Say on Pay: A wolf in sheep's clothing?[1]

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Abstract

This paper debates whether Say on Pay can fix executive pay. We argue that Say on Pay benefits executive pay when shareholders' voice offsets CEO power and mitigates directors' information deficiencies. We admonish however that Say on Pay may raise novel problems. The pay resulting from Say on Pay can harm stakeholders whose interests differ from those of shareholders influential in pay-setting. Moreover, boards may resist shareholders' intervention in pay-setting and, accordingly, manage compensation disclosures to ensure a passing shareholder vote. Consequently, Say on Pay may not only fail to remedy suboptimal pay but also legitimize it.

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The 2007-2009 financial crisis has renewed public interest in executive pay. A large debate has centered on whether shareholders should be given an annual non-binding vote on the board of directors' recommendations regarding executive pay. This concept, known as Say on Pay, has been endorsed by corporate governance watchdogs, including the Council of Institutional Investors and the Canadian Coalition for Good Governance, as well as by proxy advisory services such as the RiskMetrics Group and Glass Lewis & Co. In 2007, firms in North America began to voluntarily implement Say on Pay. Aflac was the first to do so in the U.S., only to be emulated by about 25 other firms, including Apple and Microsoft. In 2009, over a hundred U.S. firms asked their shareholders if they wish to adopt Say on Pay, as reported by Pearl Meyer & Partners.

This wave of voluntary adoptions was followed by the enactment of mandatory Say on Pay in the U.S. on January 25, 2011: public firms are henceforth required to submit their executive pay plans to shareholder vote at least once every three years.[4] By mandating Say on Pay on a large scale, the U.S. steps into the footprints of countries such as the U.K. and Australia that had already adopted compulsory Say on Pay. Previously, Say on Pay was required in North America only for U.S. firms funded by the Troubled Asset Relief Program. Although Say on Pay is not yet prescribed in Canada, many Canadian firms have voluntarily embraced it, including the "Big Five" banks (CIBC, Royal Bank of Canada, Bank of Montreal, Scotia Bank and the Toronto-Dominion Bank).

Say on Pay aims at ensuring that executive pay is in shareholders' best interests. If Say on Pay is to do so, it needs to be capable of remedying suboptimal pay that harms shareholders. Scholars are far from agreeing whether pay currently is suboptimal, with the debate ranging from those who argue that it is working properly (Kaplan, 2008; Core, Guay, & Thomas, 2005) to those who claim that it is broken (Walsh, 2009; Bebchuk, Fried, & Walker, 2002). We do not

[4] Mandatory Say on Pay in the U.S. is born of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173), which amends the Securities Exchange Act of 1934 and requires a shareholder vote at least once every three years to approve the compensation report disclosed in a firm's proxy statement. The compensation report details the pay of the CEO, CFO and the three other most highly paid executives. A central feature of the compensation report is the compensation discussion and analysis, which provides a narrative discourse and a tabular display of all material compensation aspects. The firm explains the objectives of pay, the elements to be rewarded, the individual pay components and the reasons for choosing them, the determination of each component's amount, the extent to which each component fits into the overall pay objectives and affects other components. Pay disclosures are similar in the U.S. and Canada.

wish to add to this debate; rather, we ask if Say on Pay can solve problems that cause suboptimal pay.

Optimal executive pay maximizes the combined welfare of the contracting parties, who are the CEO and the board of directors that negotiates on shareholders' behalf. Setting pay optimally requires that directors are free from idiosyncrasies that prevent them from advancing shareholders' interests. Moreover, the board needs to be knowledgeable about all factors that relate to optimal pay, including CEO, job, industry, and/or firm characteristics. Hence, pay fails to be optimal when boards cater to powerful CEOs rather than to shareholders and when information deficiencies prevent directors from considering information relevant for pay-setting.

We discuss whether Say on Pay can remedy these two problems, drawing on management theories that deal with power and information processing, including institutional theory (Selznick, 1957), upper echelons theory (Hambrick & Mason, 1984), power theory (Finkelstein, 1992), agency theory (Jensen & Meckling, 1976) and resource dependence theory (Pfeffer & Salancik, 1978). By analyzing Say on Pay from a management angle, we extend an academic debate that so far uses a legal outlook (Bainbridge, 2008; Gordon, 2006; Cheffins & Thomas, 2001) or an empirical approach (Ferri & Maber, 2011; Alissa, 2009; Cai & Walkling, 2011; Carter & Zamora, 2007).

Our analysis indicates that Say on Pay, by providing shareholders with additional authority, tips the balance of power in the boardroom away from influential CEOs and encourages directors to look out more for shareholders. Moreover, Say on Pay enhances shareholders' input during pay-setting, thereby enriching the board's information environment. Together, these two factors help counter issues relating to CEO power and informational deficiencies in the pay-setting process.

Say on Pay is however no panacea. We argue that Say on Pay can open the door to shareholders' conflicts of interests by transferring power to larger shareholders who have a high tolerance for risk and/or are linked via business ties to the firm. When these shareholders lobby for executive pay that advances their interests, stakeholders such as debtholders, employees or even other shareholders can be harmed. We further caution that Say on Pay may fail to be effective in improving pay when firms manage pay disclosures to ensure a passing Say on Pay vote for suboptimal pay plans. As a result, Say on Pay may even provide legitimacy to suboptimal pay that is then more difficult to subsequently change.

Our paper highlights that behind Say on Pay's potential to improve executive pay lurks a new set of challenges: conflicts of interests afflicting shareholders and managed compensation disclosures. We point towards solutions for these challenges, such as disclosing shareholders' conflicting interests and auditing compensation reports. Our analysis is salient given the debate over enhancing shareholder power, as illustrated by the discussion surrounding the proxy access rule (Schoenberg, 2011). We hope that our analysis raises the awareness about the challenges that accompany shareholder power and provides a step towards resolving them.

1 When do compensation problems arise?

The legal framework in North America vests the duty of setting pay with the board.[5] Corporate charters further delegate this duty to the compensation committee, a subcommittee of the board. The compensation committee determines pay via deliberations between directors who need to agree on the pay level (i.e., "How much is the CEO paid?"), the composition of pay (i.e., "What are the components of CEO pay, including cash pay, bonus pay, equity-based pay, perquisites and pensions?") and the functional form of pay (i.e., "How does CEO pay vary with performance?"). The compensation committee issues its pay recommendations to the board for approval and implementation. As argued next, this process yields suboptimal pay when boards cater to powerful CEOs and process information deficiently. Table 1 displays these two pay problems, their antecedents that we discuss next and the respective remedies that we explore later on.

