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Independent Directors, Board Compensation,
and Corporate Governance

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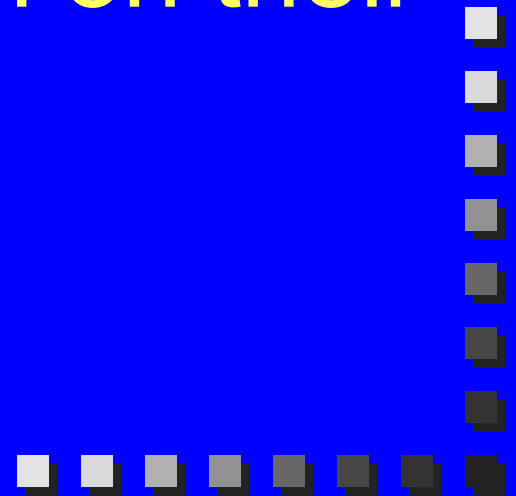
Corporate Governance

At the heart of any free economy is its capital markets. Investors put their money in these capital markets with the expectation of a return on their investment.

What assurance do these investors have that they will receive a fair return on their investment?



Corporate governance is the set of processes and procedures that ensures investors a fair return on their investment.



Corporate Governance

Over the years, our system of corporate governance has served us very well.

Indeed, without our system of corporate governance it would be difficult to imagine such a prosperous and dynamic economy. However, in light of the recent corporate scandals, it is obvious that not all aspects of our corporate governance system are working as well as they should.

Corporate governance processes are like the offensive linemen – you only hear about them when something goes wrong.



Board Independence and Long-Term Performance

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Conventional Wisdom:

- Large Company Boards should consist mostly of independent directors.
- Sarbanes-Oxley Act and NYSE Corporate Governance proposals recommend strengthening independence of corporate boards.

The Question

**Will greater board independence
produce better corporate performance?**



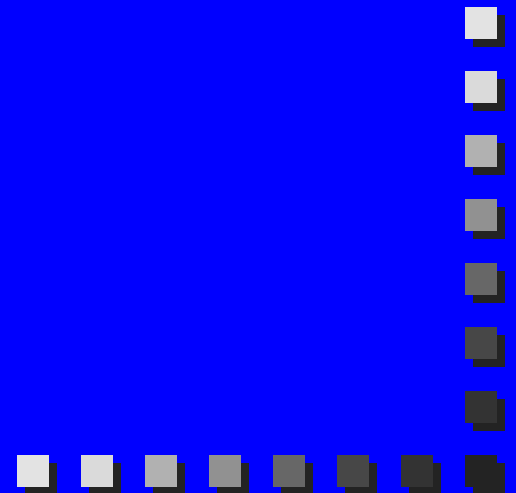
Sample Characteristics

- 1000 largest US companies; pre-Sarbanes-Oxley.
- Median firm has 11 board members: 7 independent directors, 1 affiliated outsider, 3 insiders (typically including CEO and CFO).
- 70% of sample firms have majority-independent boards.
- 6% of sample firms have majority-inside boards.



Accounting Performance Measures

- Tobin's Q (market value of assets/
replacement value of assets),
- Operating Income to Sales,
- Operating Income to Assets,
- Sales to Assets
- Sales to Employees.



- *Corporate performance* = f_1 (*Board Independence*, CEO ownership, board size, outside director ownership, no. of outside 5% holders, log(firm size), industry performance control)
- *Board Independence* = f_2 (*Corporate performance*, CEO ownership, outside director ownership, no. of outside 5% holders, log(firm size))
- *Equation 5.3: CEO Ownership* = f_3 (corporate performance, outside director ownership, log(firm size))



Panel A: Equation 5.1 (Firm Performance as Dependent Variable)

Dependent Variable: Firm Performance	Independent Variables							Adj. R ²
	INDEP	Board Size	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	Industry Control	
Q 91-93	-0.28 (-2.29)	-0.02 (-1.72)	.002 (.54)	.007 (1.36)	-0.06 (-2.85)	-0.08 (-3.28)	.80 (18.8)	.4289
OPI/AST 91-93	-0.01 (-.74)	.001 (.12)	.001 (.77)	.001 (1.46)	-0.005 (-1.57)	-0.001 (-.29)	.71 (11.8)	.2165
MAR 91-93	.13 (1.55)	.011 (1.24)	.006 (1.94)	.005 (1.35)	.03 (1.82)	.03 (1.63)	.70 (1.30)	.0189
SAL/AST 91-93	-0.09 (-1.46)	-0.01 (-2.77)	-0.001 (-.52)	.004 (1.57)	.03 (2.36)	.05 (3.72)	.89 (34.7)	.6975



