Measuring Compliance with Executive Remuneration Standards at Controlled Corporations

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Abstract

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Keywords: Agency theory; Executive remuneration; Controlling shareholders; Compliance; Corporate governance Codes; Private benefits of control

JEL Classifications: G30, G32, G34, G38, K22, K31, M12

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1 Introduction

In the last decade, a wave of reforms has shaken corporate governance mainly as a reaction to the Enron-era corporate scandals and the 2008 financial crisis. Particular emphasis has been put on executive remuneration standards, a subject that has traditionally gathered the attention of public opinion, practitioners, and researchers. In some instances, remuneration standards are rooted in the law; however, they are more often included in private corporate governance codes, to which listed companies can adhere on a comply or explain basis. Scholars who analysed the levels of compliance to these codes found some cross-sectional variability (Bianchi et al. 2011) and higher stock returns for companies that comply or, alternatively, explain their non-compliance (i.e. Arcot et al. 2010; Arcot and Bruno 2006).

However, the economic impact of best practices on corporate governance raises two questions that are still unanswered. The first is why do some companies conform to best practices better than others and what are the economic factors driving the relevant decisions. The second question is whether conformity to best practices substantially affects the economic behaviour of a firm or is mainly a compliance issue with formal implications but no real connections with corporate practices. We try to answer these questions by focusing on how large European companies conform to executive remuneration standards, whether found in the law or in private codes of corporate governance. Our analysis is based on a data-set that refers to the years 2007 and 2010, as we intend to cover two stages of corporate governance reform concerning executive pay. The first stage reacted to the Enron-type corporate scandals at the beginning of this century. The second stage takes into account the effects of the 2008 financial crisis with reforms that still have to be completed. We measure the compliance to remuneration's best practices through a set of criteria that refer to: *a)* the governance of the process for fixing executive remuneration; *b)* the disclosure of both the details of remuneration policy and individual compensation of directors.

Our results show that on average controlled corporations, i.e. companies with a controlling stake in the hands of either a family or the State, follow these practices less than widely-held ones, a result that corresponds to what Arcot et al. (2010) find with regard to compliance with governance codes. We define this difference in compliance between controlled firms and widely-held ones as "conformity gap" and try to interpret the same from the perspective of individual corporations and of society as a whole. From the former perspective, our interpretation is based on the different type of agency problems faced by controlled and widely-held firms, due to the tighter monitoring exerted by concentrated owners. In other words, the weaker compliance of controlled corporations can be related to a lesser need to provide financial incentives to management and therefore to the lower pressure to comply with remuneration best practices. From a societal perspective, we argue that deviations from executive remuneration standards in controlled corporations are more tolerated than in widely-held ones, due to the lower CEO pay and higher firm performance.

Another result reached by this study is that weaker compliance to best practices is associated with lower CEO pay and a more "conservative" incentive structures, i.e. a higher share of fixed cash-based compensation and a lower share of incentive-based pay, as well as a higher proportion of bonuses than stock-based pay. Although we cannot establish the direction of the relationship between the level of compliance and CEO pay characteristics, due to its endogenous nature, our results confirm that, at least in the field of executive compensation, the adoption of best practices is closely related to the effective behaviour of the company, rather than to formal concerns about compliance.

Our discussion may also help to frame the main policy question concerning executive pay at controlled corporations, i.e. whether the conformity gap needs closing up through stricter enforcement or better rules. The answer to this question very much depends on whether the conformity gap reflects a lower need for managerial incentives, given the monitoring by controlling shareholders, or the latter's willingness to extract private benefits of control. We argue in this paper that the former hypothesis seems to prevail, so that regulators should abstain from increasing the level of enforcement.

The paper is organized as follows. Section 2 briefly analyses corporate governance reform in Europe in the first decade of this century, focusing on compensation policies. Section 3 describes the database used for empirical analysis and section 4 presents the results of our analysis. Section 5 asks why there is a conformity gap between widely-held and controlled corporations, and whether the conformity gap depends on lack of enforcement. Section 6 concludes with a summary of the paper's outcomes and policy implications.

2 European corporate governance reform

The main pre-crisis reforms on directors' remuneration were adopted in Europe at the beginning of this century, following the Enron-type corporate scandals (Coffee Jr 2005; Ferrarini and Moloney 2005). The European Commission identified remuneration as an area in which the potential for conflict of interest between directors and shareholders was particularly high. Accordingly, the 2004-2005 Recommendations targeted internal firm governance, including board independence, better disclosure of remuneration policies and shareholders' voice on executive remuneration ('say-on-pay').[1] They were subsequently implemented at national level through either corporate law reform or (more often) corporate governance codes subject to 'comply or explain'.

