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Executive Compensation, Corporate Governance, and Say on Pay

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Executive Compensation, Corporate Governance, and Say on Pay

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ABSTRACT

This monograph explores the relation between corporate governance and executive compensation and evaluates the conditions under which shareholders can benefit from the right to interfere with the pay setting process by voting on the compensation proposed by the board of directors (Say on Pay). The first part of the monograph lays out the theoretical framework. The second part provides an overview of the origins and country-specific differences in Say on Pay regulation and a detailed summary and evaluation of the empirical literature on the subject.
The continuous growth of executive pay since the early nineties has triggered an intensive academic and public debate about the possible reasons of growing executive pay levels. On the one hand, the shareholder value (or efficient contracting) approach views executive pay in public firms as a means to mitigate an agency problem between shareholders and managers, with pay levels driven by labor market forces. On the other hand, the so-called managerial power approach views the pay-setting process as an agency problem on its own and suggests that weak boards tend to shift rents to the CEO at the cost of shareholders by implementing inefficient compensation arrangements.

In a response to the public concerns about executive pay, regulators have adopted a number of measures to improve the governance and transparency of the pay-setting process, and shareholder rights to influence such process. A key development in this context was the introduction of shareholder votes on the compensation of executives, also referred to as “Say on Pay.” Since its first introduction in the United Kingdom (UK) in 2002, many other countries have adopted different forms of mandatory Say on Pay rules for shareholders of public firms.
that differ in many details such as their enforceability, the timing and the subject of the vote.

In this monograph, we provide a comprehensive summary and survey of the theoretical and empirical literature on Say on Pay. In the first part of the monograph, we study theoretically how a poor governance structure affects the level and structure of executive pay and identify conditions under which Say and Pay could help shareholders to improve it. In the second part of this monograph, we explain the origins and the cross-country differences in Say on Pay regulation and provide a detailed summary and evaluation of the empirical evidence on the subject. Finally, we also discuss potential improvements and point out some fruitful avenues for future empirical and theoretical research.

The core issue among the proponents of the shareholder value view and the managerial power approach is the question of whether executive pay in public firms represents arm’s-length bargaining between managers and shareholders or rent seeking by powerful CEOs. Yet, formal models of executive pay are typically based on the shareholder value view and only a few of them explicitly study the consequences of the firm’s governance structure on its compensation decisions. In Section 2, we propose a framework that allows us to formalize the consequences of a poor governance structure on the board’s compensation decisions and to compare the properties of the contract proposed by a weak board to the optimal contract designed in the best interest of shareholders. This framework serves as a benchmark for studying the economic consequences of Say on Pay in Section 3.

We portray the agency problem between shareholders and managers as a problem of moral hazard. Different from the standard model, we assume that the firm’s compensation decisions are taken by the board of directors and not by the firm’s shareholders. We consider two different approaches to represent the preferences of a board with imperfectly aligned preferences. In our model, either the board maximizes a weighted average of the firm’s expected profit and the agent’s expected utility or the agent’s compensation is determined by Nash bargaining.

We study the optimal compensation contract for both approaches under various restrictions faced by the board when setting the agent’s compensation and compare the solutions with the contract that
maximizes shareholder value. In Section 2.2, we first show that a weak governance structure does not affect the performance-based part of the agent’s pay (and thereby his equilibrium effort) if wealth transfers between the principal and the agent are unrestricted. However, we find that a more management-friendly board optimally transfers a non-decreasing part of the total surplus to the agent by adjusting the lump-sum transfer. Since the agent is risk neutral, the optimal contract is a lease contract so that a weak governance translates into a non-decreasing lease payment. In Section 2.3, we study the optimal contract structure for the case where the agent is protected by limited liability. Here, the fixed contractual payment takes its lowest possible value, whereas the bonus is non-decreasing in the management-friendliness of the board and/or the CEO’s bargaining power whenever the limited liability constraint is binding.

In Section 2.4, we study the consequences of two possible forms of an “outrage constraint” in the spirit of Bebchuk and Fried (2004). These authors consider this constraint as a natural limit to excessive compensation arrangements without specifying its details. If the outrage constraint takes the form of a self-restraint in setting the agent’s total pay, the board does not adjust the fixed pay component but limits the agent’s bonus to meet the constraint. If the outrage cost takes the form of a disutility if the agent’s pay exceeds a certain limit, its consequences for the individual pay components also depend on their perceived marginal cost. Particularly, if performance-based pay triggers less outrage than raising the salary, the board offers the agent a contract with a lower salary and a higher bonus in response to the outrage constraint.

A legal reason for a differential treatment of individual pay components is the “million dollar tax cap” of the Internal Revenue Code, Section 162(m). This tax cap limits the tax-deductibility of non-performance-based compensation components to $1 million per year. Drawing on an earlier result in Göx (2008), we demonstrate that this rule could induce a management-friendly board to reward the agent for luck. Interestingly, this outcome would not be optimal in the absence of the tax cap even if the board maximizes the CEO’s utility and completely ignores the interests of shareholders.
Even though a management-friendly board always inflates the CEO’s compensation level in our model, shareholders must not necessarily suffer from this policy. In Section 2.5, we present two formal arguments that challenge this overly simplistic view. First, we show that shareholders strictly benefit from a moderately management-friendly board if it has superior information about the agent’s marginal contribution to firm value. In such a case, delegating the compensation decision to an informed incumbent board that favors the CEO can yield a higher shareholder value than an uninformed replacement with perfectly aligned interests. Second, drawing on Laux and Mittendorf (2011), we also demonstrate that the need to provide the CEO with incentives for the search of profitable investment projects can render a management-friendly board beneficial to shareholders.

