NZX Corporate Governance Institute

Research Report: Director Independence

Dr. Griffin Geng, Victoria University of Wellington

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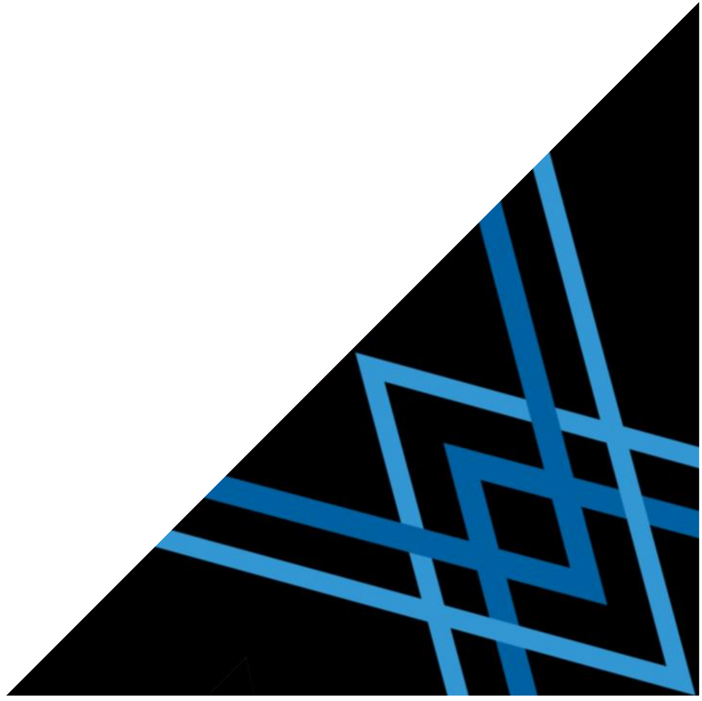

Introduction

This research report is tasked by the NZX Corporate Governance Institute, aiming to address four topics related to the independence of board directors in the context of publicly listed firms. These topics are

(a) potential conflicts that are sought to be managed through director independence settings;

(b) the impact that different levels of board independence has on overall company performance (i.e. the correlation between independent directors and company performance; and non-independent directors and company performance);

(c) the manner in which director independence is determined or measured; and

(d) analysis of the role that minority shareholders play in relation to the appointment of independent directors and the assessment of independence within other international governance frameworks for listed companies.

This report addresses these topics by a comprehensive review of the papers published on prestigious academic journals primarily in the field of corporate governance. The literature in the fields of management and corporate law might also be covered. This report has four chapters, each one dedicated to addressing one topic.

Chapter 1: Potential conflicts that are sought to be managed through director independence settings

In the corporate governance domain, two major conflicts of interest emerge. The first refers to the conflict between shareholders and managers, and the second is the conflict between majority and minority shareholders. In this chapter, I will respectively elaborate on each agency conflict in detail and discuss how the representation of independent directors in boardrooms can mitigate these conflicts of interest.

1. Agency Conflicts between Shareholders and Managers:

A fundamental conflict in corporate governance arises from the separation of ownership (shareholders) and control (management). This conflict naturally arises when there is no controlling shareholder in a company. According to Jensen and Meckling (1976), the theory posits that a principal-agent relationship exists between shareholders and corporate managers. Shareholders, as principals, delegate decision-making authority to managers, who act as their agents and are expected to operate in the shareholders' best interests. However, these agents may sometimes prioritize their personal interests over those of the shareholders.

Board directors, who are elected by shareholders to represent and protect their interests, play a vital role in balancing the principal-agent dynamic. As managers may exercise undue influence on insider directors, independent directors, who are presumably free from managerial pressure, have been shouldering an increasingly prominent monitoring to ensure that corporate resources are not directed to satisfy managers' private benefits. In this section, I will examine existing literature exploring the role of independent directors in tackling various corporate governance issues stemming from conflicts between shareholders and managers. The governance issues discussed include CEO compensation, CEO entrenchment, financial reporting quality, and the efficiency of mergers and acquisitions.

1.1 CEO Compensation:

Two primary perspectives on executive compensation are prevalent among financial economists, as summarized by Bebchuk and Fried (2003). The first, the optimal contracting view, acknowledges the agency problems inherent in corporate structures, where managers may not act in the best interest of shareholders. To remedy this, an effective compensation contract is essential, providing the necessary incentives for managers to put forth their best efforts. Despite its merits, this view bears limitations. Directors, who are responsible for designing such contracts, are themselves subject to agency problems. This can compromise their ability to create compensation contracts truly aligned with shareholders' interests. Such agency issues may stem from benefits associated with directorships, including attractive compensation packages and valuable business and social connections.

An alternative viewpoint on executive compensation is called the 'managerial power' perspective. This stance challenges the assumption that executive pay structures emerge from arm's-length contracting, suggesting instead that these arrangements may constitute a part of the agency problem, not a solution to it. It proposes that some aspects of compensation structures may reflect managerial rent-seeking behaviour rather than efficiently incentivizing top-tier performance.

It is worth noting that these viewpoints are not mutually exclusive. Indeed, both may simultaneously shape managerial contracting in the real world. In theory, including independent directors in the design of managerial compensation contracts can to some extent mitigate limitations inherent to the optimal contracting view as well as constrain the managerial rent-seeking behaviour within the compensation structure. Regulators also recognize the importance of director independence. For example, New York Stock Exchange even mandates the remuneration committee be exclusively comprised of independent directors. NASDAQ and London Stock Exchange also enforce certain

requirements for the representation of independent directors on remuneration committees.

However, contrary to the theoretical prediction that a higher proportion of independent directors on boards could limit CEO compensation, numerous corporate finance studies from the 1990s suggest that independent directors play a relatively limited role in determining CEO pay. For instance, Lambert, Larcker, and Weigelt (1993) conducted a survey of 303 large manufacturing and service firms, concluding that there's a positive relationship between CEO compensation and the proportion of independent directors on the board. Similarly, Boyd (1994) found, from a sample of 193 companies, that boards with a higher percentage of independent directors were associated with higher CEO compensations. Using more detailed director information, Hallock (1997) reported that CEO compensation tends to be higher if independent directors hold board positions in other firms concurrently, potentially compromising their oversight capacity. Extending previous empirical models, Cole, Holthausen, and Larcker (1999) incorporated managerial ownership as a determinant of CEO compensation. They showed that CEO compensation is generally higher when there is a greater percentage of the board composed of independent directors, particularly when these directors are older and serve on more than three other boards.[1]

All these previous studies seem to point out that independent directors do not effectively exercise their role in monitoring executive payments. However, research also notes that more nuances are needed to distinguish the degree of independence of independent directors. Cole, Holthausen, and Larcker (1999) find that independent directors are appointed by the CEO or the so-called `grey' directors who receive extra payment from companies on top of director fees. Using high-quality data on board director information, Coles, Daniel, and Naveen (2014) distinguished co-opted board directors and non-co-opted directors. The former is defined as those directors appointed after CEOs assumed the office, and the latter as the directors appointed before. They found that co-opted independent directors don't usually fulfil their role very well and are associated with higher

[1] Independent directors can be less effective when they serve on multiple boards or grow older. Directors simultaneously serving on several boards are considered too busy and demonstrate limited commitments to fulfil their director responsibilities. Older directors usually have a longer tenure in a company, which might erode their independence.

