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Article

The Steps Taken by Say-on-Pay towards Shareholder Primacy: An Anglo-Saxon Perspective

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Abstract

The rise of dispersed ownership, primarily at UK and US businesses, sets the stage for a reaction involving shareholder activism (primacy). This results in considerable pressure placed upon company directors. Therefore, placing shareholders and executives at cross-purposes, and represents subgroup of the "agency problem", with the shareholders determined to boost profit and the executives in pursuit of more substantial remuneration. Prior to 2002, businesses dealt with this problem by providing stock options to motivate executives through granting company shares. However, despite these practices, the ever-rising remunerations of executives left the legislator no choice but to adopt a regulatory approach. That being said, the '*say-on-pay*' approach has been employed to augment efficacy in accordance with the UK Directors' Remuneration Report Regulation and the U.S.A. Dodd-Frank Wall Street Reform and Consumer Protection Act in the US. Shareholders have been granted the right to a binding and advisory vote on the financial rights of the executives of public companies. This study, scrutinises the ways of galvanising the say-on-pay system in Anglo-Saxon corporate law by considering the problems encountered in prior practice.

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Introduction

Dispersed ownership for companies is the new black.[1] This, re-imbodies shareholders' expectations as more profit-oriented, instead of following a trend growth path. In this scheme, known as 'short-termism', shareholders are in expectation from management to continually provide their short-term profits.[2] Executives, on the other hand, carry on their legal duties and responsibilities in a free environment provided that the number of shareholders increases since they do not feel close pressure, as is the case with dominant partners in concentrated company structures. The rise of dispersed ownership sets the stage for shareholder activism (primacy) reactions that tightens the screws on the company directors.

The rapid increase in executive wages in UK businesses necessitates revision of the regulations on the subject.[3] The say-on-pay implementation envisaged in this regard aims to increase the efficiency of shareholders by controlling the company and making management more sensitive to the needs of the shareholders. Say-on-pay rights, introduced *imprimis* in the UK, are widely reported and extensively explored in the Anglo-Saxon literature.[4]

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[1] Adriana De La Cruz, Alejandra Medina and Yun Tang, 'Owners of the World's Listed Companies' (OECD Capital Market Series 2019) <https://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf> accessed 23 February 2022.

[2] Fatih Erdem, 'Short-Termism in Publicly Listed Companies and Corporate Governance' (2021) 70 Annales de la Faculté de Droit d'Istanbul 73-89; Milton Friedman, 'The social responsibility of business is to increase its profits' (New York Times Magazine, 13 September 1970) <https://www.nytimes.com/1970/09/13/archives/a-friedmandoctrine-the-social-responsibility-of-business-is-to.html> accessed 23 February 2022.

[3] Department for Business, Energy and Industrial Strategy, 'Corporate Governance Reform: Green paper' (2016) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf> accessed 23 February 2022.

[4] Stephen Bainbridge, *Corporate Governance after the Financial Crisis* (OUP 2012) 135; Mary Ellen Carter and Valentina Zamora, 'Shareholder Remuneration Votes and CEO Compensation Design' (Boston University Working Paper 2009) <https://www.researchgate.net/publication/228308283_Shareholder_Remuneration_Votes_and_CEO_Compensation_Design> accessed 23 February 2022; Martin Conyon and Graham Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK' (2010) 18(4) Corporate Governance: An International Review 296; Fabrizio Ferri and David Maber, 'Say on Pay Votes and CEO

The Say-on-pay Concept

The first regulatory initiative, the Cadbury Report, introduced in 1992 specified the "Code of Best Practice" by granting shareholders the right to vote on the financial rights of the company's board of directors. The Cadbury Report also envisages the establishment of a remuneration committee composed of independent board members in listed companies.[5] Ten years later, in 2002, legal adjustments have been enacted regarding the remuneration of executives.[6] Finally, in 2012, amendments made in the Companies Act via the Directors' Remuneration Report Regulations (DRR), the reports prepared regarding the financial rights provided to the executives are divided into two sub-reports, namely Policy Report and Annual Remuneration Report. The legal nature of the votes given by the shareholders regarding these reports are also classified as binding and advisory.[7] However, in the Green Paper: Corporate Governance Reform published by the Department of Business, Energy & Industrial Strategy in 2016, suggested that all or some of the financial rights provided to the executives should be required to be submitted to the binding votes of the shareholders.[8] It is aimed to ensure transparency, increase accountability and strengthen financial rights provided to managers and company performance.[9] British practices spread to other jurisdictions as well, but since this order was stemmed from British company law and shaped within the framework of problems specific to the UK, Gordon claims that on the particular subject in which the British-made

Compensation: Evidence from the UK' (2013) 17(2) Review of Finance 527; Christoph van der Elst, 'Answering the say for no pay' in Susan Watson and PM Vasudev, *Innovations in Corporate Governance: Global Perspectives* (Edward Elgar 2017) 151-190; Marco Becht, Andrea Polo and Stefano Rossi, 'Should Shareholders Have a Say on Acquisition?' (2021) 33(1) Journal of Applied Corporate Finance 48-57.