The analysis of Section 2 shows that the pay-setting process is a complex problem that depends on a large number of observable and unobservable factors. A sound understanding of these factors and their interplay with the board’s compensation decisions is important for shareholders and other outside parties seeking to evaluate the efficiency and desirability of real-world compensation arrangements.

In Section 3, we extend the core model from Section 2 to study the economic consequences of Say on Pay. In Section 3.1, we begin the analysis with the advisory Say on Pay model as it is used in the Anglo-Saxon countries. We show that an advisory Say on Pay can be a powerful instrument for shareholders to interfere with the compensation policy of the board. Its effectiveness critically depends on the consequences of a negative shareholder vote faced by the board of directors. The stricter the regulatory environment, the higher the willingness of the board to limit the agent’s compensation to avoid a negative voting outcome. However, this mechanism is only unambiguously desirable from a shareholder perspective if they possess the relevant information to determine the efficient compensation level. Otherwise, shareholders run the risk to distort erroneously the compensation policy of a board acting in their own best interest.

In Sections 3.2 and 3.3, we study the consequences of two forms of the binding Say on Pay model as used in some European countries. We first study the case where the binding Say on Pay vote is retroactive
and show that it creates a hold-up problem on the part of shareholders that could destroy shareholder value if the contractual obligations from the compensation contract are subject to shareholder approval. The reason is that short-term oriented shareholders have a strict incentive to disapprove all bonus payments once the CEO has supplied his effort level. If the CEO anticipates this outcome, he will have insufficient effort incentives in the first place.

Next, we study the case where the binding Say on Pay vote is prospective and show that the hold-up problem can be avoided if the shareholders must approve the agent’s compensation contract before he chooses his effort level. However, we also find that the threat of disapproving the agent’s compensation ex ante is only effective if the shareholders do not have full control over the pay level proposed by the board. Otherwise, the threat to disapprove the compensation contract proposed by a management-friendly board is empty because there is always a contract that yields the same shareholder value without destroying the agent’s effort incentives.

In sum, the analysis of Section 3 suggests that Say on Pay is a complex and powerful instrument in the hands of shareholders to influence the board’s compensation decisions. Its effectiveness and desirability from a shareholder perspective critically depend on the incentives and the information of the parties involved in the pay-setting process as well as on the organization and the legal and economic consequences of the vote.

In Section 4, we provide an overview of the empirical research on the subject. Section 4.1 provides a brief history of Say on Pay, placing it in the broader context of the trend toward greater shareholder democracy. Sections 4.2 and 4.3 review the empirical evidence on the effect of advisory Say on Pay votes, respectively, on executive pay and firm value, both in the United States (US) and in other countries. Section 4.4 reviews the corresponding evidence regarding binding Say on Pay regimes and Section 4.5 discusses other issues related to Say on Pay votes. Overall, across various countries adopting Say on Pay, a few common findings emerge.

First, failed Say on Pay votes are rare, though cases of significant voting dissent are not uncommon (and are generally more frequent than on other items voted upon at annual meetings). This may indicate
that executive pay problems may not be as widespread or that a large fraction of investors are reluctant to interfere with and micromanage the pay-setting process. Voting dissent appears to be higher at firms with excess CEO pay (i.e., high pay and poor performance) and firms with compensation provisions viewed as reducing pay-for-performance. In many countries, proxy advisors play an important role in shaping shareholders’ votes.

Second, with respect to its effect on executive pay, the adoption of Say on Pay and adverse Say on Pay votes are followed by an increase in pay-for-performance sensitivity, while pay levels do not seem to be much affected (though there is some evidence of a decline in the growth rate of pay levels). Firms often directly respond to adverse votes by engaging with institutional investors and changing compensation contracts to remove those controversial provisions that caused the adverse vote (the specific provisions vary across countries, but the common trait is that they are viewed as weakening the pay-for-performance link).

Third, with respect to the effect on firm value, most studies document a positive stock price reaction to events suggesting the future adoption of Say on Pay (at the country- or firm-level), though the stock price reaction to Say on Pay-induced actual compensation changes is either negative or insignificant. One possibility for these apparently conflicting findings is that investors’ (positive) expectations of the effects of the Say on Pay regime have not materialized. Another potential explanation is that those expectations were not driven by anticipated improvements to compensation contracts but other anticipated side benefits of Say on Pay (e.g., greater pressure on management to perform well to avoid an adverse vote; better communication between boards and management).

In Section 5, we close this monograph with some conclusions and suggestions for future research. Finally, we need to add a few caveats: first, the research on Say on Pay continues to grow as more data become available over time and across countries. Thus, some of the studies cited here are in the form of working papers and their findings should be viewed as preliminary. Second, while we tried do perform a comprehensive review, it is possible we missed some studies. Finally, we apologize if we do not discuss in equal depth all the studies and tend to focus instead on the work (and journals) we are more familiar with, including our own.
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