

# 10 myths of "Say on Pay"

**As a new paper argues, "Say on Pay" remains a contentious and misunderstood issue. To clear up some of this confusion, the authors address 10 myths on "Say on Pay."**

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Many companies currently face an unenviable task: how to attract and retain top talent amid a growing public backlash against exorbitant executive pay.

To make matters worse, many of the worst cases of CEO largesse have played out against a backdrop of rising austerity and widening income inequality.

But now the public — and in particular, company shareholders — appear to be pushing back.

The latest manifestation of this trend is the adoption of "Say on Pay" legislation by Western governments.

First required by the British government in 2003, "Say on Pay" is the practice of granting shareholders the right to vote on a company's executive compensation program.

It has subsequently been taken up by other countries — from the Netherlands and Australia to Sweden and Norway — and adopted in the United States as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

While some public anger may be understandable, it does risk forcing economic policy to go from one unhealthy extreme to another.

What's more, as David F. Larcker, Allan McCall and Brian Tayan, of Stanford, and [Gaizka Ormazabal](#), of IESE, [argue in their paper](#), much of the investment community and the public at large still remain in the dark when it comes to "Say on Pay" legislation.

To clear up some of this confusion, the authors highlight what they perceive as 10 common myths on "Say on Pay."

## **Myth 1: There's only one approach to "Say on Pay"**

There's no one-size-fits-all model for implementing "Say on Pay." In some countries, shareholders are asked to vote on executive compensation, while in others, they are asked to vote on the compensation of the board of directors. Also, "Say on Pay" votes can be binding or merely advisory.

Currently, nobody knows which, if any, of these approaches is the best for rectifying compensation problems.

## **Myth 2: All shareholders want the right to vote on executive compensation**

Many believe that shareholders generally want the right to vote on executive compensation, and that making "Say on Pay" a legal requirement leads to improved governance.

This is not supported by research. In 2007, for example, the investors of 38 U.S. companies were given the choice to have the right to vote on executive compensation, yet only two received majority approval.

## **Myth 3: "Say on Pay" reduces executive compensation levels**

Among approximately 2,700 U.S. companies that put their executive compensation plans before shareholders for a vote in 2011, only 41 (or 1.5 percent) failed to receive majority approval.

During 2012, results have been similar, with fewer than 2 percent of companies failing to receive majority approval.

What's more, these trends have held steady, despite the fact that average compensation levels continue to rise.

## **Myth 4: Pay plans are a failure if they don't receive very high support**

Given the weak approval ratings of "Say on Pay," attention has shifted to the pay packages of companies that receive passing, but not overwhelming, support.

In Australia, shareholders have the right to force directors to stand for re-election if the company's compensation plan receives less than 75 percent support in two consecutive years.

The problem here is that supermajority approval might be used by vocal opponents to increase their influence over corporate directors and executives, instead of addressing a true economic need.

## **Myth 5: "Say on Pay" improves pay for performance**

Critics of executive compensation contend that CEO pay is not sufficiently tied to performance, and so recommend voting against any increase in executive compensation if a company's total shareholder return trails the industry average over a given period.

What they fail to take into account is that the amount ultimately earned by an executive often differs materially from the original amount reported in the proxy statement.

## **Myth 6: Plain-vanilla equity awards are not performance-based**

Another common misconception is that restricted stock grants and stock options shouldn't be considered performance-based incentives unless they contain performance hurdles.

However, this ignores the fact that stock options are an effective tool for encouraging risk-averse executives to invest in promising but uncertain investments. They also help to align the interests of shareholders and managers.

## **Myth 7: Discretionary bonuses should never be allowed**

Many governance experts believe that the board should not be allowed to use discretion in determining the size of an executive's bonus, as it signals excessive CEO power and the ability of executives to extract economic rents.

However, this is not always the case. For example, in his 2010 research, Ederhof found that discretionary bonuses are paid based on non-contractible performance measures that are important for future performance.

## **Myth 8: Shareholders should reject non-standard benefits**

Some argue that the payment of large-scale prerequisites and benefits — such as personal use of corporate aircraft and golden parachutes — should be rejected on principle by shareholders.

However, rather than reject such benefits categorically, shareholders should first determine whether they have an economic justification. In other words, they should be evaluated in terms of the actual value they offer the firm.

## **Myth 9: Boards should adjust pay plans to satisfy dissatisfied shareholders**

One of the reasons shareholders delegate authority to a board of directors is that they do not — and cannot — have all the information they need to make optimal decisions regarding a company's strategy. This includes decisions about executive pay packages.

For this reason, and the fact that investors tend to be highly fragmented groups, members of the compensation committee can hardly be expected to adjust executive pay packages to satisfy all shareholders.

## **Myth 10: Proxy advisory firm recommendations for "Say on Pay" are correct**

The recommendations of proxy advisory firms such as ISS and Glass Lewis can be highly influential on voting outcomes and pay, with a number of institutional voters seemingly voting in lockstep with their recommendations.

This wouldn't be a problem if their recommendations were generally sound. Unfortunately, research suggests that proxy advisory recommendations for "Say on Pay" tend to decrease shareholder value and stock options.

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