After the 2008 financial crisis, EU legislators switched their focus on pay structures, particularly in the financial sector (Ferrarini et al. 2010). The Commission 2009 Recommendations, while enhancing the role of governance and disclosure in the remuneration process, call for pay

[1] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC); Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

structures to be aligned with long-term sustainability.[2] National legislators, on their turn, have often replaced the ‘comply or explain' approach to regulation of pay with mandatory rules also for non-financial firms. Belgium, Portugal, Spain and Italy were the first jurisdictions to move remuneration governance and disclosure into formal law (Barontini et al. 2013).

The UK, however, has traditionally had the most extensive set of governance requirements in force with respect to executive compensation in Europe. Since 2002, listed companies have been required by law to prepare a directors’ remuneration report and to submit it to the advisory vote of shareholders.[3] As to other Member States, the Commission reported in 2010 that many of them either recommend or require minimum standards of disclosure. The Commission also reported that in a minority of Member States there is a recommendation or legislative provision which promotes shareholder voting on remuneration policy.[4]

This brief overview of EU and national regulation confirms the central role of executive pay policies in corporate governance. In the following sections we analyze how these policies have been implemented in Continental Europe throughout the financial turmoil, over a period (2007-2010) when the aforementioned Commission Recommendations were adopted and implemented in light of the overwhelming sensitivity of regulators, politicians and public opinion to the topic of CEO compensation.

3 Database

We perform our analysis on a sample drawn from the FTSE Eurofirst 300 Index constituents in 2007, i.e. the 300 largest companies ranked by market capitalisation in the FTSE Developed

[2] Commission Recommendation on remuneration policies in the financial sector, C(2009) 3159, April 2009; Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies.

[3] Companies Act 2006, ss. 420-421 and Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008/410, sch. 8.

[4] Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the application by Member States of the EU of the Commission 2009/385/EC Recommendation (2009 Recommendation on directors’ remuneration), Brussels 2.5.2010, COM(2010) 285 final, p. 6. The Report specifies that Member States’ recommendations and provisions take different forms: some recommend or require of companies that they better facilitate shareholder voting; others recommend (sometimes under ‘comply or explain’ obligations) to shareholders or institutional investors that they make considered use of their rights.

Europe Index. Since we are interested in the change in compensation policies related to the financial crisis, we dropped the firms that were delisted after 2007 due to mergers and acquisitions, thus reducing the sample to 279 firms[5]. We also exclude from our sample 34 firms that did not disclose individual compensation in 2007 and/or in 2010, obtaining a data-set composed by 245 firms. Our empirical analysis is mainly focused on 182 industrial firms, since the financial sector has specific governance and market characteristics that could be related to remuneration policies.

Companies included in the sample are distributed across 16 European countries, of which 14 are EU and 2 non-EU countries (Swiss and Norway). All data on CEO compensation, compliance to remuneration best-practices and firms' characteristics were collected for 2007 and 2010. With regards to compensation policies, for each CEO we collected data on Salaries, Bonuses, Non-Monetary Benefits and other annual cash pay-outs over the year. The sum of these variables is defined as *Cash-Based compensation*. In addition, we estimated the value of *Equity-based compensation* at the date of the grant. This latter component includes the value of stock grants, stock options, and other stock-based compensation tools at the date of the grant. *Total Compensation* is the sum of *Cash-Based compensation* and *Equity-based compensation*.

The analysis of compliance to remuneration best practices covers 15 criteria reflecting three areas: remuneration governance, disclosure of remuneration policy and disclosure of individual director compensation. These criteria are based on the 2004-2005-2009 Commission Recommendations cited above. We build a scoring system by assigning a value of "1" to each criterion that a firm complies with and "0" otherwise. If the firm does not provide information on a criterion we assign a missing value.

The first group of variables (*Y1-Y4*) covers the governance of the remuneration process, proxied by the existence and independence of the Remuneration Committee, the use of

[5] In order to avoid selection bias we do not impose any condition on the inclusion of the firm in the FTSE 300 list at the end of the period (39 firms included in index in 2007 were excluded in 2010).

remuneration consultants and their independence from management. A proxy for the quality of the governance process (*Y_Gov*) is calculated as the sum of variables from *Y1* to *Y4*.

The second group (*Y5*-*Y10*) refers to the disclosure on remuneration policy and the structure of the pay-package, with regard to both the description of the current and next year's policies, and the characteristics of the remuneration structure, including the fixed/variable pay proportion, the adoption of performance criteria for bonuses and equity-based incentives, and information about termination payments.

The third group of variables (*Y11*-*Y15*) refers to the individual disclosure of the components of the compensation package granted to executive and non-executive directors, and the description of the portfolio of shares assigned and outstanding at the end of the year.

More details on each criterion are provided in Table 1.

