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Discussion paper

INSTITUTIONAL INVESTOR PREFERENCES AND EXECUTIVE COMPENSATION

BY JOSEPH A. MCCAHERY, ZACHARIAS SAUTNER

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Institutional Investor Preferences and Executive Compensation

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Abstract:

In this paper, we investigate the attitudes of institutional investors, such as hedge funds, insurance companies, mutual funds and pension funds, towards a key corporate governance mechanism, namely executive compensation. We document the preferences they have about both the level and structure of executive compensation. Our analysis takes a comparative approach as we ask investors to reveal their preferences both for firms in the U.S. and in The Netherlands. Our analysis further sheds light on who should decide on executive pay, thereby contributing to the recent debate on shareholder involvement in executive pay. Finally, we examine their views on the most important and largest component of executive pay, executive stock options, and investigate what preferences they have when it comes to the design of such options.

1. Introduction

Over the last two decades, institutional investing has become an important component of financial markets (e.g., Gillan and Starks (2007)). The increase in institutional ownership has been accompanied by an enhanced role played by institutions in monitoring the corporate governance behavior of companies. Among other things, institutional investors ascertain whether companies comply with the best practice standards elaborated in the guidelines established by corporate governance bodies, pursue proxy voting challenges at annual meetings or conduct coordinated shareholder activism.

Prior research has studied the participation of institutional investors in targeting poorly performing firms and pressuring boards of directors to improve corporate performance. In recent years, activist institutions in the United States (US) have made use of a federally-mandated privilege to submit shareholder proposals included in the management's annual proxy statement for a vote at the annual general meeting (see Cotter and Thomas (2007)). The proposal process provides a mechanism for shareholders to raise corporate governance and performance concerns and to pressure boards to implement the proposed changes. Most proposals submitted by investors (other than hedge funds) relate to the elimination of anti-takeover devices, executive compensation, the board of directors and voting rules. In the last decade, hedge funds have embraced activist strategies, taking investment stakes in underperforming firms and directly engaging management to undertake changes that are favorable for outside shareholders and their financial agenda (e.g., Brav, Jiang, Partnoy, and Thomas (2008)).

The evolving role of institutional investor participation in corporate governance is likely to continue and its growth is driven by investor strategies which have changed significantly. In this chapter, we investigate the attitudes of institutional investors, such as hedge funds, insurance

companies, mutual funds and pension funds, towards a key corporate governance mechanism, namely executive compensation. The purpose of this study is to document the preferences they have about both the level and structure of executive compensation. Our analysis takes a comparative approach as we ask investors to reveal their preferences both for firms in the US and in The Netherlands. Further, we selected these two countries because they have different legal origins, investor protection regimes, and ownership characteristics. In particular, the United States is an English common law country that is generally considered to have high investor protection, low ownership concentration, and high institutional ownership, whereas The Netherlands is a French civil law country that is viewed as having low investor protection, high ownership concentration, and low institutional ownership.

Our analysis further sheds light on who should decide on executive pay, thereby contributing to the recent debate on shareholder involvement in executive pay (“say on pay”). Finally, we study their views on the most important and largest component of executive pay, executive stock options, and investigate what preferences they have when it comes to the design of such options. To investigate these issues, we make use of a new dataset from a survey of 118 large institutional investors, including mutual funds, hedge funds or insurance firms.

Based on our survey responses, we find that a majority of investors prefer a reduction of the level of severance payments (golden handshakes) when CEOs leave, both for portfolio firms in The Netherlands and the US. This is consistent with the view that the granting of extravagant pay packages reflects poor corporate governance and a strong CEO bargaining position. Interestingly, the majority of investors do not think that overall CEO pay should be reduced in The Netherlands. Moreover, a (small) majority believes that the compensation of Dutch CEOs should be more equity-based (i.e. more stock options or restricted shares). While overall CEO

pay in The Netherlands is generally not considered as being too high, almost half of the investors believe that CEO pay in the US should be reduced.

