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Say on pay effectiveness, corporate governance mechanisms, and CEO compensation alignment

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Abstract Say on pay (SOP) is a relatively new governance mechanism that allows shareholders to pronounce on the suitability on executives' compensation. The literature has mainly examined SOP effects on Anglo Saxon contexts of corporate governance, reporting mixed results and highlighting the need to deepen our understanding of its real impact, as well as its interactions with other mechanisms of governance. Concerning these gaps, the present research analyzes the effectiveness of SOP as a mechanism for aligning CEO compensation in the context of Spanish listed companies – a good representative model of continental European systems of corporate governance–. It also examines the moderating effect of board monitoring and ownership structure. Using panel data and linear regression methodologies on a set of companies from 2013 to 2016, the results show that SOP generally increases the alignment of CEO compensation, although its effectiveness is reduced in companies with overcompensated CEOs and in owner-managed companies.
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Introduction

CEO compensation in large listed companies remains one of the most relevant and controversial topics in current academic debate (Murphy, 2013). Regular, large payments to CEOs highlight the potential for misalignment with firm performance that is generally associated with managerial opportunism (Core et al., 1999; Gomez-Mejia and Wiseman, 1997; Jensen and Murphy, 1990; Tosi et al., 2000). In response to this danger, a set of corporate and institutional mechanisms have been developed to help companies to reduce potential agency conflicts brought about by CEO compensation (Holmstrom, 1979; Jensen and Meckling, 1976; Young et al., 2008). At company level, boards of directors (and compensation committees), the primary and most important governance mechanisms monitoring CEO compensation, have not traditionally been very effective in

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aligning CEO compensation with firm performance (Hermalin and Weisbach, 2003; Ingley and Walt, 2005; Sanchez-Marin et al., 2010). At an institutional level, the implementation of Codes of Good Governance across different countries (e.g., Cadbury Code, 1992; Final NYSE Corporate Governance Rules, 2003), bringing together a set of recommendations to encourage CEO compensation alignment, have not also brought about greater linkage between CEO compensation and firm performance either (Aguilera and Cuervo-Cazurra, 2004).

These inefficiencies have stimulated the emergence of new mechanisms of corporate governance, among which say on pay (SOP) is one of the most noteworthy (Conyon and Sadler, 2010; Ferri and Maber, 2013; Stathopoulos and Voulgaris, 2016). SOP is an initiative launched by the United Kingdom (UK) by the Directors' Remuneration Report (2002), in which, with the purpose of greater compensation transparency (Conyon and Sadler, 2010), the board of directors is required to submit CEO compensation to vote at the Annual Shareholder Meeting. A number of countries have followed the UK with the introduction of similar legislation, including the United States (US), Australia, the Netherlands, Norway, Switzerland, and Sweden. In the European Union, 19 countries have already introduced the SOP mechanism, generally as a legal requirement (European Commission Report, 2010), and Spain has not been immune to this tendency, introducing compulsory SOP voting in the Sustainable Economy Act (Ley de Economía Sostenible, 2011).

Although the result of SOP voting is not usually binding – with the exceptions of Scandinavian countries, Netherlands, Switzerland and Japan, which have enforced a binding model, most Continental European countries as well as Anglo-Saxon countries have implemented advisory systems (albeit the UK implemented the binding model in 2014) –, shareholders can show their (dis)satisfaction and their opinion will be one element in the board's considerations when designing CEO compensation (Conyon and Sadler, 2010; Ertimur et al., 2013). Thus, the implementation of SOP could limit the potential discretion and lack of independence of the board designing CEO compensation, promoting transparency by providing a new means for shareholders to express themselves (Conyon and Sadler, 2010), and hence improving corporate governance efficiency in terms of aligning executive compensation with shareholders' interests (Deane, 2007; Mangen and Magnan, 2012; Pagnattaro and Greene, 2011).

The literature analyzing the effects of SOP is recent and, as such, still sparse. Specific studies examining the consequences of SOP in terms of CEO pay setting process generally has reported mixed results. While some research indicates that SOP is an effective mechanism to align CEO compensation (Cai and Walking, 2011; Ferri and Maber, 2013; Kimbro and Xu, 2016), others do not find clear influences (Alissa, 2015; Conyon and Sadler, 2010), and they may even be directly critical, showing reverse effects of SOP on CEO compensation alignment (Armstrong et al., 2013; Levit and Malenko, 2011). In addition, the effectiveness of SOP within the overall corporate governance framework of the firm remains largely unexplored, and its interaction with other governance mechanisms (e.g., managerial ownership, board independence), as well as with the CEO's power (e.g., entrenchment) has not yet been properly examined. Moreover, the extant literature is largely focused on the Anglo-Saxon environment, with most of papers centered either on the UK (Alissa, 2015; Conyon and Sadler, 2010; Ferri and Maber, 2013; Gregory-Smith et al., 2014) or the US (Armstrong et al., 2013; Balsam et al., 2016; Brunarski et al., 2015; Cai and Walking, 2011; Kimbro and Xu, 2016), which limits the knowledge about the effects of SOP on executive compensation, and its interaction with other aspects of the institutional context of corporate governance with different conditions of ownership structure, shareholders protection, voting rights and capital markets.

Therefore, considering these gaps, and with the aim of drawing a more comprehensive picture of SOP, the purpose of this research is to analyze the effectiveness of SOP as a mechanism for aligning CEO compensation. Specifically, we examine, over a set of 114 Spanish listed companies between 2013 and 2016, both the direct effects of SOP on CEO compensation design and its indirect effects considering the interactive (moderating) influence of other firm governance mechanisms – represented by the board monitoring effectiveness and the ownership structure characteristics. We thus contribute with this research to the literature on shareholder activism, firstly, by increasing the still scarce and contradictory knowledge about the impact of SOP on firm decision-making processes in terms of executive compensation alignment (Krause et al., 2014; Mangen and Magnan, 2012). Secondly, by responding to calls regarding the need to include other firm's corporate governance mechanisms in the analysis of the SOP effectiveness (Stathopoulos and Voulgaris, 2016). Thirdly, by answering the calls concerning the need to incorporate the influence of the institutional environment in the examination of SOP effects on executive compensation practices across countries (Correa and Lel, 2016). Our paper analyzes the impact of SOP in Spain, a representative model of the Continental European system of corporate governance, contributing to a better understanding of SOP consequences by offering a comparison with those in the Anglo-Saxon environment.

The paper is structured as follows. First, the theoretical aspects are set out, leading to the formulation of hypotheses. Then, the methodology is described, to show how the variables are measured and the empirical analyses are performed. Finally, the results are presented and discussed in terms of both academic and practical implications.

Theoretical framework and hypotheses

Positive effects of say on pay

Agency theory proposes that owners of companies should establish governance mechanisms to safeguard their interests in order to minimize conflicts derived from the separation of ownership and management (Holmstrom, 1979; Jensen and Meckling, 1976). Among these mechanisms SOP has been adopted recently for listed firm with the main purpose of monitoring executive compensation (Alissa, 2015; Cai and Walking, 2011; Ferri and Maber, 2013). There are four arguments that support the shareholder-alignment hypothesis (Brunarski et al., 2015) regarding the positive association between a negative SOP voting results and the alignment of CEO compensation with firm performance as a

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