

Perils of Limiting the Coverage of Mandatory Pay Disclosure

The Korean Experience

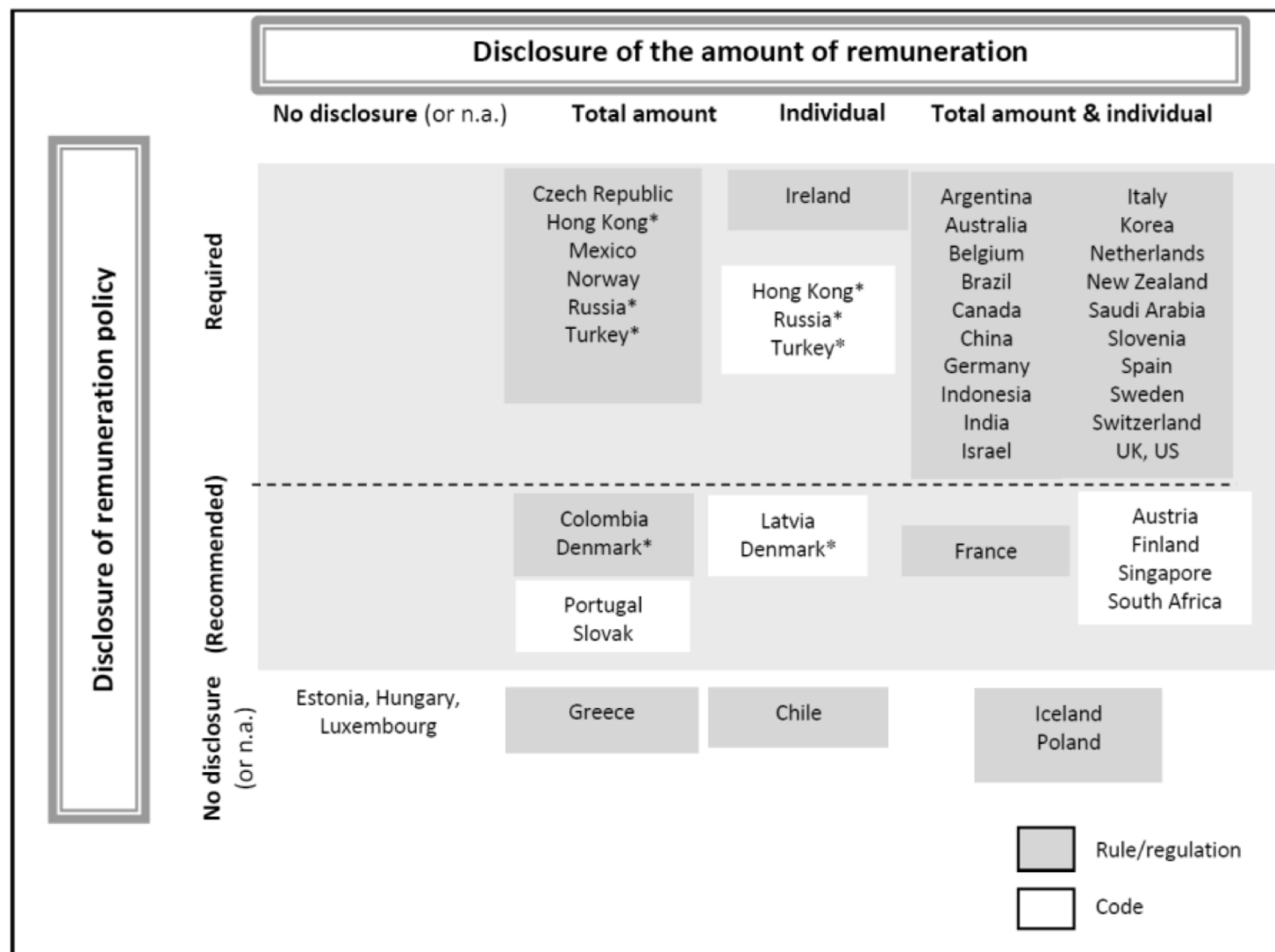
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Motivation

Disclosure Rules Differ Considerably Across Countries

Figure 4.21 Disclosure of the policy and amount of remuneration



- Required vs. Recommended
- Total vs. Individual
- Confined to vs. Beyond Directors
- Confined to Highly Paid vs. All Directors



