

ADVANCES IN PACIFIC BASIN BUSINESS, ECONOMICS AND FINANCE

Series Editors:

Dr. Cheng-Few Lee and Dr. Min-Teh Yu

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BUSINESS, ECONOMICS AND FINANCE

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BOARD STRUCTURE AND CEO COMPENSATION: EVIDENCE FROM THE 1999 FINANCIAL SERVICES MODERNIZATION ACT (GRAMM–LEACH–BLILEY ACT)

I-Ju Chen^{a,*}, Hsin-Yu Liang^b, Carl R. Chen^c and
Jia-Ying Lin^a

ABSTRACT

This study investigates the changing relationship between the board structure and chief executive officer (CEO) compensation of US commercial banks due to an exogenous shock, that is, the Gramm–Leach–Bliley Act (GLBA) of 1999. We hypothesize that the board structure of banks will change toward a more efficient role mitigating the interest conflicts between shareholders and managers and thus affect CEO compensation after the passage of the act. Our empirical results show that, after the passage of the act, bank boards significantly decreased their size, separated the dual roles of CEO and board chair, and increased board meeting frequencies and director ownership. Better-governed boards, however, are more willing to compensate CEOs after the passage of the GLBA. Our study complements the literature on the relationship between board function and CEO compensation.

Keywords: Gramm–Leach–Bliley Act; board governance; CEO compensation schemes; managerial power hypothesis managerial capability hypothesis; CEO entrenchment effect

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1. INTRODUCTION

In this chapter, we examine changes in board structure and the consequences of board change on executive compensation due to an exogenous shock. The quasi-natural experiment is based on the passage of the Gramm–Leach–Bliley Act (GLBA) of 1999. The passage of the GLBA eliminated the barriers between various types of financial institutions and promotes more financial activities for US banks (Al Mamun et al., 2004; Pacini et al., 2005; Santomero, 2001). Since the distinction between commercial and investment banks has become blurred, commercial banks have more opportunities to expand their business into insurance, investment banking, or other areas. Therefore, this study aims to understand how banks restructured their boards in the wake of regulation changes and set chief executive officer (CEO) compensation to induce managerial incentives. The banking industry is one of the most highly regulated industries, in which boards of directors usually have low incentives to monitor operations and managers have less discretion to adopt competitive strategies because of strict regulatory rules (Adams & Mehran, 2003; Levine, 2004; Macey & O’Hara, 2003). The monitoring role has since, to some extent, been taken up by government agencies (Becher & Frye, 2011; Kim & Prescott, 2005; Peltzman, 1976; Stigler, 1971; Vietor, 1989, 1994; Viscusi et al., 1995).

After the passage of the GLBA, however, bank boards were expected to take on more responsibility and perform more effectively. On the one hand, facing a more competitive environment, bank boards’ demand for directors with more expertise increased (Adams, 2010). On the other hand, these directors were also urged to motivate management teams to exploit investment opportunities that were relatively few or absent before the GLBA (DeYoung et al., 2013). Due to the banking industry’s unique features, the structures of bank boards and CEO compensation schemes are different from those of nonfinancial firms.¹ There are no conclusive findings on the linkage between board structure and CEO compensation in industrial firms and the results from industrial firms may not be applicable in the banking industry.² Therefore, it is interesting to examine this issue in the banking industry, particularly after regulatory changes.

The goal of this study is twofold. First, we aim to examine how boards are restructured in reaction to an exogenous shock that increases the demand for board monitoring and advising. Second, we investigate if and how the changes in board structure affect executive compensation.

To this end, we first examine the board structure changes in response to the passage of GLBA. The GLBA of 1999 tore down the business boundaries for financial institutions and the effect on the banking industry is expected to be even stronger than the enactment of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 that eliminated the geographical boundaries for US banks. GLBA leads to a rapidly changing business environment, creates growth opportunities in an uncharted territory, and thus forces bank management and boards to take advantage of expanding opportunity sets. All these

changes in the regulatory environment makes the board monitoring and advising function more challenge and important than ever.

The changes in the board structure directly affect executive incentive compensation and expected managerial performance. To examine the impact of board changes on executive compensation we propose two competing hypotheses regarding the relation between CEO compensation and bank boards after the deregulation, where the GLBA serves as an exogenous shock. The classic *managerial entrenchment hypothesis* predicts a decrease in CEO compensation after the deregulation since it reduces the moral hazard problem as a restructured board has more incentive to actively and efficiently monitor the operations of management and alleviate agency problems between managers and shareholders (Fama & Jensen, 1983a, 1983b). From the perspective of agency theory, greater CEO compensation is usually associated with weaker board governance, with poor oversight or control over the firm's business operations (Boyd, 1994; Chhaochharia & Grinstein, 2009; Core et al., 1999; Eisenhardt, 1989; Fama, 1980). If boards of directors enhance their monitoring function after the passage of the GLBA, we would expect to see a decrease in CEO compensation.

