2013

Say Pays! Shareholder Voice and Firm Performance

Maria Guadalupe
INSEAD

Vicente Cuñat
London School of Economics

Mireia Gine
University of Pennsylvania

Policy Paper No. 2013-015

Citation

Guadalupe, Maria, Vicente Cuñat, and Mireia Gine. 2013. "Say Pays! Shareholder Voice and Firm Performance." Policy Paper No. 2013-015. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research. https://doi.org/10.17848/pol2015-015

W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH
Researching the causes and consequences of unemployment

Policy Paper No. 2013-015

Say Pays! Shareholder Voice and Firm Performance

Maria Guadalupe
INSEAD, CEPR, IZA, and NBER
email: maria.guadalupe@insead.edu

Vicente Cuñat
London School of Economics

Mireia Gine
University of Pennsylvania, WRDS, and IESE Business School

February 2013

Abstract

This paper estimates the effect of increasing shareholder "voice" in corporations through a new governance rule that provides shareholders with a regular vote on pay: Say on Pay. We apply a regression discontinuity design to Say on Pay shareholder proposals to deal with prior expectations and the endogeneity of internal governance rules. Adopting Say on Pay leads to large increases in market value (5.4 percent), firm profitability, and long-term performance. In contrast, we find small effects on the level and structure of pay. This suggests that Say on Pay operates as a regular confidence vote, increasing efficiency, and market value.

Key Words: Agency Cost, Corporate Governance, Shareholder Meetings, Regression Discontinuity, Event Studies

Say Pays! Shareholder Voice and Firm Performance

Executive pay is recurrently a source of controversy: from the corporate scandals that led to Sarbanes-Oxley, to the discussions of the causes of the 2008 financial crisis and the hotly debated cases of "pay for failure." Shareholders' concerns have questioned not only the level of compensation but also its link to performance. These concerns motivated the inclusion of a Say on Pay law in the 2010 Dodd-Frank Financial Regulation Act. Following the act, and starting in 2011, all U.S. firms had to offer their shareholders a regular advisory vote on whether they approve of the relationship between executive pay and performance in their companies: a "Say" on pay. Say on Pay essentially provides shareholders a mechanism to express their "voice" within the firm, in an environment where—given current corporate governance rules and regulations—shareholders have rather limited ability to impact how their companies are operated and their executives are paid. Its advisory nature implies that boards do not have the obligation to follow the shareholders' majority view, though.

Proponents have argued that Say on Pay strengthens shareholder oversight and limits executive compensation excesses, while critics contend that Say on Pay will not effectively monitor compensation, and consider it to be an intrusive policy that undermines the power of the board and can be very costly to the firm.

However, to date there is limited evidence of the effect of Say on Pay on firm value, executive compensation, and performance. The policy has been compulsory for some time in other countries such as the Netherlands, Norway, and the UK. Existing evidence for the UK, where Say on Pay regulation was introduced in 2002, suggests that the policy increases the sensitivity of CEO pay to poor performance; that is, it may curb "pay for failure" (Ferri and Maber 2013; Balachandran, Ferri and Maber, 2008). But, to date, there is no evidence on the effect of adopting Say on Pay on firm performance, or on the actual response of U.S. firms to such policy.

OUR APPROACH

This paper provides a causal estimate of the effect of Say on Pay on firm outcomes and executive pay policies by exploiting the vote outcomes of shareholder-sponsored Say on Pay proposals at annual meetings in the years prior to the Dodd-Frank Act.

In order to have a controlled experiment and to establish a causal estimate that policymakers can effectively use to assess the potential consequences of the Say on Pay law, ideally we would like to randomly allocate this policy measure to different firms and examine their subsequent stock market reaction and pay policy changes. For obvious reasons, this is not a viable procedure; however, Say on Pay shareholder proposals voted in annual meetings provide a quasi-experimental setting.