Questions

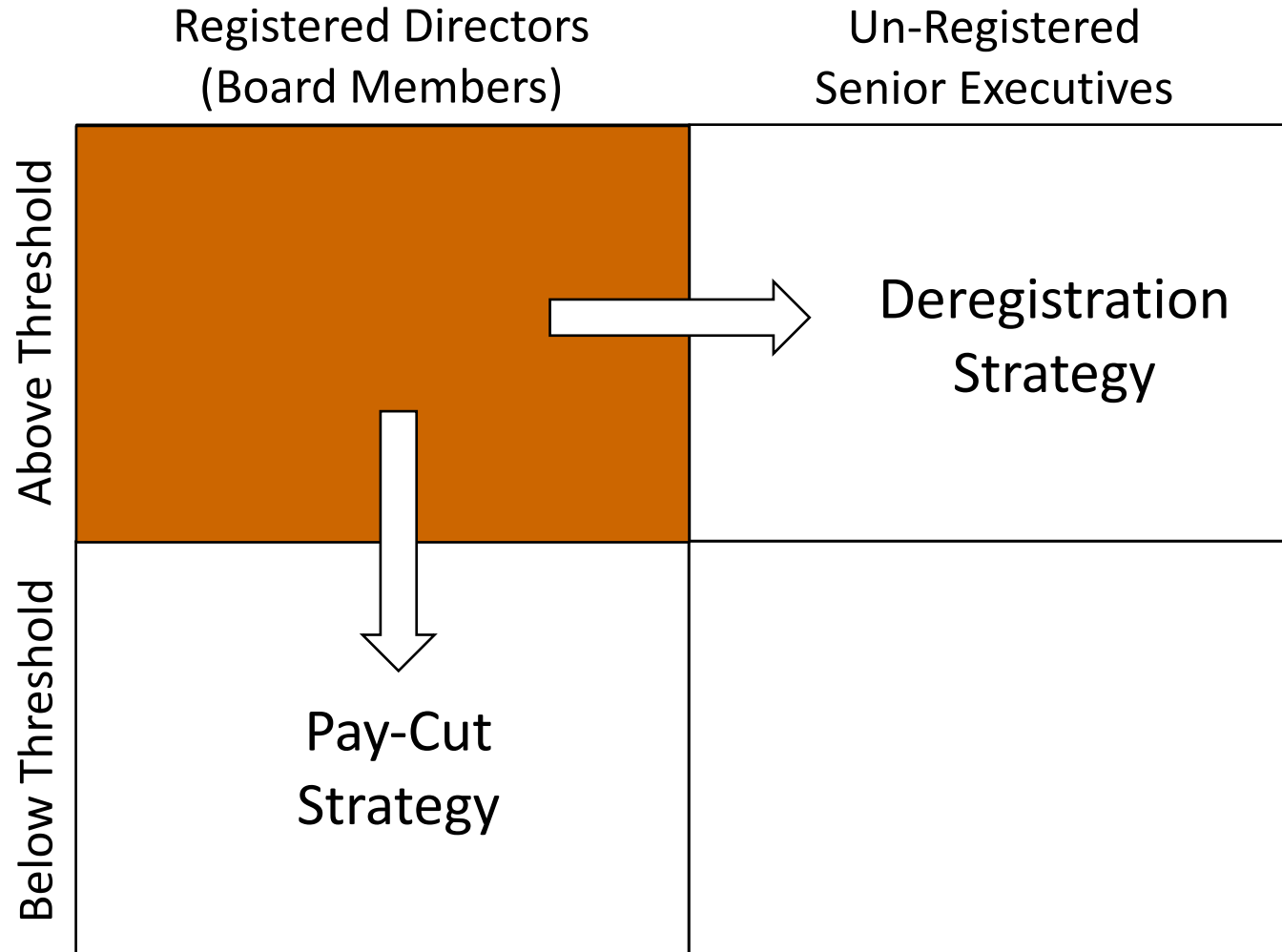
- Which disclosure regime is better?
- (sub-question) Which regime is less prone to disclosure evasion?