[5] In the U.S., the most influential state law is that from Delaware, where most public firms are incorporated. Setting executive pay is established as one of the board's duties not by Delaware General Corporate Law but by jurisprudence, such as the Disney case (Brehm et al. v. Eisner et al. 2006). In Canada, directors are required to set pay by the Canada Business Corporation Act that establishes that "Subject to the articles, the by-laws or any unanimous shareholder agreement, the directors of a corporation may fix the remuneration of the directors, officers and employees of the corporation" (Canada Bus. Corp. Act §125, 1985).

Pay Problem	Antecedents of pay problem	Remedy	Drivers of remedy
CEO power	Hiring decisions Director personality Ties between directors and CEO Directors who are CEOs	Increase the resistance of the board vis-à-vis the CEO	Social pressures from pay scandals Political pressures from increased shareholder power Functional pressures from increased goal clarity
Information problems (groupthink, status quo preference)	Excessive demographic and professional homogeneity Networks of compensation consultants and interlocked directors	Enrich the board's information environment	Differing compensation views held by shareholders Opening up blocked information flow in the boardroom via shareholders

Table 1. Pay problems, their antecedents, their remedies and the drivers underlying the remedies

1.1 Power games: Directors beholden to CEO power

Power refers to the "capacity of individual actors to exert their will" (Finkelstein 1992, p. 506). CEO power has various sources, including the CEO's tenure (Shen, 2003), her equity ownership (Cannella & Shen, 2001), her position as a chair of the board (Westphal & Zajac, 1995) as well as her personal prestige and expertise (Finkelstein, 1992). CEO power affects CEO pay: a large literature shows that CEO pay levels are higher when CEOs are more powerful, such as when they chair the board.[6] Research suggests that the higher pay of more powerful CEOs is excessive and not justified by economic factors such as CEO, job and/or firm characteristics

[6] The references regarding the link between the level of CEO pay and CEO power are available on the AMP website. Researchers still disagree about the effect of CEO power on the composition of CEO pay and its functional form (Linck, Netter, & Yan, 2008; Boone, Field, & Karpoff, 2007; Ryan & Wiggins, 2004).

(Core, Holthausen, & Larcker, 1999; Brick, Palmon, & Wald, 2006).[7] In other words, CEO power is associated with suboptimal pay.

There are various reasons for the excessively high pay of powerful CEOs, starting with the director nomination process during which CEOs play a consequential role. According to Spencer Stuart (2010), about a fifth of such nominations in 2010 were initiated by CEOs or insiders. Powerful CEOs tend to nominate more passive directors (Zajac & Westphal, 1996). Passivity can result because of personality traits: some directors defer to authority (Westphal & Stern, 2006), respond to persuasion as well as ingratiation (Westphal & Stern, 2007) and reciprocate favors (O'Reilly & Main, 2010). Moreover, directors confident in the CEO's leadership may relax their monitoring and become less vigilant (Shen, 2003).

Passivity can also result from the various ties between directors and the CEO: Hwang and Kim (2009) report that 40% of directors on U.S. boards nowadays have financial, familial and social ties.[8] Such ties can prevent directors from being impartial; rather, they risk catering to the CEO's compensation wishes. Directors can also benefit from yielding to CEO power in terms of their own CEO pay if they are CEOs. CEO pay is set via benchmarking against the pay of CEOs at comparable firms: the higher the pay of comparable CEOs, the more a CEO makes (Hallock, 1997). Directors who are CEOs at comparable firms then gain from not contesting a raise in CEO pay.[9]

1.2 Garbled information: Deficient information processing

[7] To see the importance of taking into account economic factors for determining whether pay levels are optimal, consider a CEO characteristic such as skill. A CEO may have acquired power because she has above-average skills and a track record as an exceptional leader whom many firms would be eager to recruit. Directors who understand their CEO's above-average skills serve shareholders' interests when agreeing to a high pay level since this level is justified by the CEO's skills. Directors are encouraged by concerns for their reputation and by threats from the market for corporate control to look after shareholders. CEO pay is then suboptimal only if CEO power results in pay levels higher than what is justified by skill (as well as by other CEO, job and/or firm characteristics).

[8] Compensation committees of firms listed on the New York Stock Exchange and the NASDAQ have been required since 2003 to be independent in terms of directors' financial and family ties. Internal Revenue Service rules on tax deductibility also mandate that compensation committees be composed of independent directors for firms to benefit from exemptions of Section 162(m) of the Internal Revenue Code. In Canada, the Toronto Stock Exchange recommends that compensation committees be composed of independent directors. Disclosure regarding director independence is mandated by the Securities Exchange Commission in the U.S. and Canadian Securities Administrators in Canada.

[9] Research suggests that directors do not gain in terms of their director pay when catering to a powerful CEO: Ryan and Wiggins (2004) document that more powerful CEOs are associated with lower director pay.

Boards require information about all factors relevant for setting pay, including CEO, job and/or firm characteristics. For example, directors need to know the CEO characteristics that the firm values and is willing to pay for. Moreover, directors need to understand the job and/or firm characteristics that the CEO dislikes and requires to be compensated for (such as risk that is outside of her control). The board also has to comprehend shareholders' goals in order to design pay packages that advance these goals. We argue that boards fail to be informed about all factors relevant for pay-setting when they are too homogenous and interconnected, which can then lead to suboptimal pay.

Boards can be too homogeneous because they lack demographic diversity. Spencer Stuart (2010) reports that only 1 out of 6 directors were female in 2010. Ethnic minorities too are sparsely represented on boards: amongst the largest 200 of the S&P 500 firms, 15% of directors in 2010 were African American, Asian or Hispanic (Spencer Stuart, 2010). This demographic homogeneity partly results from the director selection process. Research on hiring decisions shows that raters perceive those applicants who are demographically similar to them to be of higher quality (Judge & Ferris, 1993). Accordingly, newly appointed directors are similar to the CEO and the incumbent board (Bebchuk et al., 2002; Westphal & Zajac, 1995). Professional heterogeneity can, but need not, offset this demographic homogeneity: directors, especially those involved in pay-setting, have a variety of professional backgrounds, ranging from current or former executives to specialized professionals, including lawyers and academics (Spencer Stuart, 2010; The Korn/Ferry Institute, 2007). Resource dependence theory, which views directors as valuable resources with access to additional external resources, implies that professional heterogeneity in the boardroom can be beneficial during pay-setting, because of the diversity of information that is then brought to the pay negotiations.[10]

When boards are however without sufficient professional heterogeneity to offset their demographic homogeneity, their value and belief system can lack diversity. Directors of relatively homogenous boards likely share not only personal values but also social values, since

