CEO Compensation, Corporate Governance, and the Role of Institutional Investors

Boge Wang
School of finance, Yunnan University of Finance and Economics, Yunnan, 650221, China
Email: bogewang0827@163.com

ABSTRACT
In this paper, I analyze the effects of institutional investors on mitigating agency problem, focusing on adjusting CEO compensation by institutional investors from corporate governance. I discuss the theoretical basic of CEO compensation and point out that institutional investors can influence CEO from corporate governance mechanisms. From voting rights and ownership structure, institutional investors can both affect CEO compensation. Although changing salaries component of CEO compensation to performance-related pay is better than increasing in total CEO compensation, there still a lot to space for further to study how to improve efficiency of mitigating agency problem from the view of institutional investors.
Keywords: CEO compensation; corporate governance; institutional investors; agency problem.
Tob Regul Sci.™ 2021;7(6-1): 6957-6963
DOI: doi.org/10.18001/TRS.7.6.1.25

1.INTRODUCTION

For a long time, how to decrease agency problem raises wide attention from scholars. The reason for appearing agency problem is that there are conflicts between different groups. In firms, shareholders who are as the principals give managers power to make decisions in order to maximize interest of shareholders. But different managers have different choice preference and even different groups have imperfect information to each other, those all cause potential conflicts of interest in different groups, which arise agency problem.

The appearance of corporate governance stems from agency problem on different groups. There are varying governance mechanisms to affect managers, for example, boards of directors have rights to replace CEO or compensate CEO, shareholders decide manager-related proposals through voting rights. Institutional investors who are as an important type of shareholders can affect managers' behavior, i.e., assign directors to boards and vote for/against proposals through ownership, hence they are regarded as important participants to mitigate agency, because they can have enough motivations to do the things, which their goals is to maximize their interest of firms in the portfolio.

One way to motivate CEOs effectively is to adjust their compensation, all the time, CEO compensation is regarded as a therapy for mitigating agency problem between shareholders and management, because a better CEO compensation contract can help managers to actively make decisions as an agent. But how to set up pay or pay structure effectively is under discussion, in this paper, I discuss the problem of mitigating agency problem from institutional investors, which study that institutional investors affect CEO compensation through which corporate governance mechanisms.

The rest of the paper is as follows. Section 2 discusses the theoretical basis of CEO compensation. Section 3 discusses the effects of institutional investors on corporate governance through varying mechanisms. Section 4 discusses the effects of institutional investors on CEO compensation, which argue from the total CEO compensation and the structure of CEO compensation. In section 4, I summarize the above conclusions and discuss in this part.

2. CEO Compensation

Any discussion of CEO compensation should be based on the agency problem. Due to the separation of firm of ownership and management, managers should have done their best to maximize the shareholders' value, however, managers may pursue their own maximum wealth rather than achieving the goals, and this will cause the agency problem. Besides, the agency problem also occurs between board members and shareholders, and this will influence the executive pay-setting process. Over the past few decades, the main debates are about two views. One view is the optimal contracting theory, which considers executive pay arrangements as a method of alleviating the agency problem, another view is the managerial power theory, which is considered not only as the therapy of the agency problem but also as the agency problem.

2.1 The Optimal Contracting Theory

In order to motivate managers to maximize shareholders' value, directors are expected to design efficient pay schemes for managers to make decisions on behalf of maximum shareholders' interest. Considering which actions can be used for the plans, at first, large amounts of compensation are provided for managers to improve shareholder value. But this design has its own limitation, the generous incentives usually do not achieve its ideal effect (Jensen and Murphy, 1990). The main question is that the pay arrangements are not well correlated with managerial performance, hence, incentive contracts are designed that managers are granted a proportion of equity of the firm, the reason is that equity can be represented with the shareholders' value, by the manner, managers are considered to have enough reasons to take actions to benefit shareholder value.

Over the past decades, institutional investors and other outside shareholders encourage to use the equity-based incentives for closely tying pay with performance, especially stock options are widely used by principals. Usually, contracts will regulate a certain long time to exercise options to motivate managers for tying a long-term performance. Stock options can be not only as supplement of cash compensation but also as a relatively efficient incentives for a long time. But this kind of contracts still has some flaws. For example, when the whole stock market or the industry booms in a particular period, it's hard to say that the development of the firm is due to managers' behavior. In other words, stock options do not consider windfalls. To solve the problem, prior studies propose some strategies, one is familiar by us is the vesting schemes, which can be implemented by different stages with specific performance requirements. This method called performance-based compensation can be mostly within investment industry, which hedge fund is well-known for performance-based compensation. Besides, at-the-money is also a common problem among contracts, which do not such motivate managers to maximize shareholder value. Overall, the contracts do not tightly link incentives with managerial performance.