Existing Literature

- No study directly addresses these questions
- There are some related research ... not about evasion itself
 - Downward-biased stock option valuation (Murphy, 1996; Aboody, Barth, and Kasznik, 2006)
 - Downward-biased peer-company performance (Lewellen, Park, and Ro, 1996; Pract, Wade, and Pollock, 1999; Faulkender and Yang, 2012)
 - Incomplete compliance (Robinson, Xue, and Yu, 2011)
 - Injunction filed against disclosure (Barros et al., 2015; Costa et al., 2016)




The Disclosure Regime We Study

A Disclosure Regime with Limited Coverage



The 2013 Rule Change in Korea

(A setting that allows us to study the regime with limited coverage)

Disclosure Regime	Prior to 2013	From 2013
Disclosure of Aggregate Pay in Groups <ul style="list-style-type: none">• Inside directors (not in audit committee)• Outside directors (not in audit committee)• Audit committee members		
Disclosure of Pay for Individuals <ul style="list-style-type: none">• Limited to registered directors• They must receive a total pay in excess of 500 million KRW (\approx 500 thousand USD)		

- **The 2016 Rule Change** (effective from 2018): Registered Director (> 500 million KRW) + **5 Highest Paid Employees regardless of board membership** (>500 million KRW)

Hypotheses Development

The Costs and Benefits of Evasion

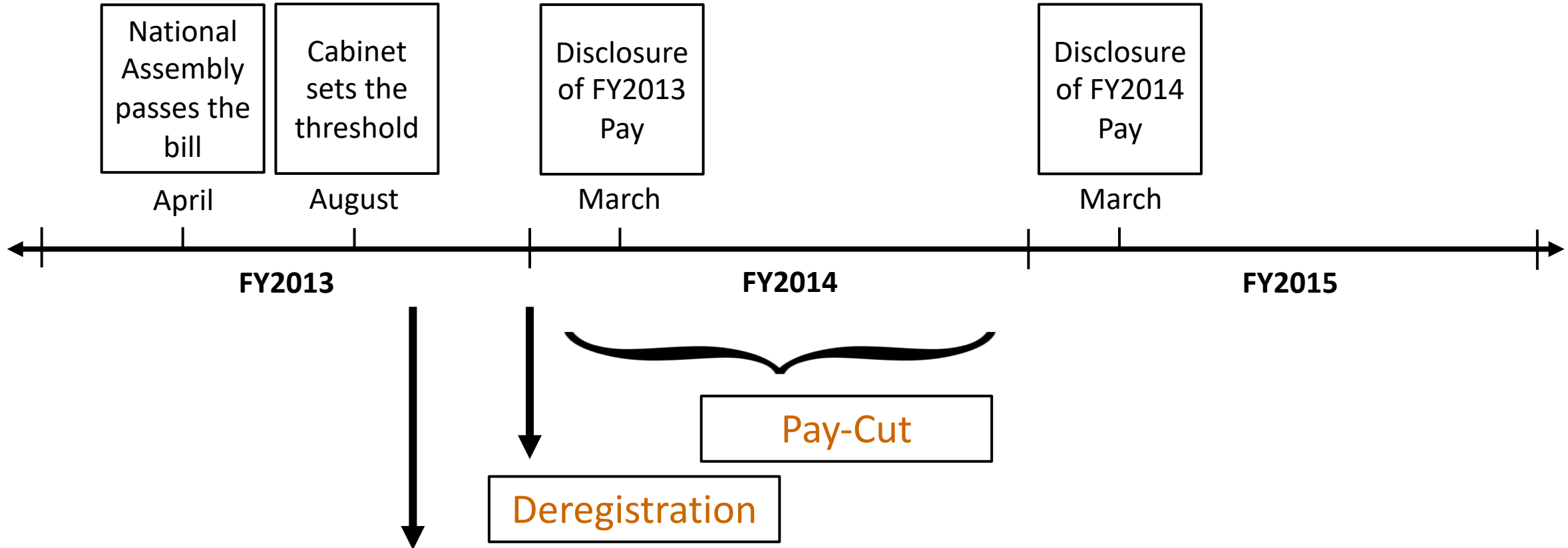
	Deregistration Strategy	Pay-Cut Strategy
Benefits	Hide executive pay from shareholders, labor union, and public media	
Costs	Forego the power & the prestige that comes with board membership	Drop in executive pay

- Benefit of evasion rise with **executive-to-worker pay gap**
- Cost of evasion fall for **family directors** (vs. non-family directors)
 - **Deregistration:** power/prestige does not com from board membership, but from their family ties; exempt from fiduciary duty
 - **Pay-cut:** can get compensated from dividends and private benefits of control
- Relative cost b/w two strategies depends upon the **level of pay before the rule change**

Hypotheses & Empirical Strategy

- (H1) **Evasive behavior** is observed after the rule change
 - However, evasive behavior itself **may not be true evasion** (empirical challenge) → Need to show that the likelihood evasive behavior strengthens or weakens in a way that is consistent with the existence of true evasion (**moderating variable**)
- (H2) **Family directors** are more likely to show evasive behavior than non-family directors
 - **Alternative hypothesis:** family directors are less likely to be fired or retire of old age → less retirement → greater fraction of evasive behavior
- (H3) The result of (H2) strengthens with **pay gap** (executives vs. workers)
- (H4) Deregistration result in (H2) does not shows up in a prior period (**DiD**)
- (H5) Family executives tend to exhibit pay-cuts than deregistration if **original level of pay** is close to the threshold

Time Line



What about evasive behavior in 2H of FY2013?

