INTRODUCTION

For the past four decades, skyrocketing pay for corporate executives has stirred public debate. According to the Economic Policy Institute, CEO pay rose 875 percent between 1978 and 2012. The New York Times recently reported that the median pay package for the top 200 CEOs rose 16 percent from last year to $15.1 million. And according to the Institute for Policy Studies’ recently published annual report on executive pay, “The pay gap between large company chief executives and average American workers has grown from 195-to-1 in 1993 to 354-to-1 in 2012.”

Lawmakers have made sporadic efforts over the years to slow the rise of CEO pay. Most recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included a number of important corporate governance provisions that take critical steps toward dealing with the problems of excessive executive compensation. To date, however, only one of those Dodd-Frank provisions on executive pay has actually been implemented. The Say-on-Pay provision allows shareholders an advisory vote on proposed executive compensation packages.

EXECUTIVE SUMMARY

Of the few provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act that address governance of excessive executive compensation, the Say-on-Pay provision is the only one that the U.S. has actually implemented. Critics argue that Say-on-Pay has been a colossal failure in the three years that it has been in effect, and that very few shareholders feel strongly enough about CEO pay to vote against CEO pay packages. This policy note presents the key economic research on the measurable impacts of Say-on-Pay in both the U.S. and the UK, the latter of which has had a version of Say-on-Pay in force for much longer. Drawing on this evidence, this paper argues that while Say-on-Pay alone will not slow the rise of CEO pay, the policy does have some measurable effect on CEO pay practices. Further, Say-on-Pay can enhance corporate governance practices by improving lines of communication between companies and their shareholders. Along with Say-on-Pay, it is critical that we pursue a range of policies that address the problems of executive compensation.

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Has Say-on-Pay played a role in constraining pay raises? According to Jesse Eisinger of ProPublica, “The ‘Say on Pay’ experiment is a bust. The Dodd-Frank Financial overhaul gave shareholders the ability to vote on the pay packages of top executives, and it turns out that they fall over themselves to approve.” Eisinger’s is a common conclusion that is often born out of legitimate frustration with how little Wall Street has been taken to task for the economic havoc it has wreaked on the global economy.

But is this conclusion accurate? Is Say-on-Pay a colossal failure? This policy note argues that while CEO pay continues its determined ascent up a seemingly limitless mountain of cash and stock grants, there is evidence, both in the United States and in the United Kingdom, that the policy is changing the most egregious pay packages. It also seems to be fostering better dialogue between corporate leaders and shareholders. However, Say-on-Pay is far from a silver bullet and should be viewed as one of a constellation of policies that target the problems associated with skyrocketing CEO pay. This policy note describes the reasons that rising CEO pay is problematic, Say-on-Pay’s history, and what the academic research shows about the policy’s respective impact in the U.S. and the U.K. It concludes with some commentary and recommendations.

WHAT IS WRONG WITH HIGH EXECUTIVE PAY?
Aside from the acute symbolism of economic inequality in America, especially as million-dollar bonuses were doled out in the midst of the worst economic crisis in decades, what is so problematic about the U.S.’s high and rapidly rising CEO pay? Economists are increasingly concerned that the structure of executive compensation encourages CEOs to engage in behavior that is economically inefficient in the long run, unreasonably risky, or even fraudulent, which can be harmful to companies, shareholders, and the economy at large. Highly paid executives, in this line of thinking, are likely to put short-term returns ahead of their companies’ long-term sustainability, especially when their pay comes in the form of stock options. There is also some evidence that the heavy use of stock options for executive compensation encourages executives to replace investment spending with stock buybacks in order to drive up earnings per share.

Mishel and Sabadish of the Economic Policy Institute argue that executive pay (along with financial sector pay) has been a major driver of the growth in income inequality over the last few decades. In addition to the well-documented societal consequences of widening inequality, there are several studies that suggest that when average workers’ pay stagnates while executives’ pay skyrocket, productivity suffers. For example, Cowherd and Levine state, “our findings indicate that product quality may be diminished when high wages for the upper echelon are not matched by high wages for lower-level employees.” Likewise, many recent studies have convincingly shown that firms in which lower-ranking employees also benefit from profitability outperform other firms.

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3. The SEC issued their proposal on September 18, 2013 and will decide the final rule after a public comment period.