An alternative view is the *managerial talent hypothesis*, which predicts an increase in CEO compensation after the passage of the GLBA. This is because better-informed boards will pay higher compensation for superior CEO talent in an increasingly competitive business environment. Managerial talent after the passage of the GLBA is particularly important, because the banking industry now faces stronger business challenges accompanied by uncertainties and growth opportunities in an unchartered territory (Aggarwal & Samwick, 1999; Cuñat & Guadalupe, 2009; Hubbard & Palia, 1995). Therefore, boards are expected to recruit capable CEOs with sizable pay after the passage of the GLBA under the managerial talent hypothesis.

We construct our sample of US financial institutions with Standard Industry Classification (SIC) codes 6000 to 6300 and collect data on board characteristics and CEO compensation from the ExecuComp database and proxy statements during 1994–2004. Because the terms of board directors usually last two to three years, the full effect of the GLBA on board structure will be observed with a lag, for example, two or three years afterward (Rennie, 2006). Therefore, we define the period from 1994 to 1997 as the pre-GLBA period and that from 2001 to 2004 as the post-GLBA period. We choose not to use longer sampling periods because the likelihood of other confounding factors increases.

We note two important findings. First, we show that board characteristics have significantly changed after the GLBA (post-GLBA period). We find that to better control owner–manager agency conflicts, the board structure has enhanced the monitoring/advising function by decreasing board size, separating the roles of the CEO and the chairperson, and increasing the meeting frequency and the level of outside director ownership. The magnitude of changes in board characteristics is particularly significant for small banks with less information transparency, that is, banks that are not on the Standard & Poor's (S&P) 1500.

Second, regression analyses demonstrate that, consistent with the managerial talent argument, boards of directors compensate CEOs with higher pay. A bank

with greater board independence tends to pay higher compensation after the passage of the GLBA, while this linkage does not exist before the GLBA. We also find that a board with better overall governance scores is more likely to compensate CEOs with higher pay. The empirical result regarding the relation between compensation and delta and vega, however, is weak, suggesting that the banking industry is relatively conservative compared to industrial firms in linking CEO compensation to bank performance or bank risk. Our empirical evidence holds after addressing the omitted variable problem, controlling for the CEO entrenchment effect, and other monitoring effects.

This study makes two contributions to the banking literature. First, we examine whether bank boards respond to the new business environment after the deregulation of the GLBA. Several studies in the utility and airline industry document that deregulation induces firms to strengthen governance mechanisms and increase board oversight (Bryan et al., 2005; Kole & Lehn, 1999; Rennie, 2006). Our study contributes to the banking literature by showing that deregulation changes the banking board structure to better the monitoring/advising function.

Second, we examine the effect of board structure changes on executive compensation after the regulatory changes. Several studies examining such an effect for nonfinancial firms obtain mixed results (Chhaochharia & Grinstein, 2009; Guthrie et al., 2012).³ Guthrie et al. (2012) find that compensation committee independence increases CEO pay and the increase occurs mainly in firms with blockholder directors or high institutional ownership concentration. Our study is in a similar vein as that of Guthrie et al. (2012) and finds that CEO compensation increases after the passage of the GLBA, particularly for banks with better board functions. We show that bank boards with better governance pay more in cash and restricted stocks or option awards to CEOs after the passage of the GLBA.

The remainder of this chapter is organized as follows. Section 2 summarizes the literature and advances the main hypotheses. Section 3 describes our data and variables and reports descriptive statistics. Section 4 presents univariate analyses. Section 5 provides the results of multivariate regression. Section 6 shows the results for robustness tests. Finally, Section 7 concludes this chapter.

2. LITERATURE REVIEW AND HYPOTHESES CONSTRUCTION

2.1 Background of the 1999 Financial Services Modernization Act (GLBA)

The role of commercial banks in economic society is unique. They accept deposits, make loans by using the deposits of customers, and engage in a key element in the payment system. Having high leverage and being a financial intermediary, banks are subject to more intense regulation than other industries to safeguard depositors' rights and to ensure the stability of financial markets (Andres & Vallelado, 2008).

In 1933, the US government passed the Glass–Steagall Act, which separated commercial banks from the securities business and formed a firewall between the activities of commercial and investment banks. However, researchers have found that commercial banks' ventures into securities activities played only a minor role in the banking crisis during the Depression (Benston, 1989; Puri, 1996). Following the initial authorization by the Federal Reserve Board in 1987, commercial banks expanded into security underwriting activities through specific subsidiaries known as Section 20 subsidiaries.

