

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.”



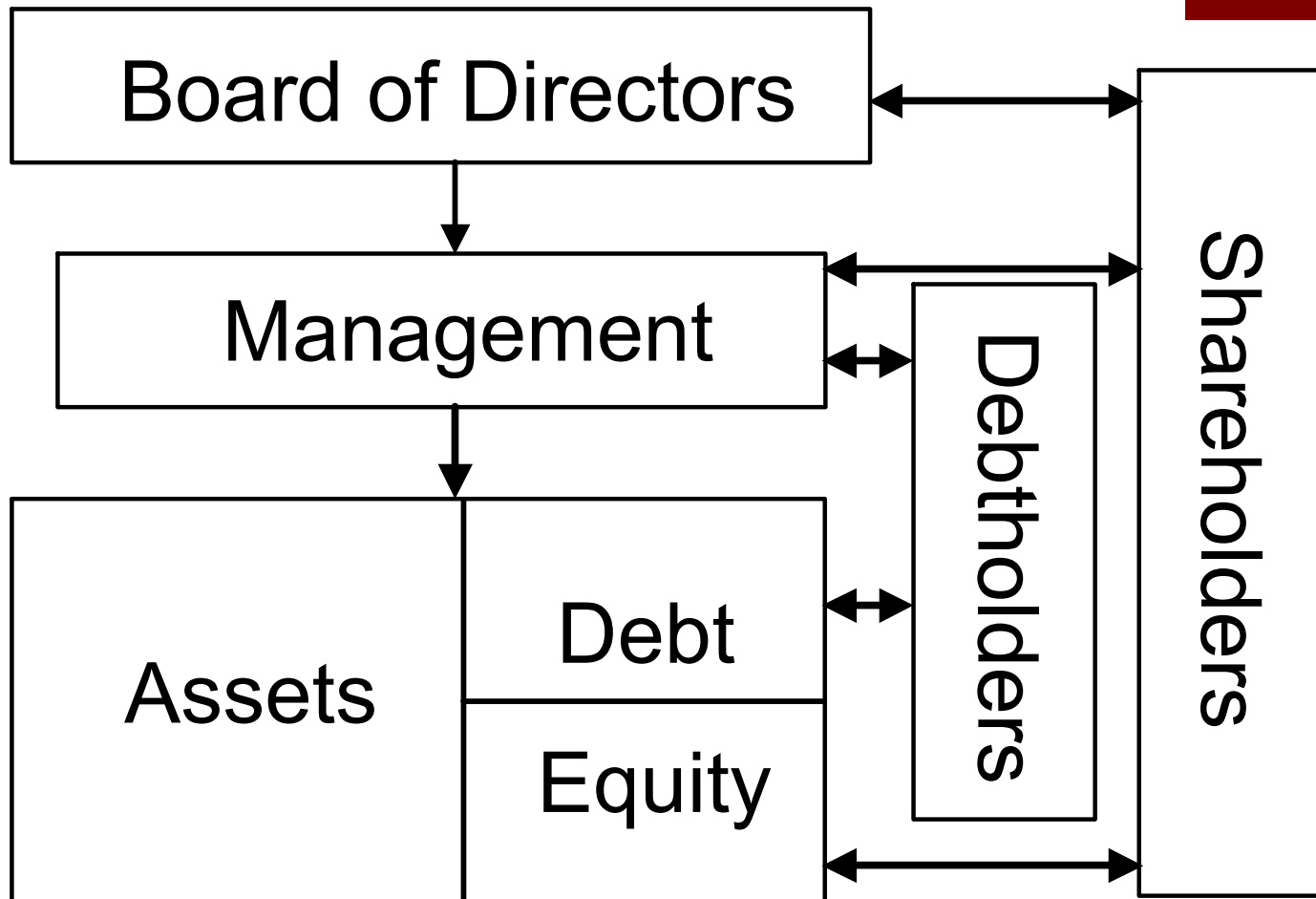
Corporate Governance Defined



Gillan and Starks (1998)

