Seven Gaping Holes In Our Knowledge Of Corporate Governance

By David F. Larcker and Brian Tayan

Almost a century after the term "corporate governance" was coined, you could assume that research and best practices have the concept well defined. In truth, many of the most basic factors that make up "corporate governance" and boards of directors—including the roles of incentives, independence, CEO skills and powe—are still hotly debated.

Nine decades after Adolf Berle and Gardiner Means proposed a theory of corporate governance, our knowledge of its "best practices" remains woefully incomplete. Corporate governance is a social science, which means that, while the factors that determine its effectiveness are complex, they are at their core subject to theory, measurement, and analysis.

Today, the dialogue about corporate governance is dominated by rhetoric, assertions, and opinions that, while strongly held, are not necessarily supported by either applicable theory or empirical evidence. Having to choose between the scientific record and their gut, many "experts" prefer their gut.

Although many aspects of governance have been the subject of empirical study, our knowledge of its central characteristics is incomplete. Many studies involve large samples of data. Large samples enable a researcher to identify patterns across many companies, but generally do not tell us how governance choices would impact a specific company. Case studies or field studies can help answer firm-specific questions, but the results tend to be highly contextual and difficult to generalize.

In the case of corporate governance, many important variables are not publicly observable to outside researchers, forcing them to develop proxies to estimate the variable they want to measure. It is extremely difficult to produce high-quality, fundamental insights into corporate governance because of these limitations.

This leaves significant "holes" in the knowledge of corporate governance. These are central issues where insufficient or inadequate study has left us unable to answer basic questions, and where key assumptions relied upon by experts have not been verified or validated. These include board oversight, the recruitment of CEO talent, the size and structure of CEO pay, and the advancement of shareholder and stakeholder welfare. The formulation of best practices (or should we say "better practices") would improve greatly from careful research into these topics.

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☐ ***1. Effective boards.*** The first major hole in our knowledge of corporate governance is understanding what attributes (composition, structure, or practices) make a board effective.

A significant portion of the research on boards examines their structural attributes to identify any correlations with outcomes. This has resulted in a mountain of research on CEO/chair duality, board classification, board tenure, diversity, busy directors, board size, director age, professional qualifications, active or retired CEOs, etc. The vast majority of this research finds that most of these attributes are not associated or only loosely associated with outcomes (with the possible exception of busy boards, which appear to be an impediment to board effectiveness).

We also have little understanding of how board practices contribute to board effectiveness. One

David F. Larcker *is an emeritus professor and* **Brian Tayan** *a researcher at the Stanford Graduate School of Business and both are members of the Hoover Working Group on Corporate Governance. [www.stanford.edu]*

promising area of study is to understand the practices that make for effective board leadership. Very little careful study has been made of the differences in board leadership across companies, and whether effective board leaders share common backgrounds, skills, or approaches. Our understanding of individual director contribution is similarly limited.

Furthermore, we have little insight into board practices such as information flow, performance oversight, and risk detection. Legal standards allow boards (absent any red flags) to rely on information provided by management, but we know little about the practices board members and management engage in to improve the quality of this information.

Isolated examples exist of boards that have dramatically restructured the information they receive from management either via board books or informal communication, but there has been no systematic study on if this impacts the quality of their decision making and company performance.

Similarly, we know (after the fact) that certain prominent corporate failures result in part from a stunning lack of awareness at the board level of major breakdowns in risk controls.

Examples include Wells Fargo, where the board was not provided accurate information about the extent and systemic nature of its cross-selling violations; and Boeing where the board was unaware of design flaws in the 737MAX and the lack of employee candor in their interaction with federal regulators. We do not know how breakdowns of this magnitude could occur in a modern setting, how to prevent them, or how oversight practices vary across companies.

Our understanding of board quality would greatly improve through a deeper understanding of the factors that foster true independence of thought among board members.

☐ ***2. Independence.*** A second hole in our understanding of corporate governance are the factors that contribute to board independence. Independent oversight is critical to the fair representation of shareholder and stakeholder interests, and arms-length negotiation with management in areas such as strategy, succession planning, performance measurement, compensation, risk management, and review of corporate actions. Stock exchanges in the United States set independence standards to ensure that directors are not compromised by a financial or working relationship with the company.