[10] For example, an outside director with an executive background understands the effort and skills required to fulfill general executive duties and knows about outside executive job opportunities, which is helpful for setting pay levels. This director is also familiar with various performance measures and conflicting interests that can afflict the CEO, which is useful for determining the functional form and components of pay. An inside director is informed about the specifics of the firm, which is helpful for evaluating the CEO's actions and setting her pay level. Moreover, an inside director understands the link between CEO actions and firm performance, thus contributing to specify the functional form and components of pay.

they are embedded in a similar institutional context. Directors' personal and social values are spread through the corporate landscape via networks such as those formed by compensation consultants. Murphy and Sandino (2010) document that 78% of their sample firms retained a compensation consultant while 9.2% bought compensation surveys (often prepared by consultants). The pool of consultants is restricted to a few large players: Towers Watson, Mercer Human Resource Consulting and Hewitt Associates serve more than 60% of the U.S. and Canadian firms analyzed in Murphy and Sandino (2010). A second set of networks responsible for spreading directors' personal and social values consists of interlocked directors. Vafeas (2000) reports that directors who sit on compensation committees hold about three other directorships. Interlocked directors act as "mechanisms of interorganizational imitation" (Haunschild, 1993, p. 589). More generally, networks play a crucial role in preserving, replicating and propagating values, ideas and beliefs (Oliver, 1992) that can lead to "shared understandings" of executive pay (Granovetter, 1985, p. 501). We next argue that this shared understanding can have adverse consequences for pay-setting because of groupthink and status quo preference.

Groupthink is a "dysfunctional mode of group decision making characterized by a reduction in independent critical thinking and a relentless striving for unanimity among members" (Forbes & Milliken, 1999, p. 496). It inhibits information processing and is associated with deficiencies such as "the incomplete survey of alternatives and objectives, poor information search, failure to appraise the risks of the preferred solution, and selective information processing" (Turner & Pratkanis, 1998, p. 781). The stage is set for groupthink when directors of homogenous and interconnected boards share personal and social values, which provides them few unique perspectives during pay-setting and prevents them from challenging each other's thinking, especially when there is high interpersonal attraction (Sundaramurthy & Lewis, 2003; Ginsberg, 1994). Interpersonal attraction stands to be high when directors have social ties, which is the case in nearly half of U.S. boardrooms (Hwang & Kim, 2009). Accordingly, Finkelstein and Mooney (2003) report that some directors, particularly insiders, frequently hesitate to be openly critical of the CEO, whereas other directors do little but applaud all CEO actions. In fact, homogenous groups are often polarized and seek out extreme positions (Sunstein, 2002), a tendency which has been observed in pay-setting (Fleming, 2008). Somewhat offsetting the propensity for groupthink is the possibility that directors with friendship ties have sufficient trust in each other to feel comfortable in freely voicing their compensation concerns (Westphal & Bednar, 2005).

Status quo preference arises when firms chose and reproduce organizational outcomes that conform to social values, norms and beliefs in order to maintain legitimacy, as argued by institutional theory (Scott, 2008). Legitimacy is "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions" (Suchman, 1995, p. 574). To ensure legitimacy, boards may avoid information that contradicts extant values, norms and beliefs (Dacin, Goodstein, & Scott, 2002). Consequently, prevalent pay practices are not challenged, especially when there is little diversity amongst directors' existing values in relatively homogenous boards. Networks that spread existing values also play an important role in preserving the status quo, since they confer legitimacy to organizational practices (Davis & Greve, 1997). Further exacerbating this status quo preference is the psychological tendency of individuals to "stick with their current situation" (Thaler & Sunstein, 2008, p. 34) and to look for familiar information to reduce communication complexity and anxiety (Sundaramurthy & Lewis, 2003).

Our discussion thus suggests that when boards are too homogenous and interconnected, directors share personal and social values, which inhibits information processing because of groupthink and status quo preference. Compensation problems then go unchallenged and suboptimal pay is not remedied. Accordingly, networks affect pay: a growing literature shows that pay levels are higher when firms rely on compensation consultants and/or have interlocked directors.[11] However, research has not yet examined whether the higher pay earned by CEOs of interconnected boards is suboptimal. Moreover, no research to date has investigated the impact of board homogeneity on executive pay.

Finally, the information processing deficiencies of homogenous and interconnected boards may well be exacerbated in the presence of powerful CEOs. Groupthink is more prevalent when groups are under direct leadership (Turner & Pratkanis, 1998). Powerful individuals tend to "set agendas, norms for discussion, rules for behavior, and standards for thoughts and opinion" (Magee & Galinsky, 2008, p. 367), thereby restricting information flow. Finkelstein and Mooney (2003, p. 103), in a survey of directors, report that "dominant CEOs who discourage constructive

[11] The references regarding the link between the level of CEO pay and compensation consultants/director interlocks are available on the AMP website.

conflict” are a frequent occurrence. The adverse effect of powerful CEOs on groupthink is a concern since CEOs frequently have more information than boards, which they can use to their advantage during pay-setting. The firms most affected by information processing deficiencies are thus those with not only homogenous and interconnected boards, but also powerful CEOs. To date, no research has analyzed the pay set by such boards, so that we do not know whether it is suboptimal.

2 Say on Pay: A remedy for compensation problems

Our discussion highlights that pay may not be optimal when boards are dominated by powerful CEOs and/or process information deficiently. These two impediments to optimal pay then open the door for Say on Pay: if Say on Pay can offset CEO power or/and reduce information processing deficiencies, it improves pay. We now discuss the extent to which Say on Pay can fulfill these two roles.

2.1 Exit power games: More resistant boards

We argue that Say on Pay modifies the power structure in the boardroom, thereby helping deinstitutionalize suboptimal pay that caters to powerful CEOs. We couch our arguments in institutional theory, which predicts that organizational change occurs when established structures and practices are deinstitutionalized. We define deinstitutionalization as the process through which the prevalent pay-setting process weakens and disappears (see also Oliver, 1992). Deinstitutionalization of pay practices results from changes in rules, norms and beliefs about executive pay; it flourishes in the presence of social pressures at the level of society, political pressures within the firm and functional pressures regarding the technical aspects of pay-setting (Oliver, 1992). We now elaborate on each one of these pressures.

