



All the Rage: Will Independent Directors Produce Good Corporate Governance?

By Peter J. Wallison

That public companies should be governed by independent directors has become conventional wisdom. Yet, academic studies suggest that supermajorities of independent directors may have a negative effect on corporate performance, and experience with recent corporate scandals suggests that independent directors are not effective in preventing financial fraud. A close examination of the incentives of independent directors, and their access to information, may explain both phenomena, and raises questions about whether a supermajority of independent directors should be the “gold standard” of corporate governance.

Of the many demands of the Sarbanes-Oxley Act, none has had more far-reaching consequences than the requirement that audit committees be composed entirely of independent directors. With this act, Congress put its imprimatur on the general notion that more independent directors on corporate boards would improve corporate governance—an idea that had already attracted widespread support in the courts, among corporate governance specialists, and even in some business groups. As a result, shortly after the adoption of the act, both the New York Stock Exchange and Nasdaq established rules requiring that the boards of listed companies be composed of a majority of independent directors, and the idea took hold that an independent board was a “best practice” that all corporations should adopt.

If a majority was good, it seems, a supermajority would be better. Thus, in a 2003 report, a committee of the Conference Board—a prestigious business organization—declared: “Every board should be composed of a substantial majority of independent directors. This goes beyond the proposals by the New York Stock Exchange to have only a majority of independent directors.”¹ And in 2004,

with this idea obviously in mind, the Securities and Exchange Commission (SEC) adopted a rule requiring that 75 percent of a mutual fund’s directors be independent of the investment adviser—and that the board have an independent chair—if the fund and adviser wished to take advantage of some important exemptions from the Investment Company Act of 1940.² That well-managed companies should be governed by a board with a supermajority of independent directors had now become conventional wisdom.

Yet, many years of academic research have provided little empirical support for the idea that independent directors contribute to better corporate performance or governance, and a number of detailed studies have shown either no relationship or a negative relationship between corporate performance and the presence of a large percentage of independent directors on corporate boards. The most widely cited and influential of these studies seemed to show a negative correlation between board composition and performance that appears to become more pronounced as the percentage of independent directors on corporate boards increases.³ Similarly, a study of mutual fund performance also showed that funds headed by a non-independent chair performed better for their investors than did funds headed by independent chairs.⁴

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To be sure, requiring more independent directors on audit committees or boards was done in order to obtain better governance, not better performance, and better governance could be considered a value in itself, irrespective of its effect on corporate performance. But studies have not shown that boards with a supermajority of independent directors are superior at monitoring, either. Accordingly, it is somewhat surprising that support for corporate governance by a supermajority of independent directors became so widespread after the adoption of the Sarbanes-Oxley Act; the empirical data associated with its effect on corporate performance was at best ambiguous, and its supposed association with good governance practices was at best theoretical.

If we consider the inherent characteristics of independent directors—their lack of knowledge about the company they are supposed to be governing and their limited incentives to learn more or take risks—it becomes somewhat easier to understand why supermajorities of independent directors have failed to prevent financial fraud in cases such as Enron or, when studied carefully, are correlated with negative effects on corporate performance.

Independent Directors and Corporate Performance

Incentives to promote growth or better corporate performance. How strong are the incentives of independent directors to promote corporate performance, and how do they compare to those of insiders and non-independent directors? Independent directors usually have only a small financial stake in the companies in which they are involved and are generally not required to make significant investments in order to become or remain as directors. Companies often attempt to align the interests of directors with those of shareholders by granting stock options, but the use of this vehicle is now declining because of the new accounting requirement that the value of these options be deducted in computing a company's earnings. In addition, where options are granted, the underlying shares are seldom acquired and held by independent directors as an investment in the company. Instead, along with most optionholders, they generally sell the underlying shares and then exercise the options to cover their short positions. Finally, many advocates of corporate governance reform seem to believe that providing stock options to directors as a form of compensation encourages the preparation of overly optimistic financial reports and is thus inconsistent with the very purpose of requiring that boards be composed of a supermajority of independent directors.