Agency theory and optimal contracting theory posits that shareholders should make the pay decision in order to limit the moral hazard problem caused by low ownership stakes of CEOs and to provide incentives to motivate CEOs to maximize shareholder wealth. Our analysis reveals that shareholders prefer to be responsible deciding about the structure and level of CEO pay. We find, moreover, no evidence that the differences in the one-tier versus two-tier board system have an effect on shareholder preferences for CEO pay decisions being delegated to the compensation committee (one tier system) or non-executive members of the board (two tier system).

Insofar as institutional investors' preferences for the design of executive stock options, we find that investors are sensitive to a transparent disclosure of option compensation, relative operating and stock price benchmarks (benchmarks that managers need to fulfill before they are eligible to exercise their options) and long vesting periods. In addition, absolute stock price benchmarks are considered relatively unimportant, which is consistent with optimal contracting models (Holmstrom (1979, 1982)).

The remainder of the chapter is organized as follows. In Section II, we provide a review of selected evidence on the role of institutional investors in executive compensation. Section III contains the data sources and summary information about the investors in the sample. Section IV presents the empirical results of our study on the preferences of institutional investors regarding executive compensation. Section V summarizes our findings.

2. Institutional investors and executive compensation

Previous research has shown that institutional investors can influence the structure and level of executive compensation. We consider two possible views on the role of institutional investors on executive compensation.

The first view arises from agency theory research and highlights the monitoring benefits of institutional investors, i.e. their role in ensuring that CEO pay is properly designed. This view implies, for example, that the pay-for-performance sensitivity of CEO pay, a measure of how well incentives of CEOs and shareholders are aligned, should be positively related to the concentration of institutional investor ownership (Jensen and Murphy 1990). Providing support for this standpoint, the empirical work by Hartzell and Starks (2003) shows that with an increase in institutional investor ownership, CEO pay levels decrease but pay-for-performance sensitivities increase.

A second view highlights potential conflicts of interests arising from business ties between institutional investors and CEOs of their portfolio firms. This perspective suggests that institutional investors with more conflicts of interests from business ties are less likely to contribute to the monitoring of CEO pay (Brickley, Lease and Smith (1988)). Moreover, this work suggests important differences between pressure-resistant institutional investors, who have greater incentives to influence the level of CEO pay, and pressure-sensitive institutional investors, who because they must continue to maintain their business relationships are unlikely to invest in active monitoring. Recent research finds evidence in support of the role that different groups of institutional investors play in influencing total CEO pay. For example, Shin and Seo (2010) show the different effect of public pension funds and mutual funds on the level of CEO pay and pay-for-performance sensitivity for CEO, thus observing a negative association of

pension fund ownership with CEO pay and a positive association for mutual fund ownership and total CEO pay.

Institutional investors not only influence executive compensation directly, but also indirectly through their trading. Trading may affect executive pay through its effect on the value of the option and stock holdings of executives. Recent evidence demonstrates the important role of trading behavior of investors. Sias, Starks and Titman (2002) show that stock returns are correlated with changes in institutional ownership, which is due to the informed trading of institutional investors. The enforcement of insider trading rules creates dangers for institutional investors which can reduce this effect (Maug 2002).

In response to the above-stated views, a new line of research has integrated the implicit assumption that institutional investors are heterogeneous in their effects on CEO compensation structure and looks to their preferences to explain the different pay outcomes for CEOs. For example, Bushee and Noe (2000) show that improved disclosure rankings increases the attractiveness to transient institutional investors who are more likely to act as traders, which can greatly influence the share price of the portfolio company. In contrast with institutions with a longer investment horizon and concentrated holdings (dedicated investors) who invest in monitoring and attempt to introduce changes in the strategies of portfolio firms, transient investors are more likely to sell the firms' shares in reaction to poor firm performance or to force CEO turnover. This increases the willingness of portfolio companies to adopt CEO pay packages that transient investors' prefer in order to ensure that investors maintain their holdings in the company's stock.

3. Data description

We exploit in this study a new dataset from a survey of institutional investors to better understand the preferences of institutional investors about CEO compensation. We use our survey to assess their views about three important aspects of executive pay, namely (i) whether adjustments to the level and structure of pay are necessary, (ii) who should decide on pay, and (iii) how executive stock option plans should be designed.