2.1.1 Social pressures

Social pressures are caused by shifts in societal expectations following corporate scandals (Deegan, Rankin, & Voght, 2000). Scandals can lead to a questioning of whether firms meet societal expectations, or, worse, can be taken as proof that firms have violated these expectations (Coombs, 2000). Executive pay scandals include highly publicized cases such as those at Enron and Worldcom, as well as the widespread controversy regarding the impact of pay practices on the 2007-2009 financial crisis (Faulkender, Kadyrzhanova, Prabhala, & Senbet, 2010; Core & Guay, 2010). Since these scandals, regulators in the U.S. have granted shareholders a larger role in pay-setting via mandatory Say on Pay. Regulators' coercive power that enforces Say on Pay lends further credibility to shareholders' enhanced role (Scott, 1987). In fact, regulators' endorsement provides legitimacy to a mechanism like Say on Pay that raises shareholder involvement in pay-setting (Scott, 2008).

2.1.2 Political pressures

Political pressures arise when firms question the wisdom of retaining established pay practices and when organizational members whose interests conflict with existing pay practices become more salient. We now discuss each one of these two antecedents of political pressures.

Firms question the wisdom of keeping prevalent pay practices when they view these practices as a source of problems, including the deterioration in support from key stakeholders like shareholders, employees and regulators. Social actors, such as regulators and the general public, are key in conferring legitimacy (Deephouse, 1996). When societal expectations change, not conforming to this change endangers a firm's legitimacy, which, as institutional theory points out, firms dread. Political pressures then arise within the firm to modify existing pay practices and adapt them to the novel societal expectations (Oliver, 1992). As argued in Greenwood and Hinings (1988, p. 306), "prevailing ideas and values have lost legitimacy and are discredited. In their place, an alternative interpretive scheme emerges, carrying with it a different pattern of structural arrangements". The widespread voluntary adoption of Say on Pay can be taken as an example of an alternative interpretive scheme, one in which shareholders play an increasing role. Before Say on Pay became mandatory in U.S., it had been voluntarily adopted by numerous firms; a similar trend towards voluntary Say on Pay is ongoing in Canada. Moreover, firms are not just changing their pay practices to include shareholders to a larger extent, but also other aspects of governance, such as director elections.[12]

Once Say on Pay is established, further political pressures arise because Say on Pay amplifies the salience of shareholders as organizational members and because shareholders do

[12] Firms are voluntarily moving from plurality to majority voting, thus making it easier for shareholders to reject nominees. In 2010, 71% of S&P 500 firms required majority voting, up from 65% in 2009 (Spencer Stuart, 2010). Under majority voting, a nominee is not elected if more votes are withheld than cast in her favor. Under plurality voting, a nominee is elected director if she receives the highest number of votes cast.

not necessarily agree with existing pay practices. Say on Pay indeed bestows additional structural power on shareholders: it provides them with novel legal rights (in the case of mandatory Say on Pay in the U.S.) or new contractual rights (in the case of voluntary Say on Pay in Canada). Before Say on Pay, shareholders lacked structural power for influencing pay, since there was no law or contract that directly involved them in pay-setting. Instead, the mechanisms then available to shareholders for expressing dissatisfaction with pay included Just Vote No campaigns, voting in director elections and selling shares (the "Wall Street Walk").[13] These mechanisms however do not focus solely on pay, thereby making it difficult for shareholders to exert their will in the context of pay-setting (and for directors to infer shareholders' concerns regarding pay).

The only direct influence over pay-setting that shareholders had prior to Say on Pay originated from their ownership power. Shareholders could file proposals on executive pay or elicit the board's attention for engaging in direct compensation negotiations, provided that they owned sufficient equity.[14] Shareholders most likely to own enough equity were, and are, institutions. In 2007, institutions owned about 58% of U.S. and 59% of Canadian equity (Aggarwal, Erel, Ferreira, & Matos, 2010). Institutions have been at the forefront of promoting practices geared towards advancing shareholders' interests, including Say on Pay (Council of Institutional Investors, 2010; Canadian Coalition for Good Governance, 2010).

With the advent of Say on Pay, large shareholders can combine their ownership power with their new structural power to increase their sway over pay-setting. Most likely to act on this combined power are large shareholders who are invested long enough to reap the benefits from exercising their Say on Pay vote or using Say on Pay as a threat when negotiating with directors. The benefits, which include the increase in equity value from improved pay practices, can then offset the costs from compensation activism, such as information collection and voting costs, as well as opportunity costs of time and resources. The influence of large shareholders on pay-setting is illustrated by the case of Occidental Petroleum.

In May 2010, Occidental's shareholders voted down its compensation report. The CEO of Occidental, Mr Ray Irani, earned $54.4 million in 2009, which secured him a seat amongst the

[13] During Just Vote No campaigns, shareholders withhold votes from director elections so that directors risk losing their board seat.

[14] To file a proposal, a registered or beneficial shareholder must own at least 1% of the outstanding shares (or $US/$CAN2,000 worth of shares) for six months (in Canada) or a year (in the U.S.) before submitting the proposal.

highest paid U.S. executives, according to the Wall Street Journal's annual pay survey (White, 2010). Following the vote, two large institutional investors, California State Teachers' Retirement System and the hedge fund Relational Investors (which jointly owned 1.24% of Occidental shares), expressed frustration about Occidental's pay practices (Clark, 2010). In a letter sent to Occidental's board in July 2010, they voiced concern about Mr Irani's high pay that exceeded that of peers at firms like Exxon Mobil (Deal Journal, 2010). Occidental subsequently pledged to widen its dialogue with shareholders (White, 2010), which culminated in several substantial changes to its executive pay being announced in October 2010, according to Business Wire. The changes focused on long-term incentive pay that Occidental offers its executives, including Mr Irani. The new incentive plans reduced the maximum possible payouts and used performance metrics that were decoupled from industry fluctuations, such as variations in commodity prices. Occidental also announced that Mr Irani would step down as a CEO in May 2011 and remain as chairman. The California State Teachers' Retirement System and Relational Investors declared themselves satisfied with the changes in Occidental's pay (Carroll, 2010).

Our discussion thus emphasizes that shareholders who stand to be influential in pay-setting after the advent of Say on Pay are those who can harness the combined force of ownership and structural power, such as institutions. The increased shareholder power in turn creates political pressures in the boardroom by encouraging directors to pay more attention to shareholders. Directors who were to ignore shareholders and pledge their support to the CEO instead would attract criticism in an environment that stresses shareholders. This criticism can arise from sources such as the business press as well as opinion leaders like corporate governance institutions and highly visible institutional investors (Joe, Louis, & Robinson, 2009). Adverse media exposure damages directors' reputation, especially if proxy advisory services support the criticism (Ertimur, Ferri, & Stubben, 2010). Director reputation can take a further toll when dissatisfied shareholders file lawsuits against the firm (Fich & Shivdasani, 2007). A reputation loss in turn undermines not only the power that directors draw from their prestige but also their structural power and economic well-being: less reputable directors are not reelected to their own board nor appointed to other boards (Yermack, 2004). Finally, if directors ignore shareholders' voice, regulators may intervene by imposing more rules onto pay-setting, thereby further eroding directors' structural power.