In contrast to independent directors, who frequently have no significant financial stake in a company, inside or non-independent directors have strong incentives to promote growth and corporate performance. Inside directors—company employees or senior officers—see the company as a source of their livelihoods and their reputations in the business community. Frequently, the retirement savings of insiders are tied up in the equity securities of the company that employs them. Similarly, non-independent directors—suppliers of goods or services to the company—see the company as a source of business and its continued growth and prosperity as a direct benefit to themselves.

The difference between the incentives of independent directors and those of insiders is particularly apposite in the case of mutual funds. There, as noted above, the SEC has now adopted a rule that will require a supermajority of independent directors and an independent chair. Most mutual fund independent directors are undoubtedly honest and diligent, but their incentives to assure that the fund's performance is strong are questionable. Since the independent directors of mutual funds receive fixed fees for their services, they will receive the same compensation whether the fund does well or not. In the worst case, the fund will be closed down, but even then the independent directors will not suffer any significant loss. Most funds are part of fund families, advised by the same adviser and overseen by the same board. If one or more of the funds is closed, the independent directors still receive their fees for overseeing the other funds in the group.

It is the inside director of the fund—the director connected with the investment adviser—who has a strong incentive to see that the fund does well. If it does not, it will lose investors, the adviser's profits will be reduced, and the employee's share of those profits will decline. Yet the proposed SEC rule reduces the number of directors with these salutary incentives. The people hurt by this rule are thus likely to be the investors, who may suffer poor fund performance because the board lacks the incentive to press the adviser for better investment results. This dynamic explains why at least one study has shown that funds with non-independent chairs showed better performance than that of funds with independent chairs.⁵

Business advice to management. It is also doubtful that independent directors are able to provide any significant business advice to management on the day-to-day operation of the company's business. There are major exceptions, of course—a director who is a former government official

may be able to add useful perspective on how the government will react to a particular company initiative—but by and large independent directors are not familiar enough with the company's operations to advise management on such important questions as whether to extend a product line, invest in new plant or equipment, or to finance through equity versus debt under current market conditions. On the other hand, management could expect to get more value from non-independent directors—the chief executive officer (CEO) or other senior officer of a supplier or customer, an investment banker who regularly advises the company on market conditions, or a senior lawyer who represents the company on corporate or litigated matters.

Aversion to risk. Finally, and perhaps most important, are the negative incentives of independent directors. There are risks in taking on a directorship in a public company. The commonly held view that directors are “gatekeepers” in the corporation, responsible for assuring that management toes the line, seems to have created a kind of presumption that if things go wrong the directors were—as the financial writers often put it—“asleep at the switch.” The directors of Enron and WorldCom—admittedly egregious cases—were recently compelled to pay substantial settlements out of their own pockets for failing to catch the frauds that occurred in both of those companies.⁶ It may well be that directors, like accountants and auditors, will be held to account when investors suffer substantial losses that, with hindsight, might have been prevented.

Although it might be argued that this threat will make independent directors more diligent—indeed, this is why the personal penalties assessed against the directors of WorldCom and Enron were widely applauded in the press—it is only likely to produce salutary results in corporate reporting. Beyond that, independent directors' lack of detailed knowledge about the company's business or management may well induce a fear of risk-taking. When communicated to management through boardroom discussions, this attitude, at the margin, may suppress risk-taking—and hence corporate performance—by companies with a large number of independent directors. Some studies, using capital investment as a proxy for risk-taking, have found a slowdown in risk-taking since the adoption of Sarbanes-Oxley,⁷ but more study of this issue is necessary. Finally, since their upside benefit from risk-taking is small—and certainly so in comparison to the benefits that accrue to management—independent

directors have few incentives to approve the acquisitions, product extensions and new capital investments that are the essence of corporate growth. It is certainly questionable whether, as a matter of policy, we should be seeking better corporate reporting at the expense of better corporate performance. Yet, this is what the headlong rush to supermajority boards seems to have done.

