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The Promise and Peril of Corporate Governance Indices

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How is good corporate governance measured?

NYSE and NASDAQ corporate governance listing requirements:

Board independence.

How is good corporate governance measured?

Gompers Ishii, Metrick (2003): The G-Index is constructed from data compiled by the Investor Responsibility Research Center ("IRRC").

Poison pills.

Golden parachutes.

Supermajority rules to approve mergers.

Staggered boards.

Limitations of shareholders' ability to call special meeting.

A **high G-Index** is associated with weak shareholder rights, that is, **poor corporate governance**.

How is good corporate governance measured?

Bebchuk, Cohen, Ferrell (2004): *The E-Index is constructed from IRRC data. It uses a 6-provision subset of the G-Index.*

A **high E-Index** is associated with weak shareholder rights, that is, **poor corporate governance**.

How is good corporate governance measured?

Glass Lewis Index uses a 5-provision subset of the E-Index.

How is good corporate governance measured?

Brown and Caylor (2004) *governance score is constructed from data compiled by Institutional Shareholder Services ("ISS").*

Bylaws (poison pills, supermajority provisions, ...).

Board structure (independence, CEO/Chair duality, nominating committee, ...).

Audit committee (independence, auditor's consulting fees, auditor rotation).

Management and Director compensation (no interlocks in compensation committee, option repricing prohibited, directors receive fees in stock).

Progressive practices (director term limits and mandatory retirement age).

A **high governance score** is associated with **better corporate governance**.

How is good corporate governance measured?

The Corporate Library

The TCL benchmark score is based on over a 100 criteria:

Bylaws (poison pills, supermajority provisions, ...).

Board structure (independence, CEO/Chair duality, nominating committee, ...).

Audit committee (independence, auditor's consulting fees, auditor rotation).

Management and Director compensation.

Progressive practices (director term limits and mandatory retirement age).

A **high TCL benchmark score** is associated with **better corporate governance**.

How is good corporate governance measured?

Stock ownership of median board member:

Can a single board characteristic be as effective a measure of corporate governance as indices that consider multiple measures of corporate charter provisions, management compensation structure, and board characteristics?

Corporate boards have the power to make, or at least, ratify all important decisions including decisions about investment policy, management compensation policy, and board governance itself.

How is good corporate governance measured?

Stock ownership of median board member:

...

It is plausible that board members with appropriate stock ownership will have the incentives to provide effective monitoring and oversight of important corporate decisions; hence board ownership can be a good proxy for overall good governance.

How is good corporate governance measured?

Stock ownership of median board member:

...

Furthermore, the measurement error in measuring board ownership can be less than the total measurement error in measuring a multitude of board processes, compensation structure, and charter provisions.

Model Specification: 4 Equations

Performance = f_1 (**Governance**, Ownership, Capital Structure, Industry Performance, Size, RDA Expenses, Board Size, Volatility, Treasury Stock)

Governance = f_2 (Performance, Ownership, Capital Structure, RDA Expenses, Board Size, Active CEOs, Board Ownership %, Volatility)

CEO Ownership = f_3 (Performance, Governance, Size, Leverage, RDA Expenses, Board Size, Volatility, CEO Tenure / CEO Age)

Capital Structure = f_4 (Performance, Governance, Ownership, Size, Industry Leverage, Market-to-Book, Board Size, Volatility, Z-score)

Governance and Accounting Performance

Governance Measure	Accounting Performance in Same Year	Accounting Performance Next Year	Accounting Performance Next Two Years
GIM G-Index	-0.013* (0.01)	-0.011* (0.03)	-0.004 (0.16)
BCF E-Index	-0.034* (0.01)	-0.031* (0.02)	-0.015 (0.07)
Glass Lewis	-0.014* (0.01)	-0.017* (0.00)	-0.011 (0.06)
TCL Benchmark Score	-0.005 (0.05)	-0.003 (0.27)	-0.002 (0.21)
Brown & Caylor GovScore	-0.004 (0.60)	-0.005 (0.61)	-
\$ Value of Median Director's Holdings	0.006* (0.01)	0.005* (0.04)	0.002 (0.16)
CEO-Chair Duality (=1 if Dual)	-0.029* (0.00)	-0.029* (0.00)	-0.017 (0.00)
% of Directors Independent	-0.131* (0.00)	-0.001* (0.00)	-0.068 (0.01)

Governance and Stock Market Performance

Governance Measure	Current Year's Stock Return	Next Year's Stock Return	Next Two Years' Stock Return
GIM G-Index	-0.010 (0.75)	-0.013 (0.71)	-0.007 (0.64)
BCF E-Index	-0.044 (0.59)	-0.021 (0.81)	-0.001 (0.97)
Glass Lewis	-0.007 (0.87)	-0.007 (0.85)	-0.033 (0.32)
TCL Benchmark Score	-0.018 (0.12)	0.000 (0.97)	0.003 (0.64)
Brown & Caylor GovScore	0.011 (0.73)	-0.049 (0.41)	-
\$ Value of Median Director's Holdings	0.012 (0.44)	0.008 (0.64)	0.003 (0.72)
CEO-Chair Duality (=1 if Dual)	-0.024 (0.70)	-0.064 (0.29)	-0.025 (0.30)
% of Directors Independent	-0.157 (0.53)	-0.250 (0.33)	-0.092 (0.40)