Directors' fear of harming their prestige and structural power as well as their economic well-being then redirects their allegiance away from the CEO towards shareholders. As a result, the CEO's power, relative to that of shareholders, declines in the presence of Say on Pay. The shift in directors' allegiance promotes the deinstitutionalization of prevalent pay practices, since directors are less likely to endorse suboptimal pay plans that please the CEO and more likely to support pay that caters to shareholders' wishes. In fact, boards stand to communicate with shareholders early on in the pay-setting process to preempt a negative Say on Pay vote. The practical experience with Say on Pay corroborates this conjecture: since the introduction of Say on Pay, firms in the U.K. and the U.S. confer early on with important investors, proxy advisory services and investor trade organizations (Davis, 2007). According to a 2004 survey, 93% of respondent shareholders believe that U.K. firms have consulted them more intensely on compensation after mandatory Say on Pay was introduced (Deloitte, 2004). GlaxoSmithKline, whose compensation report was rejected by the Say on Pay vote in 2003, has arranged an annual consultation process on executive pay and corporate governance with shareholders during which its compensation committee holds roundtables with investor representatives in the U.S. and in two U.K. cities (Davis, 2007). Similarly, since firms in the U.S. began to voluntarily implement Say on Pay in 2007, direct negotiations between boards and large shareholders have become more popular (Davis, 2007). According to a recent survey, 80% of respondent firms reached out proactively to shareholders in 2010, while 53% directly contacted institutional investors and large shareholders about proxy recommendations and governance issues (Spencer Stuart, 2010).

2.1.3 Functional pressures

The deinstitutionalization of existing pay practices is further helped along by functional pressures, which arise when technological or functional considerations compromise the instrumental values of traditional pay-setting practices (Oliver, 1992). These technological and functional considerations are embodied in the fact that Say on Pay emphasizes shareholders and thereby simplifies pay-setting. Determining the level, functional form and composition of pay is at best a complex undertaking that can lack a single clear goal. Say on Pay offsets the ambiguity permeating traditional pay-setting practices by clarifying that their goal is to advance shareholders' interests. As pointed out in Oliver (1992, p. 572), "greater clarity in organizational objectives or in the causal processes by which organizational goals are achieved will tend to deinstitutionalize prevailing organizational myths, superstitions or beliefs about the appropriate or legitimate means of obtaining organizational ends." Consequently, Say on Pay, by reducing pay-setting ambiguity via its emphasis on shareholders further encourages the deinstitutionalization of extant pay practices. Functional pressures thereby complement social and political pressures that open the door to shareholders' voice during pay-setting. We contend next that the increased room for shareholders' voice can help boards overcome information processing deficiencies as well.

2.2 Garbled information no more

As discussed earlier, shareholders most likely to get involved in pay-setting via Say on Pay have high equity ownership and long horizons, such as institutions. Their intense criticism of existing pay practices suggests that they view pay differently than boards do (CalPERS, 2011; Almazan, Hartzell, & Starks, 2005). These differing views can result not only from distinct personal and social values, but also because institutions do their own compensation research and thus have insights about pay beyond those published in compensation reports. Institutions are encouraged to do compensation research by their ownership stakes, the fiduciary duty towards clients as well as regulations and investment strategies that prevent share selloffs (Gompers & Metrick, 2001).

The potentially unique perspectives regarding executive pay that shareholders hold imply that their expanded participation in pay-setting following Say on Pay is an example of "external interventions" that produce a shock to extant protocols (Sundaramurthy & Lewis, 2003, p. 407). By setting off such a shock, Say on Pay helps boards break the cycle of using only familiar knowledge and habitual responses for decision-making: boards can learn new behavior and interpret phenomena in novel ways when setting pay (Greenwood & Hinings, 1996). As a result, shareholders' participation can unlock an information flow previously impeded by groupthink and status quo preference. Moreover, the adverse effect that CEO power has on information flow may be mitigated by the heightened power that Say on Pay gives to shareholders. As pointed out in Magee and Galinsky (2008, p. 368), "Those with greater power are more likely to express their private opinion and true attitudes". Say on Pay can thus be instrumental in overcoming information processing deficiencies such as groupthink and status quo preference.

3 Say on Pay: Unintended consequences?

Our analysis so far suggests that Say on Pay can mitigate compensation problems by increasing shareholder influence, thereby offering an alternative framework to existing pay-setting practices. Alternative frameworks pave the road for radical change, defined by Greenwood and Hinings (1996, p. 1024) "the busting loose from an existing orientation". Although Say on Pay opens the door to radical change in pay-setting, it is no panacea. In this section, we discuss what we consider to be unintended and potentially adverse consequences of Say on Pay. First, shareholders with conflicting interests can harm other stakeholders. Moreover shareholders who rely on biased information may – unbeknownst to them – vote for suboptimal pay that, as a result, stands a high chance of being legitimated. Table 2 displays these unintended consequences as well as our suggested remedies, as discussed next.

Unintended Consequence	Remedy
Shareholders' conflicting interests (appetite for risk, business ties with the firm)	Disclosure of shareholders' conflicting interests
Managed compensation disclosures	Audits of compensation disclosures
Legitimacy of suboptimal pay	Voting procedures Corporate governance Losing shareholders' rejection of the voting outcome

Table 2. The unintended consequences of Say on Pay and their remedies

3.1 Shareholders' interests: Nirvana?

Shareholders with more power because of Say on Pay can harm other stakeholders who matter in context of pay-setting. The board indeed owes its fiduciary duty not just to shareholders but to the firm. Accordingly, jurisprudence does not equate the interests of the firm with those of shareholders (Walsh, 2002; Smith, 1999). The dust has however not yet settled on the question of what parties other than shareholders the board should take into account, as attested by an ongoing debate in academic circles; parties considered include creditors, employees and suppliers (Boatright, 2006, 2002, 1994; Walsh, 2002; Smith, 1999; Goodpaster, 1991). This debate is fueled not only by the fact that several U.S. state statutes recognize a fiduciary duty towards stakeholders beyond shareholders (Fort, 1997; O'Connor, 1991) but also by the development of stakeholder theory (Freeman, 1984).[15]

The latter theory defines stakeholders on a spectrum ranging from the broad to the narrow. A broad definition views as a stakeholder "any identifiable group or individual who can affect the achievement of an organization's objectives or who is affected by the achievement of an organization's objective" including public interest groups, government agencies, unions, employees and shareholders, whereas a more narrow definition considers a stakeholder to be "any identifiable group or individual on which the organization is dependent for its continued survival", such as employees, customers, suppliers, key government agencies, shareholders and financial institutions (Freeman and Reed, 1983, p. 91). In a stakeholder perspective, executive pay is optimal when the board considers the interests of all stakeholders during pay-setting rather than those of shareholders alone. We now illustrate how the interests of shareholders need not jibe with those of other stakeholders.