2.2 The Managerial Power Theory

From the view of the optimal contracting theory, directors are always looking for a better contracts to connect CEO pay with interest of shareholders. However, in the frame of the optimal contract theory, there is a noticeable question that agency problem also occur between the board of directors and shareholders. To be more specific, shareholders nominate directors to make decisions on behalf of maximum shareholders interest, while directors do not stand with shareholders completely for their own considerations, and the action also affects the process of setting pay arrangements. For example, first, CEO will have a certain influence on the nomination process, directors would not choose to bargain with CEO about pay plans in order to satisfy CEO. Second, directors are usually absence of effective information to really support themselves to change the CEO pay arrangements. Besides, another optimal pay-setting contract is based on the competitive market, however, market forces are not enough to set optimal contracts because firms would interact with each other and externalities will make inefficient market which also affects CEO compensation.

Based on above-mentioned questions, it can be said that the optimal contracting theory could not explain CEO compensation perfectly. Hence, another theory is put forward—the managerial power theory, which suggests that executives will have their own power to set pay and the more power they have, the more rent extraction they have.

The managerial theory also supposes that pay is sensitive to firm performance when CEO owns more concentrated power (Frydman and Jenter, 2010). To be more specific, there are several situations for improving managerial power. First, when corporate governance is weak, board is inefficient to set pay arrangements. Besides, firms which own few outside shareholders or institutional investors could lead to less monitoring, resulting more powerful managers. In the frame of managerial theory, market participants are important role of CEO compensation, such as institutional investors (Bebchuk and Fried, 2003). They would affect managerial power through participating corporate governance. Clearly, managerial theory appears due to the agency problem between directors and shareholders, but it also can be seen a therapy of agency problem between executives and shareholders.

2.3 Brief Summary

All the time, the question of CEO compensation is based on the agency problem. Although the two different theories explain CEO compensation from separate views, its core is better to set managers pay arrangements to alleviate the existing agency problem. Based on the basic theories, literature is looking for better explanations on CEO compensation. No matter which theory, institutional investors would have certain influence on the process of setting CEO compensation. As an important component of shareholders, when institutional investors own a large proportion of equities, such as top 10 shareholders, they probably assign directors to the board to govern firms, through this channel to affect pay-setting.

In addition to this, even though not appointing the directors, as large shareholders, institutional investors who own large stocks of firms would also actively participate in corporate governance for monitoring, for example, they would vote for/against proposals on variations of CEO compensation or approvals on stock compensation plan. Or some institutional investors related to firm with business connections would offer sufficient industry experience suggestions to affect pay-setting. Besides, when institutional investors have a small percentage of stocks, if the ownership structure is dispersive, there is no enough constraint for monitoring the behaviour of the boards, meaning that boards would probably stand for managers to set pay arrangements or even managers can set pay at their wishes. Even from the view of competitive market to set optimal pay arrangements, in reality, market is inefficient, institution investors are in favour of facilitating market efficiency, which affect the pay structure. Overall, institutional investors influence the corporate governance to a certain degree, which affect CEO compensation plans in further. Based on this, this article analyses CEO compensation and corporate governance from the view of institutional investors to see whether and how institutional investors influence them.

3 The Effects of Institutional Investors on Corporate Governance

Governance mechanisms can mitigate agency problem, for example, for the agency problem between shareholders and managers, setting equity-based pay or stock options can motivate managers on behalf of shareholders' interest, for the agency problem between large shareholders and small shareholders, exposing to the situation of large shareholders' holdings can mitigate this problem (McCahery et al., 2016). Through governance mechanisms, shareholders can affect corporate performance. Although governance mechanisms in different studies would be divided into different categories, institutional investors which are served as an important style of shareholders would make firm decisions from these two main mechanisms: voting rights and ownership structure.

3.1 Voting Rights

Institutional investors will exercise their rights through voting. At shareholders meeting, shareholders would vote for/against proposals to participate corporate decisions. Different groups can sponsor proposals relative to their interests, hence proposals themselves are heterogeneous. Although the objectives of proposals are to help the firms improve better in the future, that does not mean that proposals are on behalf of the interests of shareholders, especially when the proposals are put forward by management, proposals are likely to create conflicts of interest between management and shareholders. Besides, shareholder-sponsored proposals should have been on behalf of the interests of shareholders to affect corporate decisions, however, due to different holding purposes, different institutional investors would make different voting decisions based on their characteristics. To better explain the voting rights by

institutional investors, this paper divides the proposals into two styles: management-sponsored proposals and shareholder-sponsored proposals, which agency problem arises commonly from management and shareholders.