Panel B: Equation 5.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables						Adj. R ²
	Firm Performance Measure	Firm Performance	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	
<i>INDEP</i>	Q 88-90	-0.21 (-6.81)	-0.01 (-6.80)	-0.0001 (-0.03)	.009 (.90)	-0.004 (-0.40)	.203
	OPI/AST 88-90	-2.42 (-8.70)	-0.01 (-5.31)	.002 (.69)	.015 (1.30)	.02 (1.48)	.198
	MAR 88-90	-0.45 (-5.31)	-0.01 (-5.52)	-0.002 (-0.91)	-0.008 (-0.55)	.03 (2.49)	.134
	SAL/AST 88-90	-0.13 (-6.23)	-0.01 (-7.99)	-0.001 (-0.16)	.04 (4.64)	.04 (4.39)	.198



Bottom Line: Poorer performing firms move towards a board that consists of a greater proportion of independent directors.

However, the performance of these firms does not necessarily improve.



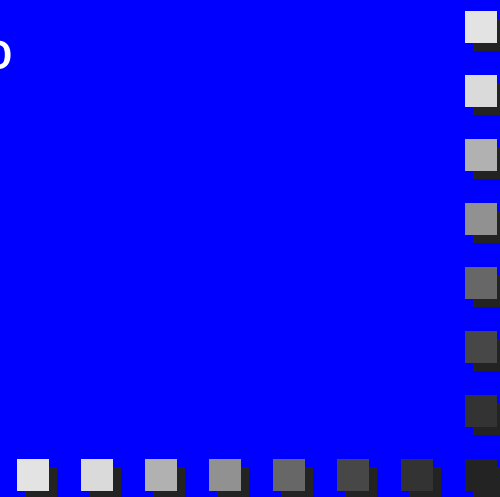
Stock Market Performance Variables and Board Structure

- If markets are (semi-strong form) efficient, then impact of board independence on share price would occur at the time the independent board is first elected.
- Measurement problems in measuring stock market based performance measures for long (several years) horizons.
- Negative correlation between board independence and prior stock market performance. Subsequent stock market performance is not statistically significant.



Results persist after controlling for

- Board size,
- Firm size,
- Stock ownership by CEO,
- Stock ownership by inside directors,
- Stock ownership by independent directors,
- Number and size of outside 5% blockholders.



Why increased board independence may not pay off in improved performance.

The Case for Inside Directors

- Including insiders on the board may make it easier for other directors to evaluate them as potential CEOs.
- Insiders may be better at making strategic investment decisions.
(Some evidence that inside director representation on investment committees improves firm performance.)
 - But, senior managers could be invited to board meetings even if they are not board members.
 - However, interaction between senior managers (other than CEO) and other directors may be different if the managers have seats on the board, are expected to attend every meeting, must vote, and are expected to participate in discussions, than if they attend at the CEO's pleasure.



Why increased board independence may not pay off in improved performance.

The Case for Inside Directors

- **Tradeoff between independence and other essentials to good decisions.**
 - Inside directors are conflicted, but well informed.
 - Independent directors are not conflicted, but are relatively ignorant about the company.
- **Tradeoff between independence and incentives.**
 - Independent directors usually own trivial amounts of the company's shares.
 - Inside directors have their human capital (and substantial financial capital) committed to their company.



A case for a modified version of the conventional wisdom that favors highly independent boards.

- Incentivize independent directors through stock and stock-option ownership. (Bhagat-Carey-Elson (*The Business Lawyer* paper))
- Institutional investors may need to put their own representatives on boards. (SEC's recent Proxy Process reform.)
- Historically, "independent" directors were not independent enough. (Board members that may be employed by a university or foundation that receives financial support from the company.) Sarbanes-Oxley Act: stricter definition of independence.
- Require directors to disclose any (social/professional/business) relationship (past or present) with the CEO. Sarbanes-Oxley Act: stricter definition of independence.



- **Heterogeneity among independent directors.** Some types of independent directors are valuable, while others are not.
 - CEOs of companies in other industries may be too busy with their own companies.
 - “Visibility” directors - well-known persons with limited business experience, often holding multiple directorships and adding gender/racial diversity are not effective, on average.
 - Hence pushing boards for greater independence may be fruitless or even counterproductive, unless independent directors have particular attributes, *which are currently unknown.*



Board Ownership and Corporate Performance

The Business Lawyer: Sanjai Bhagat, Denis Carey and Charles Elson

Sample: 1724 publicly-listed U.S. companies during 1990s.

