

Corporate Governance and Performance

Ailsa Röell

Princeton University

Programme

1. Shareholder rights and performance
2. Mechanisms for resolving agency problems: how well do they work?
 - Empirical evidence
3. Securities fraud and stock price manipulation
4. What form of regulatory intervention?
5. The myth of independent oversight

Main themes

CG mechanisms and performance

- Measurement problems

Effectiveness of

- Large shareholder voice
- Regulation
- Private legal action
 - rare outside US; curtailed inside US

Measuring Performance: Pitfalls

Shareholder value:

- Tobin's Q (MV of assets/replacement value)
 - Accounting issues (*e.g.* writedowns, intangibles)
 - Omitted-variable bias (*e.g.* “corporate culture”)
- Event studies
 - Problems pinpointing date of event
 - Event may be driven by contemporaneous conditions
- Longer-run stock returns
 - Assumes impact of CG unanticipated
cf. illiquidity and expected returns
 - Endogeneity problems
- Accounting measures
 - Manipulability

CG and performance: USA

Gompers, Ishii and Metrick 2003

Equation estimated

$$(1) \quad R_t = \alpha + \beta_1 * RMRF_t + \beta_2 * SMB_t \\ + \beta_3 * HML_t + \beta_4 * Momentum_t + \epsilon_t$$

Where the four factors correcting for investment style are

- *RMRF*: value-weighted market excess return
- *SMB*: small-firm effect
- *HML*: high-to-low book-to-market
- *Momentum*: momentum effect

GOVERNANCE PROVISIONS

	Percentage of firms with governance provisions in			
	1990	1993	1995	1998
<i>Delay</i>				
<i>Blank check</i>	76.4	80.0	85.7	87.9
<i>Classified board</i>	59.0	60.4	61.7	59.4
<i>Special meeting</i>	24.5	29.9	31.9	34.5
<i>Written consent</i>	24.4	29.2	32.0	33.1
<i>Protection</i>				
<i>Compensation plans</i>	44.7	65.8	72.5	62.4
<i>Contracts</i>	16.4	15.2	12.7	11.7
<i>Golden parachutes</i>	53.1	55.5	55.1	56.6
<i>Indemnification</i>	40.9	39.6	38.7	24.4
<i>Liability</i>	72.3	69.1	65.6	46.8
<i>Severance</i>	13.4	5.5	10.3	11.7
<i>Voting</i>				
<i>Bylaws</i>	14.4	16.1	16.0	18.1
<i>Charter</i>	3.2	3.4	3.1	3.0
<i>Cumulative voting</i>	18.5	16.5	14.9	12.2
<i>Secret ballot</i>	2.9	9.5	12.2	9.4
<i>Supermajority</i>	38.8	39.6	38.5	34.1
<i>Unequal voting</i>	2.4	2.0	1.9	1.9
<i>Other</i>				
<i>Antigreenmail</i>	6.1	6.9	6.4	5.6
<i>Directors' duties</i>	6.5	7.4	7.2	6.7
<i>Fair price</i>	33.5	35.2	33.6	27.8
<i>Pension parachutes</i>	3.9	5.2	3.9	2.2
<i>Poison pill</i>	53.9	57.4	56.6	55.3
<i>Silver parachutes</i>	4.1	4.8	3.5	2.3
<i>State</i>				
<i>Antigreenmail law</i>	17.2	17.6	17.0	14.1
<i>Business combination law</i>	84.3	88.5	88.9	89.9
<i>Cash-out law</i>	4.2	3.9	3.9	3.5
<i>Directors' duties law</i>	5.2	5.0	5.0	4.4
<i>Fair price law</i>	35.7	36.9	35.9	31.6
<i>Control share acquisition law</i>	29.6	29.9	29.4	26.4
Number of firms	1357	1343	1373	1708

TABLE VI
PERFORMANCE-ATTRIBUTION REGRESSIONS FOR DECILE PORTFOLIOS

	α	<i>RMRF</i>	<i>SMB</i>	<i>HML</i>	<i>Momentum</i>
Democracy-Dictatorship	0.71** (0.26)	-0.04 (0.07)	-0.22* (0.09)	-0.55* (0.10)	-0.01 (0.07)
<i>G</i> ≤ 5 (Democracy)	0.29* (0.13)	0.98** (0.04)	-0.24** (0.05)	-0.21** (0.05)	-0.05 (0.03)
<i>G</i> = 6	0.22 (0.18)	0.99** (0.05)	-0.18** (0.06)	0.05 (0.07)	-0.08 (0.04)
<i>G</i> = 7	0.24 (0.19)	1.05** (0.05)	-0.10 (0.07)	-0.14 (0.08)	0.15** (0.05)
<i>G</i> = 8	0.08 (0.14)	1.02** (0.04)	-0.04 (0.05)	-0.08 (0.06)	0.01 (0.04)
<i>G</i> = 9	-0.02 (0.12)	0.97** (0.03)	-0.20** (0.04)	0.14** (0.05)	-0.01 (0.03)
<i>G</i> = 10	0.03 (0.11)	0.95** (0.03)	-0.17** (0.04)	-0.00 (0.04)	-0.08** (0.03)
<i>G</i> = 11	0.18 (0.16)	0.99** (0.05)	-0.14* (0.05)	-0.06 (0.06)	-0.01 (0.04)
<i>G</i> = 12	-0.25 (0.14)	1.00** (0.04)	-0.11* (0.05)	0.16** (0.06)	0.02 (0.04)
<i>G</i> = 13	-0.01 (0.14)	1.03** (0.04)	-0.21** (0.05)	0.14* (0.06)	-0.08* (0.04)
<i>G</i> ≥ 14 (Dictatorship)	-0.42* (0.19)	1.03** (0.05)	-0.02 (0.06)	0.34** (0.07)	-0.05 (0.05)