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

The Firm



Constituents / Stakeholders

Law / Regulation

Firm = Nexus of Contracts

Markets

Politics

Employees

Shareholders

Board of Directors

Management

Assets

Debt

Equity

Creditors

Customers

Culture

Community

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



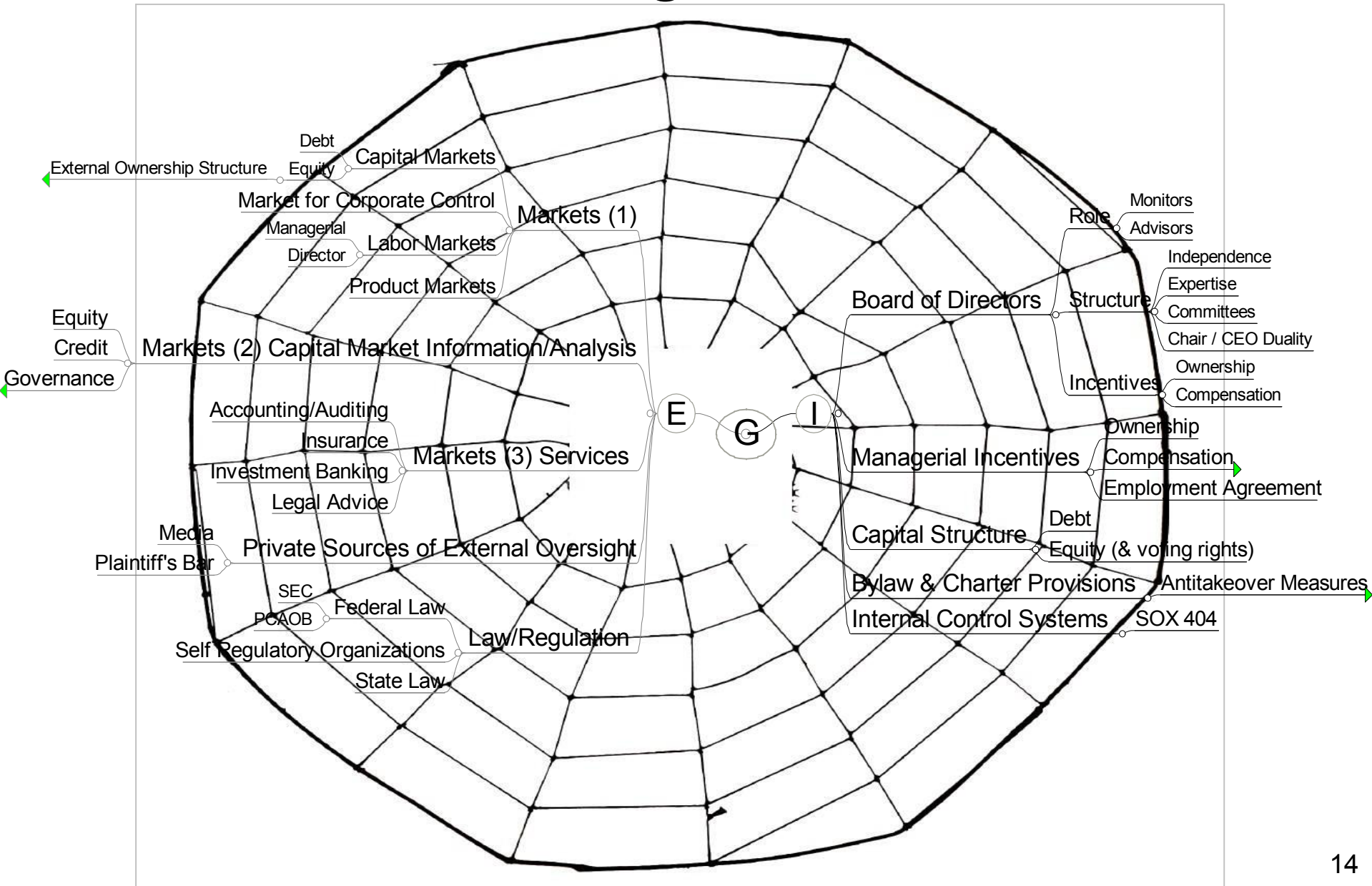
Corporate Governance

- ◆ 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”

Shareholder Monitoring

THE WALL STREET JOURNAL

- ◆ 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.