The survey questions were developed based on the existing executive pay literature. Before conducting the survey, we circulated it among academics and investor relations research experts to get their feedback and suggestions on the survey design and execution. Our survey recipients were selected from the FactSet/LionShares database, which defines institutional investors as professional money managers with discretionary control over assets. Because we ask our survey respondents to assess executive pay in the United States and The Netherlands, we need to ensure that they have at least some knowledge of CEO pay in The Netherlands. Consequently, we restrict the survey to those institutions in the database that have at least 5% of their assets under management invested in Dutch companies. Asking questions about pay in The Netherlands and the US allows us to benchmark and compare the situation in both countries. The scope of our survey includes all important investor-types, i.e. pension funds, mutual funds, insurance companies and hedge funds.

Our survey was sent by email to the chief investment officers of a total of 1,178 institutional investors on November 1, 2007. To maximize the response rate additional reminders were sent and individual phone calls made in the last weeks of December 2007 and the last responses were received in the first weeks of January 2008. We received a total of 118 surveys, resulting in a response rate of about 10%. We are able to match the identity of the institutional investors and

hence the survey responses with data from FactSet/LionShares on institutional investor characteristics such as assets under management or share turnover for 90 of these 118 investors.

The original survey also contained a wide set of question on the preferences of institutional investors for country-level investor protection, firm-level corporate governance mechanisms, and shareholder activism. An extensive analysis of these questions is provided in McCahery, Sautner and Starks (2011).

Table 1 shows in Panel A that the average institutional investor in our sample has about 623m USD assets under management. The largest 5% of investor in our sample have invested assets worth more than 3.5bn USD. The average investor further has an annual share turnover of 16% and holds 89 firms in its portfolio. The fraction of assets invested by the investors in The Netherlands and the US is approximately 10% and 9%, respectively.

[Table I about here]

Panel B reports the breakdown of the investors by type of institution. As can be seen, by far the most institutions in the sample are mutual funds (63%), but our sample also includes hedge funds, insurance firms and pension funds. Panel C shows that our respondents come from a wide range of countries, but a majority comes from The Netherlands and other European countries.

In the survey, we also asked the investors to what extent they make use of proxy voting advisors such as ISS or Glass Lewis for voting at an annual meeting. We included this question to examine to what extent investors delegate their voting decisions, for example on potential executive pay issues, to external advisors. The data, reported in Panel D of Table I, suggests that

over half of the institutions in our sample do not employ proxy voting advisory services at all. Of those investors that use proxy voting firms to some extent, most use the advice of these firms to determine their own position vis-à-vis the portfolio company of interest. Overall, this suggests that our investors show substantial levels of involvement when it comes to issues such as executive pay. More detailed characteristics about the investors can be found in McCahery, Sautner and Starks (2011).

4. Executive compensation preferences

Having supplied a general description of the characteristics of the investors in our sample, we will provide, in the next section, an analysis of their preferences with regard to different aspects of executive compensation.

4.1. The structure and level of executive compensation

The rise of executive compensation is partially the result of a perceived need to bring about change in corporate performance and to establish a link between the pay and wealth of executives and shareholder value (Hall and Liebman (1998)). Much research has documented a strong correlation between pay and corporate size, typically measured by reference to sales (Murphy (1999)). Top executive pay levels vary not only by corporate size, but also differ substantially according to industrial sector, performance and a firm's growth opportunities. Pay-to-sales sensitivities are much higher in manufacturing industries than in financial services and utilities, a phenomenon which is similar across countries.

There is evidence of increasing convergence of top executive pay levels and of remuneration structures resulting from the emergence of an international market for top

managers, the abolition of legal prohibitions on executive stock options, and the use of peer groups to determine competitive levels of compensation. However, comparative research shows that the total level of CEO pay in the US is roughly double than that in any other country, even allowing for differences in purchasing power and taxation of direct pay and perquisites (Fernandes, Ferreira, Matos, and Murphy (2010)). Interestingly, this substantial discrepancy between the United States and all other countries is only observed at the level of the CEO and does not extend down to lower-level management. Notice also that executive pay in the US significantly outpaces the pay practices of The Netherlands.