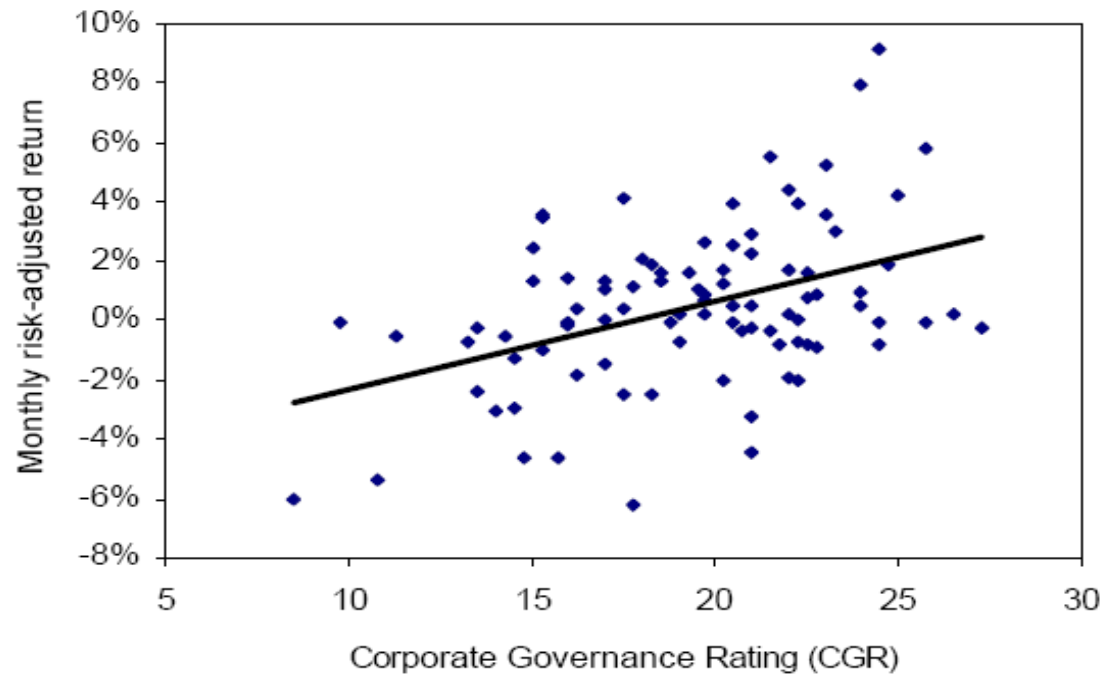
Gompers *et al.* conclusions

- Returns evidence (“long-run” event study)
 - Impact of CG unanticipated in 1990: possibly unexpected evaporation of hostile takeover market
- Q and shareholder rights
 - Controls: Delaware incorporation, size, age, S&P membership
- Capital expenditure and acquisitions
 - vely associated with shareholder rights

CG and performance: Germany

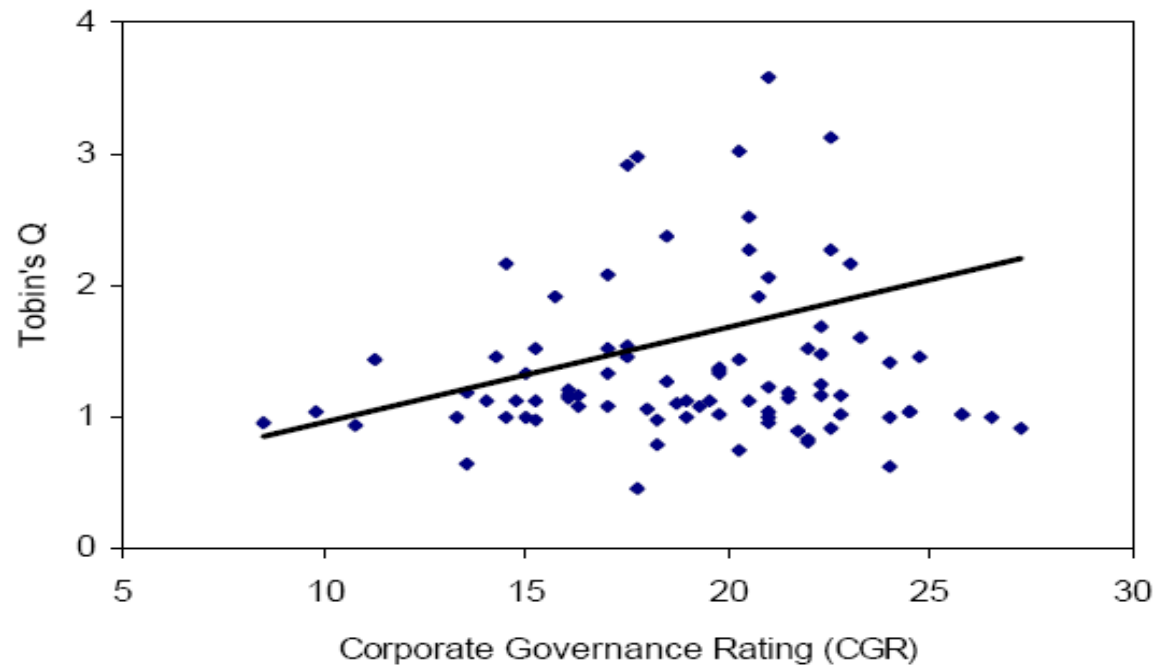
Drobetz, Schillhofer and Zimmerman 2003

Figure 2: Corporate governance rating and risk-adjusted returns



CG and performance: Germany (2)

