Some evidence on boards

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A brief history

1. ***Board independence (from CEO)***
   - Early studies: mixed findings on association between board independence and firm value
   - Recent studies: “causal” evidence of positive effect on firm value (Black et al. JFE 2012; Duchin et al. 2010)
   - Re-define independence : “co-opted boards” (Coles et al. RFS 2014)
2. ***Board accountability (to shareholders)***
   - Bebchuk’s work
   - Majority voting, say on pay, proxy access
3. ***Back to the basics: board “quality”***
   - Skills, expertise, experience, time commitment
   - What do we know?

Lehman’s board

Where Was Lehman’s Board? (WSJ, Sep 15, 2008)

Nine of them are retired. Four of them are over 75 years old. One is a theater producer, another a former Navy admiral. Only two have direct experience in the financial-services industry. Meet the Lehman Brothers Holdings Inc. external board directors, a group of 10 people who, perhaps unknowingly, carried the health of the world’s financial system on their shoulders the past 18 months. …Who was on this board? **Until the 2008** arrival of former US Bancorp chief Jerry Grundhofer, **the group was lacking in current financial-knowledge firepower. A number of the members did have past financial-markets expertise, but most of their working lives were tied to a different era**: The one before massive securitization, credit-default swaps, derivatives trading, and all the risks those products created.

Lehman's board (cont'd)

…The board's members include John Macomber, 80 years old, a former McKinsey & Co. consultant and chief executive of chemical-maker Celanese Corp; John Akers, 74, former IBM chief; Thomas A. Cruikshank, 77, chief executive of Halliburton Co. prior to Vice President Dick Cheney; and Henry Kaufman, 81. In the 1970s and '80s, Kaufman, the chief economist at Salomon Brothers, was known as "Dr. Doom" for his bearish views on the U.S. economy. Ironically, in April, Mr. Kaufman termed the credit crisis a "global calamity" and criticized the Federal Reserve for "providing only tepid oversight of commercial banking." Other current members include: Sir Christopher Gent, 60, the one-time chief of mobile-phone company Vodafone PLC; theater producer Roger S. Berlind, 75; former Telemundo Chief Executive Roland Hernandez, 50; Michael Ainslie, 64, former chief executive of Sotheby's Holdings; Marsha Johnson Evans, 61, one-time head of the Red Cross and a former Navy rear admiral. Until 2006, Lehman's board included Dina Merrill, the 83-year-old actress once featured in the old Katharine Hepburn movie "Desk Set," as well as "Caddyshack II."

How much was Lehman's board monitoring the company's on-going risk as it began accumulating its portfolio of real-estate assets and securities? In both 2006 and 2007, the risk committee of Lehman's board met twice each year, according to Lehman's SEC filings"

Industry expertise (IE)

- Surveys: IE is the most sought-after director qualification; yet in the 2000-2007 in S&P 500 firms only 25% of independent directors have relevant industry experience (Wang et al. 2014)

<u>Industry expertise on boards </u>(Faleye et al. 2014 WP)

- Positive association between IE on board and firm value
  - Advising: more corporate innovation (but not better M&A)
  - Monitoring: more pay-for-performance sensitivity
- Stronger association when CEO has limited IE and when firm grows by internal innovation (rather than acquisitions)

<u>Industry expertise on committees</u>

- Audit committee members with IE are associated with higher financial reporting quality (Cohen et al. 2014 TAR; Wang et al. 2014 JFQA)
- Comp committee members with IE associated with greater pay-for-performance sensitivity (Wang et al. 2014 JFQA)

Professional Directors (PD)*

- Professional directors: board members whose only employment is as corporate directors.
  - Median firm: 2 PD, 40% of independent directors
  - PD less likely to have been CEO/senior executives
- Negative market reaction to appointment of PD
  - More negative for firms with higher agency costs, consistent with professional directors perceived as hurting monitoring quality
- Firms with a higher proportion of PD are associated with:
  - more acquisitions, lower acquisition announcement returns, lower valuation, lower performance-CEO turnover sensitivity, lower pay-performance sensitivity