A number of explanations have been offered for the dramatic rise in CEO compensation in the US compared to other countries. First, contrasting compensation levels may reflect the difference in firm size between the US, and other OECD countries. Second, the high level of executive pay may be due partly to the substantial gap in stock market performance across the 1990s. Nevertheless, even if stock options are taken into account, the differences in compensation practices between Europe and the US are still substantial. Third, the divergence in practice may be due to the degree of influence the CEO has over the board of directors (Bebchuk and Fried 2003). Finally, the difference may also be due to the risk premium that needs to be paid if firms predominantly pay their managers using stock options, as it is practice in most large US firms (Fernandes, Ferreira, Matos, and Murphy (2010)).

In light of the general increases in executive pay and the substantial differences that arguably exists between CEO pay in US and Dutch firms, Figures I a-b present information about whether institutional investors deem adjustment in the level and structure of CEO compensation in the US and The Netherlands necessary. We seek to elicit their preferences on the level of pay by asking, separately for the US and The Netherlands, whether they think that

CEO pay is too high or too low, whether reduction in severance pay are considered necessary, and by asking whether they have a preference for caps on the overall level of CEO compensation. Similarly, we attempted to measure their preferences on the structure of pay by asking whether they think that CEOs should be more or less compensated with equity-based pay.

Turning to the Netherlands, we find that a majority, 55%, of investors prefer a reduction of the level of severance payments (golden handshakes) when CEOs leave. Interestingly, the majority of investors do not think that overall CEO pay should be reduced in The Netherlands. Moreover, a (small) majority believes that the compensation of Dutch CEOs should be more equity-based (i.e. more stock options or restricted shares). We will discuss the preferences of investors with regard to the design of equity-based pay, in particular stock options, below.

[Figures I a-b about here]

For the US, we find that respondents have a similar view with regard to reducing the level of severance pay, with 57% of the respondents being in favor of reducing the levels of severance packages. Interestingly, while overall CEO pay in The Netherlands is generally not considered as being too high, 46% of the investors believe that CEO pay in the US should be reduced.

Overall, the data indicate that a large number of investors are dissatisfied with the overall level of executive compensation in the US but not so much in The Netherlands. This result is in line with the above mentioned differences in the observed levels of CEO pay in The Netherlands and in the US.

4.2. Decision making around executive compensation

Public discontent over pay packages of top executives in the US and Europe has triggered a debate in politics, academia, and the public at large on whether shareholders should have more influence on the pay setting process (“say on pay”). Providing support for this view, it is noteworthy that recent empirical research suggests that shareholder voting indeed can serve as a check against greater compensation for managers, but mainly in poorly governed firms (Cai and Walking (2011)). Based on this evidence, we expect that institutional investors would have a preference for deciding themselves on the design and volume of executive compensation packages in their portfolio firms.

[Figures II a-b about here]

To contribute to this debate, Figures II a-b reports views about whether investors preferred having shareholders decide over executives’ remuneration at the annual general meeting (AGM). We report their responses separately for firms with a one-tier or two-tier board system, to determine whether their preferences may be related to the board system in place. Note that in the one-tier board system, a firm has one board of directors consisting of both executive and non-executive directors (as in the United States). With a two-tier board system, a firm has two separate boards, namely, a management board, which is responsible for the day-to-day management of the firm, and a supervisory board, which monitors the management board (as in Germany). Dutch firms have a choice between the two board structures.

We find that most respondents (in terms of the no votes) are opposed to giving management power over executive compensation (96% in case a firm has a one-tier and 97% in

case a firm has a two-tier board). Similarly, we find negative associations with delegating pay decisions to non-executive board members (80%) or members of a supervisory board (73%) in case of a two-tier system. Furthermore, the majority of institutional investors are not inclined to entrust board committees to deciding on executive pay. However, the data indicate a majority response to the suggestion of allocating shareholders with decision-making authority over executive compensation, both in the one-tier and in the two-tier system.

Overall, these figures give strong support to our hypothesis that institutional investors prefer to have the decision-making power over executive pay in their own hands at the annual general meeting.