Figure 1: Corporate governance rating and firm valuation



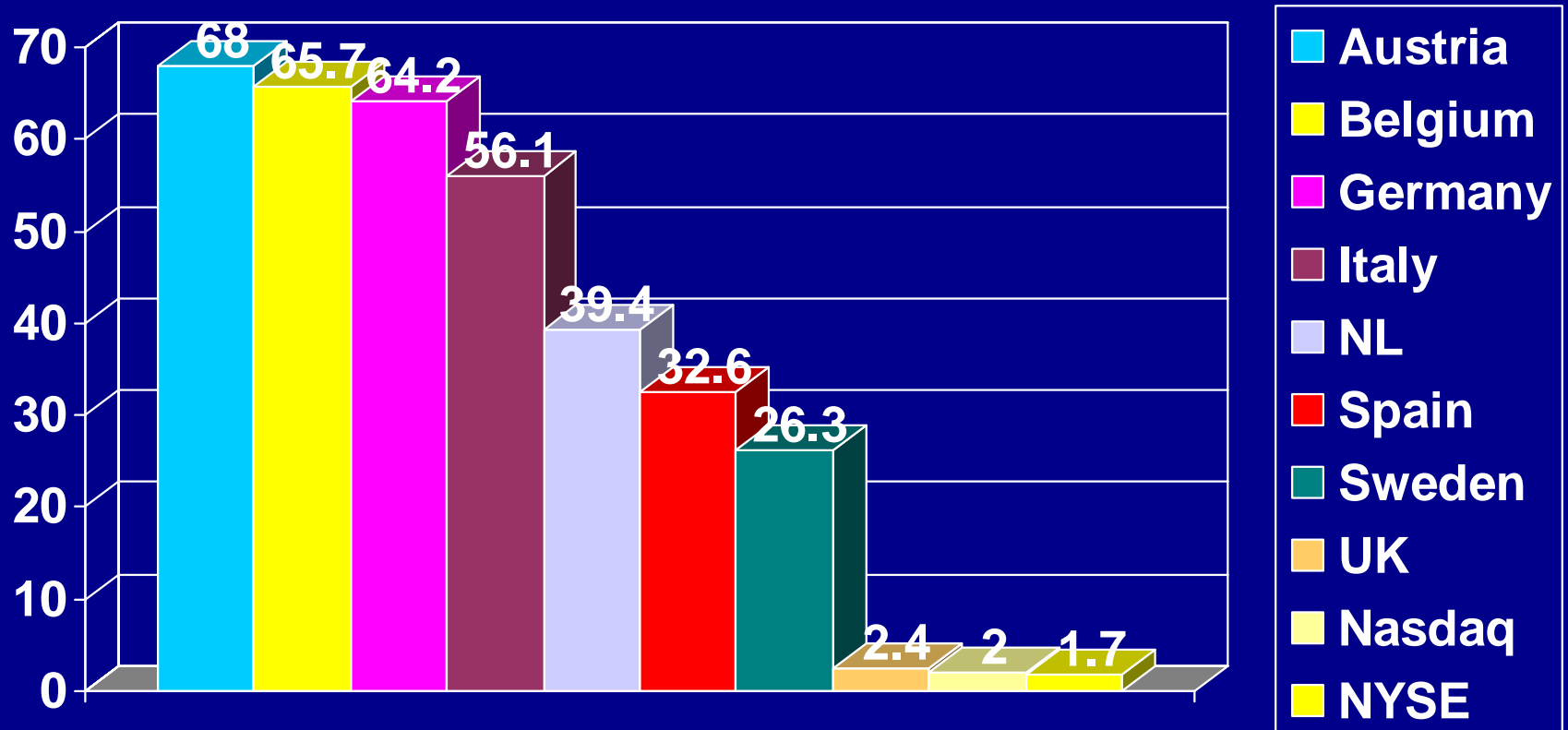
Mechanisms for resolving agency problems

1. Large Shareholders
2. Minority Shareholder Activism
3. Boards
4. Executive Compensation
5. External Certification (Audit, Ratings)
6. Litigation
7. Hostile Takeovers (CH, D, UK, US)

