcher Zeitung. See also www.ripoff.ch.
[5] *UBS Compensation report* on „UBS's new compensation model", November 17, 2008. See www.ubs.com.

to curb executive compensation by limiting tax deductibility to a maximum pay of 1 million Euro.[6] Conservatives were against this before the financial crisis but now winds seem to have changed a bit in the direction towards stronger measures.

The Conservative Christian Democratic Party favors a non-binding advisory vote of shareholders at AGM (SOP) but the main responsibility should remain with the supervisory board. As opposed to the current practice of delegating the decision-making on executive pay to a remuneration sub-committee, all members of the supervisory board should jointly be responsible and decide on the pay package. The pay package shall be “appropriate” with respect to market and industry benchmarks. The conservatives also propose a minimum 3-year vesting period for stock options and a higher level of transparency for remuneration disclosure. Further measures could include legal changes pertaining the structure of the executive pay package into fixed and variable components, tightened legal liability for supervisory board members who can be held responsible for inappropriate pay packages, and even a complete ban of stock options cannot be excluded. At the current moment a final consensus of the two governing coalition parties has not yet been reached so any regulatory outcome is still possible under the impression of the financial crisis. However, it is highly likely that an advisory SOP vote at the Annual Shareholder Meeting (AGM) in some form or another will be part of the forthcoming regulatory package on executive pay. So let us look at the empirical evidence on whether this makes sense from an economic perspective.

III. An empirical financial economist’s view on SOP

Executives need proper incentives to act aligned with the interests of their shareholders. Stock and option incentives were (once) believed to solve the so-called agency-problem by purportedly aligning the interests of the top managements with those of the shareholders. However, after more than twenty

[6] Bericht der Arbeitsgruppe zum Thema “Angemessenheit und Transparenz von Managerbezahlungen”, Sozialdemokratische Partei Deutschlands (SPD), 28 April 2008.

years in use, we have seen that stock-based incentives created huge agency problems of its own by inducing excessive risk-taking and short-termism of management dominating over the long-term benefits of the company and its shareholders. As a result, stock-based incentives enabled executives to achieve today's pay levels while shareholders did not realize that it is costly and detrimental to their interests. The two most widely cited instruments shareholders could use to protect themselves from over-paying their executives are remuneration disclosure and SOP, so let us take a look at the empirical evidence.

A. Empirical Evidence on Remuneration Disclosure

Shareholders (and other stakeholders) of the firm need full disclosure of individual executive compensation packages and underlying incentive structures. This has been achieved by the 1992 and 2006 SEC CD&A amendments in the US, and through the 2002 UK "Directors Remuneration report" in the UK. Germany has implemented the Executive Compensation Disclosure Law in 2005.

Empirical evidence shows positive effects of compensation disclosure. Looking at the 1992 SEC amendments, Lo (JAE, 2003) empirically shows that increased executive compensation disclosure rules potentially benefitted shareholders by inducing corporate governance improvements.[7] His most striking finding is the fact that "firms lobbying more vigorously against the proposal had more positive abnormal stock returns during events that increased the probability of regulation", i.e., the shareholders of those firms that were most opposed to higher disclosure would benefit most from it. We can assume a similar pattern from opposition against SOP: CEOs of well-run firms who have nothing to hide will have no problem in receiving a positive advisory vote from their shareholders, while those firms with outrageous "reward-for-failure" pay packages have reason to be afraid of angry investors and will spend resources to lobby against any form of tighter regulation.

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[7] Kin Lo (2003), Economic Consequences of Regulated Changes in Disclosure: The Case of Executive Compensation, *Journal of Accounting and Economics* 35, 285-314.

B. Empirical Evidence on "Say on Pay"

A. The UK Experience

In his excellent paper Jeff Gordon calls for "caution for a few years" before introducing SOP regulation in the US.[8] As a witness against SOP which in his opinion could evolve in a direction of pay practices that would ill-suit many firms, he cites the UK experience with "excessive pay continuing to increase" and judgments over compensations practices "delegated to a small number of proxy advisors". While his concerns are valid and need to be taken seriously before any implementation, in my opinion, the empirical evidence on SOP in the UK is quite encouraging.

In their empirical study, Ferri and Maber (2008) show that pay-for-performance sensitivity with respect to negative (operating) performance has increased, following the 2002 UK SOP legislation.[9] Their findings seem particularly to be driven by "excessive compensation" firms in the period 2000-2002 prior the introduction of SOP. This shows that the regulation is effective at those firms which should be the target of SOP. Gordon critically points to the finding that unlike pay-for-operating performance, pay-sensitivity to stock performance has not increased in the UK. But taking a closer look at the results of Ferri and Maber, we can observe that pay-sensitivity to stock performance has simply not increased because it has always been there already (and is still there after the regulation)! So while the authors find "no evidence of a change in the level and growth rate of CEO pay after the adoption" of SOP, they do find that their results are clearly in line with lesser "reward-for-failure", which is what most investors and regulators would expect from such a regulation. Needless to say that this is only one empirical paper on the UK evidence, but it is in line with economic intuition and anecdotal evidence about investors welcoming the new advisory vote with 70% approval ratings.