CEO compensation. By contrast, non-co-opted independent directors show more effectiveness in monitoring and are associated with reduced CEO compensation and increased performance-pay sensitivity.

While the aforementioned studies seem to suggest that independent directors do not effectively monitor executive compensation, researchers have also pointed out the need for a nuanced understanding of the degrees of independence among these directors. For instance, Cole, Holthausen, and Larcker (1999) noted the existence of 'grey' directors, which refer to independent directors who are appointed by the CEO or receive additional compensation from the company on top of their director fees. Using a more comprehensive dataset on board director information, Coles, Daniel, and Naveen (2014) distinguished between co-opted board directors and non-co-opted directors. They defined co-opted directors as those appointed after the CEO assumed office, while non-co-opted directors were those appointed before. Their findings indicate that co-opted independent directors often fall short in their monitoring roles and are associated with higher CEO compensation. On the other hand, non-co-opted independent directors demonstrate greater effectiveness in their oversight role, which is correlated with lower CEO compensation and higher performance-pay sensitivity.

However, it is necessary to point out that the empirical analyses used in the studies bear caveats. Other than Coles, Daniel, and Naveen (2014), the other studies merely established a correlation between independent directors and CEO compensations, which may not necessarily suggest a causal relationship from independent directors to CEO compensations. For example, an alternative explanation for the observed relationship could be that higher CEO compensations lead shareholders to instate more independent directors in boardrooms.

To address the challenges faced by these previous studies, Chhaochharia and Grinstein (2009) conducted a natural experiment that exploits a change in NYSE and Nasdaq listing rules. The change rule mandated that boards should consist of a majority of independent directors and that compensation committees should be entirely independent. In this experiment, firms were assigned to either treatment or control groups. Firms in the treatment group were those that did not meet the required threshold for independent directors prior to the rule change, whereas firms in the control group were already

compliant before the rule change. Because the change in listing rules was a response to the Enron Scandal and was enforced by the stock exchanges, any increase in the number of independent directors on the board of treatment firms is unlikely to be a product of the firms' own decisions. Chhaochharia and Grinstein (2009) estimated that CEO pay decreased 17% more in treatment firms (i.e., firms not compliant with the listing rules before the change) than in control firms (i.e., firms that were compliant). This study's findings seem to counter previous studies and suggest that independent directors can effectively curb managerial discretion in setting CEO compensation. However, in a subsequent study, Guthrie, Sokolowsky, and Wan (2012) re-evaluated the data used by Chhaochharia and Grinstein (2009) and discovered that the majority of their findings were largely influenced by two significant outliers. After adjusting for these outlier problems, Guthrie, Sokolowsky, and Wan (2012) found that the independence of the compensation committee actually led to an increase in CEO pay.

Knyazeva, Knyazeva, and Masulis (2013) used an alternative research method to establish the causal relationship between independent directors and CEO compensation. Specifically, the authors used the supply of directors in the local market as an instrument to investigate the impact of director independence on corporate governance. Their approach exploits that the supply of directors varies across regions, and a company's board is more likely to include more independent directors if there is a greater supply of directors in the region where the company's headquarters are located, assuming constant demand-side characteristics. Employing this enhanced research methodology, Knyazeva, Knyazeva, and Masulis (2013) found no correlation between board independence and CEO pay.

1.2 Managerial Entrenchment

Managerial entrenchment refers to a situation in which managers obtain a significant level of power and control in an organization, making it difficult for the board of directors or shareholders to replace them. Empirical studies suggest that managerial entrenchment can negatively impact firm value. This adverse effect arises as entrenched managers, who are subjected to fewer governance controls, tend to adopt corporate policies that could potentially erode firm value (Bebchuk, Cohen, and Ferrell, 2009; Chang and Zhang, 2015).

To assess CEO entrenchment in a company, empirical researchers usually examine the incidence of CEO changes following a poor performance, which is also called the sensitivity of CEO turnover to performance. Studies in this literature assume that effective monitoring by independent directors should increase the likelihood of CEO dismissal subsequent to poor performance, which is measured by accounting earnings or stock market return. Given that a board's decision to terminate a CEO often occurs behind closed doors, researchers employ CEO turnover to proxy for CEO dismissal.

Weisbach (1988) is the first study investigating how director independence affects CEO dismissal. Drawing on a sample of S&P 500 firms between 1974-1983, he found that there is a stronger association between prior performance and the probability of a CEO change for companies with more independent boards than for companies with insider-dominated boards, suggesting that a greater share of independent directors are more likely to remove CEOs when companies underperform. Expanding on Weisbach's (1998) work, Borokhovich, Parrino, and Teres (1996) showed that independent directors are more likely to appoint new CEOs from outside the firms following the departure of old CEOs.

Why are independent directors more likely to challenge incumbent CEOs than inside directors? The research indicates that independent directors are more concerned about how their future employers perceive their ability to make sound decisions. By contrast, inside or executive directors tend to operate under the influence of incumbent CEOs, to whom their careers are often bound. Farrell and Whidbee (2000) provide evidence to underscore the career concerns of independent directors in their study. They found that after the departure of underperforming CEOs, independent directors, who were not aligned with the outgoing CEOs and own relatively large equity stakes, receive recognition for replacing underperforming CEOs with successors who enhance firm performance.

While most studies in this field tend to establish correlations rather than causal relationships, Knyazeva, Knyazeva, and Masulis (2013) used an improved method to assess the causal effect of director independence on the sensitivity of CEO turnover to performance. Their findings revealed that a higher degree of director independence increases the sensitivity of CEO turnover to performance, echoing the results of prior

studies. However, they also acknowledged the limited scope of their study sample, which consisted predominantly of smaller firms due to constraints imposed by their research methodology.

In a separate study, Guo and Masulis (2015) leveraged a quasi-natural experiment that exploited a change in the stock listing rules of the NYSE and NASDAQ. This approach facilitated their examination of a broader sample, encompassing both large and small firms. Again, Guo and Masulis (2015) found evidence that director independence is useful in restraining managerial entrenchment, as indicated by a higher likelihood of CEO turnover following a period of poor performance.

1.3 Financial Reporting Quality

Shareholders rely on accurate and comprehensive financial reporting to guide their critical decisions about buying, selling, or holding shares. High-quality financial reports provide a comprehensive view of a company's performance, enabling shareholders to make informed decisions about their investments.

At publicly traded corporations, managerial evaluation heavily depends on firms' financial performance. This evaluation greatly impacts factors such as managerial remuneration, professional reputation, and even job stability. Consequently, managers usually have substantial incentives to engage in earnings management. Such practices are often driven by the need to meet specific targets set forth by financial analysts or stipulated in their own compensation agreements.