- Possible
- Deregistration: we investigate and supplement our findings
- Pay-Cut: cannot investigate (no data available for FY2012)

Results



Confectionary Company (1934 -)



Dam, Chul-Gon

CEO and Chairman of Orion
Founder's Son-in-law

Total Pay in FY2013

- 5.4 billion KRW
- 154 x average worker's pay

November 2013 (immediately after rule change)

- Step down from board and assume senior executive position
- Evades disclosure from 2014 to 2017

New Rule in 2018

- 5 Highest Paid Employees (>500 million KRW)
+ Registered Director (> 500 million KRW)
- 2.3 billion KRW

(H1) Evasive Behavior is Observed after Rule Change

FY2013

FY2014

Directors Who Disclose FY2013 Pay	Continue to Disclose FY2014 Pay		385
	Stop Disclosing	Deregistration (board member → senior executive)	38
		<i>de facto</i> Deregistration (no longer board member, no retirement pay)	28
		Pay-Cut (retain board membership, pay < 500 mil. KRW)	60
		Retirement	69
580	195		

126 (21.7%)
Directors show
evasive behavior

- However, evasive behavior itself **may not be true evasion** (empirical challenge) → Need to show that the likelihood evasive behavior strengthens or weakens in a way that is consistent with the existence of true evasion (**moderating variable**)

(H2) Family vs. Non-Family Directors in FY2014

Dep. Variable: Evasive Behavior	Probit				LPM
	Evasion plus Retirement Sample				Paired Sample
	(1)	(2)	(3)	(4)	(5)
Family Executive	0.248*** (2.931)	0.280*** (3.283)	0.284*** (3.327)	0.283*** (3.383)	0.531* (2.184)
Representative Director	0.018 (0.266)	0.012 (0.182)	0.015 (0.224)	0.022 (0.321)	0.223 (1.056)
<i>ln</i> (Executive Age)	-0.649*** (-2.825)	-0.657*** (-2.782)	-0.613** (-2.550)	-0.663*** (-2.725)	-1.393** (-2.552)
Executive Ownership	1.056 (1.515)	0.869 (1.275)	0.897 (1.383)	0.941 (1.484)	-1.618 (-1.853)
Proprietary Information		-0.011 (-0.376)	-0.010 (-0.343)	-0.018 (-0.588)	-0.145 (-0.820)
Large Business Group		0.057 (0.661)	0.073 (0.859)	0.080 (0.882)	0.099 (0.185)
Industry-Adjusted ROA		0.248 (1.355)	0.242 (1.316)	0.205 (1.020)	-5.839 (-1.392)
<i>ln</i> (Sales)		-0.022 (-0.995)	-0.027 (-1.170)	-0.026 (-1.127)	-0.080 (-0.605)
<i>ln</i> (Firm Age + 1)		0.040 (0.892)	0.041 (0.899)	0.047 (1.041)	-0.771*** (-3.964)
Foreign Ownership			0.013 (0.047)	0.005 (0.021)	2.468 (1.002)
Inside Ownership			-0.168 (-0.784)	-0.145 (-0.687)	-0.628 (-0.558)
<i>ln</i> (Board Size)				0.155 (1.508)	-0.427 (-0.441)
Outside Director Ratio				-0.243 (-0.817)	0.366 (0.081)
Observations	195	195	195	195	22
Pseudo (Adjusted) R-squared	0.161	0.178	0.181	0.191	0.469

- Columns (1)-(4): Probit (full sample, average marginal effect)
- Family directors are more likely to exhibit evasive behavior than non-family directors by **28.3%**
- Column (5): linear probability model (paired sample)
- Alternative hypothesis:** family directors are less likely to be fired or retire of old age → less retirement → greater fraction of evasive behavior