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, add restrictions on top of these legal criteria and recommend against the election of directors that violate their self-determined "higher" standards.

One of the most famous examples of this occurred in 2004, when ISS recommended against the reelection of Warren Buffett to the board of The Coca-Cola Company, despite his significant ownership of the company's stock, because Buffett served on the audit committee while two Berkshire Hathaway subsidiaries distributed Coca-Cola products. ISS defended its "zero tolerance" policy as avoiding a "slippery slope… when you start to make exceptions."

Most studies find very modest or no relation between independence and corporate outcomes, calling into question the reliability and validity of these common standards. At the same time, research has shown that social connections between the board and insiders can impair the "independent" judgment of directors. Similarly, the power of the CEO relative to individual board members can also compromise independence.

We have also observed that the directors of many special purpose acquisition companies (SPACs) were independent by listing standards, but had personal relations with the sponsor and significant financial incentive to close a merger without regard to the economic quality of that merger.

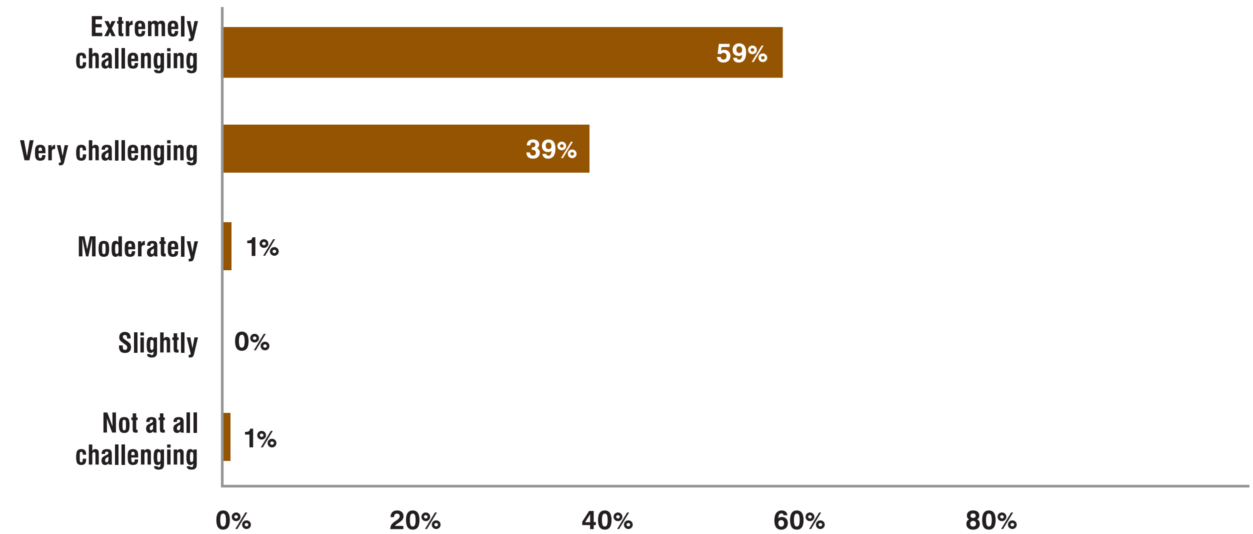
Beyond these, it is likely that other factors that we have not measured (such as the financial wealth of directors, personal qualities, and character) influence their ability to maintain an independent perspective in boardroom deliberations. Our understanding of board quality would greatly improve through a deeper understanding of the factors that foster true independence of thought among board members.