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[8] Jeffrey N. Gordon (2008),"Say on Pay": Cautionary Notes on the UK Experience and the Case for Muddling Through", *Columbia Law School Working Paper* No. 336.

[9] Fabrizio Ferri and David Maber (2008), Say on Pay Vote and CEO Compensation: Evidence from the UK, *Harvard Business School Working Paper*.

B. The US Evidence

Further empirical evidence on the potential effects of SOP on shareholder value is provided in a study by Cai and Walkling (2008).[10] The authors look at abnormal stock returns of 1,245 firms after the SOP bill successfully passed the House of Representatives on April 20, 2007, which is also the day when President-elect Barack Obama presented a companion bill in the Senate. This can be taken as evidence on what the marketplace thinks about the value implications of SOP once implemented, taking into account the probability that the regulation could still fail. The results are clear evidence in favor of a positive market reaction, showing that firms with excessive CEO compensation react significantly positive to the SOP Bill. Hence, the market reaction is strongest for those firms which are most likely to benefit and implement changes in their compensation plans. In my view, this study provides even stronger evidence in favor of SOP than the UK experience, given that market reaction to the SOP Bill is even an underestimation of the true valuation effects due to the fact that SOP is not implemented yet in the US (at the time of the study).

The same disclaimer applies in this case that this is only one yet unpublished empirical study on the (possible) effects of SOP regulation, and it is not certain whether these will happen as expected. However, the event-study approach is a widely accepted and powerful tool to show that differences in relative investor demand for stock could actually be attributable to investor perceptions of variations in company-specific compensation policies as an immediate response to a reported change in political prospects for SOP. Any concerns about the methodology would rather have to explain the cross-company differences observed rather than point to a systematic bias in measuring such abnormal stock returns in response to a regulatory event.

[10] Jie Cai and Ralph A. Walkling (2008), Shareholders' Say on Pay: Does it Create Value?, Working Paper, Drexel University.

IV. How should SOP (not) be implemented

A. Will there be negative side effects of SOP regulation?

Critics of regulatory action often mention possible side negative side-effects of SOP like corporate herding or micro-managing pay policies, and the danger of “one-size-fits-all” proxy advisor solutions. While these are valid concerns, these negative developments are already in place, and they are rather driven by the increased use of compensation consultants and the common practice to benchmark pay packages to those of “peer groups”. It is therefore questionable if SOP will be further worsen this situation. On the other side, an advisory SOP vote can works through the embarrassment factor as a very powerful corrective measure. The empirical fact of only few “NO” votes in the UK is a sign that the credible threat works, because boards will try to avoid a negative vote if possible.

Some observers argue that there should be rather firm-specific versus mandatory SOP, pointing to the fact that many firms have voluntarily adopted SOP amendments to their corporate charters through shareholder votes. The problem with a voluntary “firm-specific” regime is that firms with concentrated ownership or entrenched boards need not comply so minority shareholders remain unprotected. If SOP is a good governance device, then it would need to apply to all firms so that the bad guys cannot deviate. There is a lot of discouraging empirical evidence about voluntary “comply-or-explain” corporate governance codes showing that the fail to work in almost in all European countries (except maybe the UK).[11]

B. What information will be needed for investors to make effective use of “Say on Pay” communication and voting opportunities?

[11] Dahya, McConnell, and Travlos (2002), The Cadbury Committee, Corporate Performance and Management Turnover, *Journal of Finance* 57, 461-483; Alves and Mendes (2004), Corporate Governance Policy and Company Performance: The Portuguese Case, *Corporate Governance: An International Review* 12.

Following from the above, if shareholders want to make prudent use of a "Say on Pay" vote, they need full disclosure about the compensation of top management, both with respect to the structure and composition of individual pay packages, as well as to the sensitivities of the single elements of the pay package (salary, bonus, stock options, stock, other components) to corporate performance. This information needs to be presented to them in a simple and understandable format. Corporations and their advisors will have to be very innovative and convincing in disclosing the relevant information to their shareholders in a way that they can understand it properly. More than today, remuneration reports will need to be standardized, comparable between firms, and designed as simple as possible, so as the incentive effects are clear. Of course, to standardize the corporate reporting should not lead to streamlining the elements of compensation and thus eliminating competitive variations and innovation. So concurrently, we should encourage the development of better quality professional research to make the reported information comparable for investors. Visualization techniques may provide one useful tool to make compensation contracts understandable again. One size does not fit all, but executive pay should go back to basics again.

V. Conclusion

Should the US wait longer for analyzing the UK experience as Jeff Gordon suggests? In my opinion, there is no benefit of waiting, since there are no big risks to start immediately. After the election of Barack Obama to become President of the US we can almost be sure that SOP is coming. So the relevant question is not if SOP should come but what the requirements are to make SOP an effective tool for good corporate governance. As outlined above, the most important requirement is that shareholders have access to the relevant information on executive remuneration and incentives.

To summarize, SOP is a small step but one in the right direction. It is not sufficient, but is in line with empowering shareholder rights and accountability and with the least side effects compared to alternate measures like manipulating the tax code or capping salaries to a ceiling.