It might be objected, of course, that independent directors do not really have much influence over management's business decisions and risk-taking, or that independent directors do not see themselves as taking on management-like responsibilities. This may be true in some companies, but it is clear that the advocates of a greater role for independent directors expect them to have a role in managing the company, not simply in overseeing the preparation of financial reports and controlling the CEO's compensation. Thus, the Conference Board's Commission on Public Trust and Private Enterprise, the members of which were such significant business figures as Pete Peterson, Paul Volcker, John Snow (later Treasury secretary), and Arthur Levitt, recommended that “The board should establish a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.”⁸ With a mandate like this, it is likely that independent directors in many companies believe they have a joint responsibility with the CEO and other officers to manage the business of the company and make judgments about its risk-taking.

Under these circumstances, and given their incentives, it should not be surprising that some careful studies have found a decline in corporate performance when independent directors form a substantial majority on corporate boards.

Independent Directors and Corporate Governance

Incentives for better governance. Of course, since those advocating more independent directors are seeking better corporate governance, not better corporate performance, they may well believe that weaker financial performance is acceptable if in the end better corporate governance is the result. What do we mean, then, by better corporate governance? Although corporate governance is a broad and somewhat undefined concept, most observers would agree that at a minimum it refers to preventing fraud or financial manipulation and promoting more transparent corporate reporting. That certainly seems to be the principal thrust of the Sarbanes-Oxley

Act. The act's major features—requirements for an audit committee composed only of independent directors, improved internal controls to aid corporate reporting, and the establishment of a separate quasi-government body (the Public Company Accounting Oversight Board) to regulate the business of auditing—all focused on better financial disclosure.

Taking financial disclosure, then, as the most important issue in corporate governance, it is necessary to inquire into both the incentives and resources of independent directors to prevent fraud and produce honest financial reports, and also to compare the incentives and resources of independent directors with those of inside or non-independent directors.

Incentives to foster accurate financial reporting. First, of course, in most circumstances independent directors have no incentive to endorse false accounting, and—all else being equal—have an affirmative incentive to see that financial reports are accurate. Indeed, independent directors, because of their potential liabilities, have a clear incentive to prevent the issuance of false or manipulated financial reports. But having said this, it is necessary to consider—in addition to incentives—whether independent directors have the information resources to discover fraud or manipulated financial reporting by management. Fraud, by definition, involves concealment and deception, and it is likely that the independent directors of a company are the first ones deceived by a dishonest management. It is important to note in this connection that inside and non-independent directors, while they may have greater incentives to permit inaccurate financial reporting, also have greater incentives to prevent it. After all, while an independent director might escape liability by showing ignorance of management's fraudulent intent, inside or non-independent directors will find it harder to make this exculpatory argument.

This points to a major difference between independent and inside directors. Independent directors generally lack access to information about what is really going on in a company, while non-independent directors—and especially insiders—generally have access to this information. In other words, the independent director must work harder than the insider to obtain the information necessary to prevent the disclosure of false or manipulated financial information. And there is reason to doubt that independent directors will generally go this extra mile. Most independent directors either have other means of employment or are professional directors who

are directors of a number of companies. Few of them have the time or interest to dig deeply into the workings of any one company, to meet with employees and lower-level officers, or otherwise to become familiar with the company's compliance and disclosure activities. Of necessity, they will see only what comes to them in board meetings. The fact that independent directors have no reason to manipulate or distort financial results does not mean that they have an incentive to investigate whether this is happening. The notion that seems to underlie the current preference for fully independent boards—the idea that they will discover and prevent wrongdoing, financial manipulation, or fraud—seems largely to be an idealization of reality. If wrongdoing is ever discovered and disclosed, it is likely to be by insiders working within the company itself.

This analysis is particularly applicable to mutual funds. The SEC's requirement for a supermajority of independent directors on the boards of mutual funds was a response to the late-trading scandals that were exposed in 2003. These scandals revealed that some investment managers of mutual funds were permitting favored clients to trade in the fund's shares after the markets had closed, and thus with information about whether a fund's net asset value had risen or fallen. Before the adoption of this rule, funds were only required to have a majority of independent directors. Although there is evidence that funds with non-independent chairs show better performance than funds with independent chairs, the SEC has contended that the purpose of the supermajority requirement is to achieve better compliance, not to achieve better performance.