Insert Table 1 here

Data on firms' financial characteristics are mainly obtained from Datastream. When considering the ownership structure, we identify the ultimate shareholder according to the standard methodology developed by La Porta et al. (1999) using 20 percent of the voting rights as the cut off point for the existence of a control chain. If the ultimate owner is either the State or an individual or family, the firm is classified as either State-owned or family firm, respectively. If a listed company has no shareholder owning more than 20 percent of the votes, it is considered as widely-held. As previously stated, financial firms are excluded from the main sample.

4 Characteristics of the sample and results

Table 2 shows the main characteristics of the sample. The size of firms slightly increased from 2007 to 2010, while the effect of the 2008 financial crisis is clearly reflected in the proxies for firm performance, as shown by the decrease in 2010 Tobin's Q, ROA and the three previous years average stock return. Our analysis shows the negative impact of the financial crisis on performance notwithstanding the ownership type (i.e. widely held, family or State-owned).

Insert Table 2 here

Over the 2007-2010 period there is a slight increase in Total CEO compensation for the sample as a whole, mainly due to the increase in fixed cash and stock-based compensation. However, when the sample is split by ownership type, the pay increase looks substantial for widely held firms (Total compensation increases by 9%, from € 0.85 to 0.93 million), while it appears modest in family-owned firms, as a result of the increase in the fixed cash component, which is partially offset by the decrease in the bonus and stock-based components. State-owned firms show a decrease in Total compensation (14%, from € 0.34 to 0.29 million), due to the decrease both in bonuses and, to a much greater extent, stock-based compensation.

In terms of differences amongst ownership types, our data show that CEOs in widely held firms are paid much more than in either family or state-owned firms, in particular through a consistently higher stock-based component. In 2010 Total compensation in widely held firms was more than three times that of State-owned firms and more than 1.5 times that in family firms.

Ownership and compliance levels

The third group of variables refers to the level of compliance to best practices as to CEO pay. In recent years, even the most strenuous supporters of incentive-based compensation raised doubts about how compensation policies have been implemented by companies (Jensen 2001; Jensen et al. 2004), in particular with regards to the low sensitivity of pay to firms' downward performance and the conspicuous golden parachutes from which CEOs benefit when leaving their firm. The financial crisis of 2007 once more brought this theme to the fore, while increasing pressure of public opinion towards more equitable CEO compensation pushed regulators to intervene. In 2009, the EU Commission approved the Recommendations cited above, concerning directors' remuneration at listed companies and financial institutions.

Figure 1 shows how compliance to best practices for CEO pay (*Y_All*) developed between 2007 to 2010 irrespective of the ownership type. However, widely held firms show on average a higher level of compliance than family and State-owned firms. Data reported in Figure 1 show that in 2007 the difference in the level of compliance between widely-held firms, on the one hand, and family and State-owned firms, on the other, is positive and significant. In 2010 the gap is reduced, but the difference is still noticeable and statistically significant.

Insert Figure 1 here

In Table 3, the analysis of the level of compliance across the 2007-2010 period is split by ownership type and the three groups of proxies for compliance, i.e. governance of the process for setting CEO pay (*Y_Gov*), disclosure on the remuneration policy and structure (*Y_Rem*) and disclosure of individual compensation (*Y_Discl*).

Insert Table 3 here

Data show that the improvement in overall compliance (*Y_All*) from 2007 to 2010 is mainly driven by better compliance on the disclosure of pay-policy and structure (*Y_Rem*) and - in the case of widely-held - the disclosure of individual compensation (*Y_Dis*). On the contrary, the improvement in the governance of the process for setting CEO pay (*Y_Gov*) is not significant, irrespective of the ownership type.

Our analysis thus reveals that the level of compliance to best practices in CEO pay is not uniform amongst different types of firms, with widely-held companies characterized by far higher compliance than family and State-owned ones, especially with regard to the governance of the process for setting CEO pay (*Y_Gov*). Throughout the 2007-2010 period, the improvement in the disclosure on pay-policy and structure (*Y_Rem*) is the main determinant for the overall better compliance registered by the sample as a whole; however, the magnitude of the improvement in this area is much higher for family and State-owned firms than for widely-held ones, probably due to the relatively high level of compliance that widely-held firms registered in 2007. Nonetheless, in 2010 widely-held firms continue to comply better than other types of companies.

Ownership, compliance, and the level of CEO pay

In light of the close relationship between ownership type and compliance, a second question of relevance is to what extent these two characteristics affect executive compensation policies, both in terms of level and structure of CEO pay.

We firstly focus on the level of CEO pay and investigate this relationship through the following regression model:

$$TotalComp_{i,t} = \alpha + \beta OwnershipType_{i,t} + \gamma Compliance_{i,t} + \theta ControlVariables_{i,t}$$

where *OwnershipVariables* are dummy variables for the type of control (widely-held, family-owned or State-owned); *Compliance* is the variable for the degree of overall compliance to best practices on CEO pay (*Y_All*); and *ControlVariables* are variables for the size and performance of firms.

