Journal of Banking & Finance 69 (2016) 52–71

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Stock ownership guidelines for CEOs: Do they (not) meet expectations?

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ARTICLE INFO

Article history:
Received 20 January 2014
Accepted 10 April 2016

JEL classification:
G34
J33
M52

Keywords:
CEO stock ownership guideline
Not-meet adoption
Meet adoption
CEO compensation
Incentive alignment
Stakeholder management
Financial performance

ABSTRACT

This paper examines the determinants and the effects of CEO stock ownership guideline adoption, differentiating Not-meet/Meet adopters – those setting the guideline above/below the CEO's stock ownership at the time of adoption. While Meet adoption is mainly determined by factors related to stakeholder management, we find that Not-meet adoption is associated with factors related to both incentive alignment and stakeholder management. CEO ownership increases and CEO incentive alignment improves for Not-meet firms. But CEO ownership and incentives are unchanged for Meet firms following guideline adoption. We find no evidence that CEO compensation changes abnormally after adoption. Not-meet firms have larger improvement in operating performance and better stock performance than Meet firms. We provide evidence that the motives and the effects of guideline adoption depend on the level of the ownership restriction relative to the CEO's ownership at the time of adoption.

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1. Introduction

Over the past decade numerous public firms have implemented executive stock ownership guidelines. A survey by Equilar (2010) finds that 80.6 percent of Fortune 250 firms disclosed executive stock ownership guidelines in 2009, up from 75.5 percent in 2006. Stock ownership guidelines require executives to meet and maintain pre-determined equity ownership goals within a specified period of time, generally ranging from 3 to 5 years. Ownership guidelines are typically directed at executives with the greatest effect on firm performance, such as the CEO and other very senior executives (Ellig, 2007).

The recent trend in guideline adoption by large public firms is consistent with it being identified as a best practice in executive compensation by third party proxy advisory firms (e.g. Institutional Shareholder Services and Glass Lewis & Co.) and corporate governance leaders (Conference Board, 2002; Business Roundtable, 2003; Cook, 2008; and others). However, few studies formally investigate the determinants and consequences of adopting executive ownership guidelines,[3] with the exception of Core and Larcker (2002) and Cao et al. (2010). Furthermore, no study is on the effects of how boards set the executive ownership guideline. To fill this void, we collect and analyze a comprehensive sample of firms that adopt CEO stock ownership guidelines from 1992 to 2007. Interestingly, we find that about half of guideline adopting firms (48%) set the ownership restriction below the CEO's stock ownership at the time of adoption. For example, the median value of CEO stock ownership exceeds the median value of the ownership target ($3.32 million) by $390,000 at the time of adoption.

This suggests that there may be two distinct groups of adopters, those where the board sets the guideline above the CEO's stock ownership, Not-meet firms, and those where the board sets the guideline below the CEO's stock ownership, Meet firms, at the time of adoption. We argue that guideline adoption for Not-meet firms

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[3] Bhagat and Tookes (2012) and Farrell and Kamal (2009) study ownership guidelines for outside directors and find that stock ownership of outside directors goes up and operating performance improves after adoption.

http://dx.doi.org/10.1016/j.jbankfin.2016.04.006
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is likely motivated by incentive alignment. Not-meet adoption requires the CEO to increase ownership to meet the guideline, which should result in better alignment of management with shareholders and improved financial performance. However, CEOs of Meet firms already comply with the guideline at adoption. As such, Meet firms are more likely to adopt guidelines for stakeholder management as a response to pressure from stakeholders. Meet adoption is expected to have no economic value, resulting in no change in CEO ownership or financial performance.[4]

We test this conjecture by examining the determinants of stock ownership guideline adoption and the effects of adoption on CEO ownership, CEO compensation, and financial performance for each of these two distinct subsets of firms.[5] We find that proxies for both incentive alignment and stakeholder management are significant determinants of overall guideline adoption. But, when analyzing Not-meet and Meet adoption decisions separately, variables associated with incentive alignment remain significant determinants of Not-meet adoption decisions; whereas, only proxies for stakeholder management are associated with Meet adoption decisions. Specifically, CEO scaled wealth-performance sensitivity, an empirical measure of incentive alignment with shareholders (Edmans et al., 2009), is a significant determinant for Not-meet adoptions, whereas, the propensity of Meet adoption is increasing in the proportion of industry firms that have already adopted a guideline. Overall, our results are generally consistent with the view that Not-meet adoption is motivated by the desire to improve CEO incentive alignment. Meet adoption is more likely motivated by stakeholder management.

We next examine the effects of stock ownership guideline adoption on CEO ownership. We find that CEO ownership increases after adoption for Not-meet firms, suggesting that guideline adoption for this subset of firms is effective at increasing the CEO's level of ownership. The resulting increase in CEO ownership improves incentive alignment for Not-meet adopters. Scaled wealth-performance sensitivity increases after adoption. In contrast, we find that CEO ownership stays the same after guideline adoption for Meet firms. Lastly, we find that Not-meet firms have significantly larger improvement in operating performance and better stock performance compared with Meet firms following adoption.