Beasley's seminal study (1996) provides the first examination of the correlation between director independence and financial reporting quality. The study relied on 75 firms identified as having committed financial statement frauds, as disclosed in the Accounting and Auditing Enforcement Releases (AAERs) issued by the SEC and in the Wall Street Journal Index's "Crime-White Collar Crime" section. Beasley (1996) compared these 75 fraudulent firms with a control group of non-fraudulent firms, matched based on their size, industry, and the national stock exchange where their common stocks were traded. The study's primary finding was that firms involved in fraudulent activities had a significantly lower percentage of independent directors on their boards. This suggests that a higher proportion of independent directors on the board is associated with a decrease in financial statement fraud. However, the existence of an audit committee did not demonstrate a

significant correlation with a reduction in financial fraud. Beasley (1996) attributed this to a notable lack of active involvement by the audit committees in the fraudulent firms, as evidenced by the infrequent meetings held in the year preceding the discovery of the fraud.

It's important to note that the author acknowledges the potential limitations of the study. The 75 instances of financial statement fraud identified may not capture the full breadth and diversity of fraud cases among all public companies. As such, if the fraud occurrences captured in the AAERs and the WSJ Index are not representative of all financial statement fraud occurrences, the broader implications of this study may be somewhat limited."

A contemporaneous work by Dechow, Sloan, and Sweeney (1996) utilized a slightly larger sample of 92 firms that committed financial statement fraud and compared these firms with a group of control firms of similar characteristics but without fraudulent activities. Consistent with Beasley (1996) 's findings, they concluded that a greater share of independent directors on boards is correlated with a reduced likelihood of fraud. But, in contrast to Beasley (1996), they concluded that the presence of an audit committee also correlated with a lower probability of fraud. A close examination of the analyses in both studies suggests that the difference in their findings might stem from the different statistical methods employed. Even if a correlation between the presence of an audit committee and the likelihood of fraud can be discerned, the significance of such a correlation appears to be relatively moderate.

Building on the previous studies, Farber (2005) conducted a similar analysis and reinforced the findings of Dechow, Sloan, and Sweeney (1996) and Beasley (1996) on the relation between board independence and instances of financial fraud. Further, Farber (2005) also examined how these fraudulent firms respond after enforcement actions have been taken against them. His analyses revealed that fraudulent firms increased the representation of independent board directors after being enforced, suggesting enforcement actions prompt these firms to bolster the corporate governance mechanisms, which is critical to improving financial information transparency.

The studies above all examine how board composition affects financial statement fraud, which represents a more severe form of earnings management that significantly deviates from acceptable accounting principles. A relatively benign type of earnings management

involves abnormal discretionary accruals, which refer to the unusually large discrepancies between net income and cash flows. Because discretionary accruals could often result from certain managerial judgments or estimations, they can sometimes fall within the grey area of accounting rules.

Klein (2002) investigated the association between board independence and abnormal discretionary accruals using a sample of U.S. firms. Her research revealed that a higher proportion of independent directors on the audit committee or on the overall board is associated with a decreased level of abnormal discretional accruals, which implies an improved reporting quality. By contrast, using a sample of Canadian firms, Park and Shin (2004) did not uncover evidence of such a correlation. They attributed the ineffectiveness of independent directors to the prevalence of blockholders in Canadian firms and an underdeveloped director labour market.

In light of the conflicting findings presented by Klein (2002) and Park and Shin (2004), Chen, Cheng, and Wang (2015) revisited how board independence relates to abnormal discretionary accruals. More importantly, the authors attempted to estimate the causal effect of board independence on abnormal discretionary accruals using a quasi-natural experiment based on the listing rule change of the NYSE and NASDAQ. The experiment structure is akin to that used in Chhaochharia and Grinstein's 2009 study discussed earlier in Section 1.1. The firms, which did not meet the requirement of having a majority of independent directors on the board needed to increase independent directors, hence necessitating an increase in independent directors, were classified as treatment firms. Control firms were those firms that were already compliant before the rule change. Using the experiment, Chen, Cheng, and Wang (2015) found that the increase in board independence significantly curtailed the abnormal discretionary accruals, corroborating the findings of Klein (2002). However, it is worth noting that the causal interpretation of Chen, Cheng, and Wang (2015) 's findings hinge on the assumption that firms assigned to treatment groups were not subject to other contemporaneous shocks that might inadvertently improve firms' earnings quality.

A relevant question within this body of literature is what motivates board directors to monitor firms' earnings quality or financial reporting quality. In other words, if board directors fail to fulfil their monitoring role, do they receive any penalties? Srinivasan (2004)

empirically explored this question. He found that penalties from lawsuits and regulators were rather infrequent. However, board directors, especially those sitting on the audit committee, were significantly less likely to retain their board directorships in the three years following restatements. The chance of departure was particularly high for those firms that overstated earnings.

1.4 Value-reducing Acquisitions

CEOs may sometimes be inclined to pursue corporate acquisitions that do not necessarily enhance shareholder value and may even lead to the excessive growth of the firm. As posited in Jensen's seminal 1986 work, such value-diminishing acquisition activities are particularly prevalent in firms that generate substantial free cash flows. Instead of distributing these surplus cash flows to shareholders, managers might, driven by their personal incentives, direct the firm towards investments in projects that yield returns below the cost of capital.

But what drives managers to pursue such mergers? Several incentives could encourage them towards this direction. Firstly, organizational growth can amplify managers' influence by expanding the resources under their control, which usually come with greater power and prestige. Also, when a CEO's remuneration is tied to the size of the company, running a bigger company could directly increase their compensation. Lastly, another less obvious incentive lies within the structure of internal promotions. Firms often reward high-performing middle managers with promotions that necessitate the creation of new positions, which, in turn, require growth. The pursuit of acquisitions might also serve the purpose of creating new positions.

Several empirical studies support Jensen (1986) 's thesis. For instance, Lang, Stulz, and Walkling (1991) found that poor corporate governance is associated with a decrease in bidder firms' shareholder wealth, which is measured by the abnormal stock returns of bidders upon the announcement of acquisitions. Similarly, Morck, Shleifer, and Vishny (1990) identified acquisitions that provide private benefits to managers (i.e., diversifying acquisitions and the acquisitions of growth companies). Their results revealed that these acquisitions providing more benefits to managers tend to negatively impact shareholder wealth. A later study by Bliss and Rosen (2001) demonstrated that increased firm size resulting from acquisitions could indeed lead to higher CEO compensation.

Independent directors, in their oversight role, are anticipated to counteract value-destroying acquisitions by closely scrutinizing managerial decisions, which include considerations related to M&A and investments in new projects. Below, I reviewed a few studies investigating the relationship between board independence and acquisitions.