4.3. Designing executive stock options

Executive stock options constitute the largest component of CEO pay. At the same time, they are probably also the most difficult component of executive pay when it comes to their design, as poorly designed option plans can trigger dysfunctional managerial behavior such as excessive risk taking. It is therefore crucial to understand the views of institutional investors on how such option plans should be designed. Industry codes of good practice typically endorse the adoption of disclosure of option characteristics and the volumes granted, long vesting periods, relative performance benchmarks, and subjecting pay schemes to shareholder approval.

In order to understand the option design preferences of institutional investors, we used our survey to ask them to assess the importance of a set of key design features incorporated in option plans, namely (1) relative stock performance benchmarks; (2) relative operating performance benchmarks; (3) absolute stock market performance benchmarks; (4) absolute operating performance benchmarks; (5) exercise prices that are in the money; (6) exercise prices

that are out of the money; (7) long vesting periods; (8) long time to maturities; and (9) disclosure of option characteristics. The investors could indicate on a scale from 1 (not important at all) to 7 (very important) how they assess these different design features.

[Insert Figure III about here]

The results, reported in Figure III, are consistent with the features of good governance codes. In particular, investors consider sufficient disclosure, long vesting periods, and relative operating and stock performance benchmarks as key design features of properly designed option plans. We find less evidence in favor of linking compensation to absolute stock performance benchmarks, which is in line with the suggestions of optimal contracting models (e.g., Holmstrom (1979, 1982)). Interestingly, Figure III reveals that there is little difference between the weight given to disclosure and the absolute stock performance benchmarks in the vesting conditions. Finally, we find that institutional investors apparently do not find options that are designed with exercise prices in the money very important (such options could be used as a way to reduce incentives for risk taking).

5. Conclusion

In this chapter, we analyzed a new dataset that is constructed based on a survey among 118 institutional investors and that elicits their preferences about various aspects of executive compensation. In particular, we used our survey to understand their views about (i) whether adjustments to the level and structure of executive compensation are necessary, (ii) who should decide on executive pay, and (iii) how executive stock options should be designed.

We show that a majority of investors want to reduce the size of firm's severance packages to departing CEOs. Furthermore, the majority of investors do not think that overall CEO pay should be reduced in The Netherlands. Moreover, a (small) majority believes that the compensation of Dutch CEOs should be more equity-based. While overall CEO pay in The Netherlands is generally not considered as being too high, almost 50% of institutional investors believe that CEO pay in the US should be reduced.

Our study also reveals that shareholders prefer to be responsible for the design and volume of executive pay. Finally, our study recognizes the differences in investor's preferences in the design of executive stock options. In terms of the order of importance, we show that institutional investors prefer disclosure of option compensation, relative operating and stock price benchmarks that managers need to fulfill before they are eligible to exercise their options, and long vesting periods.

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Table I: Institutional Investor Characteristics

Panel A of this table summarizes descriptive statistics of the main characteristics of the institutional investors that returned our questionnaires (total of 118 responses). It contains information on the assets under management of the investors (value of equity portfolio measured in 1000 USD), on the fraction of shares which are invested in firms listed in The Netherlands (in %) as well as in the U.S. (in %), and on the share turnover of the investors. The share turnover is measured as the value of all buy and sell transactions in a quarter divided by the market value of the equity portfolio. The data source for these investor characteristics is FactSet/LionShares. The number of observations varies and is smaller than 118 due to limited data availability in FactSet/LionShares. Panel A further reports data on the size of the equity stakes (in %) that the institutional investors hold in their portfolio firms and reports the market values (in 1000 USD) of these stakes. This data is also from FactSet/LionShares. Panel B shows the distribution of the 118 survey respondents by investor-type. The investor-type categorization is based on self-reported information in the returned questionnaires. Panel C reports the national origins of the investors (actual seat and not legal seat). This information is hand-collected. Panel D records whether and to what extent the institutional investors make use of external proxy voting advisors when determining how to vote in a Dutch annual meeting (AGM). Conditional on using such firms (i.e. if the answer is not ‘Never’), the panel also contains information on the extent to which the advice of the proxy voting firms is used. The data source for this information is also the returned questionnaires. The FactSet/LionShares variables are calculated for the year-end 2007.