We also examine the effect of guideline adoption on CEO compensation. CEO total annual compensation and the proportion of equity based compensation paid to the CEO do not change after guideline adoption for Not-meet or Meet firms after controlling for potential endogeneity and other factors. This result indicates that the higher levels of CEO ownership for Not-meet firms do not result from changes in the level or the mix of CEO compensation subsequent to adoptions.

Overall, the effects of Not-meet adoption on ownership, compensation, and financial performance are consistent with the view that Not-meet adoption is likely for incentive alignment. The absence of a significant effect of guideline adoption for Meet firms conforms to the stakeholder management view of Meet adoption.

Our study contributes to the debate on the effectiveness of stock ownership guidelines in the context of the existing executive compensation literature in several ways. First, and most importantly, we provide evidence that the motivation for stock ownership guideline adoption depends on the level of the ownership restriction relative to the CEO's ownership at adoption. Examining the determinants of guideline adoption, we find that Not-meet adoption is likely motivated by incentive alignment, with the aim to increase CEO ownership toward an ownership target that is above the level of CEO ownership at adoption. Meet adoption is more likely a response to external pressure from stakeholders. Further, we find evidence consistent with these divergent motivations for guideline adoption when examining the consequences of guideline adoption. Specifically, stock ownership guideline adoption increases CEO ownership levels only when the ownership guideline is set above the current level of CEO ownership. This increase is not the result of changes in the level or the mix of CEO compensation. We also demonstrate that the benefits of guideline adoption on firm performance are greater for Not-meet adopting firms relative to Meet adopting firms. Second, we cover a more recent time period than Core and Larcker (2002), in which there is not only a substantial increase in equity based compensation and ownership guideline adoption but also increasing pressure on firms to adopt ownership guidelines because they are considered as a best practice in executive compensation by third party proxy advisory firms and corporate governance leaders.

In sum, we extend the prior literature by documenting divergent motivations for guideline adoption and provide new evidence on the effect of ownership guideline adoption. This suggests that the benefits of stock ownership guideline adoption cannot be generalized to all firms and depend on where the board sets the guideline relative to the CEO's stock ownership at adoption.

In a closely related paper examining the adoption of executive ownership guidelines from 1992 to 2008, Cao et al. (2010) find divergent motivations for early vs. late guideline adoption. While their paper also finds divergent motivations for guideline adoption, our paper differs from Cao et al. (2010) in two aspects. First, Cao et al. (2010) argue that early (pre-2002) adoptions appear to be driven by efficient contracting and recent (post-2002) adoptions appear to be driven mainly by public pressure. We find that the divergent motives for guideline adoption depend on the level of the ownership restriction relative to the CEO's ownership at the time of adoption in both pre- and post-2002 adoptions. Second, unlike Cao et al. (2010), when examining the consequences of guideline adoption, we control for potential endogeneity issues related to adopting decisions.

We organize the remainder of this paper as follows. We motivate our research, review the literature, and develop our hypotheses in Section 2. We provide an overview of our sample and the data in Section 3. We present our empirical results in Section 4, and provide concluding remarks in Section 5.

2. Background, motivation, and predictions

2.1. Why do firms adopt stock ownership guidelines – incentive alignment or stakeholder management?

At the heart of the trend in stock ownership guideline adoption is evidence suggesting that despite dramatic increases in restricted stock and option compensation over the past 20 years (Hall and Liebman, 1998; Hall and Murphy, 2003),[6] higher equity-based compensation in the absence of ownership restrictions may not lead to higher levels of executive ownership and may also exacerbate agency

[4] It is also possible that Meet adoption may result in better or worse financial performance. This is discussed in Section 2.2.

[5] This approach is partly motivated by Core and Larcker (2002)'s evidence of two distinct groups of adopters – Meet vs. Not-meet. However, a key difference between this study and that of Core and Larcker (2002), is that we condition the results of ownership and performance on the CEO's ownership relative to the stock ownership guideline.

[6] Hall and Murphy (2003) note that although the average real (inflation-adjusted) pay package of CEOs of S&P 500 firms more than quadrupled from \$3.5 million in 1992 to \$14.7 million in 2000, the value of stock options granted to CEOs increased ninefold over the same period. While the increase coincides with Jensen and Murphy's (1990) finding that CEOs have weak incentives to increase shareholder wealth, the dramatic increase over this period has also been attributed to elimination by Congress in 1993 of the corporate income tax deduction for executive salaries in excess of \$1 million. As a result, firms shifted a significant portion of executive compensation away from non-incentive based pay towards tax deductible incentive based pay such as stock and options (Bhagat and Romano, 2009).

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