Say on Pay

Professor Alex Edmans, London Business School
www.alexedmans.com, aedmans@london.edu

This is taken from my 16/2/17 response to the UK government's Green Paper on Corporate Governance. The full response is at http://bit.ly/AlexCorpGov.

1. Question 1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

1.1 Shareholders already have strong powers on pay. Say-on-pay votes give them more voice on pay than almost any other corporate decision (investment policy, CSR, geographical expansion).

1.2 The evidence is that the UK's current advisory regime is working. It has led to (Ferri and Maber (2013)):

1.2.i Higher value for firms with excessive CEO pay, particularly if coupled with poor performance

1.2.ii The elimination of notice periods longer than 1 year (which made it costly to fire executives)

1.2.iii The removal of "retesting provisions" (which lowered targets after they were initially set).

1.3 We can also learn from the 11 countries globally that have implemented say-on-pay. Correa and Lel (2016) find that it reduces pay levels by 7% and increases firm value by 2.4%. Moreover, advisory say-on-pay is more effective than binding say-on-pay, potentially because investors are reticent to vote "no" if a "no" vote is binding and thus likely to cause disruption, or executives require higher pay to compensate for the risk of a voided contract (as any stakeholder would do).

1.4 The evidence does not suggest that advisory votes are ignored and shareholders need more "teeth"

1.4.i In the UK, a company that receives less than 80% shareholder support increases its support the next year by an average of 17% (source: PwC). Thus, firms do respond to shareholder concerns.

1.4.ii Ferri and Maber (2013) find that a say-on-pay dissent vote of 20% (well below a majority vote) results in boards implementing 75-80% of shareholder requests on pay.

1.4.iii As the Green Paper notes, the average support is 90-95% and only six companies have lost a vote. Thus, it is not clear that there is a problem that shareholders need more power to fix.

1.5 Thus, when shareholders vote, their votes already have substantial power. Instead, the focus should be to encourage voting in the correct way. Two dimensions can be improved:

1.5.i As the Green Paper notes, 28% of votes in FTSE 100 companies are not cast.

- Note that increasing turnout alone should not be the focus. If these non-voters are uninformed, the quality of decision-making would not be improved by them voting. Instead, we should ensure that these votes go to informed voters.

1.5.ii Even the 72% of votes that are cast may be used in an uninformed manner, for example if the shareholder uses a "rule-of-thumb".

1.6 Out of the options presented:

1.6.i I oppose Option (i) to introduce annual binding votes. The evidence that advisory say-on-pay is working, and that it works better than binding say-on-pay.

1.6.ii I support Option (ii), to "introduce stronger incentives for a company losing its annual advisory vote". It is correctly targeted at the few firms that lose their advisory vote.

- The Purposeful Company's Interim Executive Remuneration Report similarly advocates an escalation mechanism after losing advisory votes.[1]

1.6.iii I strongly oppose Option (iii), to set an upper threshold on total annual pay. This is dangerous as it can lead to executives "coasting" when they approach the threshold, and settle for good rather than great performance

- It is also not clear why an upper threshold is needed. If justified by performance (enlarging the pie), it is not at the expense of anyone. The rhetoric of pie-splitting induces mediocrity.
- Paragraph 1.25 of the Green Paper suggests solving this issue by setting an upper threshold on the number rather than value of shares. Even simpler would be to pay in long-term shares only, rather than LTIPs, which would avoid the need for any threshold.

1.6.iv I support part of Option (iv). I do not think that the existing binding vote should be more frequent for all firms. Too frequent votes could divert investor attention excessively to the pay vote rather than monitoring a firm's innovation and CSR. Indeed, many investors have said that the current focus on pay already distracts them from other forms of engagement. They appoint directors to determine compensation, and many of them issue remuneration principles that already provide directors guidance[2]; they would like directors to do this job rather than passing the decision back to shareholders. It is not clear why investors should have a special vote on pay rather than other decisions delegated to directors, e.g. monitoring of innovation and CSR. However, for some

[1] If a company loses the advisory vote in any year or receives 25% or more "no" votes two years in a row, it must bring forward its remuneration policy to the next AGM as a Special Resolution requiring 75% to pass.

[2] See, for example, https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2016/11/Hermes-Corporate-Remuneration-Principles-141116.pdf

firms, more frequent votes may be desirable. This should be left to shareholders, so that they can determine the optimal frequency for their particular firm.