Summary of Results – Part 1

1. Better governance leads to better current and future accounting performance:
 - G-Index.
 - E-Index.
 - Glass Lewis Index.
 - Stock ownership of board members.
 - CEO-Chair separation.
2. Board independence is **negatively** related to accounting performance.
3. **No measure of governance is related to current or future Stock Returns.**

Part 2: Governance & CEO Turnover

CEO turnover should be more likely following bad performance.

Identify 1,923 CEO changes from 1992-2003.

Review the press release to classify the change as “Disciplinary” or “Non-Disciplinary.”

Reasons for CEO Turnover

Disciplinary Turnover

Resigned	592	30.8%
Terminated	55	2.9%
No Reason Given	20	1.0%
Sub-Total	667	34.7%

Non-Disciplinary Turnover

Deceased	30	1.6%
Older Than 63	167	8.7%
Retired / Succession Plan	578	30.1%
CEO Stayed as Chair	418	21.7%
Sub-Total	1,193	62.0%

Other - Not Included

Corporate Control	54	2.8%
No Information	9	0.5%
Sub-Total	63	3.3%

GRAND TOTALS 1,923 100.0%

Multinomial Logit - Disciplinary Turnover Results

	Baseline Performance	GIM G-Index	BCF E-Index	Glass Lewis	TCL Benchmark Score	BC GovScore	\$ Value of Median Director's Holdings	CEO-Chair Duality (=1 if Dual)	% of Directors Independent
Last 2 years stock return	-2.029 (0.00)	-0.404 (0.74)	-0.860 (0.18)	-1.617 (0.19)	-4.390 (0.02)	-2.474 (0.57)	0.529 (0.66)	-1.526 (0.00)	0.234 (0.72)
Governance	-	-0.040 (0.38)	-0.009 (0.92)	0.005 (0.93)	0.018 (0.24)	-0.064 (0.21)	-0.062 (0.26)	-0.790 (0.00)	-0.911 (0.09)
(Return, Last 2 years x Governance)	-	-0.480* (0.00)	-0.877* (0.00)	-0.116 (0.57)	0.033 (0.49)	0.038 (0.84)	-0.284* (0.00)	-1.381* (0.04)	-4.416* 0.00
Control Variables	Included	Included	Included	Included	Included	Included	Included	Included	Included
Years Included	2000--2002	2000--2002	2000--2002	2000--2002	2001--02	2002	2000--02	2000--02	2000--02
Sample Size	3,364	2,036	2,036	2,036	2,195	788	3,166	3,228	3,228

Summary of Results – Part 2

Given poor firm performance, the probability of disciplinary management turnover is positively correlated with **stock ownership of board members**, and board independence.

Given poor firm performance, better governed firms (as measured by G-Index and E-Index) are **less** likely to discipline their CEO.

Policy Recommendations – Choice of A Governance Index

No best governance index with which to identify a firm's governance quality.

Best measure of governance varies with the context.

- G Index and E Index correlated with future accounting performance.
- If performance criterion is whether top management will be replaced following poor performance:
 - both G and E indices are inappropriate.
- Outside directors' stock ownership correlated with future accounting performance, and predicts top management replacement following poor performance.

Policy Recommendations – Choice of A Governance Index

No best governance index with which to identify a firm's governance quality.

Best measure of governance varies with the context.

- If future stock-market performance is the criterion:
 - None of the academic or commercial governance indices are useful.

Policy Recommendations – Choice of A Governance Index

Commercial governance indices do not predict future stock-market performance.

Why might institutional investors still purchase such indices?

- Inexpensive way of fulfilling fiduciary obligations.
 - Investment,
 - Proxy voting.
- Cost-effective way of obtaining information on portfolio firms' governance characteristics of specific interest to them.

Policy Recommendations – Choice of Regulatory Regime

Our research does not support the “one size fits all” approach to governance mandates.

- Above approach followed by SOX, NYSE, NASDAQ.

Our research also does not support the best practices uniform governance mandates advocated by

- Institutional investors and their advocacy organizations like CII.

Policy Recommendations – Choice of Regulatory Regime

Our research does not support the “comply or explain” governance regime followed by UK and Canada.

Policy Recommendations – Caveat for Courts

Plaintiffs could attempt to bolster fiduciary breach claims with reference to firms' governance failures as identified by commercial or academic indices.

We suggest the courts be skeptical of such claims.

- Perhaps the court should require the plaintiff to establish a nexus between the governance failure and some action or inaction of the board producing the harm at issue.