3.1.1 Sources of conflicting interests

A first source of conflicting interests involves shareholders' appetite for risk that can be relatively large since equity payoffs let shareholders have a cut of upside risk while limiting their downside risk. Shareholders with a liking for risk prefer executive pay that encourages CEOs to choose risky projects (Bolton, Scheinkman, & Xiong, 2006). Research suggests that institutions increasingly fit the description of shareholders with a large appetite for risk, because they have been investing more in small and risky firms (Bennett, Sias, & Starks, 2003). Scholars debate whether pay practices that induce CEO risk-taking, including equity-based pay, have contributed to the 2007-2009 financial crisis (Faulkender et al., 2010). Executive pay that encourages risk-

[15] Although Delaware General Corporation Law does not specify to whom directors owe a fiduciary duty, it implies a duty of loyalty towards the firm by pointing out that if directors have conflicting interests, they can still contract on behalf of the firm if doing so is fair to the firm (Del. Code Ann. tit. 8, ch. 1, §144, 2011). In the U.S., the board is nowadays required to direct its fiduciary duty towards shareholders alone only in change of control situations that occur when a board is about to sell, break up or transfer control of the firm and trigger "Revlon" duties (following the 1986 case of Revlon v. MacAndrews & Forbes Holdings, Inc.) requiring the board to focus solely on maximizing shareholder value (the "shareholder primacy" model). In stark contrast to the U.S., Canada requires that stakeholders beyond shareholders be considered even in a change of control context, as reaffirmed in 2008 by the Supreme Court of Canada in the BCE case, where it relied on the "stakeholder" model of directors' duties endorsed previously in the Peoples case (Peoples Department Stores Inc. (Trustee of) v. Wise, 2004; BCE v. 1976 Debentureholders, 2008). According to the "stakeholder" model, acting in the firm's best interests requires directors to consider the interests of all stakeholders rather than those of any particular group such as shareholders.

taking can harm stakeholders whose claims have payoff structures that limit their share of upside risk while exposing them to downside risk, such as debtholders and employees (John & John, 1993). The Securities and Exchange Commission (SEC) considers the fall-outs from risky pay worrying enough to have changed its disclosure rules: in December 2009, the SEC required firms to discuss pay plans that create risks likely to cause harm (Proxy Disclosure Enhancements, 2009).

Conflicting interests also arise from business ties between firms and institutional shareholders such as banks, insurance companies and pension funds (Brickley, Lease, & Smith, 1988). Institutions with business ties tend to oppose management less (Davis & Kim, 2007; Brickley et al., 1988). For example, Fidelity Funds, whose subsidiary Fidelity Management & Research Co. received about 25% of its 2001 revenues from administrating pension plans, is relatively acquiescent on governance matters in the U.S. (Davis & Kim, 2007). During pay-setting, conflicting interests from business ties also translate into passivity: institutions with business ties do not impel firms to lower pay levels nor to raise the proportion of incentive-based pay as institutions without conflicting interests do (Brav, Jiang, & Kim, 2010; Almazan et al., 2005). Hence, institutions with business ties are more likely to approve pay that favors executives, thereby harming stakeholders who draw no personal benefits from suboptimal pay, including other claimholders and employees.

3.1.2 Say on Pay: More power to the wrong shareholders?

Say on Pay has the drawback of giving shareholders with conflicting interests additional power to advance these interests at the expense of other stakeholders. Shareholders most likely to act on this additional power have high ownership stakes and long investment horizons. Institutions not only fit this characterization but also stand a high chance of having conflicting interests from risk preferences and business ties. [16]A pay-setting process that enhances institutions' role may then yield pay practices that harm other stakeholders, including shareholders without business ties. Say on Pay is thus a double-edged sword: whether shareholders' increased role in pay-setting improves executive pay depends on their intent. If

[16]An additional concern can arise when shareholders have information processing deficiencies caused by behavioral biases such overconfidence and limited attention (Peng & Xiong, 2006). Shareholders with such information processing deficiencies may lobby for pay that, unbeknownst to them, is suboptimal. Research suggests however that the latter concern is not too pressing, since information processing deficiencies affect sophisticated investors such as institutions to a lesser extent (Bonner, Walther, & Young, 2003).

shareholders wish to advance their own interests with little regard for other stakeholders, it is questionable whether the goal of Say on Pay (i.e., improving compensation practices) is served. Instead, Say on Pay may merely shift the locus of compensation problems from powerful CEOs with conflicting interests to powerful shareholders with conflicting interests. It is even possible that powerful shareholders with conflicting interests form a coalition with powerful CEOs; this concern is not unwarranted, considering the above-mentioned research suggesting that shareholders with conflicting interests arising from business ties rarely oppose management.

The issue of shareholders' conflicting interests is particularly salient considering regulators' push to increase shareholder involvement in governance. Shareholders can advance their own interests in two ways. On one hand, they can increase their part of the pie (i.e., shareholder value) by ensuring that the entire pie (i.e., firm value) is larger, which implies that they as well as other stakeholders are better off. This view is consistent with jurisprudence that has deferred to shareholders in the belief that "corporations ought to be run for the benefit of shareholders, not because they 'own' the corporation, or because of some contract or agency relation, but because all other constituencies are better off as a result" (Boatright, 1994, p. 402; see also Berle, 1932). On the other hand, shareholders can increase their slice of the pie by taking a cut from the other stakeholders' part. The claims to the firm's resources are then distributed differently, with shareholders getting a larger portion and other stakeholders a smaller one. Claim redistribution is the catch of shareholder value maximization, particularly when shareholders have conflicting interests.