Panel A: Institutional Investor Characteristics

Investor Characteristic	Mean	Median	STD	5%	95%	Obs.
Assets under Management (in 1000 USD)	623,000	140,000	1,260,000	9,540	3,550,000	90
Fraction of Assets invested in NL (in %)	10.38%	6.85%	13.96%	0.00%	33.38%	90
Fraction of Assets invested in US (in %)	9.21%	0.00%	18.93%	0.00%	48.23%	90
Share Turnover	0.16	0.13	0.13	0.04	0.32	87
Number of Firms in Portfolio	89	60	135	20	292	89

Ownership Position in Portfolio Firms	Mean	Median	STD	5%	95%	Obs.
Percentage Ownership Stake (in %)	0.131	0.006	0.573	0.000	0.534	7919
Value of Ownership Stake (in 1000 USD)	6,103	841	20,100	44	29,400	7919

Panel B: Type of Institution

	All Investors		Hedge Fund		Insurance		Mutual Fund		Pension Fund		Other Investors	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Questionnaire Responses	118	100.0%	7	5.9%	9	7.6%	74	62.7%	7	5.9%	21	17.8%

Panel C: Investor Origin (Actual Seat)

	All Investors		Hedge Fund		Insurance		Mutual Fund		Pension Fund		Other Investors	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
The Netherlands	12	13%	2	50%	0	0%	7	11%	1	33%	2	14%
UK	12	13%	0	0%	1	14%	7	11%	1	33%	3	21%
Germany	8	9%	0	0%	1	14%	7	11%	0	0%	0	0%
France	9	10%	0	0%	2	29%	5	8%	0	0%	2	14%
Luxembourg	3	3%	0	0%	0	0%	1	2%	0	0%	2	14%
Other European Countries **	33	37%	1	25%	3	43%	26	42%	0	0%	3	21%
US	9	10%	0	0%	0	0%	6	10%	1	33%	2	14%
Other North American (Canada, Caymans)	4	4%	1	25%	0	0%	3	5%	0	0%	0	0%
Total	90	100%	4	100%	7	100%	62	100%	3	100%	14	100%

**Note: Each European country in this category (BE, CH, NO, IE, IT, FI, ES) has five or less investors in the sample

Panel D: Importance of Proxy Voting Advisors

Usage of Proxy Voting Advisors	Always	That depends on the company	That depends on the agenda item	That depends on the circumstances	Never	Sum	Obs.
Percent of Responses	17%	10%	7%	13%	53%	100%	118

Manner of Usage of Proxy Voting Advice	Always follow advice fully	Use advice to determine own position	Use advice in case of own doubts	Others	Sum	Obs.
Percent of Responses	9%	65%	13%	13%	100%	55

Figure I a-b: The structure and level of executive compensation

This figure reports the views of institutional investors about the structure and level of executive compensation in the US and The Netherlands. The data source for this information is the returned questionnaires.