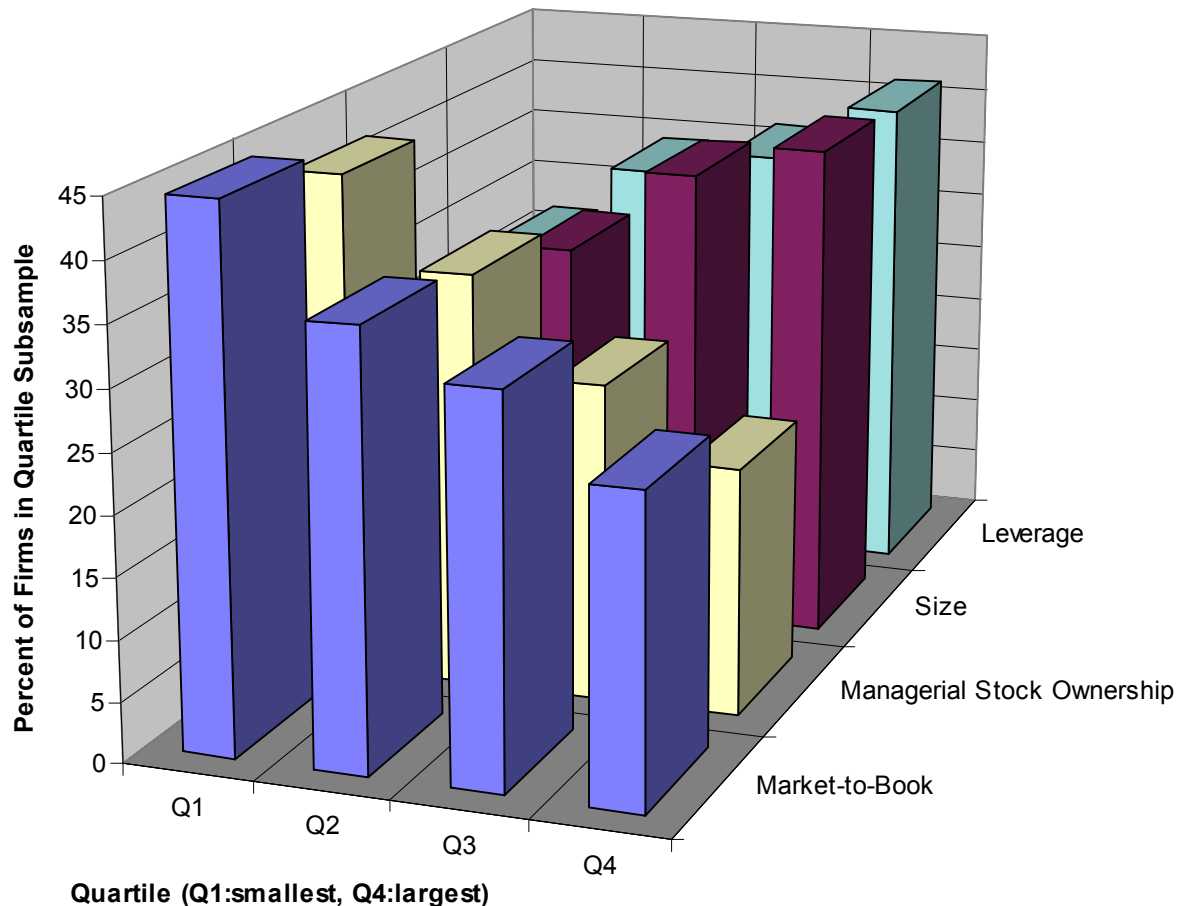


Shareholder Monitoring



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

Independence and Activity of Audit Committees



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

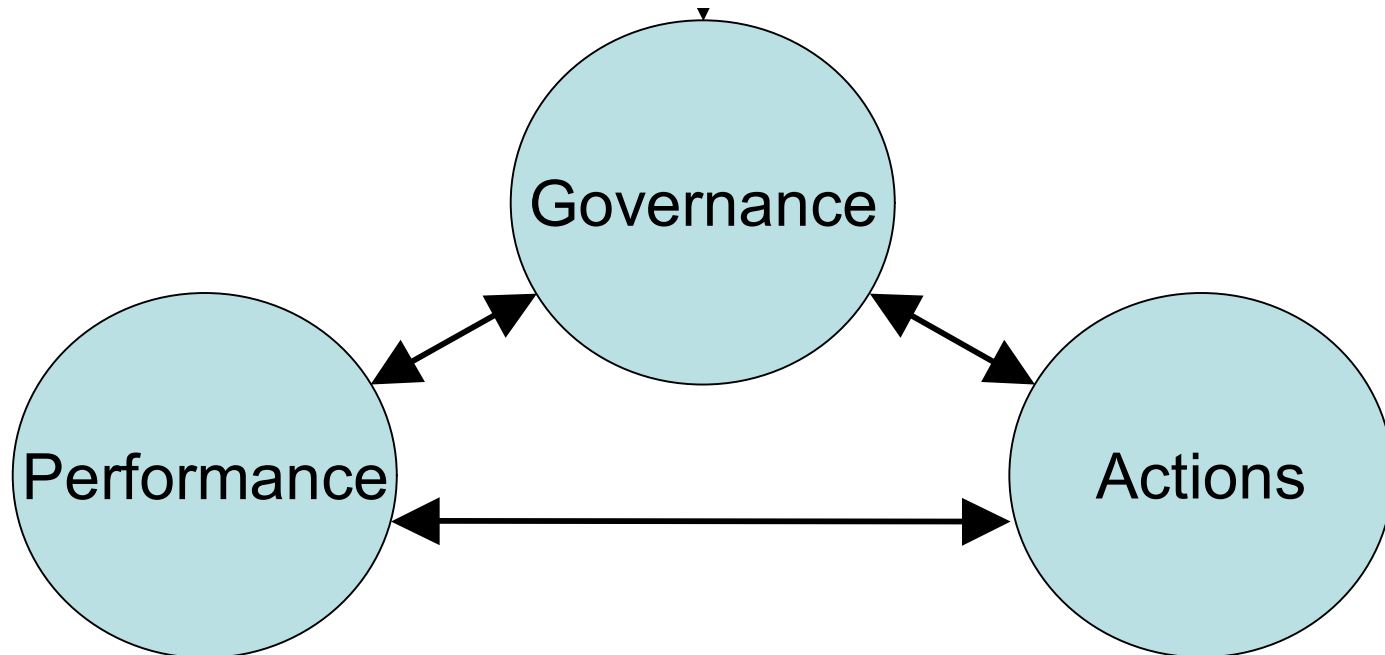
- ◆ Governance is a *set* of mechanisms
 - More than individual components
 - Evidence that some governance mechanisms
 - Complements
 - Substitutes