Byrd and Hickman (1992) examined the announcement returns of bidders in 128 tender offer bids in the U.S. Their findings suggested that firms with a board composition of over 50% independent directors, on average, have a higher propensity to generate positive returns for bidders. However, they also observed an intriguing trend: when the proportion of independent directors exceeds 70%, the quality of decision-making appears to diminish, as indicated by reduced bidder announcement returns. This phenomenon can be explained by the possibility that an overabundance of independent directors might dilute the professional business knowledge necessary for effective decision-making, leading to less informed or strategically sound decisions.

Masulis, Wang, and Xie (2007) evaluated a more recent sample of tender offers. While the purpose of their study was not to assess the relation between board independence and bidders' return, their auxiliary analysis revealed that, on average, corporate boards comprising over 50% independent directors were not significantly correlated with bidders' announcement return.

In a different study, Schmidt (2015) examined how CEOs' social ties with independent directors can influence bidders' announcement returns using a sample of 6,857 tender offers during 2000-2011. Apparently, boards, where CEOs are socially connected with independent directors, are less independent than boards where no such ties are present. Schmidt (2015) found that, on average, bidders' announcement return was significantly lower when CEOs were socially connected with independent directors, highlighting the critical role of board independence in curbing managers' tendencies towards value-reducing acquisitions. In addition, Schmidt (2015) provided a more nuanced perspective that less independent boards could be valuable in certain types of acquisitions (i.e., complex acquisitions), where board advice becomes exceedingly important.

In comparing these findings, those of Byrd and Hickman (1992) and Schmidt (2015) appear to stand in contrast with the result shown by Masulis, Wang, and Xie (2007). However, these disparities might be attributed to different approaches employed to define

director independence. In contrast to Masulis, Wang, and Xie (2007) which solely used employment affiliation as the criterion for independent directors, Byrd and Hickman (1992) and Schmidt (2015) accounted for additional connections between CEOs/firms and independent directors. Therefore, Byrd and Hickman (1992) and Schmidt (2015) may offer a more objective view of the relationship between board independence and the prevalence of value-reducing acquisitions.

2. Conflicts between Controlling Shareholders and Minority Shareholders

Controlling shareholders, often in the form of founding members or key investors, possess substantial voting rights, which grant them significant influence over the company's strategic decisions. Conversely, minority shareholders, due to their relatively small stake, typically have minimal influence over such decision-making processes. This disparity in control can engender conflicts of interest. The controlling shareholders may use their control to direct resources toward the benefits of the controlling shareholders at the expense of the minority shareholders. These actions could include higher compensation for controlling shareholders serving in executive roles and related-party transactions.

An important condition for this conflict to arise is that controlling shareholders' control rights are not proportional to their cash flow rights. Control rights refer to the extent to which a shareholder can have a final say on corporate decisions and steer the company's strategic direction. Cash flow rights, on the other hand, refer to the rights of shareholders to receive distributions from the company's profits. The controlling shareholders have the power to influence or decide the company's actions due to their control rights, yet they bear only a proportionate part of the financial consequences of those decisions due to their limited cash flow rights. This gives them the incentive to use their control power to make decisions that benefit them personally, rather than decisions that maximize the overall value of the firm. The divergence between cash flow rights and control rights can take place if a company issues dual-class shares or a subsidiary is controlled by a parent through pyramid ownership structure in a business group (e.g., Korean chaebol).

Can independent directors curb controllers' expropriation?

Regulatory bodies and courts have progressively placed more reliance on independent directors as a safeguard for public investors against exploitation by controlling shareholders. However, as posited by Bebchuk and Hamdani (2017), the protection

offered by independent directors may often fall short of expectations. The reason behind this is that the appointment and retention of these independent directors largely hinge upon the discretion of controlling shareholders. Consequently, their effectiveness in managing conflicts with controllers is significantly undermined, and they may often prioritize accountability towards controllers, particularly in controlled companies.

Several empirical studies substantiate the claims put forth by Bebchuk and Hamdani (2017). Chou, Hamill, and Yeh (2018), in their study utilizing Taiwanese data, discovered that controlling shareholders are more likely to appoint 'independent' directors who aren't necessarily strictly independent. This tendency is particularly noticeable when controlling shareholders have ample opportunities to expropriate minority shareholders, usually when their control rights exceed their cash flow rights. Similarly, Baran and Forst (2015) examined the quality of board independence in U.S. dual-class firms. Their findings revealed a negative association between disproportionate insider control, facilitated by dual-class shares, and multiple board quality metrics such as the independence, experience, tenure, and age of directors.

Research conducted in other jurisdictions, such as China, India, and Hong Kong, echo these findings. The presence of independent directors on boards did not noticeably mitigate controlling shareholders' tendencies to expropriate minority shareholders. For supporting evidence, see Peng, Wei, and Yang (2011) for China; Cheung, Rau, and Stouraitis (2006) for Hong Kong; and Jameson, Prevost, and Puthenpurackal (2014) for India.

Empowering Minority Shareholders

a. Implementing Enhanced Director Independence

In light of the foregoing discussions, it is apparent that the current system for the appointment and retention of independent directors is inadequate for these directors to effectively monitor and curb expropriation by controlling shareholders. To address these conflicts, legal scholars, including Bebchuk and Hamdani (2017), have proposed the introduction of an "enhanced independent director" role. The idea is to provide minority shareholders with greater authority in the appointment, termination, and renewal of a portion of independent directors. Bebchuk and Hamdani (2017) provide extensive details on the potential implementation of such an enhanced independent director system. This

approach has already been adopted, in varying forms, by stock exchanges in the U.K., Italy, Israel, and the American Stock Exchange.

b. Adopting Cumulative Voting

An alternative solution could be the implementation of a cumulative voting system. In this arrangement, each shareholder is allocated a number of votes equal to the product of the number of shares they hold and the number of director seats up for election. Crucially, this system allows shareholders the flexibility to distribute their votes as they wish: they can spread their votes across various candidates, or they can concentrate all their votes on a single candidate. The main advantage of cumulative voting is that it enables minority shareholders to consolidate all their votes on a single candidate, potentially amassing enough votes to secure a board seat. This consequently amplifies the voice of minority shareholders, thereby facilitating a more equitable power balance between majority and minority shareholders.

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Chapter 2: The impact that different levels of board independence have on overall company performance

This chapter reviews the literature on whether board independence can have any impact on firm performance. While this question remains central to shareholders and regulators alike, the answers to this question in the academic literature are far from definitive, owing to the complex nature of the question itself. The mixed findings are partly due to the problematic categorization of independent directors, given that a growing body of literature questions the extent to which independent directors are truly independent. This chapter does not explore the debate around the categorization of independent directors. I defer the discussion of this literature to Chapter #3.

Independent directors serve advisory as well as monitoring functions in their capacity as corporate directors (Adams, Hermalin, and Weisbach, 2010). The advisory function of independent directors involves providing strategic guidance to the company. Independent directors often have extensive experience and broad industry knowledge that can be leveraged to inform strategic decisions. They provide an external perspective and can help the firm identify opportunities or threats that internal directors may overlook. The monitoring function, on the other hand, involves oversight of the company's management. Independent directors serve as a check on the power of the CEO and other executives and help prevent those conflicts of interest discussed in Chapter #1. Viewed from this perspective, a greater share of independent directors on corporate boards is beneficial for firm performance or firm value.