(H3) Executive-to-Worker Pay Gap

Dep. Variable: Evasive Behavior	Probit				LPM
	Full Sample		Pay Ratio Subsample		Full Sample
			Above Median	Below Median	
	(1)	(2)	(3)	(4)	(5)
Family Executive	0.200*** (2.638)	0.199*** (2.631)	0.354*** (4.062)	0.047 (0.655)	0.068 (0.646)
× Above Median Pay Ratio					0.256* (1.886)
Above Median Pay Ratio					-0.117 (-1.087)
Executive-to-Worker Pay Ratio		0.001* (1.734)			
Control variables	Yes	Yes	Yes	Yes	Yes
Observations	148	148	74	74	148
Pseudo (Adjusted) R-squared	0.161	0.170	0.243	0.441	0.072

- Family directors paid above median pay ratio are more likely to exhibit evasive behavior than non-family directors by **25.6%**
- **Pay Ratio:** (executive total pay – retirement pay)/average worker's pay (industry adjusted)
- **Median Pay Ratio (raw):** **18.1** (family directors), **14.5** (non-family directors)

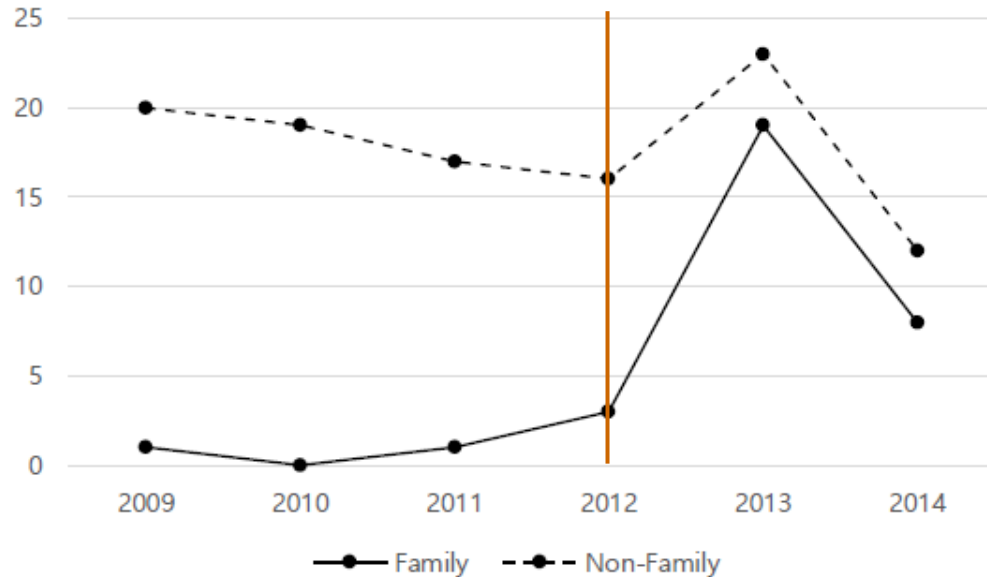
(H4) Family vs. Non-Family Directors Before FY2014

(Difference-in-Differences for Deregistration)

Dep. Variable: Deregistration	Probit Model					LPM
	2009-2012		2013	2014	2013-2014	2009-2014
	(1)	(2)	(3)	(4)	(5)	(6)
Family Executive	0.001	0.127	0.277***	0.313**	0.308***	-0.088
	(0.013)	(1.073)	(2.925)	(2.186)	(3.729)	(-0.799)
× FY13 & FY14						0.343***
						(2.687)
Control Variables	Y	Y	Y	Y	Y	Y
Year FE	Y	Y	N	N	Y	Y
Firm FE	Y	N	N	N	N	Y
Observations	365	365	167	106	273	638
Pseudo (Adjusted) R-squared	0.578	0.080	0.230	0.140	0.141	0.181