☐ ***3. CEO labor market efficiency.*** The efficiency of the labor market for CEO talent is a third area

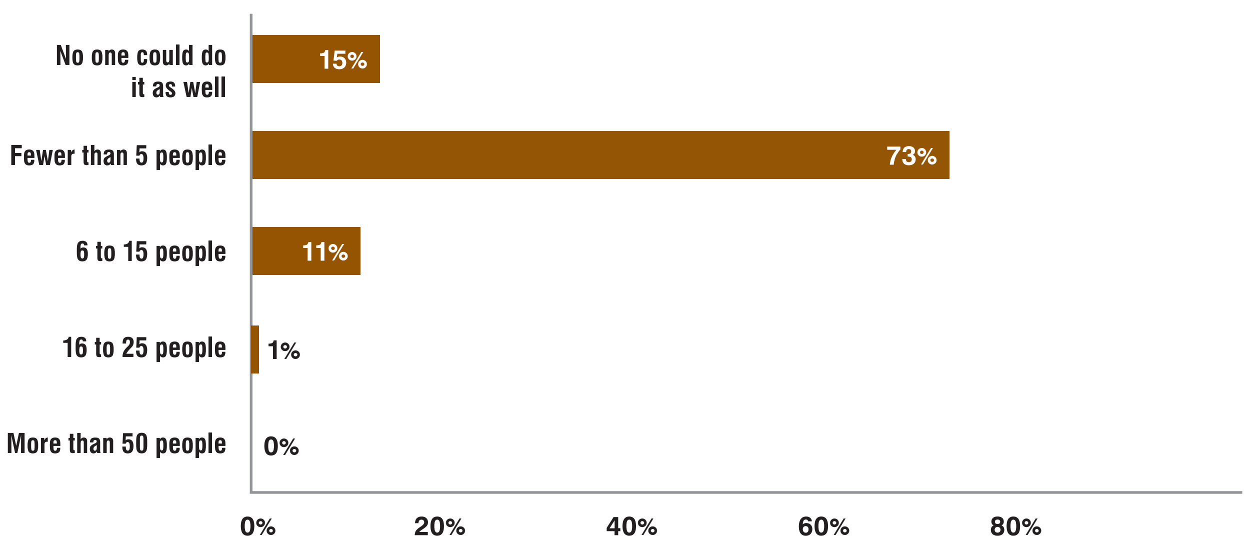
Do Boards Over-Value Their CEOs?

Are They Really This Irreplaceable?

How challenging is the job of CEO at your company?



Roughly how many people are capable of stepping into the CEO role at your company and do at least as well as your current CEO (including both inside and outside your company)?



Source: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. "CEO Talent: America's Scarcest Resource? 2017 Talent Survey."

where our knowledge is inadequate. An efficient labor market is one in which the supply and demand for talent are roughly in balance, information on the requirements of the job and the qualification of candidates is available, and candidates select a job suitable to their talents and are appropriately paid for their labor.

If the match turns out not to be a good fit, either party can terminate the relation and a new matching process takes place. The labor market for many middle and lower-level positions appears to be largely efficient.

Companies are slow to terminate an underperforming CEO, slow to hire a successor, and commonly have inadequate succession plans.

The labor market for CEO talent, however, does not appear to fit this description. Research shows that companies are slow to terminate an underperforming CEO, slow to hire a successor, commonly have inadequate succession plans, and the candidate pool for large companies appears to be incredibly small and fragmented.

The efficiency of the labor market has important implications for CEO recruitment and oversight. If this market is inefficient, distortions can arise in the balance of power between the CEO and the board. Management will face less pressure to perform, with the board unwilling to terminate an underperforming CEO for fear that an adequate replacement might not be available.

A tight labor market would also explain high compensation. A board could offer large sums of money to recruit a candidate whose skills are necessary, but considered to be in short supply. An inefficient labor market might also explain why some companies find it difficult to compare the qualifications of internal talent (whose track record is well known) and external talent. Our understanding of CEO recruitment, performance evaluation, and succession planning would greatly benefit from thoughtful insights into how the CEO labor market actually works.

☐ ***4. CEO compensation levels.*** Among large U.S. companies CEO compensation is high and controversial. Criticism of pay tends to emphasize the gaps between CEO pay and that of the average worker, and between CEO pay and executives one level down (C+1 level). Companies are also criticized for issuing mega-grants (one-time grants purportedly covering multiple years) that can be valued at hundreds of millions of dollars. Despite the very large amounts paid to the CEOs of the largest U.S. companies, we simply do not know the value of the CEO to an organization, and what pay levels are appropriate for this employee.

