Corporate Governance & Regulation: Panacea or Pandora’s Box

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Outline

- Overview of Corporate Governance
- Some of my work
- What we do and don’t know
  - Boards, Compensation
- Enron and its aftermath
- Q&A
Corporate Governance Defined

*Shleifer and Vishny* (1997)

“… ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”
Corporate Governance Defined

Zingales (1998)

“...the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm.”
Corporate Governance Defined

Gillan and Starks (1998)

“…the set of structures that provide boundaries for the firm’s operations.”
The Firm

Board of Directors

Management

Assets

Debt

Equity

Shareholders

Debtholders
Constituents / Stakeholders

Law / Regulation

Firm = Nexus of Contracts

Markets

Employees

Suppliers

Shareholders

Creditors

Customers

Culture

Community

Board of Directors

Management

Assets

Debt

Equity
Why Corporate Governance?

- Parties within the nexus of contracts have
  - Different goals and preferences
  - Imperfect information
    - Actions, knowledge, and preferences
- Potential conflicts of interest
  - Pick any two parties in the nexus
  - e.g. Shareholders vs. Debtholders
    - Risk shifting
    - Asset substitution
- Agency problems
Separation of ownership & control

- Managers
  - Run the firm
  - Fiduciary obligation to shareholders
  - Small ownership stakes
  - Goal: maximize own value

- Shareholders
  - Own the firm
  - Have voting rights
  - Residual claimants
  - Goal: maximize shareholder value
Corporate Governance

- Mechanisms that may mitigate agency conflicts

- Types of Mechanisms
  - Internal to Companies
  - External to Companies

- Not necessarily mutually exclusive …
Internal Governance
External Governance
The Big Picture
My research focus

- Presence of potential agency conflicts
- How those potential conflicts are resolved (or minimized)
- Explaining variation in governance
  - Based on underlying economic
- What defines "Corporate Governance"
Calpers Goes Over CEOs' Heads In Its Quest for Higher Returns
22 January 1993

Advanced Micro Devices Inc. has agreed to meet with Calpers next week to discuss the fund's shareholder proposal that would require the company's chairman to be an independent director.
Shareholder Monitoring

- Shareholder Activism & Shareholder Voting
- Relationship Investing, Corporate Change and Shareholder Value
Shareholder Monitoring

The Directors of Sears, Roebuck and Co.

NON-PERFORMING ASSETS
Independence and Activity of Audit Committees

Figure 1. Percent of Firms with Completely Independent and Active Audit Committees by Explanatory Variable Quartile Subsamples
Boards, Audit Committees, and the Information Content of Earnings

- Focus on earnings response coefficients
  - As a function of
    - Board and audit committee independence, size, and activity
    - Indices of Board Structure
  - Earnings innovativeness is related to board structure
Governance Indices / Scoring

- Governance is a *set* of mechanisms
  - More than individual components
  - Evidence that some governance mechanisms
    - Complements
    - Substitutes
Contracting with the CEO

- Much focus on
  - Level of pay
  - Form
  - Little on the written agreements
    - Related to firm / Industry / CEO characteristics
General Approaches
What we (think) we know: Boards

- Board Independence
  - Associated with better decisions
    - Positive market response to the adoption of antitakeover measures
    - Higher premia on acquisition
    - More rapid replacement of poorly performing CEOs
    - Constraints on CEO pay
What we (think) we know: Boards

- **Board Size**
  - Smaller boards associated with increased value
    - Spurious?
    - If “size matters” firms could simply add value by shrinking the board

- **Link between board structure and performance is elusive**
  - Cause and effect?
Board composition is itself affected by financial performance.

- Chicken and egg problem
- Companies often add outside directors in response to poor performance

None-the-less

- Empirical associations can be informative
Under-studied issues

- Independence, Effectiveness, & Expertise
  - How to measure
  - Impediments to these?

- Structure
  - Committees

- Functions
  - Monitors versus Advisors
What we (think) we know: Compensation

- Pay to performance sensitivity critical
  - Align incentives
  - But sensitivity appears low

- USA early 1990’s
  - Demand for Stock Options
  - Increased sensitivity of pay to performance
  - BUT – does a rising tide lift all boats?
What we (think) we know: Compensation

- Balance between
  - Incentive alignment
  - Rent extraction
- Work suggests incentive-laden compensation
  - Associated with financial shenanigans
  - Restatements, Fraud, Lawsuits
What we (think) we know: Compensation

- Compensation policy as a window on
  - The functioning of the board
  - Governance policy
Governance Failure(s) & Regulatory Reforms
“A splendid board on paper”
- 14 members, only two insiders.
- Mostly outsiders
  - Relevant business experience
  - Owned stock, some large amounts
  - Stock options or phantom stock as part of compensation package
  - State-of-the-art audit committee charter
    - direct access to financial, legal, and other staff
    - power to retain other accountants, lawyers, or consultants
Board Committees and Years of Service