1. Large Shareholders: Evidence

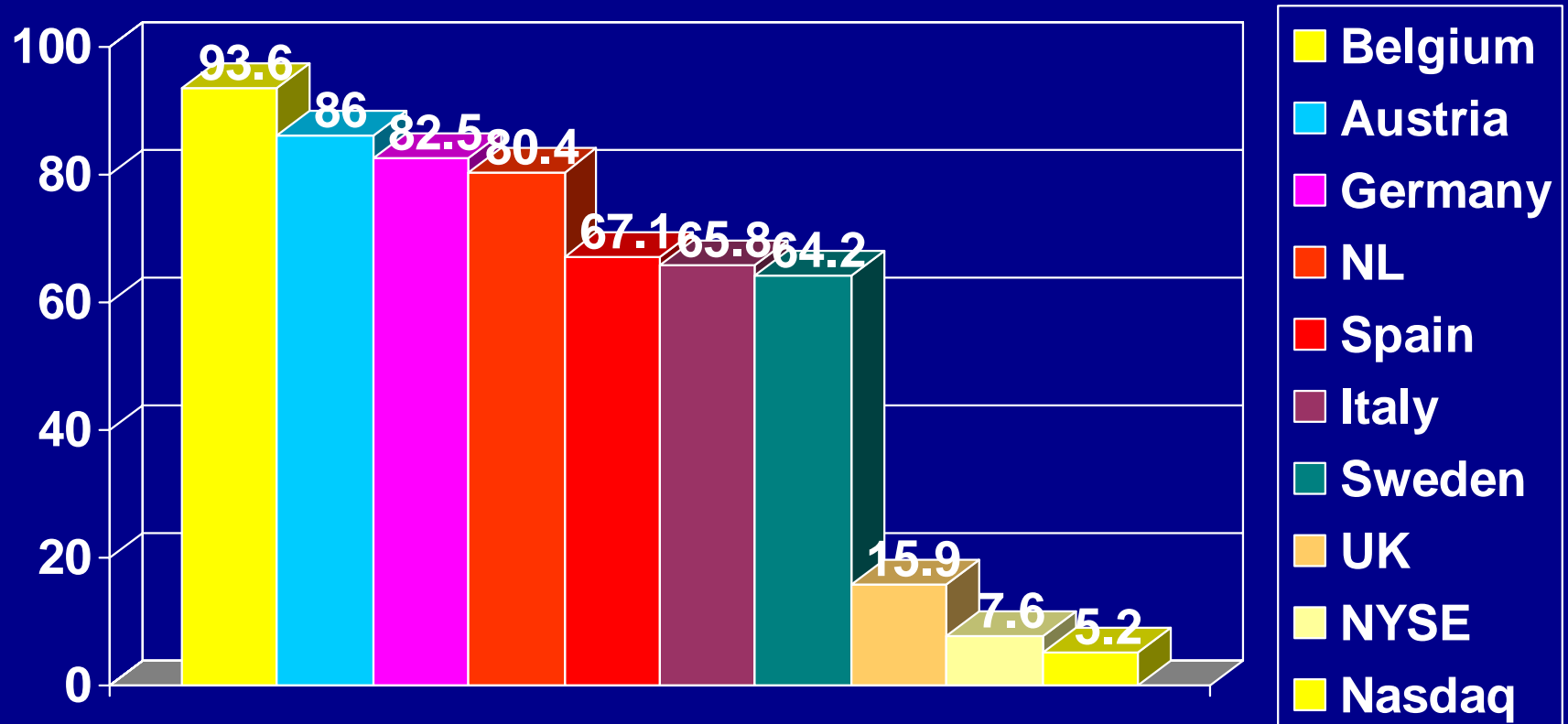
- Most of the time shareholder actions operate through the board of directors
- corporate law and securities regulations impose limits on large shareholder powers
- focus on simple hypotheses not always well grounded in theory
- different measures of concentration depending on how disclosed holdings are treated

Percentage of listed companies under majority control



Source : country chapters in Barca and Becht (2001)

Percentage of listed companies with a blocking minority of at least 25%



Source : country chapters in Barca and Becht (2001)

Large Shareholders: Evidence (2)

- Static measures of concentration are not always satisfactory
- Concentrated ownership is the norm outside the US
- Link between ownership dispersion, voting control and corporate performance:
 - regressions of profit rates and returns on assets on a control dummy: not significant (see Short 1994 and Gugler 2001)

Large Shareholders: Evidence (3)

- ownership concentration is endogenous (Demsetz and Lehn 1985)
- “hump-shaped” relationship between concentrated ownership and Q (Stultz 1988, Morck et al. 1988)
- I.V. and panel studies find corporate performance causing managerial ownership (Kole 1996, Cho 1998) or both determined by similar variables (Himmelberg, Hubbard and Palia 1999)

2. Minority shareholder activism

Why many institutional investors are cautious

- Banks and insurance companies

“A bank is not just a shareholder, but also has the firm as a client. For insurers the same applies. That distinction between roles is not easy to make. Moreover many firms have no understanding for such a distinction” R. Maatman, lawyer for ABP, NL

“You are in a difficult position if you want to present a new contract to the management board whilst you have voted against one of their proposals the day before.” D. Brilleslijper, Delta Lloyd, NL

Shareholder activism (2)

- Fund managers have same conflict
 - e.g.* Fidelity pressured in Hewlett-Packard vote, USA
 - 401(K) business at stake
- Pension funds
 - Company pension funds subject to reciprocal control by managements

Shareholder activism (3)

This leaves independent, public or nonprofit sector-related pension funds as actors

How did they do?

- negligible impact on corporate performance irrespective of form or aim of shareholder proposals
- but measurement problems: timing, simultaneity, backdoor impact

3. The board of directors

- The board:
 - selects the CEO,
 - monitors management,
 - votes on important decisions (mergers, CEO remuneration, capital structure decisions)
- In theory: CEO like executive branch of government and board like legislative branch
- In practice: more like a 'rubber stamp assembly'?

A board of directors, C19



Board models

- most regulatory efforts focus on independence of the board
- very few formal models:
 - Hermalin and Weisbach (1998):
 - extent of monitoring a function of the board's "independence"
 - independence of the board is endogenous
 - board appointments determined through negotiations between existing board and CEO
 - as firm does better CEO's bargaining power grows and independence of board diminishes
 - gradual erosion of the effectiveness of boards over time.