Various methods have been used to determine CEO value. Some researchers compare CEO pay with the pay of other highly paid professionals (hedge fund managers, private equity, venture capital, and even professions farther afield such as entertainers and athletes).

While the change in CEO pay over time has mirrored that of these other occupations, it still does not tell us whether CEOs (or these other professionals, for that matter) are "fairly" compensated. Similarly, researchers have shown that growth in CEO pay can be explained by growth in the size of the average corporation.

There are also vastly differing views on how much value the CEO can be credited with generating. Some research attributes as little as three percent of value creation to the CEO, and others as high as 40 percent. At the most basic level, however, we do not know the "correct" amount that should be offered to a CEO for their labor.

Executive pay would benefit from clearer methods for aligning pay and performance, and for communicating this relation to shareholders.

☐ ***5. Pay for performance.*** Another hole in our knowledge of corporate governance is how best to align pay and performance. The compensation committee is faced with a variety of choices, such as the form of payment, the metrics upon which payment is conditioned, the time period over which performance should be measured, and other restrictions.

An obvious decision is the mix between cash (whose value is fixed) and equity (whose value changes with stock price). An executive might prefer to receive cash because of the certainty it offers, but this does not provide incentive to perform.

In contrast, an equity or bonus award can be seen as "tying" the executive's financial results to that of shareholders, but it does so by imposing risk on a risk-averse executive. These choices have a direct bearing on the incentives and risk premium in the pay level of the individual.

Another decision is the time horizon over which payments should be made and the conditions that must be achieved. Currently, a typical company offers a mix of approximately 40 percent short-term (annual) awards and 60 percent long-term (multi-year) awards. The largest companies offer a smaller mix of short-term awards (30 percent or less).

Beyond these "high-level" choices, boards must decide whether to make awards contingent on the achievement of performance metrics. Many companies use a mix of financial metrics (revenue, earnings, cash flow, relative stock-price performance, etc.) and nonfinancial metrics (innovation, employee or customer satisfaction, safety, ESG-objectives, etc.). These are weighted by the board based on the importance of each metric for motivating the CEO to accomplish strategic corporate objectives.

Other pay decisions include the use of clawback provisions, hedging restrictions, and pledging policies.

The result of all of this is that the modern compensation contract is a hodge-podge of choices. Few experts have taken a step back to ask whether pay plans need to be this complex, whether complexity increases (or possibly decreases) the incentive to perform, whether complex pay programs strengthen or weaken the alignment between executives and shareholders, or how to measure compensation when its design is this complex.

At the same time, research has shown the unintended consequences of current practices. Complexity has led to a significant lengthening of disclosure, copy-cat behavior across firms, and increased investor confusion.

Executive pay would benefit from clearer methods for aligning pay and performance, and for communicating to this relation to shareholders. Given the controversy surrounding CEO compensation, this would be a good time to uncover how pay is actually set and why it is set in this manner.

It is not clear how to identify the most relevant shareholder attributes and how to categorize investors according to these criteria.

☐ ***6. Importance of shareholder base.*** A sixth hole in our knowledge of governance is whether certain shareholders are "better" for a corporation than others. Companies pay considerable attention to their shareholder base, and employ investor relations departments to manage these. Our knowledge of the impact of a shareholder base on corporate decisions and performance, however, is incomplete.

Shareholders differ in time horizon, activeness, objectives, and engagement. These differences can influence their preferences for use of capital (distributions versus investment), their interest in company-specific governance choices, and their willingness to engage on corporate policy. However, we do not know what impact these differences have, if any, on the decisions a company actually makes.

Research has shown that companies believe their stock price would trade higher if they could attract their "ideal" shareholder base. Overwhelmingly, these would be comprised of "long-term" investors. There is some evidence that companies with a high percentage of "transient" (short-term) investors have higher stock price volatility than companies with long-term (index) investors. Others find modest evidence that firms with a dedicated investor base are less likely to be misvalued.