<u>Caveat:</u>

- PD not necessarily thickly informed, nor truly "full time"

**** "Does the market value professional directors?" Wahid and Welch (2016), WP, Univ. Toronto***

Other attributes (experience/expertise)

- Foreign directors on US board (Masulis et al. JAE 2012)
  - Negative effect on firm value
  - Reduced monitoring effectiveness (misreporting, excess pay, lower attendance)
  - Some benefits (better cross-border acquisitions)
- CEO as directors (Fahlenbrach et al. JFE 2010)
  - Little evidence of effect on firm value and governance
- Directors from “related” industries (upstream/downstream) industries: (Dass et al RFS 2014)
  - Positive association with firm value and positive reaction to their announcement
- Functional expertise:
  - Positive reaction to the appointment of directors with accounting expertise to the audit committee (pre-Sox) (DeFond et al JAR 2005)
  - Studies on effect of having on board lawyers, politicians, academics, etc.

Skill *sets:* individual- and board-level

- Regulation S-K 2009: U.S. firms must disclose the experience, qualifications, attributes or skills that led the nominating committee to choose an individual as a director

Adams et al. (2015): examine firm disclosures in 2010

- Each outside director listed with 2.7 skills on average (skill *sets*)
- All firms have at least one director with finance and accounting skills
  - Other frequently represented skills are outside executive experience (83%), outside board experience (74%), leadership skills (68%), strategic planning skills (63%), and management experience (62%)
- On average, only 1/3 of committee members have a skill matching the committee's purpose (higher for AC, much lower for CC)
- **Boards differ in terms of high-low diversity of skills on the board**
- **Commonality in skill sets associated with better firm performance (perhaps better decision-making)**

Board diversity

- <u>Board diversity and firm value</u>
  - Female representation associated with better monitoring, but average effect on firm value is negative (Adams and Ferreira 2009 JFE)
  - Gender quotas in Norway associated with loss in firm value (Ahern and Dittmar QJE 2012)

- <u>Board diversity and volatility </u>(Giannetti et al. 2016):
- Firms with more *diverse* boards have greater stock return and fundamental volatility consistent with board diversity resulting in more erratic decision-making
  - Analysts make larger forecast errors
  - Higher executive and director turnover, less performance-related (consistent with presence of conflicts in the boardroom)
  - Note: diversity defined as ethnic/gender/age/education/experience

"Busy" directors (director workload)

- Early studies test association between directors' busyness (multiple seats) and firm performance
  - Most studies: negative effect (busyness = low time commitment)
  - Some studies: positive effect (busyness as proxy for quality and expertise)

<u>Recent 'causal' evidence: negative effect</u>

- Firm performance improves when some directors lose seat at other firms due to M&A (exogenous shock; Hauser 2013, WP)
  - Underlying assumption: "freed up" time will be reallocated toward other seats
- When a director/CEO passes away ("attention shock") negative market reaction at interlocked firms, but only for interlocked firms whose directors' workload is likely to increase (e.g. sharing same committee with deceased director) (Falato et al. JFE 2014)

A note on proxy advisors and shareholder voting

<u>Proxy advisors' guidelines </u>for director elections:

- Focus on independence, busyness, attendance, responsiveness to shareholder votes, governance problems
- No guidelines on qualifications/skills/expertise (Ferri et al. 2016)
  - Probably viewed as too difficult/subjective
- Recommend in favor of new directors up for elections.
- Effectively, ex ante "vetting" of new directors left to the board
- Problem of "right" mix of skills only addressed ex post
- Example: proxy fights (Alexander et al. RFS 2010)
  - Significant stock returns around announcements of proxy advisor's recommendations.
  - Evidence that voting recommendations are both predictive about contest outcomes (changes in outcome probabilities) and *informative about the ability of dissidents to add value* (changes in outcome-contingent valuations)