Yet whether the rule will have this result is questionable. Will independent directors have access to—or the incentive to seek—the information that would allow them to discover and prevent misdeeds such as late-trading? No independent directors were ever charged with malfeasance or negligence because late-trading was permitted in the shares of their funds; indeed, in every case, late-trading by favored clients was permitted by investment advisers, without the knowledge of the independent directors of the funds involved. If these funds had all had independent chairs and a supermajority of independent directors, as now required by the SEC, there is no reason to believe that this would have prevented wrongdoing by the adviser. The fact is, the only directors who had an opportunity to discover and prevent late-trading were directors of the funds who were employed by the investment adviser, and thus would be considered inside directors. These insiders would also have had the

incentive to prevent late-trading or other wrongdoing because they would have suffered financially—and might in fact have been held liable themselves—when the wrongdoing was discovered. No one knows in how many cases inside officers and employees of investment advisers discovered and stopped late-trading or other misbehavior before it affected the funds themselves.

Unfortunately, as more and more independent directors are chosen by a committee of other independent directors—another of the “reforms” that is widely praised by corporate governance specialists—the gap between the ideal and the reality is likely to widen. Experience with human nature suggests that positions as independent directors will become political prizes, awarded by existing independent directors to their friends; independent directors could become bureaucrats, protecting their turf and prerogatives from management but uninterested in extending themselves to improve the company’s performance or its governance.

Conclusion

One of the ironies associated with the corporate scandals that produced the Sarbanes-Oxley Act is that many of the companies where false or manipulated financial disclosure occurred had nominally independent boards and audit committees made up solely of independent directors. Indeed, Enron’s audit committee was not only composed entirely of independent directors with financial backgrounds, but was also chaired by an emeritus professor of accounting at Stanford Business School. The analysis in this essay suggests why this gap between theory and reality should not be surprising. Independent directors have limited access to information and weak incentives to do the hard work necessary to ferret out fraud or manipulated financial disclosure. It is true that they have no incentive to produce false disclosure, but that is not the same thing as an incentive to work hard to prevent it.

All of this raises serious questions about whether the use of independent directors as gatekeepers makes sense as a matter of policy. There are many indications that the presence of supermajorities of independent directors may be reducing the performance of companies; their lack of information about what is happening below the board level in companies they govern and the lack of incentive to overcome this knowledge deficit make independent

directors weak enforcers of good corporate governance practices. It is therefore puzzling why—with these deficiencies—a board of directors composed of a supermajority of independent directors has come to be considered the gold standard of corporate governance.

Notes

1. The Conference Board, *Report of the Commission on Public Trust and Private Enterprise*, 2003, p. 9. Members of this committee included Peter G. Peterson, John Snow, Arthur Levitt, Warren Rudman, and Paul Volcker.

2. This rule (Release No. IC-26520 of August 2, 2004; 69 Fed. Reg. 46,378) was adopted over the dissents of two commissioners and has been at least temporarily stayed by the U.S. Court of Appeals for the District of Columbia Circuit.

3. The most comprehensive and influential of these studies, which reviewed a large number of other studies with similar results, is Sanjai Bhagat and Bernard Black, “The Uncertain Relationship between Board Composition and Firm Performance,” *The Business Lawyer* 54, no. 921 (May 1999). A second study by the same authors, published in 2002, shows the same result: “We find a reasonably strong inverse correlation between firm performance in the recent past and board independence. However, there is no evidence that greater board independence leads to improved firm performance. If anything, there are hints that greater board independence may impair firm performance. The weak results in this Article, combined with similar results from the other research surveyed in Part II.A, do not support the conventional wisdom favoring the monitoring board, with a high degree of board independence.” Bhagat and Black, “The Non-Correlation between Board Composition and Firm Performance,” *The Journal of Corporation Law* 27, no. 231, p. 263.

4. Geoffrey H. Bobroff and Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, Fidelity Investments study, March 10, 2004, available at <http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm>.

5. *Ibid.*

6. See Peter J. Wallison, “The WorldCom and Enron Settlements: Politics Rears Its Ugly Head,” *Financial Services Outlook*, March 2005.

7. Daniel A. Cohen, Aiysha Dey, and Thomas Lys, *The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs*, Social Science Research Network, July 8, 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=568483.

8. Conference Board report, 9.