Board models (2)

- Warther (1998; see also Romano 1999):
 - minority directors who oppose management dismissed;
 - directors only vote against management if evidence of mismanagement is overwhelming
 - boards only intervene in crises
- Noe and Rebello (1997) ; Rajeha (2001):
 - independent directors are uninformed;
 - insiders vote with outsiders if the latter are a majority
- Adams (2001)
 - advisors vs. adversaries

Boards: Evidence

- board composition and corporate performance are “not related” in the US (Hermalin-Weisbach 2003, Bhagat-Black 1999, Romano 1998)
- independent boards protect bidder shareholders against overbidding (Byrd-Hickman 1992)
- independent boards are more likely to remove CEOs following poor performance

Boards: Evidence (2)

- board size perhaps negatively related to performance (Hermalin-Weisbach 2003) but opposite is true for banks (Adams-Mehran 2003)
- patently bad ideas (Dutch “structural regime” with board appointed by co-optation) depress shareholder value (Q) (de Jong, Nijman *et al.*)

4. Executive compensation

Main economic rationale for current structure of executive pay:

tie CEO compensation to performance and thereby align managers' and shareholders' objectives

Executive compensation (2)

Alchian and Demsetz (1972) & Jensen and Meckling (1976): Manager should be a 'residual claimant'

Agency theory: tradeoff between risk-sharing and incentives

Jensen and Murphy (1990): median CEO earns 'only' \$3 for every \$1000 increase in share value. Huge increase in use of options over last decade.

Executive compensation (3)

Modern agency theory of executive pay,
Holmstrom and Tirole (1993):

- Stock-based compensation:
 - Stock price an unbiased estimate of fundamentals
 - Induces managers to focus on long-run value
 - performance measure that cannot be manipulated easily

Executive compensation: optimal contracting or extraction of rents?

- Bebchuk, Fried and Walker (2002): CEO pay in the US cannot be rationalized on the basis of agency theory
- most CEO compensation contracts in the US do not optimally:
 - correct for common shocks through market indexing,
 - set the strike price on stock options,
 - limit the CEO's ability to unwind their stock holdings

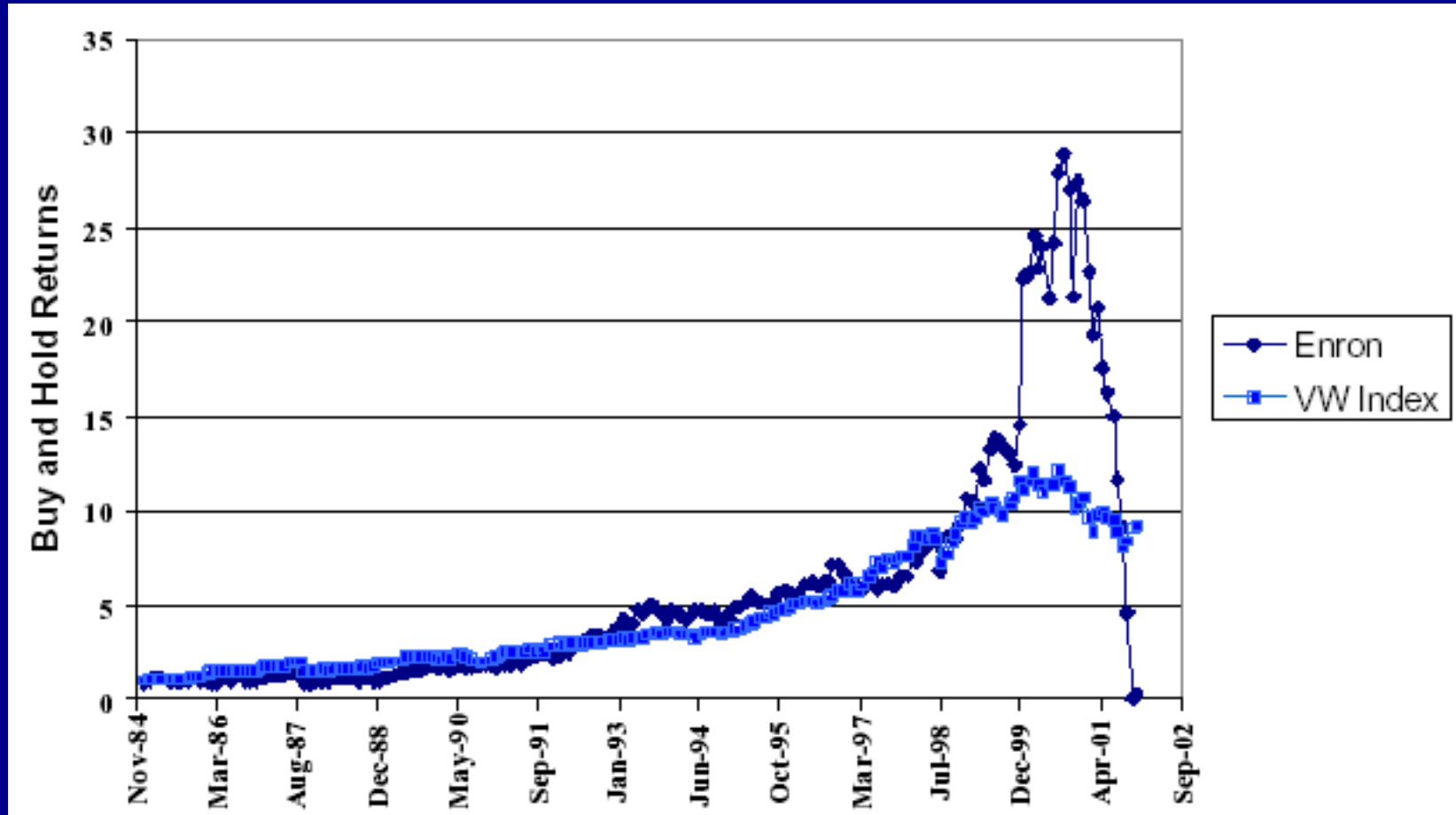
Executive compensation: optimal contracting or extraction of rents? (2)

- US compensation practice reflects a failure in corporate governance
- It is a form of managerial rent extraction:
 - managers pretend that their pay is performance-based,
 - but they are insulated from stock price volatility through the repricing or reloading of options
 - managers go through this pretence to ‘camouflage’ their rent extraction

Corporate Crises of 2001-ff.