3.1.1 management-sponsored proposals

Usually, when management decides proposals, they would prefer considering their own interests, so there exists conflicts between the interests of shareholders and management. Institutional investors can exercise their voting rights against management-sponsored proposals to protect the interests of shareholders, James et al. (1988) prove that when management-sponsored proposals are harmful to the interest of shareholders, institutional investors are more likely able to vote against proposals, especially it happens in mutual funds, foundations, and public-employee pension funds. But actually, not all institutional investors in the different situations choose to vote against management-sponsored proposals. Matvos and Ostrovsky (2010) prove that some funds are more prone to get close to management than other funds according to management-sponsored proposals, the reason is that they are afraid of possible management retaliation and consider future potential business connection with firms. Overall, even though some management puts forward the proposals which may harm the interest of shareholders, the choices of voting rights by institutional investors are not the same, they may stand by the side of management.

3.1.2 shareholder-sponsored proposals

Proposals are not only sponsored by management, shareholders can also put forward to proposals on firm-level governance mechanisms to influence firm development. Institutional investors who are on behalf of the interest of shareholders should vote for shareholder-sponsored proposals, that is, they should vote against management. In fact, lots of prior literature prove that view, Dimmock et al. (2018) prove that mutual funds with higher accrued capital gains are likely to be vote against management, which means management would loss a vote. Jie et al. (2019) find that the more holdings of peer firms the institutional investors own, the more possibility the institutional investors vote against management according to shareholder-sponsored proposals. But in reality, some other types of institutional investors do not put the interest of investors at the first place, in contrast, they would vote against shareholder-sponsored proposals and be for management. Morgan et al. (2011) prove that rather than standing for shareholder-sponsored proposals, mutual funds prefer vote against proposals on shareholders, but study also prove that when proposals are with shareholders' wealth, mutual funds are more likely vote for it. Asharaf et al. (2012) prove that when mutual funds have relationship with firms in aspect of pension business, they have motivations to vote for management and against shareholder-sponsored proposals. Overall, institutional investors do affect corporate governance through exercising their voting rights, but how to vote and the results of voting are not unique, in fact, they would be affected by the characteristics of firm and institutional investors, different styles of proposals and so on.

3.2 Ownership Structure

The ultimate aim of institutional investors is to maximize the portfolio, which means they are not necessary to participate corporate governance, because the costs of participating in firms may outweigh benefits. But when institutional investors hold enough equity of firms in the portfolio, they have motivations to improve firms in order to gain more benefits, which the benefits of improving corporate governance outweighs costs of that (Bushee et al. 2014). The large holdings of institutional investors can affect corporate decisions through different channels. Specifically, Bethel and Gillan (2003) find that the ownership structure of firms can affect voting process, the more institutional investors own shares, the more they vote against management, which means institutional investors influence corporate governance through increasing shares. Kang et al. (2018) prove that when institutional investors become blockholders, they can improve corporate governance and firm value from three channels: industry expertise, past activism experience, and accumulated long-term monitoring experience. These channels can make institutional investors acquire information/monitoring advantages from large amounts of equity to have motivations to change firm decisions and add firm value. Overall, even though through different channels, institutional investors with blockholdings expect to gain more benefits from improve corporate governance.

3.3 Brief Summary

On the whole, institutional investors can affect corporate governance through varying governance mechanisms. No matter which mechanism, institutional investors expect to change firm governance behavior. Among them, CEO has great power of making decisions of firms directly, hence institutional investors hope to influence the behavior of CEO. For example, institutional investors can exercise their voting rights to change compensation-related proposals, even issues on ownership, when institutional investors hold majority shares of firms, they may force boards of directors to accept the patter of executive pay plans they choose. Thus, institutional investors can have certain influence on executive pay.

4 The Effects of Institutional Investors on CEO Compensation

Institutional investors can have impact on CEO compensation. From the perspective of governance mechanisms, the nature of ownership is to get voting rights, hence there are two situations to affect CEO compensation. First, when institutional investors are minority shareholders, they usually do not propose pay-related proposals, but when the adjustment of proposals on CEO compensation are unreasonable, institutional investors would exert voting rights to express their attitude to for/against proposals, that is, institutional investors influence CEO compensation through voting rights. Second. When institutional investors are majority shareholders, they have enough motivation to put forward to proposals on CEO compensation, which stimulate CEO to improve firm performance better. If they own sufficient equity, or get controlling votes through allying part of other shareholders, they can directly pass proposals to change CEO compensation. Overall, due to agency problem between management and shareholders, institutional investors expect to modify CEO compensation to be balance interest between CEO and themselves, which make them get maximal benefits. The changes on CEO compensation outline two aspects: the overall level of CEO compensation and the structure of CEO compensation.