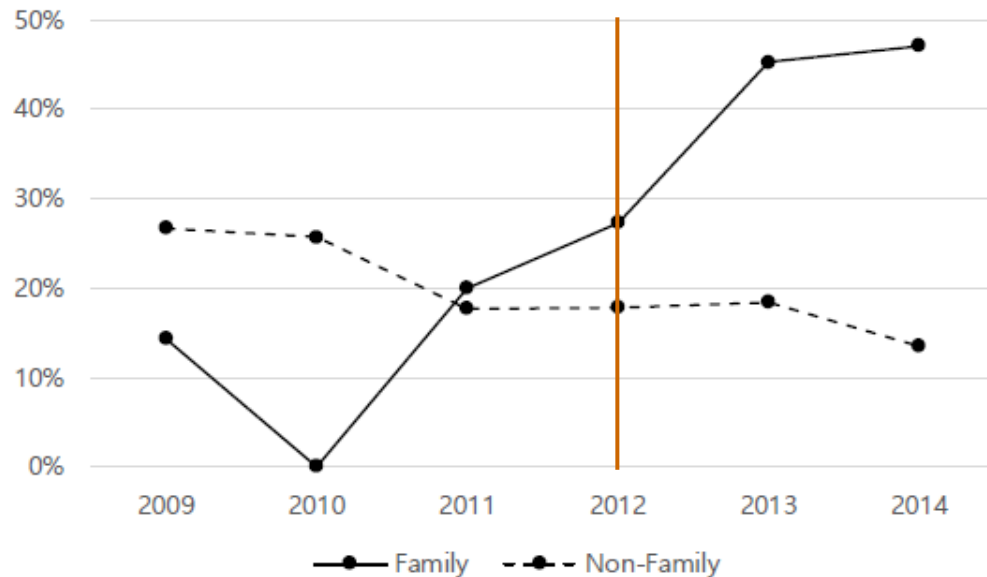
- Family directors start to exhibit evasive behavior **exactly when they are expected**

A. Number of Deregistration



- # of deregistration **stable during 2009-2012**
- It **jumps** for both family and non-family directors **from 2013**
- The jump is **steeper** for family-directors

B. Fraction of Deregistration



- Deregistration/(Deregistration + Retirement)
- Non-family directors: **stable throughout**
- Family directors: **a big jump from 2013**

(H5) Deregistration vs. Pay-Cut

Panel A. Executive Pay and KRW 500-600M

Dep. Variable: Pay Cut	Family Executive		Non-Family Executive	
	(1)	(2)	(3)	(4)
<i>ln</i> (Executive Pay)	-0.262*** (-5.288)		-0.017 (-0.233)	
KRW 500-600M		0.543*** (3.770)		-0.120 (-1.142)
Representative Director	0.273*** (4.600)	0.252*** (3.854)	0.356*** (3.894)	0.351*** (3.959)
<i>ln</i> (Executive Age)	-0.613** (-2.505)	-0.308 (-0.982)	0.482 (1.150)	0.624 (1.456)
Executive Ownership	0.419* (1.691)	0.799*** (2.735)	-5.076 (-1.094)	-4.431 (-0.803)
Industry or Firm-Level Variables	Y	Y	Y	Y
Observations	68	68	58	58
Pseudo R-squared	0.584	0.578	0.434	0.446

- **Sample:** Deregistration + Pay-Cut (exclude retirement)
- **Family directors:** prefer pay-cuts if their original pay is low or close to the threshold
- **Non-family directors:** no pattern

Panel B. KRW 500-700M and KRW 500-800M

Dep. Variable: Pay Cut	Family Executive		Non-Family Executive	
	(1)	(2)	(3)	(4)
KRW 500-700M	0.227*** (2.682)		0.095 (0.922)	
KRW 500-800M		0.242*** (3.594)		0.081 (0.788)
Representative Director	0.256*** (3.420)	0.244*** (3.637)	0.354*** (3.851)	0.360*** (3.978)
<i>ln</i> (Executive Age)	-0.515* (-1.782)	-0.451* (-1.695)	0.457 (1.116)	0.434 (0.992)
Executive Ownership	0.453 (1.561)	0.509* (1.884)	-4.643 (-1.068)	-4.211 (-0.920)
Industry or Firm-Level Variables	Y	Y	Y	Y
Observations	68	68	58	58
Pseudo R-squared	0.510	0.522	0.443	0.440

- This tendency slightly weakens as the **gap between the original pay and the threshold** (500 million KRW) widens

Conclusion

- Pay disclosure rules with **limited coverage** leads to disclosure **evasion**
- Can the result be **generalized** to other countries?
 - I think so. There are other countries with such limited coverage
 - Japan also limits the coverage to board members paid above 100 million JPY
- Did the **new disclosure rule** of 2016 (effective from 2018) serve its purpose?
 - Yes
 - Out of **28** family directors that deregistered in 2013 and 2014, **4** re-registered during 2016-2018 and **17** disclosed their pay as non-registered directors in 2018
 - Registered Director (> 500 million KRW) + 5 Highest Paid Employees regardless of board membership (>500 million KRW)