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

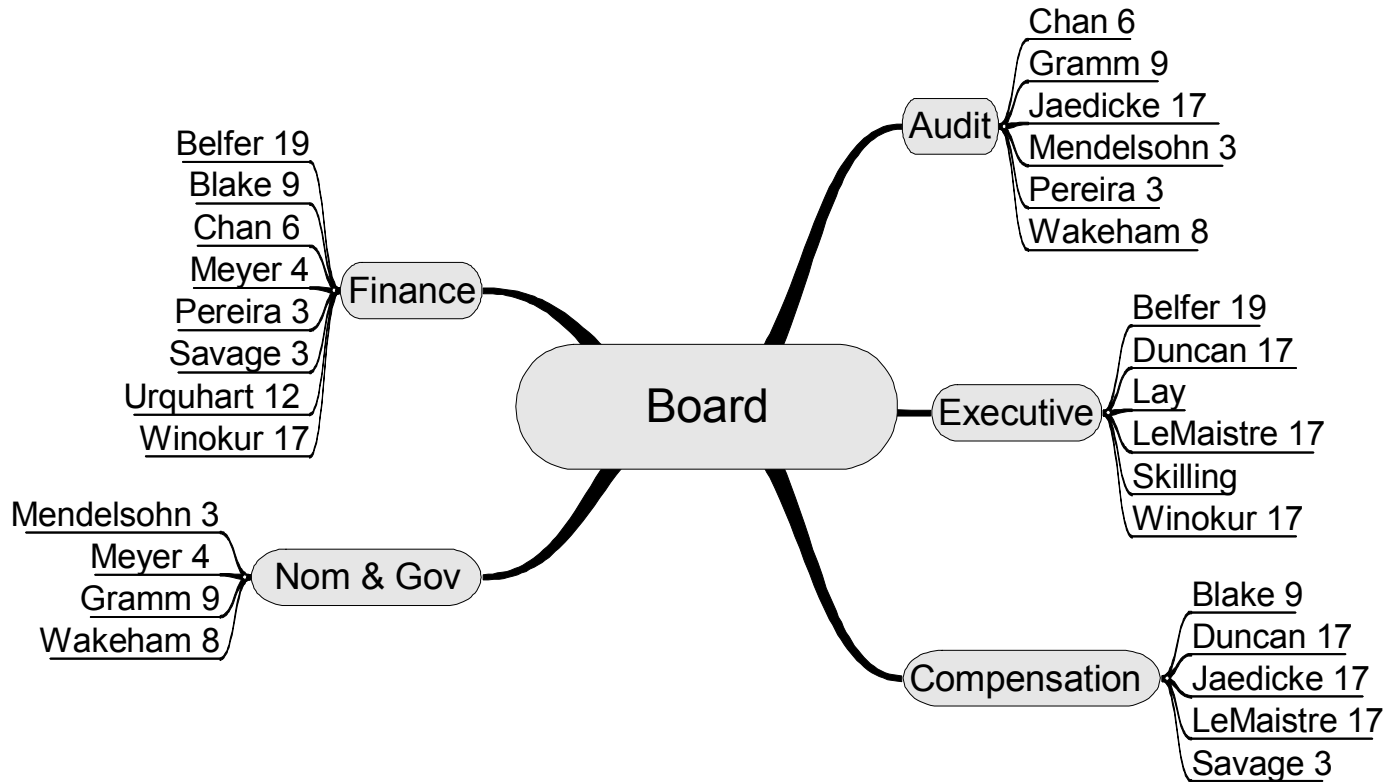




- ◆ “A splendid board on paper”
 - 14 members, only two insiders.
 - Mostly outsiders
 - Relevant business experience
 - Owned stock, some large amounts
 - Stock options or phantom stock as part of compensation package
 - State-of-the-art audit committee charter
 - ◆ direct access to financial, legal, and other staff
 - ◆ power to retain other accountants, lawyers, or consultants