Nevertheless, independent directors are not devoid of limitations. Firstly, the constraint of time and attention poses a significant challenge to independent directors' engagement with corporate governance. Many independent directors often have other full-time positions, which may encroach their ability to fully engage with each company's issues, understand its business, and fulfil their oversight duties effectively. This concern is particularly prominent with the so-called "busy" directors, who serve on an excessive number of boards (Fich and Shivdasani, 2006).

Secondly, information asymmetry could undermine independent directors' ability to monitor. Independent directors are not involved in the day-to-day operations of the

company, which may lead to a gap in information between them and the management. Independent directors' judgment and decisions are largely dependent on what information is relayed to them by the CEOs. In certain circumstances, the CEOs simultaneously serve as board chairpersons and steer the board discussion agenda. This makes it even more difficult for independent directors to fulfil their monitoring responsibilities.

In addition, the information asymmetry may also erode directors' advisory functions. As theorized by Adams and Ferreira (2007), CEOs who selectively disclose information to avoid director oversight would also suffer from low-quality advice for corporate strategies. This is precisely because the board, lacking the necessary detailed information, is ill-equipped to assist in informed decision-making.

1. Research in 1990s.

A considerable number of studies emerged in the 1990s, aiming to evaluate the impact of board independence on firm performance. Researchers in the 1990s generally faced two primary obstacles that limited their ability to conclusively answer this question.

Firstly, they grappled with econometric challenges in isolating the causal influence of board independence on firm performance. For instance, a negative correlation between board independence and firm performance doesn't necessarily imply that board independence impairs firm performance. It could, instead, suggest that poor performance prompts the firm to appoint more independent directors in a bid to enhance performance.

Secondly, the quality of research was often compromised due to a lack of comprehensive data on board composition. Researchers had to manually collect board data from regulatory filings, a task made even more challenging given the non-electronic nature of regulatory filings in the early 1990s and prior.

The findings of research on this topic in the 1990s are highly mixed. Below, I will separately review the research that has documented positive, negative, and null effects of board independence on firm performance.

Positive Effect:

Rosenstein and Wyatt (1990) were among the earliest researchers seeking to investigate this question. They examined how the stock market reacted to the announcement of an independent director's appointment by a company's management. Their study encompassed 1,251 such announcements made in the New York Stock Exchange and American Stock Exchange between 1981-1985. Their findings showed that the stock market generally responded favourably to the news of independent directors' appointments, as indicated by a statistically significant positive return. Nevertheless, the economic effect was relatively small, with the average stock return in response to the appointment of an independent director being just about 0.3%.

Yermack (1996) studied the influence of board size and composition on firm valuation. His sample consisted of the Forbes 500 largest corporations (excluding utilities) spanning the years from 1984 to 1991. Instead of relying on stock market returns, Yermack (1996) analysed how firms' valuations changed in response to a change in independent directors. The primary valuation method used is Tobin's q ratio, which is calculated as the market value of assets divided by the book value of assets. The underlying intuition of Tobin's q ratio is conceptually similar to the price-to-book equity ratio, though the former emphasizes asset value, whereas the latter uses equity value. A higher Tobin's q ratio implies that the firm is more highly valued in the market. His analysis found that firms with a larger share of independent directors demonstrated a higher Tobin's q ratio. However, none of the profitability measures, such as the ratio of sales to assets, return on assets and return on sales, showed a statistically significant relationship with the proportion of independent directors on the board.

Negative effect:

In their exploration of how governance mechanisms influence a firm's performance, Agrawal and Knoeber (1996) analysed the Forbes 800 largest firms in 1987, using Tobin's q ratio as their performance measure. One of the governance mechanisms they studied was the proportion of independent directors. Their analysis revealed an inverse relationship between independent directors and firm value.

Despite similarities in sample selection (both studies used Forbes-listed firms) and valuation measurement approach, the conclusions reached by Agrawal and Knoeber

(1996) and Yermack (1996) are at odds. These differing findings could be attributed to the distinct research methodologies employed in each study. For instance, Yermack's (1996) model explicitly incorporated firm fixed effects to control for unobservable, time-invariant firm characteristics such as geographical location and industry competition dynamics. But Agrawal and Knoeber (1996) did not take these fixed effects into account in their model, which could have confounded their results. For example, firms in highly competitive industries with slim profit margins might struggle to attract independent directors, leading to an apparent negative correlation between firm performance and the proportion of independent directors.

From a research methodology perspective, I would posit that Yermack's (1996) findings seem more robust and persuasive, given the thorough control for firm-specific factors. Consequently, while Agrawal and Knoeber (1996)'s research provides valuable insights, the lack of control for firm fixed effects could limit the credibility of their conclusions.

Null effect:

In their analysis of the relationship between board independence and firm performance, Hermalin and Weisbach (1991) conducted a study involving a sample of 142 New York Stock Exchange-listed firms. They used Tobin's q as a measure of firm value. Their results, however, indicated no statistically significant correlation between board independence and firm performance. Hermalin and Weisbach (1991) acknowledged the non-linear nature of the relationship between board independence and performance. Rather than simply using the proportion of independent directors as a model variable, they instead employed three indicator variables, representing the presence of independent directors in ranges of less than 40%, between 40% and 60%, and above 60%. This technique accounted for different possible effects of independent director representation within these thresholds. Their analysis showed that in most models, the coefficient estimates for all three indicators were statistically indistinguishable from zero, suggesting no significant influence of board independence on firm performance within these ranges.

In conclusion, the body of research from the 1990s presents a varied and often contradictory picture regarding the relationship between board independence and firm performance. Even if one were inclined to posit that independent directors exert a positive

influence on firm performance, evidence suggests that such an effect, if it exists, is likely to be weak.

2. Research Post-2000

Methodological advancements in the post-2000 era have enabled researchers to revisit and refine the question of board independence's influence on firm performance. The development of new datasets has allowed for the analysis of significantly larger research samples, providing more robust and nuanced insights.

For instance, Nguyen and Nielsen (2010) undertook a study to determine shareholders' perception of the value of independent directors by examining the stock market response to these directors' sudden deaths. Their sample encompassed 108 sudden deaths of independent directors from 1994 to 2007. Their findings suggested that the sudden loss of an independent director corresponded to an average decrease in firm value by 0.85%. The strength of this research method lies in its focus on "sudden" deaths, signifying that the departure of these directors was not triggered by firm-specific events and was not anticipated by market investors. This decline in market value upon director death, the authors argued, reflects both the cost of finding new directors and their learning curve, as well as the market perception that the newly appointed directors might be less independent than their predecessors, as they are appointed by incumbent CEOs.