If regulators want to improve governance by enhancing shareholder rights, they need to ensure that other stakeholders are not harmed, especially when there are powerful shareholders who have the wherewithal to act on conflicting interests. Regulators may then have to level the playing field between shareholders with conflicting interests and other stakeholders, for instance by requiring that shareholders disclose conflicting interests like those resulting from business ties.[17] Much in the spirit of former U.S. Supreme Court Justice Brandeis who argued that

[17] Shareholders with conflicting interests have strong incentives to not voluntarily disclose conflicts that provide them with private gains. Accordingly, stakeholders who are unable to distinguish firms with shareholders who have conflicts of interests from firms without such shareholders may price-protect themselves by interacting with all firms only at a discounted price. Such price protection penalizes firms whose shareholders do not have conflicts of interests. The latter firms may then lack the resources to invest in value-generating projects, which can be detrimental for society at large.

"sunlight is said to be the best of disinfectants" (Brandeis, 1914, p. 92), disclosure would allow other stakeholders to protect themselves from harm. For example, stakeholders such as shareholders without conflicting interests could simply offer to pay less for their shares, thereby signaling to the board that there is a cost to having shareholders with conflicting interests. Other stakeholders could negotiate the terms of their interaction with the board to ensure that they are protected from harm.

The board in turn would play the role of the "mediating hierarch" between various stakeholders (Kostant, 1999, p. 219; see also Blair & Stout, 1999), although coordinating and protecting the interests of multiple stakeholders may prove to be challenging (Marcoux, 2003). The board can, in theory, ignore the wishes of powerful shareholders with conflicting interests if doing so is in the firm's best interests. After all, neither Say on Pay nor direct negotiations with shareholders are binding, and directors owe their fiduciary duty to the firm rather than to shareholders. Directors concerned with their own power and economic well-being may however be reluctant to not lend an ear to the wishes of powerful shareholders with conflicts of interests, as discussed earlier. Consequently, directors' fiduciary duty alone may not be sufficient for ensuring that stakeholders are not harmed by Say on Pay. Disclosure of shareholders' conflicting interests can then represent a step into the direction of protecting stakeholders.[18]

3.2 Shareholders' information: Managed?

Even when shareholders do not have conflicting interests, Say on Pay can be ineffective. Consider a firm that wishes to ensure a passing Say on Pay vote while keeping in place a suboptimal pay plan that caters to its powerful CEO. The firm can engage in impression management (or symbolic compliance) by biasing information pertaining to its pay plan. As

[18] Shareholders are already subject to disclosure regulation, although not regarding conflicts of interests, nor in the specific context of pay-setting. In 2003, the SEC required that mutual funds disclose not only their proxy voting policies and procedures but also their actual votes on specific proposals (Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 2003). Moreover, regulators in the U.S. and Canada mandate that firms disclose shareholders who own more than 10% of a firm's equity (Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 2002; Continuous Disclosure Obligations, 2011). Finally, regulators require firms to disclose related party transactions for shareholders who own more than a certain percentage of the voting shares, the percentage being 5% in the U.S. and 10% in Canada (Executive Compensation and Related Person Disclosure, 2006; Continuous Disclosure Obligations, 2011). However, these requirements may be ineffective in preventing stakeholders other than shareholders from being harmed since the SEC exempts firms from such disclosure if the benefits of the transactions are shared with all other holders of the same class of securities (Executive Compensation and Related Person Disclosure, 2006). Similarly, Canadian rules are geared towards protecting minority shareholders rather than other stakeholders (Continuous Disclosure Obligations, 2011; Protection of Minority Security Holders in Special Transactions, 2008).

Ashforth and Gibbs (1990, p. 180) point out, “rather than actually change its ways, the organization might simply portray – or symbolically manage – them so as to appear consistent with social values and expectations.” Impression management represents a decoupling between the actual pay practices that are adopted and those that firms feel they should adopt to respond to institutional demands for greater shareholder involvement (Scott, 2008). Research suggests that pay-setting is afflicted by impression management: Westphal and Zajac (1994) document that many firms adopt plans linking executive pay to performance only to subsequently not implement them. In the presence of impression management, Say on Pay is of little use for remedying pay problems: shareholders who rely on biased compensation information are unlikely to prod a firm into changing its pay plans. Accordingly, impression management allows firms to adopt Say on Pay without actually implementing it, consistent with Westphal and Zajac (1998, p. 128) who argue that “top managers can satisfy external demands for increased accountability to shareholders while avoiding unwanted compensation risk and loss of autonomy by adopting but not implementing governance structures that address shareholder interests and by bolstering such actions with socially legitimate language”.

Impression management strategies include influencing perceptions or expectations about pay and distracting attention away from pay towards positive, unrelated, events (Lindblom, 1994). A board can launch a public charm offensive to show concern for shareholders and emphasize the steps taken to consider them. A charm offensive can involve press releases, conference calls and the helping hands of proxy advisors that have considerable power over shareholder voting outcomes (Morgan, Poulsen, & Wolf, 2006).[19]

3.2.1 Caveat emptor: Compensation reports

Impression management can also be achieved via compensation reports. Directors know that shareholders can use these reports for evaluating pay practices and deciding about their Say on Pay vote. When directors wish to portray pay as consistent with shareholders’ aspirations, they can do so by strategically choosing the form and content of compensation disclosures. As pointed out by Arthur Levitt, “There are all kinds of ways of not telling it like it is, and

[19] The notion that firms engage in impression management ties into what Bebchuk and Fried (2004, p. 5) call “camouflage”: firms camouflage (“obscure and legitimize”) executive pay on a large scale to prevent shareholders from detecting outrageous compensation. Camouflage tactics include relying on compensation consultants to justify pay and paying executives via pension plans, option plans that fail to filter out windfalls, golden goodbyes, post-retirement perks and consulting contracts.

compensation committees have been pathetic in this regard." (Levitt, 2005, p. 42). Impression management via compensation reports can range from justifying compensation choices in a fashion that caters to shareholders (i.e., framing information without changing its content) to misrepresenting or hiding content (Wade, Porac, & Pollock 1997). Research suggests that disclosures in compensation reports relating to performance graphs are managed (Bannister & Newman, 2006). Moreover, concerns have been raised that the now defunct Lehman Brothers failed to properly disclose the compensation of its former CEO, Mr Richard Fuld (Sterngold, 2010).

We have various reasons to suspect that firms engage in impression management via compensation reports. To start, these reports are not only lengthy – their average length is 18 pages (Dalton & Dalton, 2008) – but also complex, which provides fertile ground for managing information. For instance, boards can hide suboptimal pay practices behind technical and legal jargon that makes compensation reports unclear and perfunctory. Commentators, including former SEC chairman Christopher Cox, worry about the lack of plain English and firm-specific information in compensation reports as well as about the abundance of technical and legal language (Leder, 2007). Furthermore, research suggests that other corporate disclosures, such as environmental and social responsibility disclosures, are frequently used for managing impressions (Cho & Patten, 2007). Similarly, financial reports can be afflicted by earnings management (Healy & Wahlen, 1999), especially when boards are not independent and influenced by powerful CEOs (Cornett, Marcus, & Tehranian 2008; Klein, 2002). The advantages to CEOs of managing impressions include financially benefitting from suboptimal pay while maintaining their legitimacy (Westphal & Zajac, 1994).