In Table 4, the intercept of regression is the coefficient for non-family firms in 2007. Within the first specification (column (1)), the coefficients on both *Family* and *State* are negative and significant, suggesting that Total CEO compensation in these types of companies is significantly lower than in widely-held firms. With regards to family firms, this result confirms the findings of Croci et al. (2012), who find that EU family firms pay lower CEO compensation.

Insert Table 4 here

In regression (1) the coefficient on *Y=2010*, a dummy that captures the difference in compensation between 2010 and 2007, is not significant, as evidence of the fact that not relevant changes are detected in the level of CEO pay for the sample as a whole. However, when in regression (2) the ownership types are interacted with the 2010 year, the negative and significant coefficients on *State*Y=2010* and *Family*Y=2010* reveal that in the period 2007-2010 State-owned firms and – to a lesser extent – family firms significantly reduced CEO Total compensation.

Column (3) of Table 4 shows results when the level of compliance to CEO pay best practices is considered. As the positive and significant coefficient *Y_All* suggests, the level of compliance to best practices is associated with higher CEO pay. This result may be interpreted as evidence that firms that pay their CEOs more are also more compliant, in order to make their compensation policies more acceptable to public opinion and minority shareholders. However, an alternative interpretation of results could be that the compliance to best practices implies an appropriate level of variable - and then risky - compensation, for which the CEO may require a premium, thus pushing higher the level of Total compensation. Since we cannot establish the direction of the relationship between the level of compliance and CEO pay, both interpretations are considered as supported by the results of the analysis.

More detailed results on the relationship between the level of compliance and the structure of CEO pay are reported in Table 6 and commented later in the text.

Results for the complete model, reported in column (4), substantially confirm the main findings described above. In particular, the level of compliance *Y_all* is strongly correlated to the level of CEO compensation also when combined to the proxies for the type of ownership. Dummy variables Family and State, that capture the difference from widely-held companies, have lower coefficient than in models (1) and (2), because these firms are on average less compliant with best practices on CEO pay, and this effect is now partially captured by the variable *Y_all*; however, State-owned firms have lower CEO compensation even after that their lower compliance is taken into account, as highlighted by the negative and significant coefficient in the presence of the variable *Y_all*.

Finally, Table 4 also highlights that the control variables significantly affect CEO Total Compensation. In line with the results obtained in previous studies (Djankov et al. 2008; Murphy 1999; Rosen 1982; Murphy 1985), the size of the firm (*FirmSize*) has a large and positive impact on the amount paid to the CEO, as well as *TobinsQ*, a proxy for the complexity of operations and growth opportunities.

As a further step in the analysis, we investigate the structure of CEO compensation, measured as the proportion over Total compensation of Fixed Pay and Benefits (*%Cash*), and Bonus and stock-based pay (*%Incentive*), respectively. Within the incentive-based component, we measure the relative weight of the bonuses (*%Bonus*) as (Bonus+stock-based pay)/Variable pay.

Insert Table 5 here

Our results highlight the different structure of CEO compensation among the different types of firms considered. As shown in Columns (1) and (3), both family and State-owned firms have more conservative remuneration policies than widely-held firms, with a higher proportion of fixed cash-based pay and, for State-owned firms, also a consistently lower recourse to incentive-based pay. The different approach to compensation policies that characterize ownership types is also confirmed by the different nature of the incentives provided to the CEO, with family and State-owned firms making higher recourse to bonuses in lieu of stock-based incentives (column 5).

The interaction terms in columns (2), (4), and (6) highlight that in 2010 this trend is even more pronounced, with family and Stated-owned firms further increasing the relative weight of fixed cash-based pay (the coefficients on *Family*Y=2010* and *State*Y=2010* in column (2) are both positive and significant), while decreasing the recourse to incentive-based pay (column (4)). In State-owned firms, the tendency to a more conservative policy is also confirmed by the further increase in the relative weight of bonuses in place of stock-based pay (column (6)).

In Table 6 we relate the structure of CEO pay to the level of compliance to best practices.

Insert Table 6 here

The results show that firms with a higher level of compliance have a lower share of fixed cash-based compensation and a higher share of incentive-based pay. Moreover, within the latter component, the proportion of bonuses versus stock-based pay is negatively related to the level of compliance. These findings show that firms that are more compliant with governance and disclosure best practices on CEO compensation are also more oriented towards higher incentives, in particular with stock based mechanisms.

These results thus confirms that there is a significant linkage between the level and structure of CEO pay and the adoption of best practices in management compensation, as an evidence that compliance is not only a formal concern but is closely related to the effective behaviour of the company.