In another study, Masulis and Zhang (2019) scrutinized the value of independent directors by focusing on those preoccupied with external distractions, either personal or professional. Personal distractions included major illnesses/injuries and the receipt of major national or international awards. Professional distractions encompassed challenges encountered at another firm where the independent director was concurrently serving on the board. Their analysis, which used a sample of S&P 1500 firms, revealed that about 20% of independent directors experienced distractions in a typical year, and these directors missed around 25% of board meetings, showed a lower trading frequency in the firm's stock, and had a higher likelihood of leaving the board within the next two years. They found that a one-standard-deviation increase in the fraction of distracted independent directors was associated with an decrease in return on assets by 2.9% and a reduction in Tobin's q by 3.76%. These findings led the authors to conclude that independent directors could indeed augment firm value.

In summary, while the pre-2000 research presented mixed findings, studies conducted in the post-2000 era, utilizing enhanced research methodologies and larger research samples, consistently indicate that independent directors can positively influence firm performance and firm value.

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Chapter 3: The manner in which director independence is determined or measured

Director independence is a foundational principle of contemporary corporate law. The division between ownership and managerial control in corporations permits businesses to leverage the skills of expert managers. However, this separation can also give rise to the "principal-agent problem," wherein managers (agents) might not always prioritize the interests of the shareholders (principals).[2] Recognizing the challenges for shareholders to oversee day-to-day managerial decisions, the role of supervising managers is delegated to independent directors, who are tasked with ensuring that corporate actions align with shareholder interests. Thus, board independence plays an essential role in bridging the gap between ownership and control, acting as a safeguard against potential conflicts.

Since a series of scandals at the beginning of the 21th century, regulators and shareholders have placed a greater emphasis on the independence of boards, intending to prevent managers from directing shareholders' wealth for self-interests. According to Spencer Stuart Board Index Survey, independent directors made up 86% of board members in 2022, rising from 75% in 2005. In most S&P 500 firms, CEO is the only insider on the board.

1. Different definitions for director independence

The focus of corporate law and regulatory bodies, such as stock exchanges, differs when it comes to defining director independence. Corporate law in certain common law jurisdictions lacks a clear, predefined standard regarding this matter.[3] Instead, courts adopt an ex-post situational approach, assessing director independence only when conflicts arise in specific transactions. In such instances, courts conduct a case-by-case analysis, scrutinizing whether a director can derive personal benefits from contentious transactions where benefits are not shared with the other shareholders. The analytical

[2] See chapter 1 for various conflicts that can arise between shareholders and managers.

[3] Corporate law sometimes uses the term interested/disinterested directors, as opposed to using the term independent/non-independent directors, to characterize if a director stands on both sides of transactions.

framework means that a director can be independent in some corporate matters and non-independent in other corporate matters. Taking the Delaware corporate law as an example, Nili (2020) indicated that this approach, due to its dependency on procedural factors such as the burden of proof, specifics of the case, and the availability of admissible evidence, could yield varying outcomes for different cases.

In contrast, regulatory bodies like stock exchanges utilize an ex-ante approach. They establish explicit pre-requisites detailing what could disqualify a director from being labelled as independent. Once a nominee passes these baseline requirements (e.g., no familial or financial tie to the company), the exchange mandates the company's board to verify further that the nominee maintains no substantial direct or indirect relationship with the listed company. This approach, in essence, seeks to pre-emptively ensure director independence rather than retrospectively assessing it in the wake of conflicts.

2. Challenges in Director Independence Designation

Nili (2017, 2020) argued that the current framework for designating and disclosing director independence in the U.S. market is largely insufficient for several primary reasons.

First, Nili pointed out the excessive discretion vested in management to determine director independence. While stock exchanges do set certain exclusion thresholds, these are often seen as low. The ultimate authority lies with the board to assess whether any material information could impact a director's independence. The issue, however, is the potential conflict of interest when boards self-police their independence. This situation can be further exacerbated by factors such as social ties in the recruitment of independent directors and behavioural biases, including groupthink, confirmation biases, social conformity, and status quo biases.

Second, Nili argued that the existing regulatory framework fails to provide investors with adequate information concerning the board's designations of director independence. Using Delaware as a case in point, Nili (2017) noted that disclosure of director independence is particularly inadequate in scenarios involving related-party transactions, concurrent and past outside employment, affiliations with charitable organizations, and significant personal relationships. The board possesses considerable discretion in determining what current and prior relations between a director nominee and the firm are counted as material and thus require shareholder disclosure for the evaluation of

directorial independence. This discretion potentially opens gateway for managers to appoint seemingly independent directors who may harbour conflicts of interest.

Third, while corporate law's analytical approach offers a more effective means of scrutinizing director independence, it has a significant limitation: independence can only be determined through litigation. This process is not only costly but also reactive, undertaken after the damage has occurred. Furthermore, while shareholders can challenge director independence in court, such challenges must be linked to a specific board action and must meet procedural and substantive thresholds before discovery.

Fourth, the absence of a private right of action for violating exchange rules leads to the underenforcement of these rules. While providing false information or omitting material facts is illegal, the SEC appears to show little interest in pursuing these violations.

Nili's (2017) observations are further corroborated by Houston, Lee, and Shan (2019). They examined the case of former-employee directors and compared firms' self-classification of director independence with classifications made by third-party proxy agent Institutional Shareholder Services (ISS) based on its own standards. In line with Nili (2017)'s argument, Houston, Lee, and Shan (2019) found that firms are more aggressive in asserting the independence of former-employee directors. Companies are significantly more likely to classify a former-employee director as independent than ISS, which adopts a more conservative approach to determining director independence.

Issues surrounding the aggressive designation of independent directors are not limited to the U.S. market. Research from other jurisdictions reveals a similar problem. Crespí-Cladera and Pascual-Fuster (2014) scrutinized the independence of declared independent directors in Spain, employing eight measurable criteria in accordance with Spanish regulations. Although Spanish firms in their sample declared an average of 32.5% of their board members as independent directors, this figure dropped to 14.2% when considering only those directors who satisfied all eight criteria. This suggests that 56.3% of those self-declared as independent directors failed to meet at least one of the eight independence criteria. In another study, Santella, Drago, and Paone (2007) examined the designation of director independence in 40 blue-chip Italian companies. They observed a generally low level of compliance with independence requirements. This trend was prevalent among both financial and non-financial companies.

3. Managerial Influence in Independent Director Appointment

CEOs may be incentivized to undermine the monitoring function of independent directors by taking advantage of the discretionary nature of director independence classification. Through this manipulation, the perceived independence of the board of directors may remain intact, while actual independence is compromised. For instance, Shivdasani and Yermack (1999) found that when a CEO participates in the director selection process (i.e., sitting on the nomination committee), companies are more likely to appoint fewer truly independent directors and a larger number of 'grey' outsiders who have conflicts of interest. Their research revealed that the involvement of CEOs in the nomination committee corresponded with a decrease in the proportion of genuinely independent directors by 13 percentage points and an increase in 'grey' directors by 5 percentage points.