Between 2006 and 2010, shareholders in 258 U.S. firms (belonging to the S&P 1500) proposed to adopt Say on Pay through a shareholder proposal in their annual meeting. In 170 of the votes, the proposal obtained 40–60 percent support, with an average vote in favor of 43 percent. The proposals effectively passed in 55 of the cases. Our approach is to use a regression discontinuity design that compares the stock market reaction and other outcomes to Say on Pay proposals that pass by a small margin to those that fail by a small margin. The intuition behind this strategy is that the average characteristics of a firm in which a Say on Pay proposal passes with, say, 50.1 percent of the votes are similar to those of a firm in which the proposal gathers only, say, 49.9 percent and fails to pass. However, this small difference in the vote share leads to a discrete change in the probability of implementing these proposals: proposals around the majority threshold that pass are 30 percent more likely to be implemented. In other words, for close-call proposals, passing is akin to an independent random event that is correlated with the implementation of the proposal but is "locally" exogenous and therefore uncorrelated with other firm characteristics. We show that for votes around the majority threshold, passing is uncorrelated with observed firm and meeting characteristics. Moreover, it is precisely for these close-call proposals that the vote contains substantial information—switching from an unpredictable outcome to either pass or fail—that is not already fully incorporated in stock market prices prior to the actual vote. This estimation strategy (technically referred to as a "regression discontinuity design") improves on other potential empirical approaches, such as comparing all firms that voluntarily implement Say on Pay (which is potentially correlated with firm characteristics), or using the current compulsory implementation in the Dodd-Frank-Act (which is problematic given that the act bundles many proposals).

Results On Shareholder Value

With this strategy in hand, we evaluate the effect of Say on Pay on the stock market value of the firm (which reflects investors' valuation of the firm and hence of the value of these proposals); on executive compensation and its different components; and on performance measures such as earnings per share, Tobin's Q, earnings, and labor productivity.

We find that Say on Pay significantly increases shareholders' value. On the day of the vote, a Say on Pay proposal that passes yields an abnormal return in the stock market of 2.7 percent relative to one that fails. There are significant additional returns on subsequent days going up to a cumulative abnormal return of 3.8 percent one week after the vote. Given that the shareholder vote outcome is not binding, the stock market reaction to the passing of a proposal should take into account the probability with which the proposal will be implemented. Using our estimated probability of implementation of 50 percent, we calculate that implementing Say on Pay delivers an increase in shareholder value that ranges from 5.4 percent to 7.2 percent. This is a very significant effect that suggests that investors expect an increase in the value of the firm from the adoption of the Say on Pay proposals.

Effect Of Say On Pay On Firm Performance

There are at least two reasons why performance may increase when the firm implements Say on Pay. First, if Say on Pay implies a stricter alignment of pay with performance, these improved incentives would make the CEO more effective at generating higher profits. Second, if it facilitates more efficient monitoring, the annual vote on Say on Pay may work as a vote of confidence to the CEO, providing enough pressure to deliver a better performance at the risk of being dismissed if the vote does not pass. In addition, the fact that there is a new established venue for expressing shareholders' "voice" lowers the cost of coordinating and aggregating shareholders opinions regarding management and increases the incentives to monitoring.

Our results show that one year after the vote, firms that passed Say on Pay experience a significant improvement in firm performance relative to the firms where the proposal did not pass. We observe significant increases in earnings per share, return on equity, return on assets and Tobin's Q, and a reduction in overhead costs (SG&A). We also find that they have a significantly higher increase in sales per worker (21.5 percent higher growth one year after the vote and a further 24.9 percent increase two years later). This improvement in sales per worker seems to reflect partly a reduction in the number of employees, one year after the vote, but most of it occurs through an increase in firm sales. This seems to suggest an improvement in productivity.

Effect Of Say On Pay On CEO Compensation

The effects on compensation are generally smaller. We do not find large systematic changes in the level or structure of CEO compensation. We also find that CEOs are not more likely to leave the firm following a positive Say on Pay vote.

Given that performance at the Say on Pay firms is improving, arguably resulting from higher effort from management, it is not surprising that there are no dramatic changes in pay: to the extent that pay is linked to performance, and performance increases, pay can remain unchanged even if shareholders are stricter on pay awards given a level of performance (and reduce stock and option grants). This suggests that while Say on Pay may tie compensation more closely to performance, our results rule out that it leads to an across the board reduction in compensation.

Changes In Firms Following Say On Pay

In sum, we find that shareholder value as reflected by the stock market significantly improves, and so does firm performance one and two years after the vote takes place in these firms. In contrast, we find limited changes in compensation levels or structure, with firms being less likely to grant stock options and restricted stock, but no dramatic changes in the level of compensation.