SAY-ON-PAY IN THE U.S.
Several OECD countries have Say-on-Pay provisions, including the U.K., Switzerland, and Australia. In the U.S., Congressman Barney Frank supported the country’s first effort to give shareholders the right to vote on executive compensation packages with the 2007 Shareholder Vote on Executive Compensation Act. The bill passed in the House but not the Senate. Around the same time, shareholder groups began attempting to place proposals in proxy statements requesting votes on executive pay, and a few corporations began voluntarily giving shareholders the right to vote on compensation. In 2009, the American Recovery and Reinvestment Act required Say-on-Pay for Troubled Asset Relief Program (TARP) recipients as an additional measure of accountability for corporate failures, demonstrating an understanding of the link between risky behavior and high pay. Finally, provision 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act imposed Say-on-Pay on most U.S. corporations beginning with their annual meetings on or after January 21, 2011.

Companies are required to hold a Say-on-Pay vote at least once every three years. The determination of whether Say-on-Pay will be annual, biannual, or triennial is also voted on by shareholders and is known as the Say-on-Frequency. The Say-on-Frequency, or Frequency Votes, must be held the first year that Say-on-Pay applies and at least once every six years thereafter. The results of the Say-on-Pay and Say-on-Frequency votes must be reported along with other meeting results on the 8-K Form, which is filed with the Securities and Exchange Commission (SEC). The 8-K form is required within 150 days after the date of the shareholder meeting, but no later than 60 days before the shareholder proposals seeking to be included in the company’s proxy are due.¹¹

Given that the United States’s Say-on-Pay rule is so new, academic research evidence on its impact is scarce. In 2011, 37 companies (1.4 percent) explicitly failed their votes, 57 (2.6 percent) in 2012, and, as of September 4, 50 (2.45 percent) in 2013.²¹ As Chart 1 illustrates, the typical vote falls in the 90-100 percent range. But winning a Say-on-Pay vote is not enough. Proxy advisors, such as Glass Lewis and ISS, assert that when at least 25-30 percent of shareholders vote against a pay package, that is cause for scrutiny of the company’s corporate governance processes (e.g. the election of compensation committee members and sometimes the full board).³ In 2011, 8 percent of U.S. companies’ packages passed with less than 70 percent of shareholders in support; in 2012 and 2013, 9 percent. Adding those percentages to the companies whose packages were explicitly voted down, between 9.4 percent and 11.6 percent of U.S. corporations received a condemnation from their shareholders about their CEO pay practices - certainly not an indication that shareholders are eager to approve.

The U.S. academic literature that examines the causal relationship between levels and kinds of pay and shareholding voting patterns is still meager.

• Kimbro and Xu examined the first two years of Say-on-Pay and found that shareholders’ rejection of pay packages is linked with lower returns, higher share volatility, and excessive compensation.⁴

• Balsam and Yin examined the impact of the first year of Say-on-Pay in the U.S. They found evidence that firms modified their compensation packages prior to voting to win shareholder approval for their executive

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compensation. “In particular we find decreases in the CEO compensation for affected firms in 2010 [the year prior to Say-on-Pay’s implementation], with larger decreases found for firms that overpaid their CEOs in the previous year” (22). In addition, they found that affected firms shifted their compensation mix to more performance-based compensation in 2010. Shareholders are more likely to vote against executive compensation when the firm pays a “large absolute amount of compensation, has a large increase in CEO compensation from the prior year, or has a larger amount of compensation that cannot be explained by economic factors” (22). Among various dimensions of the compensation package, shareholders are more likely to vote down a package when they contain “other compensation,” i.e. private jets, country club memberships, etc. Finally, they found evidence that firms that reduced their compensation in 2010 in advance of the first Say-on-Pay vote received higher approval numbers for CEO pay packages.15

• A report written by Eguilar states that a majority of companies that failed their votes reported lower shareholder returns and larger pay packages than half their peers. Additionally, the most common reason corporations fail their Say-on-Pay votes is a disconnect between pay and performance for their CEOs.

SAY-ON-PAY IN THE U.K.

By contrast with the American academic evidence, Say-on-Pay has generated a raft of studies in the U.K. since it was implemented in 2002. After much public outcry about climbing executive pay in the face of stagnating workers’ wages, in the early 1990s, U.K. legislators began to address the issue with a series of recommendations and reports calling for more disclosure of how executive pay is determined. In August 2002, the U.K. government introduced new legislation, the Directors’ Remuneration Report Regulations, to increase “accountability, transparency, and performance linkage of executive pay.”16 Research on the British experience has been extensive and is summarized as follows:

• Ferri and Maber state that, controlling for market factors like firm performance and size, Say-on-Pay does not appear to push down overall executive compensation levels in the U.K. or slow its growth. They do find, however, that Say-on-Pay communicates shareholders’ sensitivity to poor performance and that U.K. corporate boards tend to respond to issues like golden parachutes when there is a strong disapproving message from shareholders.17