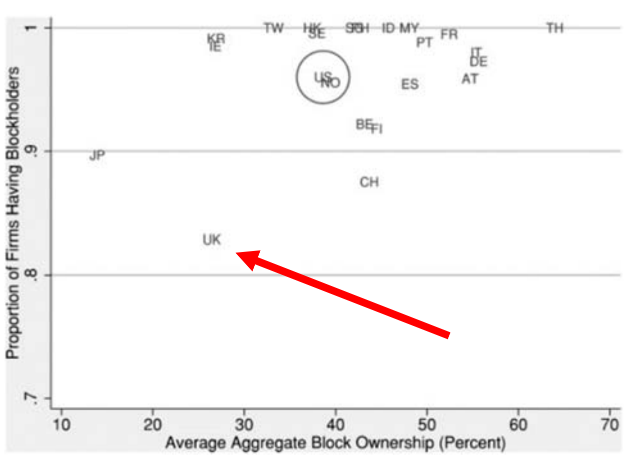
- In the US, there is a "frequency vote" at least once every six years to determine whether the say-on-pay vote will occur every 1, 2, or 3 years. (Say-on-pay is advisory in the US).

1.6.v I support part of Option (v): greater RemCo involvement with shareholders. This is desirable, because shareholders ultimately bear all the consequences of executive pay, including any effect on stakeholder morale or executive treatment of stakeholders.

- I do not support engagement with employees on executive pay. I strongly support employee engagement for issues in which they have expertise, and on their own pay. However, executive pay is an extremely complex decision – e.g. the discussion of performance-based versus time-based vesting for equity. Even compensation committees and consultants cannot agree. Employees may focus more on more observable criteria, such as pay ratios, rather than more important dimensions such as horizon. Employees leave a company's R&D policy to scientists; incentive design requires similar expertise.

- Employee support may be heavily influenced by management's treatment of employees, rather than other stakeholders. While employees are critical, so are other stakeholders. Since shareholders are ultimately affected by the stewardship of all stakeholders, they have the incentive to evaluate management performance on all dimensions. Pay may become a political process where executives take short-term actions to win worker support, e.g. boosting short-term worker pay at the expense of long-run training, or other stakeholders.

1.7 A sixth, broader and more far-reaching option should be considered. Instead of giving shareholders stronger power, the focus should be on creating stronger shareholders: blockholders (large shareholders). Large stakes give a shareholder "skin in the game" to engage in extensive research on the correct way to vote. The following chart from Holderness (2009) shows that the UK is a global outlier in having few blockholders (defined here as a 5% shareholder):



1.8 Moreover, blockholders can improve corporate governance generally, over and above "say-on-pay" voting. Blockholders can promote long-term value creation in two ways:

1.8.i Engagement / Voice. A blockholder's large stakes give him both the *incentives* to engage with a firm (since he has skin-in-the-game) and the *power* to do so (due to voting rights). Engagement can involve not only disciplining management (e.g. curbing excessive pay or empire building), but also advising management (e.g. proposing new strategic directions, revamping culture, and acting as a sounding board). There is significant evidence on the benefits of engagement for shareholder and stakeholder value.[3]

1.8.ii Monitoring / Exit. A fragmented shareholder has too little "skin-in-the game" to analyse a company's intangible assets (such as culture). He will thus focus on freely-available short-term earnings – "the market sells first and asks questions later." In contrast, blockholders' large stakes give them the incentives to ask questions first and analyse long-term value (Edmans (2009)). If a firm has delivered low earnings due to investment, blockholders will not sell (and may buy more). Informed blockholders insulate managers from the need to cater to short-term pressures, and free them to focus on long-term purpose. Warren Buffett is an example.

Blockholders also discipline managers against pursuing the short-term. With fragmented shareholders, a manager may inflate the short-term stock price by cutting investment. An informed blockholder will notice such myopic behaviour and sell her stake. The threat of such disciplinary "exit" deters a firm from acting myopically to begin with.

Key to exit is that the blockholder displays *conditional*, not unconditional loyalty. A blockholder who remains with the firm, even if it acts myopically (such as VW's shareholders), will not exert governance. Indeed, Buffett sells if the firm has not built its brand after several years. Causal evidence shows that stock liquidity improves firm value since it enhances blockholder discipline.[4] Contrary to misperception, selling in the short-term does not mean taking a short-term perspective. What matters is not whether an investor *trades* in the short- or long-term, but whether she trades on short-term or long-term *information*. Blockholders, due to their large stakes, have incentives to gather long-term information. Uber's customers recently deleted their accounts to discipline management[5]; similarly, shareholders who sell their shares in a non-purposeful company are exerting discipline rather than being short-termist. We should promote *large* shareholders with long-term perspectives, not *long-term* shareholders who entrench management by remaining with the firm regardless of performance.

[3] Becht, Franks, Mayer, and Rossi (2009), Carleton, Nelson, and Weisbach (1998), Dimson, Karakas, and Li (2015), Brav, Jiang, Partnoy, and Thomas (2008), Brav, Jiang, and Kim (2015), Brav, Jiang, Ma, and Tian (2016).
[4] Fang, Noe, and Tice (2009), Bharath, Jayaraman, and Nagar (2013), Edmans, Fang, and Zur (2013).
[5] I am not taking a stand as to whether Uber's actions merited such discipline; merely emphasising that customers had the disciplinary device of "exit" available to them and that customer discipline is typically seen as desirable.

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