These results suggest that rather than curbing pay, Say on Pay provides an automatic mechanism that allows shareholders to express dissent. Current corporate governance rules and regulations in the United States grant limited power to shareholders to express their voice on the performance of the board and executives of their companies. Say on Pay votes are held regularly, and they do not require an explicit intervention of shareholders other than sending in their vote. Furthermore, since compensation is benchmarked against performance, Say on Pay votes resemble an annual confidence vote in which shareholders approve or reject the CEO's performance. This empowers shareholders, who have a mechanism through which they can punish a CEO for poor performance. Even though the votes themselves are of an advisory nature, they are very visible and can also serve as a coordination mechanism for further votes to remove management. The process also requires CEOs to disclose more information about pay, and to present a coherent discourse about their past and planned performance. If shareholders have more information and a better way to discipline managers, their monitoring is more effective and the incentives to monitor are higher. This improved mechanism to express their voice seems to be one reason for the increase in performance.

Given the Estimated Positive Effects, Why Don't More Firms Voluntarily Adopt Say On Pay?

Our results suggest large positive performance effects of Say on Pay, both in terms or market value and effective measured performance. These very positive results beg the question of why don't all firms implement this policy independently?

It must be noted that even in the firms where these proposals passed and garnered the positive stock market and performance effects that we estimate, management systematically advised shareholders to vote against the proposal. In the proxy materials mailed to shareholders, management states a recommendation on any proposal included by shareholders to be voted on. In all but a couple of shareholder Say on Pay proposals, the management recommendation was to vote against them. This suggests that while Say on Pay is beneficial for shareholders at these firms, management and boards are averse to implementing it. This difference in interests is a concern from a corporate governance perspective, since managers and boards should be implementing policies that are in the ultimate interest of the owners of the firm, the shareholders. Our study does not allow us to tell the source of this divergence. However, to the extent that management seems to put impediments to the adoption of policies that favor shareholders, and that shareholders have difficulties in passing these measures, this may be a setting where government policy can intervene to alleviate the asymmetry.

Extending Say On Pay To All Firms?

While we have a good estimate of the effect of Say on Pay on firms where shareholders proposed to adopt this policy between 2006 and 2010, in order to extrapolate the effect it may have on firms in the economy at large, as would be the case with a regulation such as that included in Dodd-Frank, we need to have a sense of how firms in our sample compare to the average firm in the economy. The firms in our sample are those in the S&P 1500 with a shareholder proposal to adopt Say on Pay. We explore how these firms differ from other firms in the S&P 1500 and find that the main difference is that although targeted firms are significantly larger (in terms of market value and number of employees), they do not have systematically different performances. Thus, while one should be very cautious about extrapolating our results on firms where shareholders decided to adopt Say on Pay to the average firm, it does not seem that targeted firms were different along any dimensions other than size. This means that it was not under- or overperforming firms that were more likely to adopt the proposal, such that one can more easily extrapolate our results to other firms in the economy, since these were similar to the ones in our study.

CONCLUSIONS

Our results show that adopting a Say on Pay proposal can increase shareholder value by up to 5.4 percent. It also leads to a significant increase in a firm's operating performance, earnings per share, and labor productivity, suggesting that the ability of shareholders to express their opinions on the relationship between performance and compensation leads managers to improve their performance. This suggests that at least for the firms that proposed to adopt Say on Pay in the United States between 2006 and 2010, the concern that the policy would have a detrimental effect on firm performance seems unwarranted.

We do not find large systematic changes in the level of CEO compensation. However to the extent that executives are delivering higher performance to their shareholders, it seems that pay is more closely related to performance following Say on Pay.

In the debate of whether Say on Pay would be excessively costly, ineffective, or have positive effects on firms, our evidence points to the fact that having an annual vote to approve the executive's compensation plan creates a new channel for shareholders to voice their opinions regarding management. This channel lowers the costs of coordinating and aggregating shareholders' opinions and therefore increases the incentives to monitor. This in turn increases executives' efforts and firm performance. Given that management was systematically opposed to these proposals, firms apparently were not completely able to self-regulate and independently adopt measures that benefited shareholders. This is a setting where a government-mandated Say on Pay policy, such as the one incorporated in Dodd-Frank, is likely to have a positive effect on the governance of U.S. firms and their performance.

REFERENCES

Balachandran, Ferri and Maber. 2008. "Solving the Executive Compensation Problem through shareholder votes? Evidence from the U.K" mimeo.

Ferri, F., and D. Maber. 2013. "Say on Pay Votes and CEO Compensation: Evidence from the UK." Review of Finance 178: 527–563.