Large firms: S&P 500

Annual sales (roughly) over \$3 billion.

Small firms: S&P Small-Cap 600

Annual sales (roughly) under \$0.4 billion.



Table 4, Panel A

Director Stock Compensation Regressions

Dependent Variable is 1 if the company grants some shares to each director,
0 otherwise.

	1992	1993	1994	1995	1996
Current and Two Previous Years Stock Return	-5.42 (-1.20)	-2.49 (-.83)	-11.91 (-2.53)	-10.81 (-2.01)	-11.86 (-1.98)
Year +1 Stock Return	-.66 (-.30)	-1.77 (-.67)	.39 (.19)	1.22 (.43)	-
Year +2 Stock Return	-.49 (-.20)	1.41 (.80)	1.00 (.36)	-	-
Company's Growth Opportunities	174 (1.04)	2 (-.13)	26 (.16)	156 (.85)	-145 (-.75)
Company Size	.06 (9.89)	.06 (11.43)	.08 (12.24)	.08 (11.79)	.09 (12.22)

Table 4, Panel B

Director Stock *Option* Compensation Regressions

Dependent Variable is 1 if the company grants some stock options to each director, 0 otherwise.

	1992	1993	1994	1995	1996
Current and Two Previous Years Stock Return	8.89 (1.48)	-1.08 (-.26)	6.84 (1.15)	12.24 (1.85)	5.49 (.80)
Year +1 Stock Return	5.33 (1.84)	12.5 (3.47)	2.86 (1.09)	-3.73 (-1.06)	-
Year +2 Stock Return	14.3 (3.41)	3.26 (1.36)	-3.52 (-1.00)	-	-
Company's Growth Opportunities	382 (1.71)	418 (2.05)	635 (2.95)	593 (2.63)	729 (3.28)
Company Size	-.04 (-5.90)	-.06 (-7.98)	-.07 (-8.13)	-.06 (-7.37)	-.06 (-7.09)

Table 4, Panel A

Larger companies are more likely to compensate their directors with stock.

Table 4, Panel B

Smaller companies are more likely to compensate their directors with stock option.

Companies with greater growth prospects are more likely to compensate their directors with stock option.



What is the impact of directors' ownership of stock and stock-option in disciplining CEOs of poorly-performing U.S. companies?

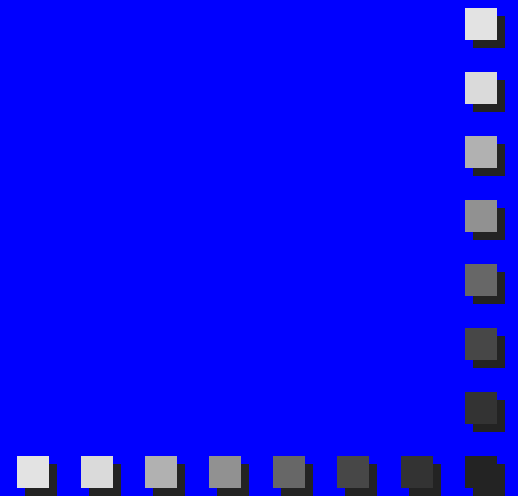


Table 7
Reasons for CEO turnover in 449 US companies

	Deceased	Retired	Older than 63	Corporate Control	Resigned	No Reason Given	No Information	# of Turnovers During this Year
1991			2			1		3
1992		1	2			1		4
1993		10	5		3	1	1	20
1994	2	21	5	1	9	4		42
1995		29	6		8	6	1	50
1996	1	11	6	1	9	6		34
1997		3	1		4	1		9
1991- 1997	3	75	27	2	33	20	2	162

Table 8

Poorer performing companies are more likely to experience discipline-related CEO turnover.