5 Discussion of the conformity gap

The previous section shows that family- and State-owned corporations are less aligned with best practices on CEO pay than widely held firms. This conformity gap generates two sets of questions. The first is why controlled corporations conform to corporate governance and remuneration standards less than widely held corporations. The second is whether lower compliance by controlled corporations indicates an enforcement problem or some measure of society's tolerance for this type of behaviour.

Why a conformity gap?

The conformity gap at controlled corporations may depend on two different sets of reasons. The first relates to the specific characteristics and needs of controlled corporations in terms of CEO pay. As shown in the previous section, controlled corporations pay smaller remuneration packages than widely held ones and make use of a more conservative pay structure as to the proportion between fixed and variable pay. This is because controlling shareholders often monitor the managers more effectively than dispersed ones (Fama and Jensen 1983), so that incentive pay is either less needed or better controlled (Ferrarini and Moloney 2005). Another reason may be that the manager is a member of the controlling family, so that he needs less equity-based compensation (McConaughy 2000; Gomez-Mejia et al. 2003; Croci et al. 2012). The lower pressure that controlled corporations face to providing CEOs with financial incentives easily reverts into a lower emphasis on the governance aspects of remuneration (criteria *Y1*-*Y4*) and a lower attention to the disclosure of compensation policy (criteria *Y5*-*Y10*).

From a similar perspective, one could add that controlling shareholders are less interested in full adherence to corporate governance standards as an instrument to appease investors' concerns for excessive pay. Not only does pay at controlled corporations raise less concern in general (Bebchuk and Hamdani 2009), but controlling shareholders dominate shareholder meetings and appoint the board (which is competent for pay-setting). Possible criticism of remuneration policies by minority shareholders through say on pay bothers controllers mainly to the extent that the firm is in need of raising new capital[6].

A second and alternative interpretation for the conformity gap is that the lower alignment to best practices in controlled corporations is a means for easing the extraction of private benefits at the expense of minority shareholders. In fact, controlling shareholders could use executive remuneration to appropriate private benefits of control (PBC). They could appoint one or more of their family (or group) members to managerial positions fixing 'excessive' remuneration for them, as a way to distribute PBC (Cheong and Kim 2014). Alternatively, they could award 'excessive' remuneration to outside managers in order to capture the same and get their assistance in the extraction of PBC from the company through related party transactions (Barontini and Bozzi 2011; Croci et al. 2012).

In both cases, flawed or imperfect corporate governance practices are instrumental to the appropriation of PBC (Enriques et al. 2009). For instance, the lack of a sufficient number of truly independent directors in the remuneration committee will ease the fixing of pay levels not aligned with the market, while incomplete disclosure of pay structures will help conceal the existence of flawed incentives or perquisites. In similar cases, the conformity gap at controlled corporations should be regarded as a manifestation of controlling shareholders' extraction of PBC or at least as a way to facilitate it.

[6] Nonetheless, institutional investors exercise pressure on boards in order to get more aggressive pay structures for executives also at controlled corporations (Croci et al. 2012).

In this paper we do not directly test whether controlled corporations extract PBC. However, prior research on continental European firms shows that family control is positively related to performance, with some exceptions within individual countries (Barontini and Caprio 2006; Maury 2006). Therefore, the conformity gap at controlled corporations, at least family-controlled ones, is likely to derive more from low pressure to provide CEOs with financial incentives and from limited concern for minority shareholders' dissent, than from the willingness to facilitate the extraction of PCB by controlling shareholders.

An enforcement problem?

The second set of questions asks whether the conformity gap derives from weak enforcement of the relevant standards or from society's tolerance of non-compliance by controlled corporations. Enforcement issues arise with respect to regulation, which is mandatory, while remuneration standards are often incorporated in corporate governance codes (Barontini et al. 2013) that can be departed from under 'comply or explain' provisions (Wymeersch 2013). To the extent that executive remuneration is subject to mandatory rules, the type of enforcement matters. Public enforcement is common for disclosure standards that are often embodied in mandatory legislation and are enforced by securities markets supervisors (Ferrarini and Ungureanu 2015). The quality of public enforcement will depend on a variety of factors, including resources dedicated to it (Jackson and Roe 2009). Private enforcement is relatively less common, as litigation on executive remuneration matters is infrequent and cases of directors' liability for flawed compensation are rare (Bebchuk 2009). In particular, most instances of board's accountability for flawed compensation are covered by the business judgement rule and directors are held liable only in extreme cases where basic procedures and requirements for remuneration setting are not complied with (Thomas and Wells 2011; Milhaupt and Pistor 2008).