The sample used in Shivdasani and Yermack (1999)'s research consisted of Fortune 500 firms from 1994 to 1996, a period when it was still permissible for CEOs to serve on the nomination committee. However, even subsequent to a series of regulatory reforms prohibiting CEO participation in the nomination committee, their influence on director appointment still seems to persist. For example, in a study conducted with a more recent sample up to 2010, Coles, Daniel, and Naveen (2014) explored the behaviour of independent directors appointed after a CEO assumes the role. Their findings suggested that these directors often show loyalty to the appointing CEO, resulting in weaker monitoring quality. This underscores the continued influence of CEOs on board governance.

4. The Consequences of Discretionary Director Independence Designation

Several empirical studies have assessed the impact of discretionary director independence designation. Houston, Lee, and Shan (2019) scrutinized the case of former-employee directors, utilizing a sample of S&P 500 firms spanning from 2000 to 2012. As previously noted, a significant portion of these former-employee directors are classified as independent, despite a more conservative perspective by ISS suggesting the contrary. The researchers observed that companies are more likely to face shareholder class action litigation when former-employee directors are appointed. This heightened litigation risk is primarily attributable to situations where the former employee

is (1) closely associated with current management, (2) occupies a crucial monitoring position, and (3) steps in to fill the shoes of an outside director.

In another study, Hwang and Kim (2009) discovered that a substantial number of directors designated as independent by firms are, in fact, not socially independent from CEOs. In their sample of Fortune 100 firms from 1996 to 2005, conventional measures of director independence suggested that 87% of directors were independent. However, when social ties between CEOs and directors were taken into account, only 67% of directors were found to be both conventionally and socially independent. This study revealed that independent directors with social ties to CEOs demonstrate inferior monitoring quality, as evidenced by higher CEO compensation, weaker sensitivity of CEO pay to performance, and a lower probability of CEO departure following poor performance.

Director tenure is another significant factor that can negatively impact director independence. Boards with a large proportion of long-serving directors can become entrenched and exhibit unwarranted deference to management. Thus, long-serving independent directors may not be as independent as initially appear. Huang and Hilary (2018) investigated how director tenure influences firm value and accounting performance. Their research uncovered that while an increase in board tenure correlates with a rise in firm value up to a certain threshold, beyond this point, it negatively impacts firm value. The authors attributed this trend to the trade-off between the accumulation of firm-specific knowledge and the preservation of board independence. While a board accrues more firm-specific knowledge as the average tenure of board members increases, fostering an increase in firm value, heightened familiarity between the board and management can compromise board independence. Empirical evidence from their study suggests that an overly long-serving board is linked with subpar decision-making quality, as exemplified by poor M&A performance, deteriorated financial reporting quality, and inflated CEO compensation.

In conclusion, current legal and empirical corporate finance studies indicate that the prevailing rules concerning the determination of director independence could fall short even in the U.S. market, where corporate governance rules are considered advanced. Investors are not adequately informed about the relationship between directors and CEOs, which leads to the improper designation of director independence. Evidence

indicates that such inappropriate designations can undermine governance quality and diminish firm value.

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Chapter 4: Analysis of the role that minority shareholders play in relation to the appointment of independent directors and the assessment of independence within other international governance frameworks for listed companies.

A foundational tenet of corporate law posits that the inception of major corporate decisions lies inherently with the board. Due to the impracticality of shareholders directly participating in a corporation's intricate daily operations, there is a requisite delegation of decision-making power to board directors. Such directors are then bound by fiduciary duties, which mandate that their decisions are aligned with the overarching aim of enhancing shareholder value. Yet, this power dynamic is not without its inherent complications; the delegation of authority can create potential conflicts of interest, especially if directors privilege personal interests over their fiduciary responsibilities to shareholders.

The election of directors serves as a pivotal countermeasure designed to attenuate the potential discord between shareholders and board members. In scenarios where shareholders find themselves in contention with board decisions, they possess the recourse to pivot the company's trajectory. This can be executed by replacing incumbent directors with a refreshed group of directors. The latent threat of potential removal through the election process acts as a deterrent and thereby compels directors to fulfil their fiduciary responsibilities.

Yet, the theoretical underpinnings of the director election process and its empirical manifestations reveal a discord. Academic and anecdotal evidence implies that independent directors, despite being elected under the banner of safeguarding shareholder interests, could fall short of fully upholding their fiduciary mandates. In this chapter, I will examine archival studies and summarize potential caveats in the director election process. The analysis will focus on critical elements like the director nomination process, prevailing voting methodologies, and other considerations in institutional investors' voting policies.

1. Director Nomination

The participation of minority shareholders in director nominations is uncommon, largely due to the "public good problem" they encounter. Minority shareholders undertaking the nomination bear the full brunt of costs associated with selecting, evaluating, and sometimes even soliciting independent proxies for their nominated directors. However, the benefits the minority shareholders derive from this process are merely proportional to their shareholdings (Bebchuk, 2003). This economic imbalance, given the substantial efforts and resources involved, often dissuades these shareholders from presenting alternative director nominees. Consequently, the vast majority of director elections go uncontested. As highlighted by Brav, Jiang, Li, and Pinnington (2021), a scant 1.5% of board elections are contested, characterized by a "dissident" shareholder proposing a different set of nominees.

Other than shareholders' apathy in director election, managers tend to wield considerable influence over the director nomination process. Although director nominations are primarily overseen by board nomination committees—often comprised largely of independent directors—research suggests that the list of nominated candidates frequently favours management, often overlooking the interests of minority shareholders. For instance, a comprehensive study by Cai, Nguyen, and Walking (2022) covering the period from 2003 to 2014 analysed 9,801 director appointments in U.S. public firms. Their research uncovered that a significant number of newly appointed directors had professional ties with sitting board members. Notably, candidates with affiliations to CEOs had a distinctly higher likelihood of being selected than those associated with non-CEO directors. Their findings indicate a subtle, yet significant, influence of CEOs on the nomination process even such practise is discouraged by regulators.

2. Voting Method

The New Zealand Companies Act of 1993 mandates that companies appoint directors using majority voting rules and, at the same time, offers room for alternative voting methods if stipulated in the company's constitution. While the law provides this flexibility concerning the voting methods, the majority of publicly listed companies in New Zealand

opt for the majority voting method for their board elections. For the sake of comprehensiveness, this section compares two globally prevalent voting methods: majority voting and plurality voting methods. I will also briefly discuss the potential value implications of these voting methods.

At the end of this section, I also touch upon the cumulative voting and straight voting methods. However, given that the majority of director elections in New Zealand—and elsewhere—are uncontested for reasons discussed in the preceding section, the relevance of this discussion is somewhat limited.

Plurality Voting vs. Majority Voting

The *plurality voting* system elects candidates based on receiving the highest number of votes, even if these do not equate to an outright majority. In scenarios of uncontested director elections, plurality voting can significantly diminish shareholder influence in the elections.[4] This is because, theoretically, a nominee might secure a board position with a mere smattering of affirmative votes. In an extreme case, a board nominee can still be elected even though the nominee is opposed by all other shareholders except share-owning managers. Therefore, this method raises concerns about the elected directors' commitment to genuine shareholder interests.

