Int. Fin. Markets, Inst. and Money 34 (2015) 147–160

Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

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

Controlling shareholders' incentives and executive pay-for-performance sensitivity: Evidence from the split share structure reform in China☆

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ARTICLE INFO

Article history:
Received 19 September 2014
Accepted 25 October 2014
Available online 31 October 2014

JEL classification:
G3

Keywords:
Corporate governance
Controlling shareholders
Pay for performance
China market

ABSTRACT

Using the split share structure reform in China as a natural experiment, we study how changes in controlling shareholder incentive affect the pay-for-performance sensitivity. The reform converts the shares owned by controlling shareholders from non-tradable to tradable shares. The removal of such market friction allows for a better alignment of interests between controlling and minority shareholders, which gives managers more incentives to improve corporate performance. We find that the pay-for-performance sensitivity improves greatly after the reform. Changes in the pay-for-performance sensitivity are also associated with firm ownership structure, the level of agency conflicts and governance quality. Given that firms with controlling shareholders are the dominant form of business organization in many countries around the world, our results have important implications in that they show that a better alignment between controlling and minority shareholders' incentives has a significant effect on executive compensation.

1. Introduction

The relation between executive pay and firm performance is a key factor in determining the effectiveness of CEO compensation structure. Based on the agency framework, researchers generally interpret a higher executive pay-for-performance sensitivity as indicating a better alignment of interests between management and shareholders. However, previous studies have continuously reported mixed results regarding pay-for-performance sensitivity. Studying the U.S. market, Bebchuk and Fried (2004) argue that there is pay without performance, whereas Hall and Liebman (1998) and Conyon and He (2011) report a positive relation between change in performance and change in CEO pay. International evidence is also mixed. Izan et al. (1998) find no evidence of pay for performance among firms in Australia, whereas Colpan and Yoshikawa (2012) find a positive relation between pay and performance in Japan. Florin et al. (2010) survey the executive

☆ We are grateful to Katherine Schipper for her valuable comments and suggestions. We thank ananonymous referee for providing comments. We also thank discussants at the 2013 FMA and 2014CICF conferences for their comments. Chen acknowledges the financial support from ChinaNational Natural Science Foundation (No. 71263034) and Program for Changjiang Scholars andInnovative Research Team in University (IRT1258) and Lu acknowledges the financial supportfrom China National Natural Science Foundation (No.70802062, 71272197, 71032006).
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http://dx.doi.org/10.1016/j.intfin.2014.10.003
1042-4431/

compensation literature and conclude that "it is remarkable that, although hundreds of papers have been written on the subject, there is no real consensus on the relation between executive pay and firm performance".

A major factor that contributes to such complexity but has not been adequately addressed in the literature is the influence that controlling shareholders have over executive compensation contracts. Several comparative corporate governance studies have shown that controlling shareholders represent the prevailing structure in most countries (i.e., Becht and Röell, 1999; La Porta et al., 1999; Faccio and Lang, 2002; Claessens et al., 2000). Even in U.S. firms, controlling shareholders have proven more common than is usually thought (Bebchuk and Weisbach, 2009; Holderness, 2009).[1] According to Bebchuk and Weisbach (2009), for firms with controlling shareholders, the conflicts between controlling and minority shareholders often dominate the classic owner-manager connection. Several studies have found controlling shareholders to be associated with a significant amount of tunneling (Bertrand et al., 2002), reduced firm value (Gompers et al., 2009) and lower executive pay-for-performance sensitivity (Wang and Xiao, 2011). After providing a comprehensive review of the state of corporate governance research, Bebchuk and Weisbach (2009) called for more studies of controlling shareholders, "given the importance of firms with controlling shareholders in many countries around the world".[2]

In this study, we examine the effects of changes in controlling shareholders' incentives on executive pay-for-performance sensitivity in the context of the split share structure reform in China (hereafter termed the reform). Implemented in 2005 for Chinese listed firms, the reform permits controlling shareholders to convert their formerly non-tradable shares into tradable shares during a specific period (Chen et al., 2012).[3] The purpose of the reform is to better align the interests of controlling shareholders with those of minority shareholders. A significant market friction has been removed by the reform, and controlling shareholders are now able to realize gains by selling their shares on the stock market. Controlling shareholders have therefore become more concerned about stock prices and have stronger incentives to monitor managers. Dispersed ownership is also made possible by the reform, making managers more aware of the interests of minority shareholders, which increases their incentives to improve firm performance. A key objective of this study is thus to examine how changes in controlling shareholders' incentives affect executive pay-for-performance sensitivity.

There is another advantage of conducting our research in the context of the reform. Many of the empirical studies on executive compensation must address the issue of endogeneity. Specifically, those controlling shareholders' incentives and executive compensation might be driven by unknown firm characteristics or business strategies. To mitigate the potential endogeneity issue in executive compensation studies, researchers strive to identify an exogenous event and observe how compensation contracts change. For example, Paligorova (2010) examines the change in pay-for-performance sensitivity following the implementation of the Sarbanes–Oxley Act in 2002. Perry and Zenner (2001) document an increase in pay-for-performance sensitivity after the adoption of Internal Revenue Code Section 162(m). Some studies (e.g., Core and Guay, 2010; Bhagat and Romano, 2010) have examined the usefulness of the Troubled Asset Relief Program and Pay for Performance Act of 2009 by looking at its effect on pay-for-performance sensitivity. The split share structure reform in China represents an exogenous shock that fundamentally changed the incentives of controlling shareholders, thereby providing an interesting setting to examine how the latter affect executive compensation.

This study joins the literature on the relation between corporate governance and executive compensation and contributes to it by providing evidence on how controlling shareholders' incentives affect executive compensation. Furthermore, the reform represents an exogenous shock to a firm's external governance environment that mitigates the potential endogeneity issue inherent in corporate governance studies. We show that there is a significant increase in executive pay-for-performance sensitivity subsequent to the reform. Such improvement is economically significant and represents an approximately 26.18% increase in pay-for-performance sensitivity relative to the sample average for the pre-reform period. To the best of our knowledge, this study represents the first effort to identify a causal effect of controlling shareholders' incentives on executive pay-for-performance sensitivity using a security legal reform as a natural experiment. Bebchuk and Weisbach (2009) find that firms with controlling shareholders are the dominant form of business organization in many countries around the world, thus our results have important implications in that they show that a better alignment between controlling and minority shareholders' incentives significantly affects executive compensation.

We also highlight the effects of ownership structure differences and corporate governance quality on the relation between controlling shareholders and executive compensation. Our results show that the improved pay-for-performance sensitivity during the post-reform period is more significant for non-state-owned enterprises (i.e., privately controlled firms) than for state-owned enterprises (SOEs), and for firms with ex-ante larger conflicts between controlling and minority shareholders. Additionally, the pay-for-performance sensitivity experiences greater increases in firms with weaker corporate governance before the reform, suggesting that the reform does result in a pay-for-performance sensitivity improvement. However, corporate governance must be simultaneously strengthened to reach the reform's full potential.

[1] A common type of controlling shareholder in U.S. firms is the so called "controlling minority shareholder" (Bebchuk et al., 2000; Becht and Röell, 1999), who owns a minority of firm cash flow rights but possesses a majority of voting rights. A good example of this is a dual-class stock ownership (Bebchuk and Weisbach, 2009).

[2] Bebchuk and Weisbach (2009 further note that "governance arrangements that are optimal for investor protection in companies without a controlling shareholder could be suboptimal for companies with such a controller, and vice versa."

[3] Section 2 details the institutional background of the Chinese stock market and offers a more detailed description of the split share structure reform in China.