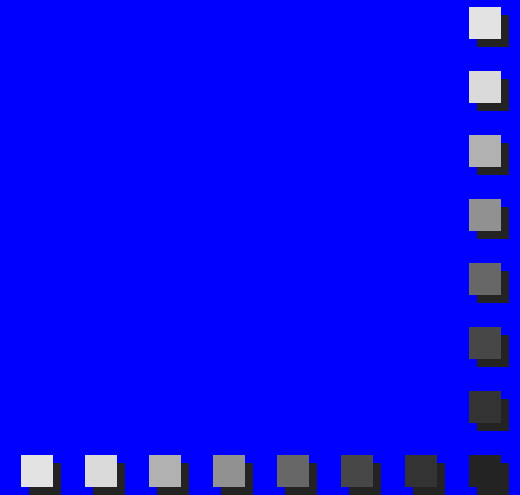


Figure 8: Reasons for CEO Turnover And Prior Performance

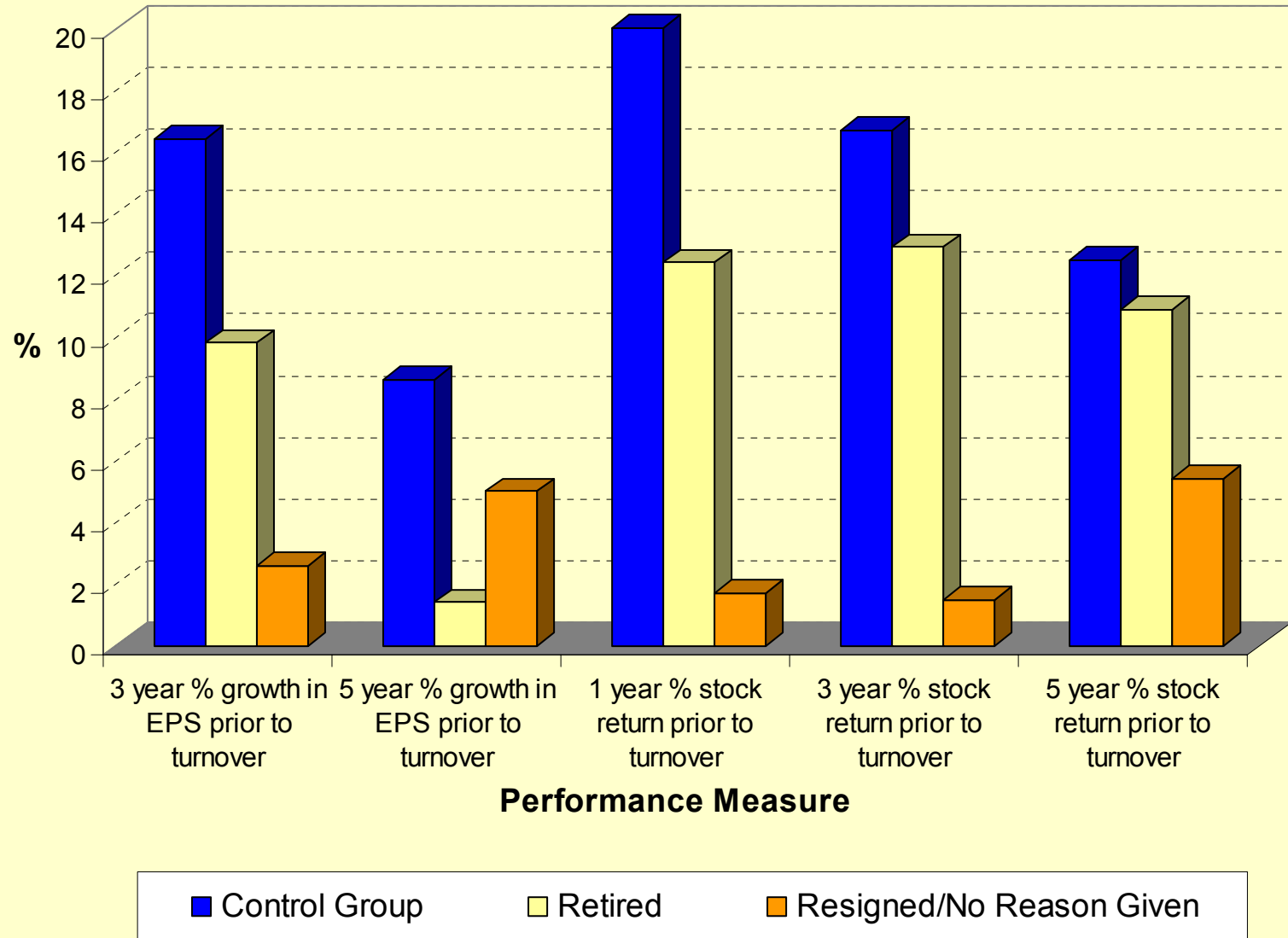


Table 9 Regression Result

Poorer performing companies are more likely to experience discipline-related CEO turnover,

especially as the median director's ownership of (dollar value) stock and stock-option increases.



Takeaways

- Larger companies are more likely to compensate their directors with stock.
- Smaller companies are more likely to compensate their directors with stock option.
- Companies with greater growth prospects are more likely to compensate their directors with stock option.
- When board members own more stock and stock-option, they are more likely to discipline the CEO of a poorly-performing company.