[5] The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd., 'The Financial Aspects of Corporate Governance' (1992) <https://ecgi.global/sites/default/files//codes/documents/cadbury.pdf> accessed 23 February 2022.

[6] The Directors' Remuneration Report Regulations 2002 (UK Statutory Instruments, 2002 No 1986).

[7] Ibid, Regulation 7, Article 241A.

[8] Ricardo Correa and Ugur Lel, 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation Around the World' (2016) 122(3) Journal of Financial Economics 5-6.

[9] Jean Chen and Zhen Zhu, 'Directors' Remuneration in the United Kingdom' in Alexander Kostyuk, Markus Stiglbauer and Dmitrey Govorun (eds), *The Theory and Practice of Directors' Remuneration: New Challenges and Opportunities* (Emerald 2016) 110-111.

legal concepts (as such in say-on-pay) found as a remedy may not have the same results provided that they are applied in other countries[10] and also works well in the US application due to the alike perspectives to commercial law.

The Dodd-Frank Wall Street Reform and Consumer Protection Act brings rules regarding the finance sector, the provision 14(A)-(a)(2) has been added to article 14(A) of the Law on Stock Exchanges with Article 951 of the Law. It was clearly regulated that the shareholders should be given voting rights on the financial rights and resignation compensations (golden parachutes) of the senior executives and board members who are on duty. The golden parachute vote is the quasi-indemnity that includes large bonuses to management (who will likely be fired) if a company changes hands. It should also be indicated that stock-buyback[11] would be another solution. In practice, in order to solve this problem, ways such as giving stock options to the managers who are not shareholders in the partnership and paying premiums in proportion to the profits are also used. Another solution has been to increase the efficiency and oversight authority of the shareholders by participating in the decision process in determining the financial rights provided to the managers, which has been effectively implemented in recent years, i.e. say-on-pay.

With the amendments brought by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the independence and role of the remuneration committee has been intensified and partnerships have been obliged to establish a policy for financial rights paid to the company managers. Even though they are advisory, it has been observed that these votes have an impact on the companies; the executives have made changes in their wage packages and begun to seek ways of persuading against criticism. It was understood that the reason why the said financial rights were not accepted by the

[10] Jeffrey Gordon, '"Say On Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In' (Columbia Law and Economics Working Paper No 336, 2009) 347-351.
[11] Fatih Erdem, 'Stock Buybacks in Public Companies: A Necessity or a Trap?' (2021) 27(2) Marmara Üniversitesi Hukuk Araştırmaları Dergisi 1624-1644.

shareholders was that the payments were found to be exorbitant when compared to the company's performance.[12] According to research on Russell 3000 and S&P 500 companies, American companies had a say-on-pay report failure rate above 3% in 2021 for the first time in the last 10 years.[13] Although there are authors linking this to COVID-19-related adjustments,[14] other studies state, shareholders prefer to vote negatively in cases where the financial benefits provided to the managers are much higher than the average and payments are incompatible with the performance.[15] However, the say-on-pay concept is not effective as it is seems, as it has the potential to control over sudden increases in remuneration, it is less impactful to turn the tide in terms of the general upward trend in pay rates.[16]

The Agency Problem and Shareholder Activism

The "agency problem" in corporate governance relates to an issue concerning the separation of ownership and control of a company. Within this context, shareholders expect managers to maximize the company value, while managers prioritise maximizing their remunerations.[17] Wilful misconduct by executives pushing company's interests into the background may produce the activities that benefit their own interests instead of increasing the shareholder value and residual claim on the liquidation balance. Therefore,

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[12] William Allen, Reiner Kraakman and Guhan Subrahamnian, *Commentaries and Cases on the Law of Business Organization* (Wolters Kluwer Law 2012) 337; Susan Berson and Dave Berson, *The Dodd Frank Wall Street Reform and Consumer Protection Act – From Legislation to Litigation* (American Bar Association 2010) 240-241.
[13] Todd Sirras, Justin Beck and Austin Vanbastelaer, '2021 Say on Pay Failures Partly Due to Covid-19 Related Pay Actions' (Harvard Law School Forum on Corporate Governance, 19 June 2021) <https://corpgov.law.harvard.edu/2021/06/19/2021-say-on-pay-failures-partly-due-to-covid-19-related-pay-actions> accessed 23 February 2022.
[14] Ibid.
[15] Randall Thomas and Christopher van der Elst, 'Say on Pay Around the World' (2015) 92(3) Washington University Law Review 665-667.
[16] Brian Cheffins and Randall Thomas, 'Should Shareholders Have a Greater Say Over Executive Pay?: Learning from the US experience' (Vanderbilt Law, Joe C. Davis Research Paper No. 01-6, 2001) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=268992> accessed 23 February 2022.
[17] Udo Braendle and John Katsos, 'Directors' Remuneration and Motivation' in AlexanderKostyuk, Markus Stiglbauer and Dmitrey Govorun (eds), *The Theory and Practice of Directors' Remuneration: New Challenges and Opportunities* (Emerald 2016) 23.