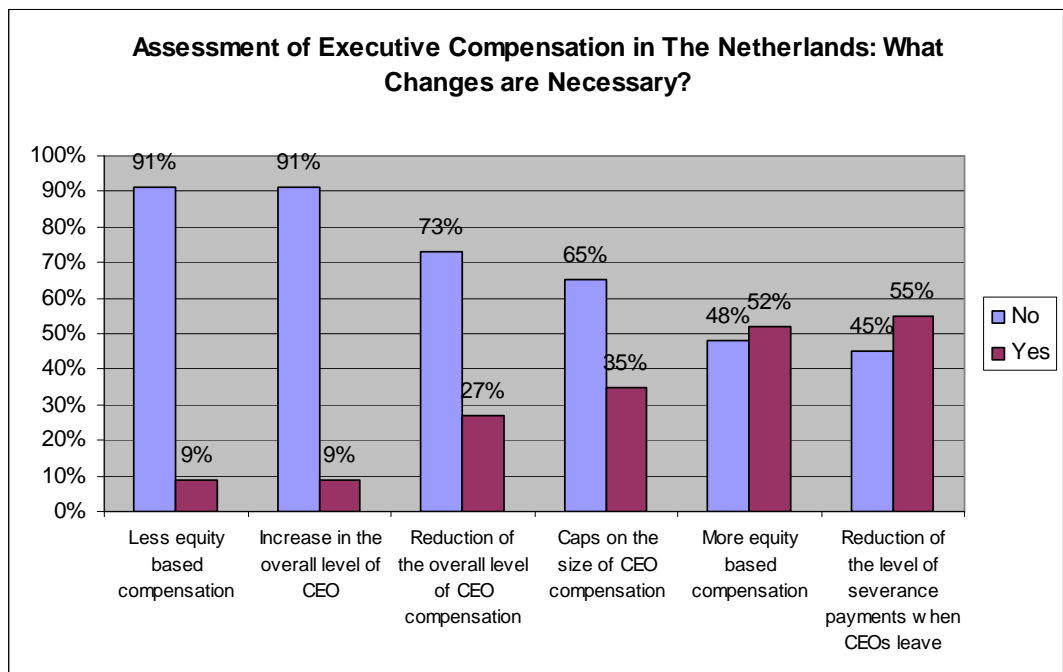
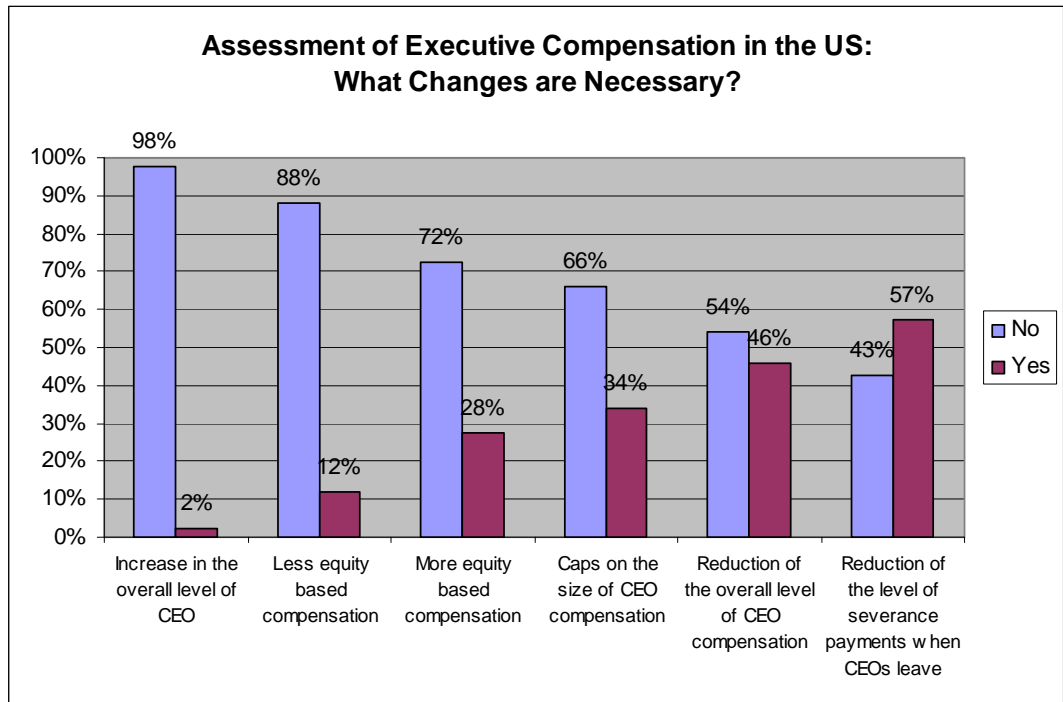


Figure II a-b: Decision making around executive compensation

This figure reports the views of institutional investors about the decision making around executive compensation. The data source for this information is the returned questionnaires.