Weak enforcement could therefore explain the non-conformity to executive remuneration standards only to a limited extent, for the standards are often non-mandatory and private enforcement is almost precluded by the business judgement rule. Morever, weak enforcement would concern executive pay at both widely-held and controlled corporations, so that it may be difficult to explain the conformity gap by reference to it. No doubt, widely-held firms have better incentives to conform to best practices in remuneration matters, for they pay their managers higher salaries and grant the same more aggressive remuneration packages, while controlled corporations have a lower need to conform for the reasons articulated above. As a result, proper enforcement could generate better compliance at controlled corporations, but weak enforcement is not sufficient to explain the conformity gap highlighted in this paper.

We could rather explain the conformity gap – or at least the part of it which does not clearly derive from poor enforcement - by assuming that society tolerates deviations of controlled corporations from executive remuneration standards, at least to some extent. Firstly, society might tolerate such deviations because controlled corporations – family-owned firms in particular – tend to pay their managers less than widely held firms, using less powerful incentives (Anderson and Bizjak 2003; Croci et al. 2012)). Secondly, societal acceptance of the conformity gap might be justified by the fact that controlled corporations – family-owned ones in particular – often perform better than widely held firms (Anderson and Reeb 2003; Barontini and Caprio 2006)).

Thirdly, the conformity gap could be tolerated for the same reason why the appropriation of some PBC through related party transactions is accepted in most legal systems, i.e. in order to compensate controlling shareholders for the costs of their monitoring, from which also minority shareholders benefit. As argued by Gilson and Schwartz (2013), the relevant question is: 'how should the state maximize the virtues and restrict the vices of PBC consumption'; and the answer should be: 'to provide mechanisms through which controlling shareholders can credibly commit to limit PBC consumption to efficient levels – where the gains from better monitoring and management exceed the PBC costs to minority shareholders'.

To sum up, from a corporation's perspective the conformity gap could be mainly interpreted as an effect of the lower agency problems between management and shareholders faced by controlled corporation, and then explained by the reduced need for incentive pay in the presence of controlling shareholders, except for cases in which the non-conformity is functional to the extraction of PBC by the latter. From a societal perspective, the conformity gap could be seen as a manifestation of society's tolerance of the appropriation of some PBC by controlling shareholders, rather than a problem of poor enforcement.

6 Conclusions

In this paper, we have examined whether the level and structure of CEO compensation are related to the degree of compliance to remuneration's best practices and to the ownership of firms. Our analysis has highlighted two main, interrelated results: first, that less compliant firms pay their CEOs less, with a more conservative structure in terms of incentives provided to the management; second, that controlled corporations on average comply less than widely-held firms, a feature that we call "conformity-gap". As for the relationship between compliance and CEO pay level and structure, two different interpretations of our results are equally feasible. On the one hand, firms that pay their CEOs more are also more compliant, in order to make their compensation policies more acceptable to public opinion and minority shareholders. On the other, better compliance to best practices is related to a higher level of variable compensation, for which the CEO may require a premium, thus pushing the level of pay higher.

Our analysis has also shown that firms complying less on average are controlled corporations that also pay their CEOs lower and more conservative compensation packages. We thus interpret the conformity gap between controlled and widely held corporations mainly as a consequence of the tighter monitoring exerted by controlling shareholders, which reduces the need to provide financial incentives and therefore the pressure to comply with remuneration's best practices.

Of course, our results do not rule out an alternative explanation, i.e. that worse compliance at controlled corporations is intentionally pursued in order to ease the extraction of private benefits of control (PBC). However, empirical evidence for European firms does not seem to support this view, as it shows that these companies do not pay more executive compensation than widely-held firms and that financial performance of controlled firms –family firms at least – is better than that of widely-held firms.

Our discussion of the results may help to frame the main policy question concerning executive pay at controlled corporations, i.e. whether the conformity gap needs closing up through stricter enforcement or better rules. To the extent that the conformity gap signals the willingness of controlling shareholders to extract PBC, better enforcement or the introduction of better rules are advisable, provided that an appropriate equilibrium is reached between effective enforcement and society's tolerance of some PBC appropriation compensating controlling shareholders for their monitoring and risk-bearing. However, our analysis suggests that the conformity gap largely reflects the differences in remuneration structure and levels deriving from the different needs of controlled corporations in terms of incentives provided to the CEO. If this is the case, regulators should abstain from increasing the level of enforcement, in order to preserve the differences in compensation packages related to the different agency problems faced by controlled and widely-held corporations.