4.1 The Overall Level of CEO compensation

One method of motivating CEO to improve firm performance is to increase the overall level of CEO compensation. Through the manner, Institutional investors expect that executives can regard the interest of shareholders as their own interest and then take actions to improve the development of firm. But this will arise several problem.

First, the aim of voting for increasing CEO pay by institutional investors is not based on maximum interest, the reason for increase in the pay is that institutional investors are connected with firms, for example, Butler and Gurun (2012) prove that when CEOs have the same educational background with mutual funds, they are more likely to increase total compensation. And then, it is easy to appear the overpaid CEO compensation, based on this situation, institutional investors should have decreased the total level of that, because generous pay do not motivate CEOs effectively, some types of institutional investors do not choose to vote against proposals on decreasing pay (Ashraf et al., 2009; David et al., 1998; Butler and Gurun, 2012). For example, when firms have business ties with institutional investors (e.g., pressure-sensitive institutional investors or mutual funds), these institutional investors would choose to compromise on the generous level of CEO compensation to keep important business relationship with invested firms. In summary, increase in the overall level of CEO compensation is not an enough perfect method for institutional investors to solve agency problem, because the effects of changing the overall compensation are ambiguous.

4.2 The Structure of CEO compensation

The structure of CEO compensation can be divided into different components, but from the view affected by institutional investors, CEO compensation is mainly made up from two parts: the salaried component of pay and the performance-related component of pay. In the above analysis, the increase in total pay is not enough for mitigating agency problem between CEO and institutional investors, hence, institutional investors turn attention to the adjustment of the structure of CEO compensation within nearly fixed total pay. The goal of Institutional investors is to maximize portfolio, hence when stock prices of firms in the portfolio increase, institutional investors can gain

benefits directly. One method of mitigating agency problem is to changing salaried component of pay to pay-performance component of pay, that is, increasing equity-based pay, which better combine interest of institutional investors with CEO behavior. Clifford and Lindsey (2016) prove that active institutional investors choose to add the part of equity-based pay in the overall CEO compensation. Almazan and Starks (2010) prove that the pay-for-performance part increase with increasing institutional ownership. Hartzell and Starks (2003) prove that there is positive relationship between institutional investors and pay-for-performance part of compensation.

Above literature all prove the evidence that institutional investors prefer the method of mitigating agency problem. Although this method is regarded as an efficient incentive by institutional investors to encourage CEO make decisions considering interest of shareholder, but from the perspective of CEOs, whether really motivating CEOs remain doubt. For example, if the firms belong to the industry in the development period, combining CEO behaviors with equity is a wise choice because it can make CEO gain a lot benefits from stock increase, however, if the whole industry fall into the mature or declining period, this method is not sufficient effective, the reason is that no matter short-term or long-term period, the stock prices will remain invariant or even declining. Besides, the personalities of CEOs will also have different influences toward to effects of changes of the structure of CEO compensation. For example, equity-based pay may be quite efficient for radical CEOs, because they are rewarded more benefits though the method, but conservative CEOs do not like this, they probably prefer salaried pay. So even institutional investors prefer more about pay-for-performance part, it can not guarantee to solve the agency problem ideally.

4.3 Brief Summary

Through adjusting the total pay and the structure of pay, institutional investors expect to mitigate agency problem between them. But due to different specific situation, like industry development and personalities of CEO, they do not solve the problem totally according to their assumptions. So whether there are another methods to solve the conflicts of institutional investors and CEO, and how to improve the method effectively is worth further discussion.

5. Conclusion

This paper illustrates agency problem between shareholders and management from the view of institutional investors. Through two main theories: the optimal contracting theory and the managerial power theory, CEO compensation is both core method of mitigating agency problem, hence this paper focus on how to mitigate agency problem from influencing CEO compensation. Institutional investor as an important type of shareholders can affect CEO compensation from main corporate mechanisms, that is, voting rights and ownership structure, but no matter which mechanism, the core method is to affect pay-related proposals by using voting rights. Institutional investors expect to use the method to affect CEO compensation, the expected results is to effectively motivate CEOs on behalf of interests of shareholders, but both the increase in total CEO compensation and pay-for-performance part do not achieve anticipation.