The passage of the Financial Services Modernization Act, that is, the GLBA of 1999 has eliminated barriers to affiliation between the banking and securities industries, insurance companies, and other financial service providers since the Great Depression (Barth et al., 2000; Yildirim et al., 2006). The GLBA opens the door for banks, securities firms, and insurance firms to combine their businesses as financial conglomerates, giving them more options to diversify their activities and improve their abilities (Geyfman & Yeager, 2009). Financial services institutions, including banks, securities firms, insurance companies, and investment companies, can merge to satisfy all consumers' financial needs with lower costs through economies of scale. According to a document published by the American Bankers Association (1999) and Macey (2000), the GLBA provides strong incentives to commercial banks to expand into investment banking and insurance services, to investment banks to move into commercial banking and insurance, and to insurance companies to move into investment banking, all through the formation of a financial holding company.

2.2 Adjustment of Bank Board Structure After Passage of the GLBA

It has been indicated that regulatory agencies act as a tool of external discipline for regulated firms (Becher & Frye, 2011; Kim & Prescott, 2005). Since the shareholders or managers of regulated firms have limited discretion over firm operations, these firms have low incentives to pursue positive net present value projects and profits (Gaver & Gaver, 1995; Ovtchinnikov, 2010; Stigler, 1971). In other words, regulation transfers owner–manager agency costs to taxpayers, so shareholders or managers have low incentives to maximize the profits for regulated firms and the malfunction of governance also deters market competition (Kim & Prescott, 2005; Kole & Lehn, 1999; Rennie, 2006; Winston, 1998).

Deregulation creates environmental uncertainty and market growth opportunities, both of which strengthen the importance of managers' role in terms of new products or new market entry policies (Hambrick & Finkelstein, 1987; Kim & Prescott, 2005; Ovtchinnikov, 2010). Since deregulation provides managers with greater discretion, it increases the cost of monitoring managerial performance (Kole & Lehn, 1997; Lehn, 2002). Shareholders/directors thus shoulder the owner–manager agency costs to motivate managers to explore growth opportunities and maximize the potential benefits for shareholders (Fama & Jensen, 1983a, 1983b; Hermalin & Weisbach, 1991; Jensen, 1993; Jensen & Meckling, 1976; Jensen & Murphy, 1990; Smith & Watts, 1992; Weisbach, 1988; Yermack, 1996).

Studies in other regulated industries, such as the airline and utility industries, have investigated the effect of deregulation on the effectiveness of governance structure and find that deregulation induces firms to strengthen governance mechanisms and increase board oversight (Bryan et al., 2005; Kole & Lehn, 1999; Rennie, 2006). By investigating the deregulation of electric utilities, Bryan et al. (2005) find a significant increase in CEOs' cash compensation and equity-based compensation after the passage of the National Energy Policy Act of 1992 and the governance structure of the electric utilities industry was adjusted to better control owner-manager agency conflict (Rennie, 2006).

Becher et al. (2005) examine the impact of technology and regulatory changes in the banking industry from 1992 to 1999 by comparing compensation between banks and non-banks and find that banks started utilizing more equity-based compensation for their board of directors. However, board structure remained static during the decade. DeYoung et al. (2013) investigate the relation between bank CEO contractual risk-taking incentives and the response to these incentives around 2000 when industry deregulation expanded banks' growth opportunities. The authors suggest that bank boards set CEO incentives to exploit growth opportunities after the passage of the GLBA (DeYoung et al., 2013).

The aforementioned studies indicate that deregulation leads to a rapidly changed business environment, creates growth opportunities, and forces bank management and boards to take advantage of expanding opportunity sets. The effect of the GLBA on the financial industry is unprecedented. The passage of the GLBA of 1999 tore down the business boundaries for financial institutions, hence the effect on the banking industry is expected to be even stronger than the enactment of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 that eliminated the geographical boundaries for US banks. All these changes in the regulatory environment, on the one hand, encourage bank executives to grab the increased opportunity and take risks; on the other hand, the board's monitoring/advising function has become more important than ever. Based on the above discussions, therefore, we propose the following hypothesis.

H1. As banks faced expanded business in unchartered territory, bank boards were restructured toward more active and efficient monitoring/advising after the passage of the GLBA.

2.3 Do Better-Governed Boards Increase or Decrease CEO Compensation?

2.3.1 The Managerial Entrenchment Hypothesis

Because of the uniqueness of the banking industry and government involvement in its operational activities, CEO compensation and CEO pay–performance sensitivities in the banking industry are lower than in non-financial industries (Adams & Mehran, 2003; Fields & Fraser, 1999; Houston & James, 1995; John & Qian, 2003). Starting in the 1980s, US banks experienced deregulation such as that of interstate acquisitions and competition. Crawford et al. (1995) examine the effect of banking industry regulatory changes on CEO pay–performance sensitivities in the early 1980s and find that, prior to the 1982 deregulation, there

is no relation between CEO pay (including salary, bonus, or option wealth) and firm performance but a significant increase in the pay–performance sensitivities after deregulation. [Cuñat and Guadalupe \(2009\)](#) also investigate the effect of product market competition on executive compensation using two major deregulations in the banking industry, the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 and the Financial Services Modernization Act (GLBA) of 1999, as quasi-natural experiments. They find that bank executives receive a lower fixed payment component but a higher proportion of stock options granted in total compensation after the deregulation. These studies suggest deregulation induces the use of CEO incentives to exploit growth opportunities and therefore strengthens the linkage between CEO compensation and commercial bank performance. The channels through which the compensation is changed, however, are not examined.