It is not clear how to identify the most relevant shareholder attributes and how to categorize investors according to these criteria. One question researchers have explored is whether passive investors (those who simply want to match an index return over time) care about the governance choices of individual firms.

Some studies find that passive ownership, while "long-term oriented," is associated with less monitoring and deference to management. Activists, on the other hand, are seen as combatting management complacency and challenging boards that are overly compliant. However, these are also accused of being short-term oriented, discouraging long-term investment, and encouraging a sale to realize short-term gains.

At the same time, quiet activists exist—investors that take a significant minority stake in the firm, join the board, and engage with the company. Can these investors bring new knowledge to a company that its board and management have not already considered?

Finally, we have seen that companies with engaged founders or families of founders serving on the board can shepherd the culture and direct investment; however, we also see breakdowns of these over time. For this reason, founders who retain voting rights in excess of their ownership percentage (dual class shares) are subject to criticism, but we know little about the circumstances under which dual-class ownership is favorable or unfavorable.

In short, we do not know whether the composition of a shareholder base substantively matters to corporate outcomes.

Have companies incorporated stakeholder needs to a sufficient degree, and is a higher level of investment required?

☐ ***7. Role of stakeholders.*** Finally, we do not know the role that stakeholder interests should play in governance, or how these should be prioritized relative to shareholder interests. Historically, governance models in the U.S. and United Kingdom have been shareholder-oriented, with a primary focus on stock-price appreciation. Models in European and Asian countries are said to be more stakeholder-oriented. With the rise of ESG (environmental, social, and governance), the U.S. has been shifting toward a more stakeholder-oriented approach.

To some degree, U.S. companies have always incorporated stakeholder needs into their strategic planning—considering the welfare of their employees, the stability of suppliers, the reliability of products, and the company's reputation in society as part of the business planning process.

The question is whether companies have done so to a sufficient degree, and whether a higher level of investment to satisfy stakeholder objectives is required. We do not know the economic ramifications of higher stakeholder investment, including how much more should be spent, the impact this would have on productivity and value creation, and how the costs and benefits would be distributed across society. Existing research on the economic impact of ESG is highly mixed.

The potential also exists that a reorientation toward stakeholder interests might weaken management discipline. Some researchers argue that a dual mandate to serve both shareholders and stakeholders allows management to sidestep accountability to either, with the potential to increase costs on shareholders and stakeholders alike.

Do companies view the legal and compliance issues associated with research on corporate governance effectiveness too large for such research to succeed?

Why does this matter? Despite extensive research effforts, our knowledge of corporate governance remains deficient in many important areas, including practices that improve board effectiveness, the correct size and structure of CEO compensation, the efficiency of the CEO labor market, and the role that shareholders and stakeholders can and should play in setting corporate objectives and investment. What new methods should researchers employ to answer these questions? Do companies view the legal and compliance issues associated with this type of research too large for such research to succeed?

Most of the research on board structure finds little evidence that structural attributes contribute to governance quality. At the same time, the issue of how to improve board effectiveness remains a significant unanswered question. What practices in board leadership, meeting management, and information flow are most likely to improve board quality? How can these be measured and demonstrated in a rigorous manner? Is it possible to study the social interactions among board members to understand how they contribute to board success or failure?

CEO compensation remains highly controversial, in part because central questions regarding pay have not been answered. How should we measure the level and incentive value of CEO pay? How much impact do the efforts of an individual CEO have on performance overall? How scarce is CEO talent, and how difficult is it to identify the most qualified individuals in terms of skill, experience, and fit?

The ESG movement has compelled corporate leaders to reconsider the shareholder-centric model. Central to this movement are criticisms that companies today are too short-term oriented, exposing themselves to long-term risk and generating externalities that are harmful to society. How valid are these claims? How much investment would be required to improve stakeholder outcomes? What would be the costs and benefits of this investment, and how should the costs be distributed through society? Would any of this improve outcomes for shareholders or society relative to what they currently enjoy ■