Board

Audit
- Chan 6
- Jaedicke 17
- Mendelsohn 3
- Pereira 3
- Wakeham 8

Finance
- Belfer 19
- Blake 9
- Chan 6
- Meyer 4
- Pereira 3
- Savage 3
- Urquhart 12
- Winokur 17

Nom & Gov
- Mendelsohn 3
- Meyer 4
- Gramm 9
- Wakeham 8

Executive
- Belfer 19
- Duncan 17
- Lay
- LeMaistre 17
- Skilling
- Winokur 17

Compensation
- Blake 9
- Jaedicke 17
- LeMaistre 17
- Savage 3
Board Committees and Years of Service
RED FLAGS KNOWN TO ENRON'S BOARD

1. Audit Committee told Enron accounting practices “push limits”
2. Board approves Fastow’s Code of Conduct waiver for LJM1
3. Whitewing moved off-balance sheet with $1.5 billion
4. Board approves second Fastow waiver for LJM2
5. LJM2 update: “Q41999: 8 days/6 deals/$125 million”;
   $2 billion in funds flow to Enron; Board approves Raptor I
6. Executive Committee approves Raptor II
7. “Project Summer” to sell $6 billion in assets fails;
   Board approves Raptor III/IV
8. Board approves third Fastow waiver for LJM3; Board told $27 billion in assets off-balance sheet
9. Board told total revenues jump from $40 billion in 1999 to $100 billion in 2000; Audit and Finance Committees review LJM procedures and FY2000 transactions
10. Fortune article questions Enron’s earnings and accounting
11. Board told 64% of international asset portfolio “Troubled” or “Not Performing”; 45 million Enron shares at risk in Raptors and Whitewing
12. Board told of $2.3 billion deficit in market value of Enron’s international assets
13. Fastow sells interest in LJM to Kopper
14. Skilling resigns; Finance Committee told of $6.6 billion in prepay and FAS 125 transactions
15. Lay defends use of SPEs in online session with employees
16. Finance Committee told of $800 million earnings write-down from Raptors; Audit Committee told of closed investigation into the Watkins letter

Stock Price

Prepared by U.S. Senate Permanent Subcommittee on Investigations, May 2002
Board compensation

- Over $350,000 in 2000
- Average of $104,500 for peer group
- Investment banks – max of about $155,000
Senior Employee Compensation 2001
- For 2000 performance
- $750 million cash payments
  - 2000 net income of $975 million

Compensation committee authorized
- Full board concurred
- Board members indicated they were unaware of the total bonuses paid
In 2000 audit firm Aurthur Andersen received

- Total fees from Enron of $52 million
- $25 million for performing the audit
- $14 million arguably connected to the audit
- $13 million for other consulting
  - $5 million on the SPE’s

Senior Andersen representative indicated no areas of significant concern
Internal Andersen documents:
“Setting aside the accounting, idea of a venture entity managed by [the] CFO is terrible from a business point of view.
Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?”
Summing up Enron

- The “perfect governance storm”
- Any aspect of governance that could break down …
Governance Reforms Post Enron

- US Securities legislation reform
  - Comparable to the 1930’s
- Increased federalization of corporate governance
Sarbanes-Oxley

- PCAOB oversight of the Audit profession
- Audit-related
  - Audit committee mandate, functions, skills
  - AC must have a "financial expert."
    - understanding of GAAP, experience in the preparation or auditing of financial statements and the application of certain accounting principles.
  - Restrictions on audit firms consulting for audit clients
  - Rigorous internal controls
    - Viewed as particularly costly
NYSE Key Proposals

- Increased role and authority for boards
- Majority board independence
  - Tighter definition of “independence”
- Audit committee qualifications
- Audit, Compensation, and Nominating Committees required
  - 100% independent
Enhanced disclosure

- Off-balance sheet entities
- Fees to auditors
- Internal control weaknesses
- CEO Compensation
- Related-party transactions
Changing Market Forces

- Governance consulting / assessment services
- Governance rating systems
  - ISS
  - Governancemetrics
  - Moody’s
    - Credit ratings)
Shareholders

- Shareholder proposals
  - Stock options
    - Prohibit repricing
- Open up the board nominating process
- Public Pension Funds
  - Increasing governance focus
Concerns

- Form over substance?
  - Board independence on paper versus in practice?
- Costs versus benefits?
  - Banning loans to officers
  - Imposing board structures
- Unintended consequences?
Summing it all up

Let’s not lose sight of the big picture

- Capital markets worldwide
- Source of wealth creation
  - Will continue to be so going forward
  - Shareholders and employees alike
Summing it all up

- Commonality of interests between
  - Shareholders,
  - Employees, and
  - Other stakeholders

- But
  - Governance landscape is changing
  - Worldwide
Summing it all up

- Increased focus on governance by
  - Institutional investors
  - Regulators

- New compliance and disclosure requirements
  - Some required for all firms
  - Others are comply or explain why not
Summing it all up

- But, governance comprises a broad set of structures
  - Internal
  - External
- Governance is not a matter of “one-size-fits-all”
  - Within a country
  - Across countries