- 25 largest bankruptcies in 2001 – 2002.
- Executive pay explosion
 - 52 executives and directors > 10M, 31 > 25M, 16 > 50M, 8 > 100M.
 - Ken Lay (CEO, Enron), 247 M, Gary Winnick (CEO, Global Crossing), 512M.
- Challenge to standard “agency” view of executive compensation.
- Popular view: rent extraction by CEO's.
- Need better governance.

Enron



Source : [Gillan and Martin \(2002\)](#)

Scandals

Recessions catch what the auditors miss.

J.K. Galbraith

- Securities fraud
- Stock price manipulation

Stock-based compensation in speculative markets

- Perverse incentives

“In the bubble, the carrots (stock options) became managerial heroin, encouraging a focus on short-term prices with destructive long-term consequences. ... It also encourages behavior that actually reduced the value of some firms to their shareholders - such as making an acquisition or spending a fortune on an internet venture to satisfy the whims of an irrational market.”

Michael Jensen, *The Economist*, November 16, 2002

- Bolton, Scheinkman and Xiong (2003) model

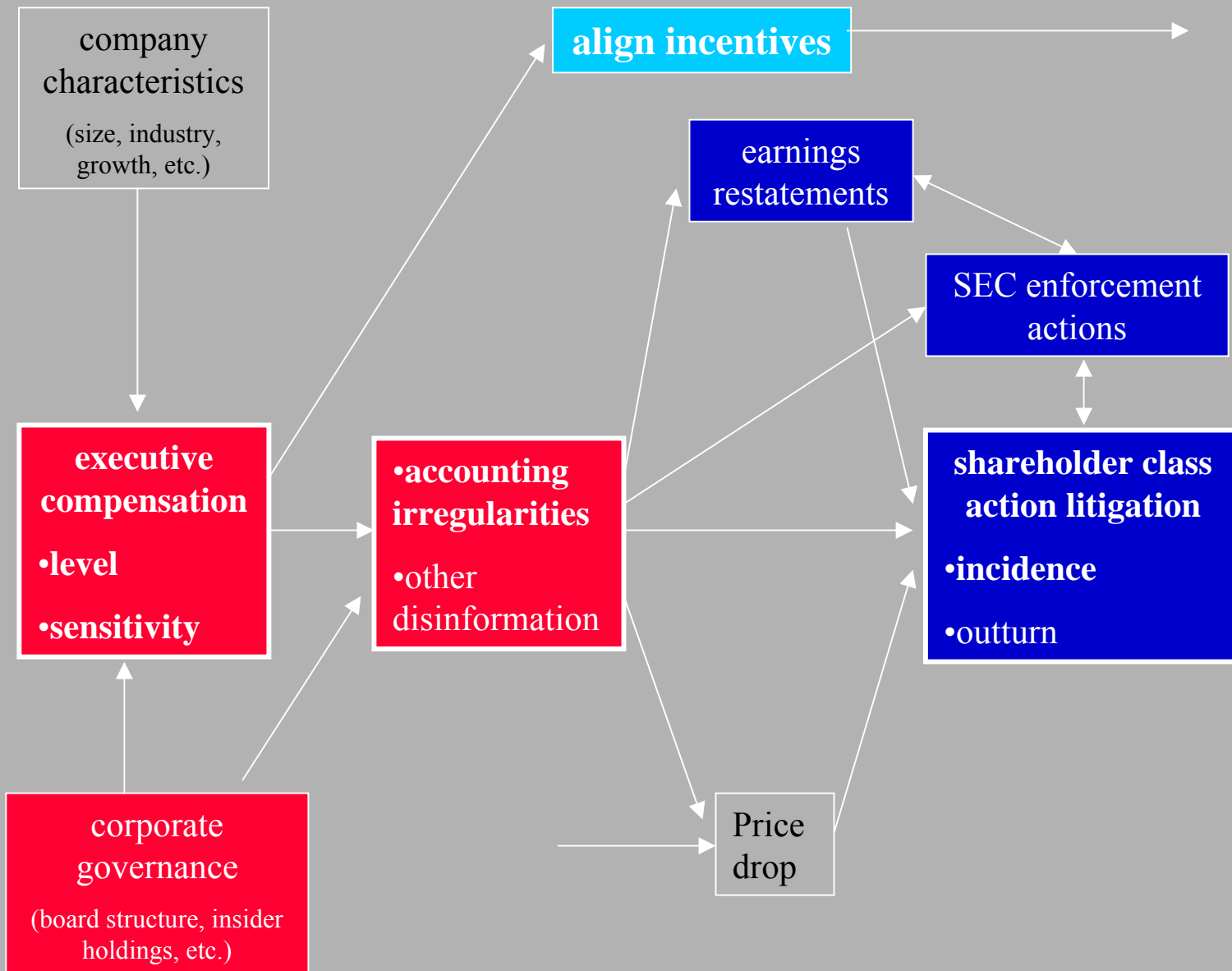
Executive compensation and fraud

- Incentives for stock price manipulation

“... the options craze created an environment that rewarded executives for managing the share price, not for managing the business. Options gave executives strong incentives to use accounting tricks to boost the share price on which their compensation depended.”

