

# Executive Compensation: The Trend Toward One Size Fits All

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In principle, the optimal incentive contract varies for each executive according to the executive's characteristics and cost of effort and the activities that the firm wants to incentivize. Yet many observers worry that executive compensation is homogenizing, with contracts converging on a "one-size-fits-all" template (Gordon (2009), Hou, Priem, and Goranova (2017), Murphy and Jensen (2018)). This paper conducts an empirical investigation to determine to what extent executive contracts are in fact converging, and to explain why this might be happening, and what are its consequences for corporate performance.

Convergence in the structure of compensation plans is hard to quantify because of the multidimensionality of contracts. Executives receive compensation in many different forms, including salaries, bonuses, long-term incentives, stock, stock options, retirement benefits, and different types of perquisites. I propose a direct measure of contract similarity based on a spacial representation of contracts.

Using this measure, I find that the structure of compensation of public firms in the US is converging, and the amount of the convergence is economically large. The way firms distribute total compensation across different components of pay –salary, bonus, stock awards, option awards, non-equity incentives, pensions, and perquisites– is becoming more similar since 2006. In particular, 25% of the variation across firms disappeared in the last 10 years.

This convergence is an economy-wide phenomenon. It is not explained by firm characteristics and it does not respond to industry-specific forces. I find similar levels and trends of convergence if I separate the sample based on firm size, age, and profitability. Additionally, all industries are converging at similar rates and the magnitude of convergence within-industry is similar to the whole-economy convergence.

An economy-wide change of this nature and magnitude raises two questions: why is this convergence happening, and is it a good or bad thing? The bulk of this paper will attempt to answer these two questions.

A popular hypothesis for the convergence in pay is that a more active participation by shareholders in corporate compensation policies has fueled standardization year after year. Indeed, public companies have to disclose their executive compensation plans, and shareholders have an advisory vote on them (the so-called Say-on-Pay (SOP)). The existence of shareholders' vote on compensation plans might increase convergence in the structure of pay if shareholders have homogenous preferences or are inadequately informed about optimal variation since management has to consider their preferences as a new element in the optimization process of defining the best compensation structure for the firm.

Even though many of the major investors make their own voting decisions, the empirical findings suggest that shareholders routinely rely on proxy-advisory firms for

recommendations on how to vote and that firms do react to their recommendations (McCahery, Sautner, and Starks (2016), Ertimur, Ferri, and Oesch (2013), Malenko and Shen (2016), Larcker, McCall, and Ormazabal (2015)). The existence of a small number of proxy advisors and the limited time to provide recommendations on thousands of proxy meetings has created a growing concern of a “best compensation practices” regime pushing towards a “one-size-fits-all” trend (Gordon (2009), Hou, Priem, and Goranova (2017), Murphy and Jensen (2018)).

If proxy advisory firms make a standard recommendation and investors follow that recommendation, then we would expect that more active participation of shareholders in defining compensation plans would foster standardization. To test this hypothesis, I will use a change in the requirements of SOP voting as a quasi-natural experiment. In 2011, when the SEC implemented the mandatory SOP vote, it also required that shareholders vote on the frequency of that voting. In particular, in the first year of SOP (and every six years after that), shareholders voted on whether SOP votes will occur every one, two, or three years. Firms with a higher frequency of SOP voting are exposed to shareholders’ influence more frequently. If the increase in similarity is due to more influential shareholders, firms with SOP every year should have higher levels of similarity than firms with SOP every two or three years.

A standardized compensation plan cannot take into account each company and its executive specific characteristics. Therefore, under an optimization view, standardization is unlikely to incentivize optimal contracts. On the other hand, convergence might make comparisons between firms easier and thus reduce agency problems by facilitating monitoring activities. It is an empirical question whether the standardization in CEO pay is good or bad.

Accordingly, I will examine the relationship between ASC and firm policies. I consider policies directly related to the CEO like CEO turnover and level of total pay. Then, I will examine policies related to CEO behavior, like accounting and auditing misconduct, empire- building behavior, and innovation. Several studies show that the design of compensation contracts have an impact on executive retention (Fich and White (2003), Shen, Gentry, and Tosi Jr (2010), Gopalan, Huang, and Maharjan (2016), Jochem, Ladika, and Sautner (2018)), accounting misstatements (Jensen (2005), Greenspan (2002), Efendi, Srivastava, and Swanson (2007)), acquisitions (Datta, Iskandar-Datta, and Raman (2001), Cai and Vijh (2007)), and innovation (Coles, Daniel, and Naveen (2006), Low (2009), Manso (2011), Aghion, Van Reenen, and Zingales (2013), Balsmeier, Fleming, and Manso (2017)). Finally, I will examine whether the convergence of compensation plans benefits shareholders by looking at Tobin’s Q. Because correlations do not mean causality, I will also examine a plausible exogenous change in similarity to test the relationships described above.