Because the decision on CEO compensation is delegated to the board of directors ([Chhaochharia & Grinstein, 2009](#); [Guthrie et al., 2012](#)), one would expect the impetus to change CEO compensation arises from the alteration of boards. Most of the literature suggests that greater CEO compensation is usually associated with weaker board governance, with poor oversight or control over the firm's business operations ([Boyd, 1994](#); [Chhaochharia & Grinstein, 2009](#); [Core et al., 1999](#)). From the agency theory perspective, CEOs usually focus on maximizing their own wealth instead of that of shareholders. They are interested in pursuing a higher level of salary or compensation than one the shareholders would prefer ([Walsh & Seward, 1990](#)). Since the board of directors is delegated to monitor the operations of management and alleviate the agency problems between managers and shareholders ([Fama & Jensen, 1983a, 1983b](#)), empirical studies suggest that the higher compensation of CEOs usually stems from a poorer internal control mechanism of the board of directors, because such CEOs are able to dominate or coopt the board ([Eisenhardt, 1989](#); [Fama, 1980](#)).

[Boyd \(1994\)](#) provides empirical evidence of a negative relation between CEO compensation and board control, constructed with multiple measures, such as CEO duality, the percentage of insiders, board stock ownership, and director compensation. [Core et al. \(1999\)](#) document that board structure and ownership structure are associated with the level of CEO compensation after controlling for other determinants of compensation. Specifically, CEO compensation is an increasing function of board size, the percentage of gray directors, and the percentage of busy directors but a decreasing function of CEO ownership. The authors generally find that firms with weaker governance structures are associated with higher compensation. [Chhaochharia and Grinstein \(2009\)](#) use the passage of SOX as an external shock and examine how different levels of board structures affect CEO compensation surrounding SOX in 2003. The authors hypothesize that boards that did not comply with the requirements should adjust more to the rules than boards that did. Their empirical analysis shows a significant decrease in CEO compensation for firms that were more affected by SOX, compared with firms that were less affected. These studies generally conclude that a strong board is associated with lower CEO compensation, while higher CEO compensation usually exists in firms with a weaker board structure. Based on the

above arguments, therefore, we posit our second (managerial entrenchment) hypothesis as follows.

- H2.* After the passage of the GLBA, banks have had stronger boards with better monitoring functions and are, hence, expected to decrease CEO pay.

2.3.2 The Managerial Talent Hypothesis

In contrast to the prediction of agency theory, banks could actually increase executive compensation, since they have been relying more on managerial talent in the development of more complicated business operations since deregulation. After the passage of the GLBA, bank boards faced increased pressure to fulfill the duty of monitoring/advising and reduce the information asymmetry between boards and managers as more growth options were embedded in business activities, making the supervision more demanding and complicated. However, [Adams \(2010\)](#) indicates that bank directors are governed by the Clayton Act, which stipulates that a person cannot serve as a director or an officer for two banks. The strict restriction on interlocking in the banking industry makes it harder for a bank to recruit capable directors who are experts in the expanded banking business. When the supply of capable directors is limited, the board will inadvertently emphasize the effectiveness of the management team to exploit growth opportunities for the bank. To effectively motivate CEOs, the boards will recruit more talented managers and pay CEOs more after the passage of the GLBA.

[Aggarwal and Samwick \(1999\)](#) and [Cuñat and Guadalupe \(2009\)](#) find that bank CEOs are granted higher compensation when the banking industry is more competitive. [Guthrie et al. \(2012\)](#) find that CEOs' total compensation has increased since the 2002 passage of SOX, particularly in the sample of firms with effective shareholder monitoring. The authors indicate that important factors besides the agency problem could affect boards' consideration of CEO pay. Constrained by the availability of the human capital of board directors, better-governed boards will rely on CEOs to form better operation strategies, allocate funds to more profitable investment projects, and contemplate potential growth opportunities in a complicated business environment ([Le & Chen, 2023](#)). Therefore, we form our third hypothesis as follows.

- H3.* To recruit more talented CEOs after the passage of the GLBA, a better-governed board will compensate them with higher pay.

3. DATA, VARIABLES, AND SUMMARY STATISTICS

In this section, we describe the data sources for Section 3.1, the variables are defined in Section 3.2, and summary statistics are reported in Section 3.3.