CEO Incentives and Acquisitions: Evidence from the Pay Ratio Disclosure Mandate*

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Abstract

We find that the sensitivity of CEO pay to firm size (pay-size sensitivity) drops by 60% after the first-time disclosure of a relatively higher CEO-worker pay ratio under the 2017 Pay Ratio Disclosure Mandate. The sensitivity of CEO "flow" pay to positive performance ("upside" pay-performance sensitivity) also declines by 86%, while downside pay-performance sensitivity remains unchanged. These results are consistent with the notion that greater public scrutiny of CEO compensation in high pay-ratio firms curbs CEO pay growth. We further show that the change in pay sensitivities is associated with a shift in the type of M&A deals firms pursue, as well as the market reaction to deal announcement. Specifically, firms engage in fewer large deals but more small deals, with large deals exhibiting higher quality but small deals showing lower quality. These results suggest that the weaker link between CEO pay and firm size incentivizes CEOs to switch screening effort from small deals to large deals, as they can no longer derive as much additional pay from undertaking large-scale but potentially value-destroying deals. Our results provide novel evidence on how arguably exogenous changes in the drivers of CEO compensation affect CEO decisions and firm outcomes. We provide a simple model showing that while the magnitude of pay-size sensitivity affects the allocation of screening effort between large and small deals, the magnitude of "upside" pay-performance sensitivity is irrelevant.

Keywords: Pay Ratio Disclosure, pay-size sensitivity, pay-performance sensitivity, CEO incentives, M&A

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