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Tables

Table 1. Criteria describing the governance and disclosure of remuneration practices

Area	Category	*Variable*	*Criteria to research*	*Explanations*
GOVERNANCE	Remuneration governance	Y1	Existence	*The existence of a remuneration committee set up within the board, either separate or joined with other committee*
		Y2	Independence	*If RemCom is made up of all non-executive, majority independent director*
		Y3	Existence	*Company making use of remuneration consultant (should state if not)*
		Y4	Independence	*Remuneration consultant is independent of management, i.e. does not work for management*
DISCLOSURE	Remuneration policy	Y5	Policy overview	*Description of the remuneration policy implemented in the financial year in review*
		Y6	Forward-looking policy	*Overview of the remuneration policy for the following financial year / subsequent years*
		Y7	Fixed-variable	*Proportion between fixed and variable components (state if no variable compensation)*
		Y8	Performance criteria for bonus	*Financial / non-financial performance criteria applied for the annual bonus (state if bonus is not awarded)*
		Y9	Performance criteria for share plans	*Financial / non-financial performance criteria applied for the share-based remuneration (state if no share-based pay is*
		Y10	Termination payments	*Information on the policy regarding termination payments (state if no policy or no such payments)*
	Individual disclosure	Y11	Executive directors	*For each executive director, breakdown of each component of annual compensation*
		Y12	Non-executive directors	*For each non-executive director, breakdown of each component of annual compensation*
		Y13	Granted	*Number of shares granted during the year in review*
		Y14	Exercised	*Number of shares excercised during the year in review*
		Y15	Unexercised	*Number of shares unexercised/outstanding*

Table 2. Descriptive statistics

	2007				2010			
	All	WH	Family	State	All	WH	Family	State
Firms Characteristics								
Log Asset	16.70	16.74	16.47	16.97	16.86	16.87	16.67	17.11
Tobin's Q	1.95	2.04	2.01	1.53	1.57	1.55	1.82	1.25
3Y_Ret	25.9%	25.7%	27.1%	24.9%	-3.6%	-4.7%	0.9%	-6.9%
ROA	7.5%	7.7%	8.0%	6.0%	5.8%	5.8%	6.7%	4.3%
CEO Compensation								
Fixed Cash	244,207	286,746	205,166	166,628	262,302	302,774	231,514	175,741
Bonus	200,330	218,209	219,822	108,266	202,503	225,981	215,222	102,598
Stock-Based comp.	250,300	351,343	154,999	70,281	270,548	405,848	145,166	17,658
Total compensation	694,911	856,335	579,987	345,494	735,254	934,425	591,903	295,996
Firms compliance								
Y_All	0.64	0.75	0.52	0.48	0.71	0.80	0.62	0.57
Y_Gov	0.58	0.71	0.43	0.41	0.62	0.73	0.51	0.41
Y_Rem.	0.64	0.74	0.52	0.51	0.72	0.79	0.63	0.64
Y_Discl.	0.68	0.79	0.59	0.49	0.78	0.87	0.68	0.61
Number of obs.	182	107	53	32	192	108	52	32

Table 3. Compliance to remuneration best practices, by ownership type

Type	n.obs.		**y_all**		y_gov	y_rem		y_dis	
Family	53	2007	**0.521**		0.429	0.522		0.592	
		2010	**0.619**		0.514	0.635		0.685	
		diff	**0.098**		0.085	0.113		0.092	
		p-value	**(0.012)**	**	(0.153)	(0.021)	**	(0.107)	
State	32	2007	**0.475**		0.406	0.510		0.488	
		2010	**0.567**		0.414	0.635		0.606	
		diff	**0.092**		0.008	0.125		0.119	
		p-value	**(0.013)**	**	(0.888)	(0.014)	**	(0.110)	
WH	107	2007	**0.749**		0.706	0.745		0.789	
		2010	**0.802**		0.731	0.792		0.872	
		diff	**0.054**		0.026	0.047		0.083	
		p-value	**(0.097)**	*	(0.548)	(0.184)	***	(0.022)	**

Table 4. Compliance to remuneration best practices and CEO Compensation

	(1)		(2)		(3)		(4)	
Intercept	9.9878		9.9230		9.1945		9.2996	
	(17.54)	***	(17.34)	***	(15.51)	***	(15.99)	***
Family	-0.2299		-0.1704				-0.0686	
	(-3.23)	***	(-1.75)	*			(-0.70)	
State	-0.6585		-0.5663				-0.4351	
	(-7.32)	***	(-4.71)	***			(-3.56)	***
Y = 2010	0.0295		0.0933		-0.0371		0.0569	
	(0.51)		(1.21)		(-0.61)		(0.75)	
Family * Y = 2010			-0.2896				-0.2266	
			(-2.97)	***			(-2.34)	**
State * Y = 2010			-0.7490				-0.6509	
			(-6.26)	***			(-5.44)	***
Y_all					1.1467		0.8209	
					(5.80)	***	(4.05)	***
Size	0.2220		0.2236		0.1992		0.2121	
	(6.90)	***	(6.94)	***	(6.07)	***	(6.69)	***
Qratio	0.1000		0.1029		0.1339		0.1171	
	3.1456	***	3.2230	***	4.1198	***	(3.72)	***