• Carter and Zamora find that, the proportion of shareholder votes against CEO pay proposals is higher when the CEO salary is higher, when there is weak sensitivity between pay and poor performance (i.e. when performance is poor and pay is not reduced accordingly), and when there is greater potential for equity dilution from stock-based compensation (especially stock option pay). Furthermore, corporate boards respond to shareholder votes by curbing salary increases, diluting stock option grants, and improving the relationship between bonuses and performance.18

• Finally, Conyon and Sadler compare voting on pay resolutions to voting on non-pay resolutions. They find that less than 10 percent of shareholders vote against the compensation proposal or abstain from voting on compensation and that this percentage is falling over time. However, investors are more likely to vote against Say-on-Pay resolutions than against non-pay resolutions (e.g. electing a director to the board or appointing auditors). Firms with higher CEO pay attract greater voting dissent. But they find limited evidence that Say-on-Pay alters the average level and structure of CEO compensation.19

Amongst this somewhat nuanced research evidence, a few core patterns stand out. Both the U.S. and U.K. research suggests that shareholders show displeasure by voting down pay packages when that pay does not accurately reflect the CEO’s job performance and when the stock options in pay packages diminish the value of their own stock. Corporate boards tend to adjust egregious pay packages in response to shareholder disapproval and concerns about stock dilution.

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17 Ibid.
ENHANCING COMPANY-SHAREHOLDER DIALOGUE FOR BETTER CORPORATE GOVERNANCE

Some critics argue that Say-on-Pay is toothless because it requires an advisory vote. While binding votes would certainly have more impact, advisory Say-on-Pay still serves as a market signal. It communicates shareholder perceptions of executive performance and corporate pay practices, which creates opportunities for better governance.

According to Pamela Park of Business Law Currents, of the 57 companies that failed their Say-on-Pay votes in 2012, only eight failed to achieve majority shareholder support in 2013. Park argues that the increased shareholder approval is the result of companies’ engagement with their shareholders, “which has led to significant changes to companies’ corporate governance practices and pay structure.” For example, Viad Corp, after its epic failure (21 percent approval), aggressively solicited feedback from its shareholders about their concerns and made a variety of changes, including adopting new performance goals, developing a new “peer group” of executives with which to benchmark its pay practices, and implementing a holding period on restricted stock for executives who haven’t met their stock ownership guidelines. In 2013, Viad’s executive compensation was approved by 96.3 percent of shareholders, a clear success following the feedback process the company undertook after its 2012 failure.

POLICY RECOMMENDATIONS

A review of the research on Say-on-Pay shows that it can succeed at constraining the most egregious corporate pay, especially at corporations that are not returning value to their shareholders. Further, Viad’s corporate governance changes from 2012 to 2013 are striking and demonstrate how Say-on-Pay can enhance corporate governance. But Say-on-Pay will never be a panacea for solving the problem of excessive CEO pay in the U.S. Shareholders alone will never put enough countervailing pressure on companies to slow down the growth of CEO pay because of their own conflicts of interest. Mutual funds own more than 20 percent of all shares in U.S. public companies. This gives them extraordinary influence in determining executive pay at these companies, but mutual funds manage company pension and 401(k) plans and are directly retained by the very managers whose pay packages they are asked to approve. Indeed, a 2011 AFSCME report revealed that the largest mutual funds – Vanguard, BlackRock, ING, and Lord Abbett – “are the least likely to use proxy votes to align executive pay with performance,” and vastly outweigh the preferences of the smaller funds, which seem to vote against “management-initiated” compensation proposals. During 2012, only 16 percent of mutual fund families voted against Say-on-Pay proposals to constrain executive pay. With this in mind, requiring mutual funds to disclose the corporate accounts they manage, especially the companies for which they are voting on a CEO’s pay package, would strengthen Say-on-Pay.

To apply the kind of political pressure necessary to actually move the needle on skyrocketing CEO pay, we also need to implement policies that address the concerns of other corporate stakeholders, including taxpayers and workers. One way forward is to close the performance pay loophole in the Federal tax code, which costs U.S. taxpayers billion of dollars each year. It is also vital that the SEC follow through with their strong recommendation for provision 953(b) of the Dodd-Frank Act, the CEO-worker pay gap disclosure rule; and finally implement provision 956, which was designed to alleviate the financial risk imposed by stock-option-heavy executive compensation packages.

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