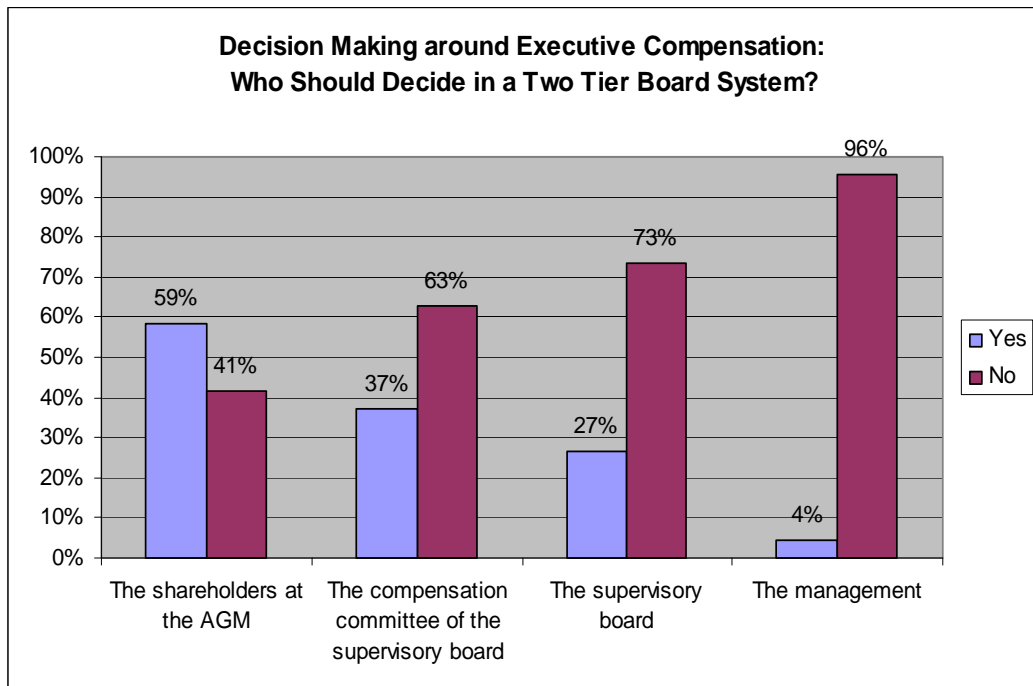
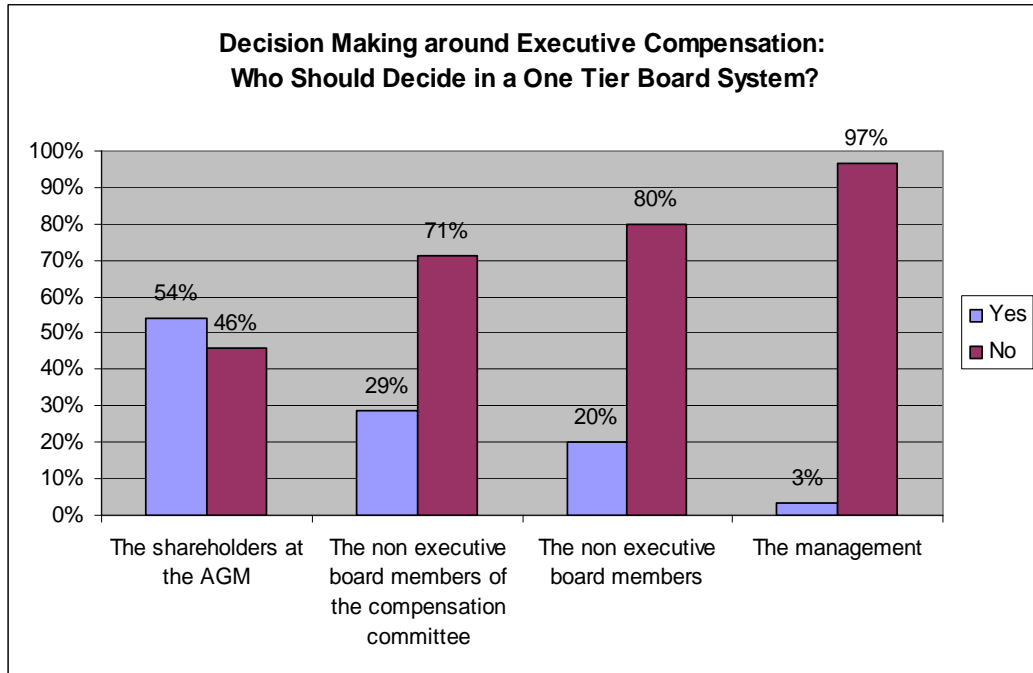


Figure III: Designing executive stock options

This figure reports the views of institutional investors about the design of executive stock option plans. The data source for this information is the returned questionnaires.