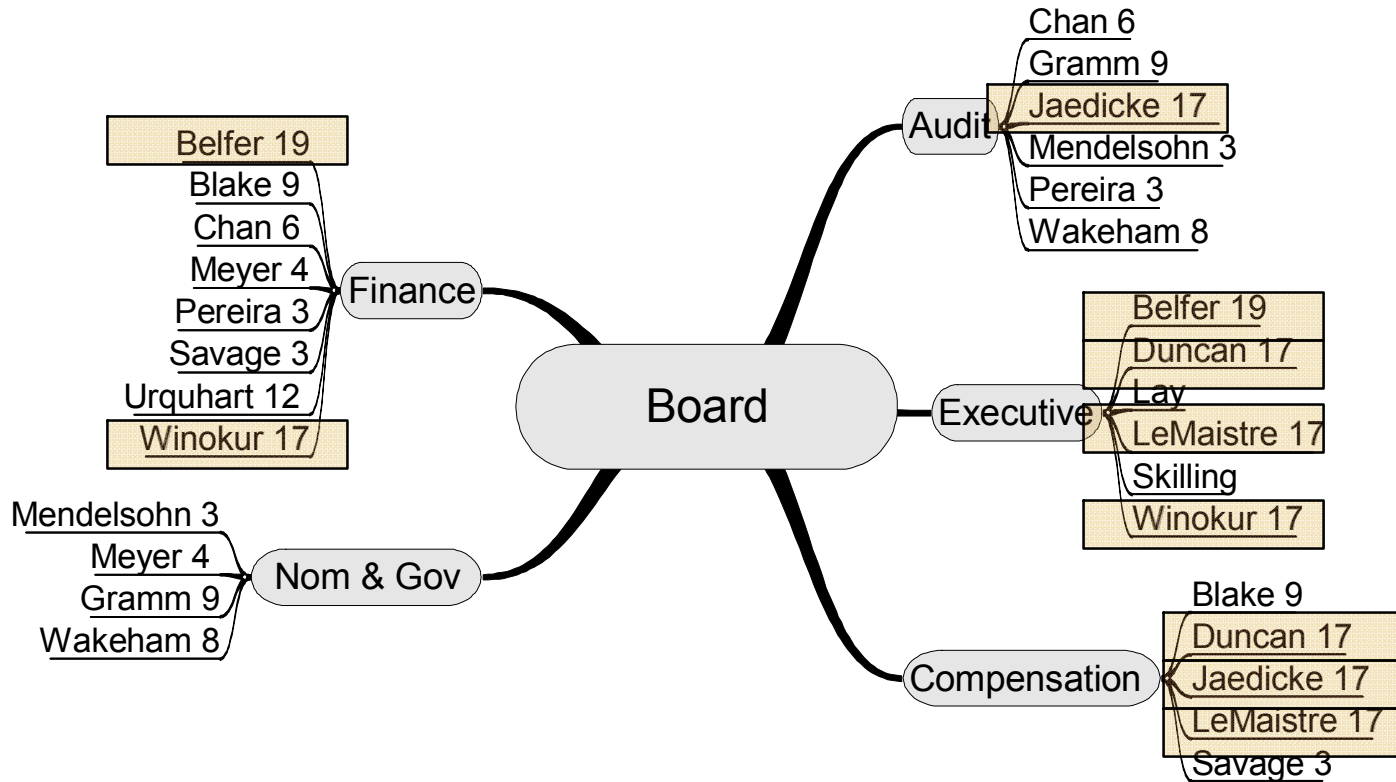


Board Committees and Years of Service



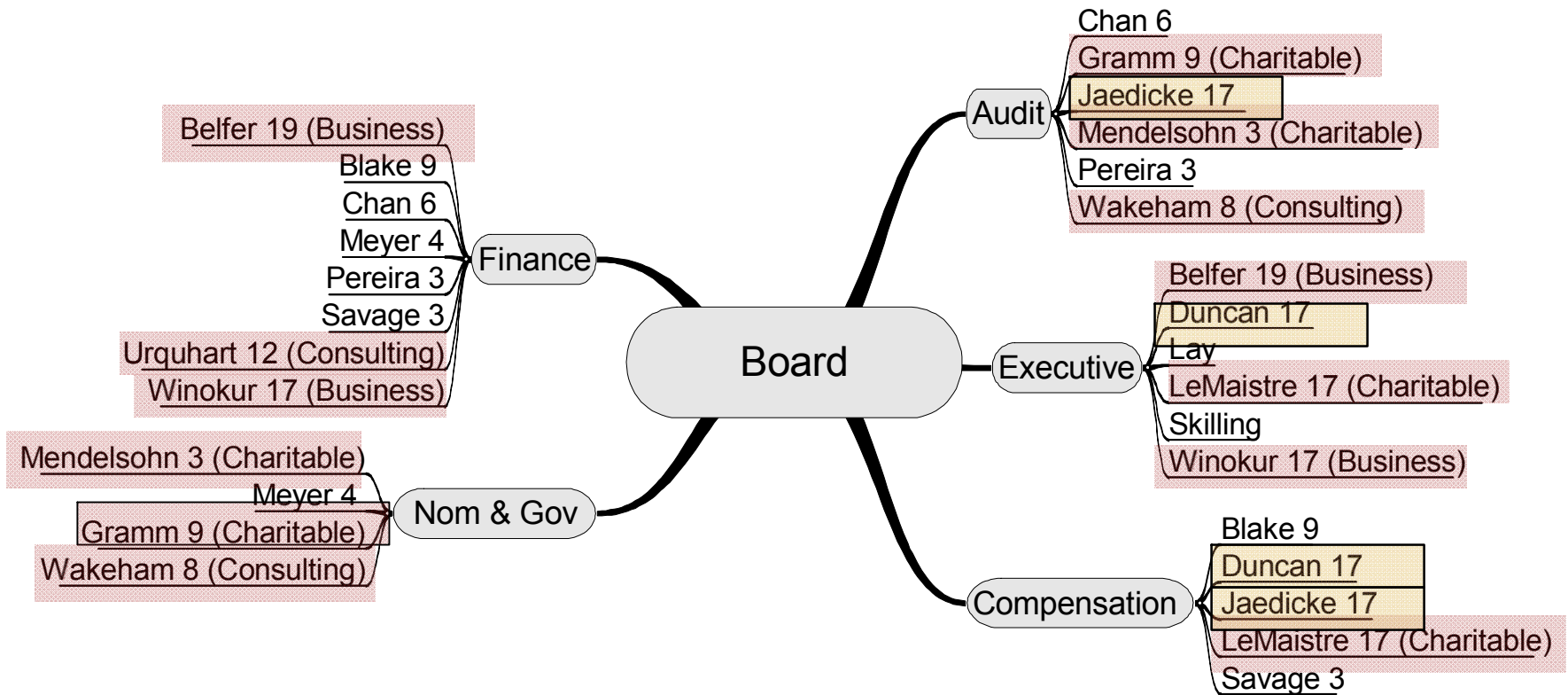


Board Committees and Years of Service





Board Relationships With Enron