Table 5. Ownership and pay structure

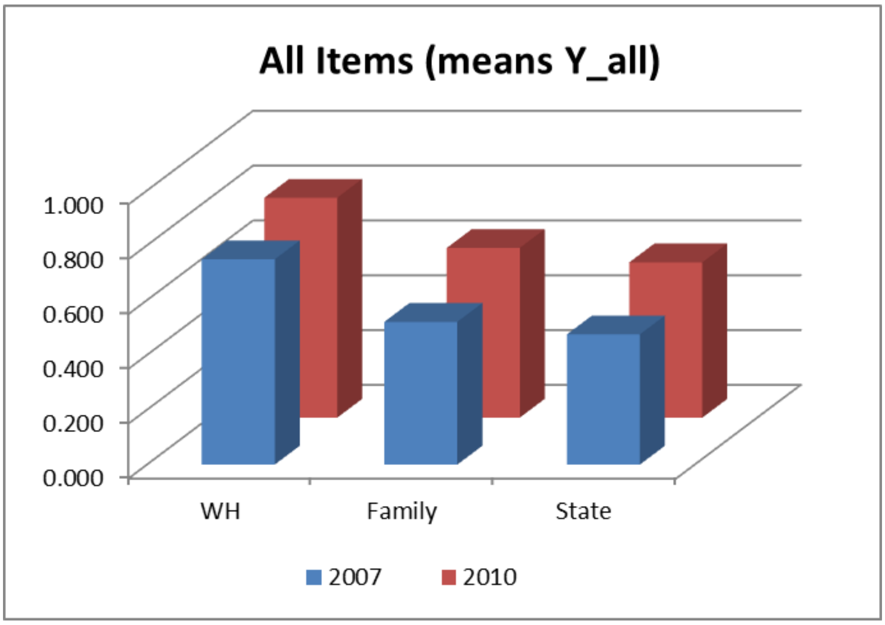
Dep. Variable	%cash	%cash	%incentive	%incentive	%bonus	%bonus
Intercept	1.2565	1.2868	0.1210	0.0951	0.8832	0.9004
	(6.36) ***	(6.46) ***	(0.66)	(0.52)	(2.86) ***	(2.89) ***
Family	0.0737	0.0515	-0.0315	0.0091	0.0915	0.0928
	(2.98) ***	(1.52)	(-1.37)	(0.29)	(2.30) **	(1.70) *
State	0.1753	0.1365	-0.1552	-0.1087	0.2810	0.2738
	(5.60) ***	(3.26) ***	(-5.34) ***	(-2.81) ***	(5.69) ***	(4.15) ***
Y = 2010 (WH vs 2007)		-0.0325		0.0179		-0.0267
		(-1.21)		(0.72)		(-0.63)
Family * Y = 2010		0.0962		-0.0717		0.0907
		(2.83) ***		(-2.29) **		(1.64)
State * Y = 2010		0.2130		-0.2022		0.2868
		(5.11) ***		(-5.26) ***		(4.33) ***
size	-0.0381	-0.0387	0.0292	0.0303	-0.0300	-0.0299
	(-3.40) ***	(-3.45) ***	(2.82) ***	(2.92) ***	(-1.72) *	(-1.71) *
qratio	-0.0360	-0.0378	0.0268	0.0268	-0.0141	-0.0162
	(-3.30) ***	(-3.40) ***	(2.65) ***	(2.61) ***	(-0.81)	(-0.91)

Table 6. Compliance to remuneration best practices and pay structure

	%cash		%incentive		%bonus	
Intercept	1.4631		-0.0477		1.1761	
	(7.27)	***	(-0.25)		(3.71)	***
Y_all	-0.2638		0.2154		-0.3573	
	(-3.85)	***	(3.37)	***	(-3.25)	***
Family	0.0474		-0.0100		0.0586	
	(1.88)	*	(-0.42)		(1.44)	
State	0.1380		-0.1248		0.2307	
	(4.28)	***	(-4.15)	***	(4.51)	***
Size	-0.0343		0.0261		-0.0255	
	(-3.11)	***	(2.54)	**	(-1.47)	
Qratio	-0.0419		0.0316		-0.0225	
	(-3.87)	***	(3.14)	***	(-1.29)	

Figures

Figure 1. Compliance to remuneration best practices, by ownership type



Differences in Y_all, by ownership type

Y_all	2007		2010		All	
WH-Family	0.228	***	0.183	***	0.206	***
WH-State	0.274	***	0.236	***	0.255	***
Family-State	0.046		0.053		0.049	

*** = significant at 1%

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