Arthur Levitt, ex-SEC chairman (2002)

- Value of option grants increased ninefold from 1992 to 2000
- Enormous growth in earnings restatements
 - 1991: 0; 1992: 6; 1993: 5; ...; 1997-2000: 700



Compensation and accounting choices/ selfdealing

- Bonus contract incentives drive accounting decisions
 - Healy (1985), Holthausen *et al.* (1995), Guidry *et al.* (1999)
- Equity-based compensation (options) predicts discretionary accruals
 - Bergstresser and Philippon (2002), Gao and Shrieves (2002), Peng and Roell (2004), Cheng and Warfield (2003)
- Equity-based compensation and option exercise predicts SEC accounting enforcement actions
 - Johnson *et al.* (2003), Erickson *et al.* (2003)

Compensation and accounting choices/ selfdealing (2)

- Executive option holdings predict accounting restatements
 - Burns and Kedia (2003), Richardson *et al.* (2003)
- Timing of disclosures around option grants suggests selfdealing
 - Yermack (1997), Aboody and Kasznik (2000)
- Exercise decisions and insider sales predict accruals
 - Beneish (1999) , Huddard and Lang (2003)

Compensation and Earnings Manipulation [Peng-Roell 2003]

	Coef.	t-stats	
<i>constant</i>	0.0763	8.05	***
<i>SALARY</i>	-0.0040	-2.68	***
<i>BONUS</i>	0.0007	0.92	
<i>SHAREOWN</i>	0.0001	0.86	
<i>OPTVESTED</i>	-0.0009	-0.96	
<i>OPTUNVESTED</i>	-0.0019	-1.49	
<i>OPTEXERCISE</i>	0.0148	5.97	***
<i>OPTGRANT</i>	0.0077	4.84	***
<i>BM</i>	-0.0299	-9.56	***
<i>SIZE</i>	-0.0050	-4.25	***
<i>LEVERAGE</i>	0.0043	0.65	
<i>VOLATILITY</i>	0.0504	7.79	***
<i>INDUSTRY</i>	YES		
<i>YEAR</i>	YES		
Number of obs	10947		
R-squared	0.15		

Accounting manipulation and private securities litigation

- Johnson *et al.* (2002)
 - aggressive accounting \Rightarrow litigation (post-PSLRA 1995)
- Lu (2003)
 - earnings management \Rightarrow litigation
- DuCharme *et al.* (2003)
 - abnormal accruals in IPOs/SEOs \Rightarrow litigation
- Heninger (2001)
 - +ve abnormal accruals \Rightarrow lawsuits against firm auditors

Shareholder litigation

- Main beneficiaries are lawyers
- Amount recovered small (~5% of maximum dollar loss)
- Disciplinary effect:
 - Executive turnover somewhat higher
 - Financial losses to managers minimal
 - No admission of guilt: almost all cases settled out of court
 - D&O insurance taken out by company

Compensation and litigation

[Peng-Roell 2003]

variable	Coef.	t-stats		Δ Prob
<i>constant</i>	-4.781	-16.80	***	
<i>SALARY</i>	0.006	0.15		0.001
<i>BONUS</i>	0.015	1.54		0.005
<i>SHAREOWN</i>	0.001	0.39		0.001
<i>OPTVESTED</i>	0.052	2.51	**	0.009
<i>OPTUNVESTED</i>	0.038	1.47		0.006
<i>OPTEXERCISE</i>	0.024	0.57		0.002
<i>OPTGRANT</i>	0.053	2.07	**	0.007
<i>BM</i>	-0.177	-1.72	*	-0.008
<i>SIZE</i>	0.238	8.21	***	0.047
<i>LEVERAGE</i>	0.567	3.44	***	0.013
<i>VOLATILITY</i>	1.054	7.54	***	0.028
<i>industry dummies</i>	Yes			
<i>Year dummies</i>	Yes			
n obs (Prob of 1s)	12971	(0.047)		
Pseudo R ²	0.17			

Recent legal reforms discourage securities class action litigation

- 1998 securities class actions to be brought only in Federal courts
 - Curtails jurisdiction shopping
- **1995 Private Securities Litigation Reform Act**
 - Discourages frivolous litigation
e.g. reduced liability for unknowing parties (outside directors), limits on attorney's fees, shift of defendant's legal fees to plaintiff if suit is baseless, lead plaintiff requirements
- 1994 Supreme Court decision
 - Curtails liability of "aiders and abettors"
- 1991 statute of limitations (1 year from discovery, 3 years from offense)

Policy Responses continued

- OECD Principles (1999) & ongoing review
 - OECD Roundtables: Asia, Russia, Brazil
- 40+ Corporate Governance Codes in the European Union
 - All member states (except L)
- Commonwealth Principles
- Sarbanes-Oxley Act
- NYSE, NASDAQ & Conference Board proposals
- SEC proposal: shareholder democracy

Sarbanes-Oxley Act 2002

- Auditor and analyst independence
- Personal certification of reports by CEO and CFO
- Forfeiture of compensation following restatements
- Ban on loans to officers and directors
- Enhanced disclosure requirements
- Whistleblower protection