Through analysis, we can find that institutional investors influence CEO compensation through corporate governance mechanisms, which is considered to motivate CEO effectively to mitigate agency problem. But current literature mainly focus on adjustment of the structure of CEO compensation, which increases the part of performance-related pay within the nearly fixed CEO compensation, it can be seen to well connect interest of shareholders with CEO behavior. But the results it bring may not be as perfect as institutional investors expect, because the factors of CEO and industry will determine different choice preferences, and that will both lead to agency problem itself to not be well mitigated. Besides, prior literature pay more attention to voting rights, which is considered to an effective corporate governance mechanism to influence firm decisions, hence in the study of CEO compensation by institutional investors, they mainly focus on voting rights to affect the structure of CEO compensation.

Based on above analysis and results, it can be said that related literature focus that institutional investors use their voting rights to change CEO compensation to mitigate agency problem, but results and effects may be ambiguous. So there are several questions to be further studies. First, besides voting rights, there is any other way for

institutional investors to influence CEO behavior? For example, when institutional investors hold certain proportion equity of firms, can they change CEO behavior to be on behalf of institutional investors through threats of exit? Because the threats of exit may influence stock prices of firms, which further influence CEO compensation, so that motive CEO to make decisions for better firm development. Second, how different industry and CEO personalities influence institutional investors behavior on mitigating agency problem？Third, is there any difference between dispersed and concentrated holdings by institutional investors to affect CEO compensation to mitigate agency problem?

Overall, institutional investors do exert effect influence on CEO compensation to mitigating agency problem, but there are some space to better improve method and it still need our to further explore.

References

[1] Almazan A , Starks H . Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive Compensation[J]. Financial Management, 2010, 34(4):5-34.

[2] Ashraf R, Jayaraman N, Ryan Jr H E. Do pension-related business ties influence mutual fund proxy voting? Evidence from shareholder proposals on executive compensation[J]. Journal of Financial and Quantitative Analysis, 2012: 567-588.

[3] Bebchuk L A, Fried J M. Executive compensation as an agency problem[J]. Journal of economic perspectives, 2003, 17(3): 71-92.

[4] Brickley J A, Lease R C, Smith Jr C W. Ownership structure and voting on antitakeover amendments[J]. Journal of financial economics, 1988, 20: 267-291.

[5] Butler A W, Gurun U G. Educational networks, mutual fund voting patterns, and CEO compensation[J]. The Review of Financial Studies, 2012, 25(8): 2533-2562.

[6] Bushee B J, Carter M E, Gerakos J. Institutional investor preferences for corporate governance mechanisms[J]. Journal of Management Accounting Research, 2014, 26(2): 123-149.

[7] Clifford C P, Lindsey L. Blockholder heterogeneity, CEO compensation, and firm performance[J]. Journal of Financial and Quantitative Analysis, 2016: 1491-1520.

[8] Dimmock S G, Gerken W C, Ivković Z, et al. Capital gains lock-in and governance choices[J]. Journal of Financial Economics, 2018, 127(1): 113-135.

[9] David P, Kochhar R, Levitas E. The effect of institutional investors on the level and mix of CEO compensation[J]. Academy of Management Journal, 1998, 41(2): 200-208.

[10] Frydman C, Jenter D. CEO compensation[J]. Annuual Review of Financial Economics, 2010, 2(1): 75-102.

[11] Hartzell J C , Starks L T . Institutional Investors and Executive Compensation[J]. Journal of Finance, 2003, 58(6):2351-2374.

[12] He J J, Huang J, Zhao S. Internalizing governance externalities: The role of institutional cross-ownership[J]. Journal of Financial Economics, 2019, 134(2): 400-418.

[13] Jensen M C, Murphy K J. Performance pay and top-management incentives[J]. Journal of political economy, 1990, 98(2): 225-264.

[14] Kang J K, Luo J, Na H S. Are institutional investors with multiple blockholdings effective monitors?[J]. Journal of Financial Economics, 2018, 128(3): 576-602.

[15] McCahery J A, Sautner Z, Starks L T. Behind the scenes: The corporate governance preferences of institutional investors[J]. The Journal of Finance, 2016, 71(6): 2905-2932.

[16] Matvos G, Ostrovsky M. Heterogeneity and peer effects in mutual fund proxy voting[J]. Journal of Financial Economics, 2010, 98(1): 90-112.

[17] Morgan A, Poulsen A, Wolf J, et al. Mutual funds as monitors: Evidence from mutual fund voting[J]. Journal of Corporate Finance, 2011, 17(4): 914-928.

[18] Kazemi E. Unconsummated Marriage (" Honeymoon Impotence"): 25 years' Experience with 871 Couples, in Kermanshah, Iran. Tobacco Regulatory Science (TRS). 2021 Aug 31:5018-31.