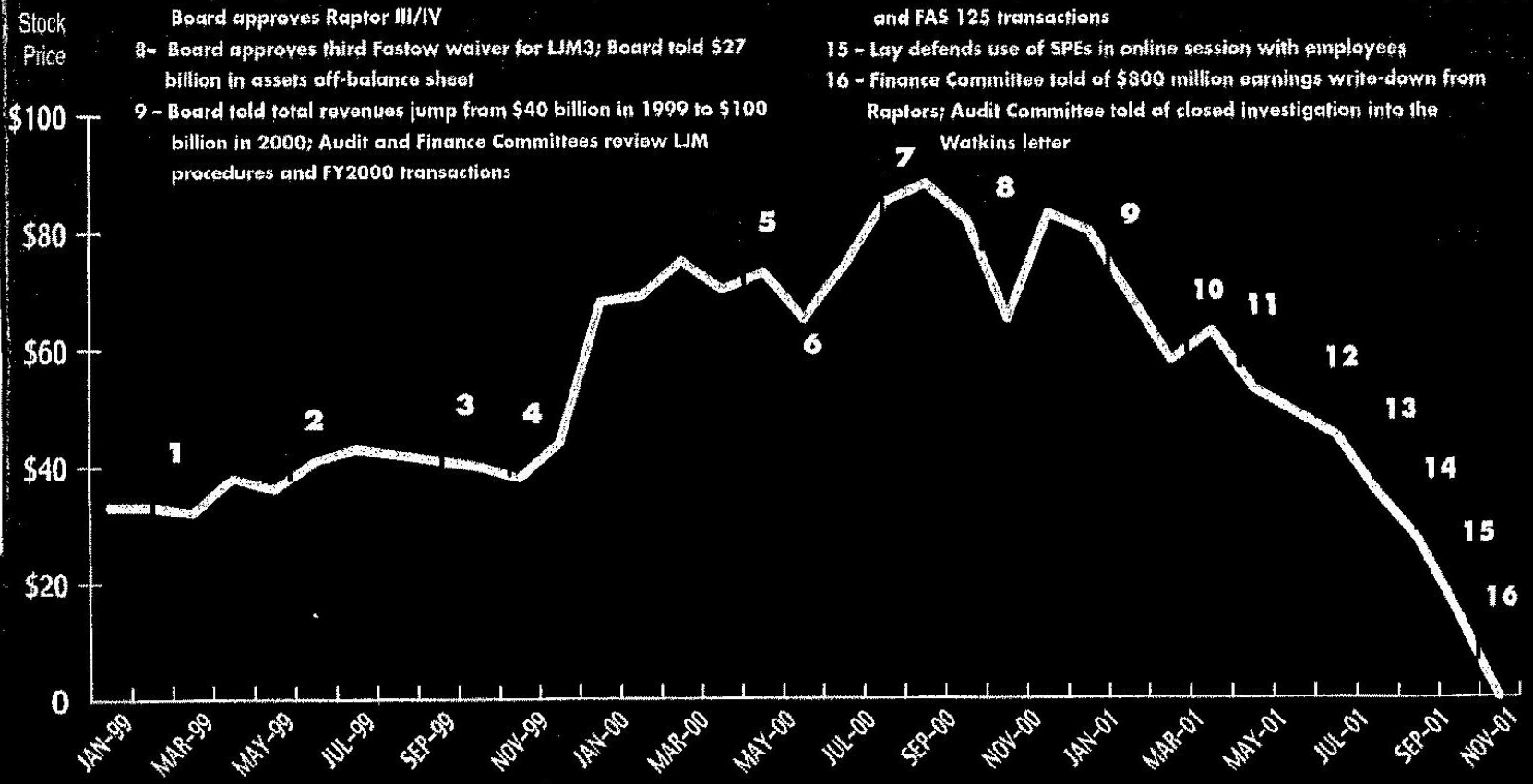




RED FLAGS KNOWN TO ENRON'S BOARD

- 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 prepays 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

EXHIBIT #1
U.S. Senate Permanent Subcommittee on Investigations





- ◆ 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 Arthur 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
- 39



- ◆ 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