the executives' efforts to maintain their current positions may endanger their own interests above the interests of shareholders or the company.[18]

From a financial point of view, the interests of executives are generally evaluated by the perception that the company's performance seems well. The agency problem creates a manipulative perception on firm performance. Therefore, obfuscating remuneration reports impacts shareholders to less likely dissent when voting say-on-pay. Nevertheless, the winds have changed when the majority of company shares are held by institutional investors like banks and insurance companies that are more likely to dissent being that reports are not articulable.[19]

The financial rights provided to executives in public and other dispersed ownership-structured companies have been one of the most controversial issues of corporate governance. In this context, shareholder activism, refers to the need to take control of the company by shareholders to maintain better company performance. In the lack of shareholder activism, it is mostly observed that executives are likely to demonstrate the company's bright side in order to get the best possible remuneration by hindering shareholders. Activist shareholders act with motives to increase the value of the company and getting profit through active control of management. This involvement can be considered a necessity in accordance with the "Stewardship Code",[20] which has brought the obligations of shareholders into a more concrete form. It was aimed that the shareholders should be more involved with the company (have more say rather than a pacified partnership) and fill power gaps in companies with a dispersed ownership

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[18] Erdem (n 2).

[19] Bo Qin, Reggy Hooghiemstra and Yu Flora Kuang, 'Does obfuscating excessive CEO pay work? The influence of remuneration report readability on say-on-pay votes' (2017) 47(6) Accounting and Business Research 659-729.

[20] The UK Stewardship Code was firstly introduced in 2010 by the Financial Reporting Council. However, the latest version is released in 2019. See, Financial Reporting Council, 'The UK Stewardship Code 2020' <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf> accessed 23 February 2022.

structure.[21] One can also interpret this Code as beneficial for short-termism in corporate governance, since it aspires for the long-term sustainability of corporations.

The obligation to the remuneration reporting obligation, occurring since 2002,[22] could be regarded as one of the most effective regulations for British companies that have received the most shareholder activism sparks. The activities of companies and company managers have been made more transparent and accountable. However, the disclosure provided on the basis of these reports was insufficient in reducing the gap between company performance and the remuneration of executives, as spending on the executives has increased even more.[23] In this context, the second revolutionary change was experienced with the 'Executive Pay and Remuneration Bill'[24] in 2013 when shareholders were able to use a binding vote (at least every three years) on the Remuneration policy by making the Directors' Remuneration Report mandatory. However, in practice, it remains difficult to involve institutional shareholders in support of companies' sustainable objectives.

The main problem yet to be resolved is the standpoint of institutional shareholders considering nothing but capital dividend (rather than the continuation of the company) especially the corporate shareholders who have taken over most of the partnership structures. The Stewardship Code initiated the implementation of the 'apply or explain' principle in a voluntary manner (not legally binding). In the context of this soft law, the vulnerability of this system is that the institutional shareholders, who are expected to be activists, bring their obligations weak.[25]

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[21] Brian Cheffins, *Corporate Ownership and Control: British Business Transformed* (OUP 2008) 344.
[22] The Directors' Remuneration Report Regulations 2002 (2002) No. 1986.
[23] Betty Wu, Iain MacNeil and Katarzyna Chalaczkiewicz-Ladna, ''Say-on-pay' regulations and director remuneration: evidence from the UK in the past two decades' (2020) 20(2) Journal of Corporate Law Studies 541-577.
[24] Executive Pay and Remuneration Bill (2013) Originated in the House of Commons, Session 2013-14.
[25] Marc Moore, 'Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance' (2009) 9 Journal of Corporate Law Studies 77.

Conclusion

Although influence of shareholders in the management of companies has increased, it was empirically shown that "say-on-pay has to date had limited success as a regulatory strategy".[26] This is because information given in the context of remuneration reports and company performance is never in a certain correlation.[27] In fact, the determination of the director's remuneration and the interest of the shareholders are interrelated; alike shareholders, managers also want the highest financial rights. The problem is whether the managers see their interests above the shareholders (and the company itself). Hence, a possible solution is to achieve a balance between the company performance and the remuneration of executives. It seems as if the trajectory of say-on-pay towards the shareholder activism trend is truly instrumental. Nevertheless, it would be a quixotic expectation to anticipate sharp results at short notice from the so-called quasi-successful regulatory approach regarding the say-on-pay that would likely come in useful if this approach is integrated in the corporate culture by cementing internal auditing mechanisms and intra-business democracy.

[26] Wu, MacNeil and Chalaczkiewicz-Ladna (n 23) 575.
[27] Ryan Krause, Kimberly Whitler and Matthew Semadeni, 'Power to the Principals! An Experimental Look at Shareholder Say-On-Pay Voting' (2014) 57(1) Academy of Management Journal 94-115.