Responses to Sarbanes-Oxley

(Protivi survey)

- New procedures governing external auditor's non-audit services: 72%
- Board and board committee changes (membership and/or charter): 40%
- Internal audit department
 - Evaluating financial reporting process: 45%
 - Adjusting procedures for catching problems: 39%
 - Evaluating disclosure process: 37%
 - Adding staff/compliance training: 20%

Summary of US trends

- Less scope for private enforcement through securities class action litigation
- Strengthened accountability of management and monitors:
 - Directors
 - Auditors
- Encourage whistleblowers
- More powers of enforcement for public agencies (undo years of neglect)
 - SEC, *etc.*
- More disclosure
 - Pay (expensing of options), accounts, CG, procedures

Main problem: who monitors the monitor?

Government agencies

- SEC under enormous political pressure
 - accounting and financial services lobbies are top Congressional donors
 - Levitt's unsuccessful battles regarding accounting standards
- Regulatory competition (Spitzer & other state attorneys) can counteract danger of regulatory capture

Other monitors & conflicts of interest

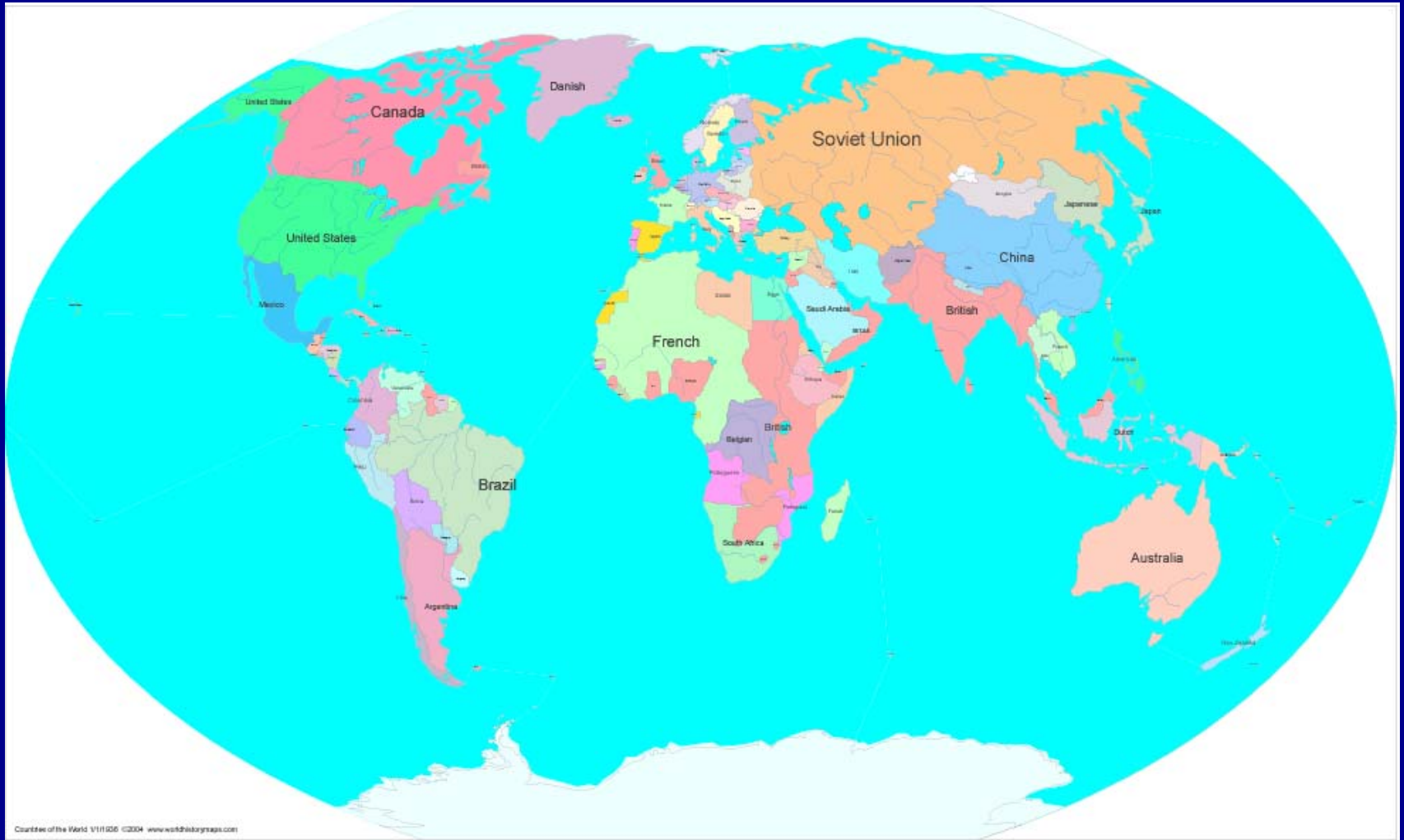
- Auditors
 - Make money from non-audit services
 - Reappointment depends on current board and management
 - Self-regulating profession: rules and safe harbors
 - Limited terms and proscribed non-audit services in some countries
- Board
 - Reciprocal appointments (*e.g.* NYSE: Grasso-Langone)
- Large potential activist shareholders
- Whistleblowers

Conclusion

Effectiveness of CG mechanisms

- Measurement problems
- Blockholders, shareholder activism
- Regulation
- Private legal action

Countries of the world, 1936



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