Of course, using compensation reports for managing impressions also involves costs such as being penalized by the regulator for failing to comply with disclosure rules. Moreover, directors publicly accused of managing compensation reports may see their reputation harmed and their economic prospects diminished, which happened for directors involved in financial reporting problems (Srinivasan, 2005). The costs of impression management stand to be higher for firms with information intermediaries such as financial analysts who can act as monitors for the information disclosed in compensation reports. Consistent with this conjecture, research shows that financial disclosures are more reliable when firms are followed by more analysts (Yu, 2008).[20]

Our discussion thus indicates that firms are most likely to manage compensation reports when they have powerful CEOs and are not followed by information intermediaries. Managed compensation disclosures can render Say on Pay ineffective, a concern that applies to other governance mechanisms as well. When a governance mechanism relies on the parties being monitored to produce the information used for monitoring, the monitored parties may manage this information; as a result, the governance mechanism fails to achieve its aim. The question then arises of how to make information used in monitoring – compensation reports in the case of Say on Pay – more reliable. Problems regarding the reliability of other disclosures have been addressed, albeit incompletely, via mechanisms such as independent audits (Becker, DeFond, Jiambalvo, & Subramaniam, 1998).

3.2.2 Suboptimal pay legitimated?

When firms successfully engage in impression management and ensure a passing Say on Pay vote for suboptimal pay, this vote has consequences for the legitimacy of pay. A passing shareholder vote signals that the pay plan conforms to shareholders' expectations. In a societal environment that emphasizes shareholders' role in pay-setting, such conformity suggests that the firm's pay practices operate "within the bounds and norms of society" (Brown & Deegan, 1998, p. 22). According to legitimacy theory, acting within the bounds of what society views as socially acceptable behavior is crucial for maintaining legitimacy (Palazzo & Scherer, 2006).

A passing Say on Pay, although based on managed compensation information, can thus confer legitimacy to suboptimal pay. This argument is supported by research on elections suggesting that the percentage of winning votes influences the winning party's legitimacy (Craig, Martinez, Gainous, & Kane, 2006; Bratton, 1998). Pay plans that obtain legitimacy stand to become institutionalized (Dacin et al., 2002). An institutionalized practice is difficult to change,

[20] Similarly, it is more difficult for firms with institutional investors to manage impressions, since institutions can use their own compensation research as a check on the information disclosed in compensation reports (Cornett et al., 2008). Research indicates that institutions increase the reliability of financial disclosures (Cornett et al., 2008), especially when they invest for the long term (Koh, 2007). As cautioned however in Section 3.1, institutions may have their own agenda and lobby for pay that harms other stakeholders. In that case, it is not clear how compensation reports are affected by the presence of institutions, especially since research is still silent on how shareholders with conflicting interests affect disclosures.

since it requires social, functional or political pressures (Oliver, 1992). Consequently, Say on Pay may have the unintended consequence of not only resulting in managed compensation information, but also in institutionalizing suboptimal pay that is then all the more challenging to subsequently modify.

There is however room for hope: suboptimal pay may be prevented from obtaining legitimacy by other characteristics of the Say on Pay vote, the firm and the governance environment. Political science research implies that the loser’s acceptance of the election outcome (i.e., shareholders who vote against the compensation plan), voter participation, the quality of the voting procedures (i.e., their fairness and trustworthiness) and the institutional procedures (i.e., the firm’s governance) affect the legitimacy of a pay plan that passes the Say on Pay vote (Craig et al., 2006; Bratton, 1998). As a result, a passing vote can fail to legitimize pay, for instance when shareholders who voted against the plan mount substantial opposition. Shareholders best equipped to do so have the resources and public visibility to attract support for their opposition, such as institutions. The latter may thus be instrumental in preventing suboptimal pay that passed the Say on Pay vote from becoming entrenched. Of course, institutions can play such an oversight role only if they are not prevented by conflicts of interests from mounting opposition.

4 Conclusion

One of the more visible outcomes of the Dodd-Frank Wall Street Reform and Consumer Protection Act is mandatory Say on Pay. By requiring firms to submit their compensation policies to shareholder vote, mandatory Say on Pay formally introduces shareholders into a decision process so far vested with the board of directors. Our purpose in this paper has been to analyze whether Say on Pay is well equipped to solve compensation deficiencies. We view these deficiencies as arising mainly from excessive CEO power and information problems in the boardroom. We argue that there is room for optimism: Say on Pay, by increasing shareholder involvement in the pay-setting process, can reduce pay deficiencies. More specifically, shareholders can provide a counterweight to powerful CEOs and thereby reduce CEO sway over pay-setting. In addition, shareholders’ input during the pay-setting process enriches the board’s information environment, thus helping reduce information problems such as groupthink and status quo preference.

We caution however that Say on Pay is no panacea. To start, powerful shareholders may lobby for pay plans that advance their own interests at the expense of other stakeholders such as less powerful shareholders, debtholders and employees. Additionally, boards that wish to keep in place deficient pay plans can manage their compensation disclosures so that the pay plans appear consistent with shareholders' interests. Shareholders then are unlikely to dethrone suboptimal pay via the Say on Pay vote. Rather, suboptimal pay practices that have gained legitimacy from a passing Say on Pay vote are difficult to subsequently change and likely persist.

Reforms such as Say on Pay that modify the decision process at the top of corporate hierarchies should therefore not be taken at face value; instead, they need to be understood in the larger context of the existing powers that shape corporate decisions and the new powers that reforms insert into the decision process. The existing powers have traditionally been vested with the board of directors; accordingly, much legislation (including the Sarbanes-Oxley Act), jurisprudence and academic scholarship has focused on the conditions under which the board can function properly. Say on Pay represents a deviation from this board-centered outlook by increasing the power of shareholders. Hence, it can be argued that Say on Pay brings corporate governance into uncharted territory. Our discussion cautions not only that the existing powers (i.e., the board) may resist this change but also that a shareholder-centered framework is not void of problems, notably those resulting from conflicts of interests. We hope that out paper draws the attention to the fact that modifying the corporate decision process from being board-centered to increasingly involving shareholders is a double-edged sword that carries its own set of challenges below a surface of solutions.

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