While plurality voting allows shareholders to withhold votes for dissatisfying nominees, such actions rarely prevent a board member's election. Yet, as posited by Grundfest (1993), sizable withhold votes can sometimes foster change. The underlying premise is that directors, valuing their reputations, would proactively address shareholder concerns to prevent adverse public opinion.

Several empirical studies have assessed how companies react to significant withheld votes, generally validating Grundfest's (1993) assertions. Del Guercio, Seery, and Woidtke (2008) investigated how firms respond to shareholder votes in uncontested director elections, particularly focusing on "vote-no" campaigns—initiatives by activist shareholders urging others to withhold votes from certain board members. Their study, spanning from 1990 to 2003, identified 112 such campaigns. Their analysis revealed that

[4] Plurality voting is highly popular among U.S. companies and accounts for 98.5% of elections in the U.S.

companies targeted by these campaigns demonstrated marked improvements in operational performance and witnessed an increased likelihood of CEO departure following poor performances. Building on this, Ertimur, Ferri, and Oesch (2018) expanded the study conducted by Del Guercio, Seery, and Woidtke (2008). They considered a broader set of cases with significant withheld votes in uncontested director elections from 2003-2010. Their research showed that while significant withholdings of votes seldom result in changes to the board, companies do respond by addressing the root causes behind adverse votes. The conclusion was that in uncontested director elections, shareholders predominantly cast their votes to prompt directors to tackle specific issues rather than to replace them outright.

The *majority voting* system elects directors who secure the outright majority (>50%) of the total votes cast. On the surface, this majority voting method seems to offer minority shareholders a stronger voice in director elections, ensuring that the elected directors more effectively undertake their monitoring and advisory roles for shareholders. Several empirical studies assess the impact of majority voting rule's impact on shareholder wealth.

In their studies from 2009 and 2013, Cai, Garner, and Walkling explored the efficacy of majority voting in achieving its intended objectives. Their 2009 research revealed that, for an uncontested election under the plurality voting system, even underperforming directors in underachieving firms often garner as much as 90% support. This observation led them to conclude that majority voting might not substantially influence director elections.

In their 2013 study, the three authors scrutinized the traits of companies that embraced majority voting and assessed its influence on shareholder value. Notably, they discovered a trend where underperforming firms are more inclined to adopt majority voting. Yet, the broader stock market remains relatively unmoved by such adoptions. On days when majority voting proposals were ratified, the average stock market return was below 0.6%. Another important finding in Cai, Garner, and Walkling's 2013 research was the absence of any discernible operating performance uptick in firms that transitioned to majority voting. Surprisingly, the firms changing to the majority voting system appear to display subpar financial metrics and valuations following the change. Corroborating these findings, Sjostrom and Kim (2007), using an analogous dataset, analysed stock price

fluctuations surrounding announcements of companies transitioning to majority voting. Their outcomes echoed the conclusions reached by Cai, Garner, and Walkling in 2013. In sum, both studies suggested that majority voting might not be the panacea for enhancing shareholder value as once hoped.

Ertimur, Ferri, and Oesch (2014) revisited the dynamics of stock price movements around announcements related to the adoption of majority voting, utilizing a refined econometric methodology. They recognized that firms embracing majority voting might inherently differ from those that do not, introducing a potential "self-selection" bias when comparing stock returns between the two groups. While Cai, Garner, and Walkling (2013) previously tried to correct this self-selection bias by carefully selecting comparable firms in control groups based on observable company attributes, this method might be insufficient. It could overlook potentially influential but unobservable factors. To remedy this, Ertimur, Ferri, and Oesch (2014) employed a regression discontinuity design, offering a more robust solution to the self-selection issue. Their analysis revealed abnormal returns ranging from 1.43% to 1.60% around the dates of annual meetings when majority voting adoption proposals were considered, indicating that investors view the transition to majority voting as a value-adding move.

In conclusion, research on the efficacy of majority voting in enhancing shareholder value presents varied results. Notably, even studies that highlight the beneficial impact of majority voting often indicate a modest economic uplift in shareholder value, raising questions about the effectiveness of majority voting rule in protecting minority shareholders' interest.

Cumulative voting vs. straight voting

Cumulative voting in corporate board elections intends to offer minority shareholders a more significant chance to elect a director. With this approach, shareholders are granted a vote count equivalent to their shareholding multiplied by the number of director positions available. They have the flexibility to distribute their votes across candidates — they might allocate all votes to a single nominee, divide them among multiple candidates, or adopt any other distribution strategy. This system contrasts with straight (or statutory) voting. In straight voting, shareholders can assign a vote for each directorial vacancy based on their share count but can't pool all their votes behind one nominee.

While cumulative voting intends to amplify the voice of minority shareholders in the boardroom, its practical application remains restricted. The primary reason is its relevance mainly in contested director elections, where shareholders can propose director candidates to compete with board-endorsed candidates. As previously mentioned, due to challenges in shareholder proxy access, the vast majority of director elections go uncontested, a trend especially pronounced in the U.S. market. Consequently, limited research exists on the impacts and effectiveness of cumulative voting.

3. Other Considerations

Research highlights that certain conflicting considerations might deter institutional investors from voting for their preferred directors. First, mutual funds' voting policies can be shaped by the business ties with their portfolio firms. Davis and Kim (2007) noted that some large U.S. mutual funds garner significant revenues from managing the pension plans of their portfolio companies. The authors found that business ties significantly influence the voting practices of these mutual funds. Mutual funds with substantial business connections might establish voting policies that lean towards supporting management across all their portfolio firms. This is because these mutual funds are wary of their voting practices coming under public scrutiny. As a result, in order to avoid any allegations of violating fiduciary duty and to preserve amicable relations with firms they have business ties with, these funds tend to favour management-aligned voting policies across all portfolio firms.

Second, some mutual funds find it difficult to oppose board-endorsed director candidates in elections for fear of managerial retaliation. Matvos and Ostrovsky (2010) revealed that, in contested director elections, certain funds consistently appear more aligned with management than others. Additionally, a fund's likelihood to oppose board-endorsed directors rises when its peers also seem inclined to oppose them. Matvos and Ostrovsky argue this behaviour stems from mutual funds' concerns about potential retaliation from management for voting contrary to their preferences. Such retaliations might manifest as jeopardized business ties, such as current or potential pension management contracts, or restricted access to company management. Nonetheless, the capacity of a firm to penalize a dissenting fund decreases when multiple funds vote in opposition. In an

extreme scenario, if all funds vote against management-backed directors, the management might even consider stepping down, rendering it incapable of retaliation. This collective strength or "safety in numbers" phenomenon can introduce a dynamic of peer influence in mutual fund proxy voting.

In summary, both Davis and Kim (2007) and Matvos and Ostrovsky (2010) highlighted that mutual funds' voting behaviours in director elections are influenced not only by management-imposed barriers but also by the funds' own vested interests. These interests may not always coincide with those of the mutual fund investors. Such findings challenge the fiduciary duty that these funds are supposed to uphold for their investors.

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