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Shareholder Say-on-Frequency Vote and CEO Compensation

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Abstract

This study investigates the effect of CEO compensation on shareholder frequency votes, which are non-binding advisory votes on how often a company should hold future say-on-pay votes. We show that shareholders do consider CEO compensation and its components when they cast their frequency votes. On average, shareholders of small firms with high total and excess compensation, poor performance, high percentage of independent directors, low percentage of named executive officers, and institutional ownership are more likely to vote differently from the board recommendations.

I. Introduction

Executive compensation has become a contentious issue brought on by the accounting scandals of 2000–2002, option backdating (Heron and Lie, 2007), and the recent outrage over compensation paid to the executives of the many financial firms greatly affected by the financial crisis. Executive pay package has been criticized for promoting excessive risk taking and playing a part in the collapse of the financial sector (Bhagat and Romano, 2009). Although researchers have examined the impacts of a variety of variables on executive compensation[1], critical questions remain as to whether the levels of executive compensation are “too high” and whether overall pay packages are designed optimally. If the pay packages are indeed "too high," then how do we reduce these alleged outstandingly high pay packages? One possible mechanism is shareholder voting. If shareholder voting can help reduce excessive compensation, how often should shareholders vote on the issue?

This article examines whether shareholders consider CEO compensation when casting their say-on-frequency (SOF) votes, which are non-binding advisory votes on how often a company should hold future say-on-pay (SOP) votes. To the best of our knowledge, no academic study on SOF votes has been conducted to date. In the United Kingdom, a public company is required to hold an *annual* shareholder vote to approve the directors’ remuneration report at the company’s annual general meeting. On January 25, 2011, the US Securities and Exchange Commission (SEC) adopted rules to implement SOP, SOF, and say-on-golden parachutes, collectively referred to as the SOP Advisory Votes.[2] This ruling gives investors “voice” as regards the pay packages of the top executives in US corporations. Whereas the UK rules require annual SOP votes, the US SOP rules give shareholders the right to cast SOF votes, which are non-binding advisory votes on how often a company should hold future SOP votes.

Following the new SEC rules, a company's board of directors makes SOF recommendations, and shareholders cast their SOF votes at the company's annual shareholder meeting. Generally, companies provide a rationale for their frequency recommendations. The most cited reason for a one-year frequency is that it provides the highest level of accountability to shareholders. Companies that recommend a two- or three- year frequency believe that a longer frequency enables a program to run its course before judgment can be made. This condition is especially true for many executive compensation packages with a long-term nature. Shareholders are given four choices with respect to frequency: every year, every two years, every three years, or abstain. As a result, shareholder votes may not be consistent with

[1] The variables include, for example, firm performance (Kim, 2010; Bertrand and Mullainathan, 2001; and Gao (2010), CEO tenure (Ozkan, 2011; Byrd et al, 2010), capital structure (Lin et al, 2012; Ortiz-Molina, 2007), corporate governance (Fahlenbrach, 2009; Ozkan, 2007), and regulation change (Ng et al, 2011; Cremers and Romano, 2011; Cai and Walking, 2011; Huang, (2010); and Lo (2003).

[2] See Ferri and Weber (2009) for a summary of the history of say-on-pay.