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Say on Pay and Compensation Design

What did say on pay actually say about CEO compensation?

Will shareholder yes votes be as prevalent when stock prices aren't rebounding? The "Financial Times" reported in July 2011 that of the first 2,300 meetings of the Russell 3000 index companies only 1.7 percent (39) had votes of less than 50 percent and an additional 8.2 percent (188) had less than than 70 percent of the vote. Is this a vote of confidence or the first exhibition of newfound protest powers? Really understanding the significance of these votes and what might happen next is not so easy. As one colleague put it, all we are certain of about say on pay is that its arrival has the new-baby effect — it's demanding far more time and energy than expected, and its full impact on the world won't be known for years.

One Impact of This Year's Say on Pay: More Talk

The 2011 proxy season was the first time publicly traded firms in the United States were required by law to solicit from their shareholders advisory yes or no votes on the pay package awarded to the CEO.

I've heard executives, board members, compensation practitioners and shareholder activists all acknowledge devoting a lot of energy to preparing for these inaugural say on pay votes. Companies are increasingly engaging their owners — shareholders (mostly large institutional shareholders) — on the topic of CEO pay and pay practices in advance of shareholder meetings where the votes take place. Companies' proxy statements have evolved to be more transparent, and anecdotal evidence suggests that boards of directors made pre-vote modifications to compensation plans when pushback was particularly strong. But, did the heightened company-shareholder engagement or the transparency

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forced by the say on pay regulation have any systemic or large-scale impact on the level or mix of CEO pay?

Did Say on Pay Change the Way Boards Pay Executives?

Trying to determine if say on pay had a material effect on how companies pay executives is nearly impossible from one year's data, but some observations are compelling. In a forthcoming 2011 report I wrote with Judit Torok from The Conference Board, we analyze the 2009-2010 change in CEO compensation for 2,047 firms publicly listed in the United States. In this year-to-year matched set of companies, we found:

- In every industry, the median CEO received a raise (positive year-on-year change) in total CEO compensation. For example, the median 2009-2010 total CEO pay raise is 26.65 percent in industrial and transportation equipment, 28.64 percent in wholesale trade and 36.15 percent in holding companies. Construction had the smallest median change, 1.12 percent (positive nonetheless).
- The mix of pay shifted some. For example, in the communications industry, the average share of total compensation paid in salary fell by 6.53 percentage points to just over one-quarter (26.12 percent) of total compensation. At the same time, the share in stock awards was up 7.35 percentage points to 28.68 percent.
- On average, salary's share of total compensation fell in all but two of the 22 industries, (with food and tobacco and non-banking financial services seeing less than a one-percentage-point gain in the average salary share). Stock-based pay, on the other hand, increased its average compensation share in 20 of the 22 industries (only food and tobacco and commodities saw modest declines).

That these changes occurred in the year that U.S. say on pay regulation came into effect is not substantive evidence, however, that the say on pay votes caused these changes. A year ago, prior to say on pay, Torok and I computed that the annual median change in total compensation was negative in 12 of 22 industries, with the year-on-year median CEO pay hits ranging from cuts of -1.17 percent in textiles and apparel to -23.38 percent in construction. If 2010's CEO compensation outcomes are due to say on pay, then the new Dodd-Frank regulation caused 12 industries to reverse the pay cutting they inflicted on CEOs the previous year. Disentangling the measureable effects of say on pay will take more time and robust statistical analysis. But rest assured, researchers are working on it.

What Will Happen to Say on Pay in the Future?

In spring 2011 — the time when many shareholders were casting their say on pay votes — many companies in the United States had seen considerable gains in stock prices. The S&P500, for example, rose more than 24 percent between the start of July 2010 through the start of July 2011. What will happen in say on pay votes in a year when the stock market has not done so well?

Imagine a company with a given executive compensation system in place (e.g., salary at a certain level and fraction of at-risk bonus, restricted stock, stock options, other compensation, etc. all known). Suppose stock prices rose (as we saw in spring 2011) and that the say on pay vote was a 90-percent pass. What if the company has the identical compensation system in place (all formulas unchanged) the following year but stock prices fall? How likely is it that the company will now experience, say, an 80-percent pass vote, or a 70-percent pass vote? If such a drop in say on pay affirmation occurs, how much of that percentage point drop in support do you suppose is due to the stock price and not to a change of mind about the quality of the pay system?

In the coming months and years, researchers and practitioners will need to answer many questions, not the lesser of which are:

- What is a good vote of confidence on CEO pay? Does a vote pass at better than 50 percent in favor or should a substantially higher vote share (say, 80 percent or 90 percent or 95 percent) be necessary to demonstrate shareholder approval?
- What should a company do after a negative vote, whether that be less than 50 percent or even less than 70 percent or 90 percent? Some critics of say on pay argue that firms have very little time to do anything about negative votes since by the time information is reported in a proxy the organization is already well into its next fiscal.
- Is the vote is really about pay or, perhaps, some other gripe shareholders have with management?

Only time (and a lot of statistical work) will tell. ws