See corporate governance as a response to agency costs

Know the role of the board, employees, lenders, analysts, and regulators in monitoring managers

Understand how compensation policies can help mitigate agency problems

Be familiar with the different ways shareholders can act to manage the agency conflict

Understand the major regulations and their role in corporate governance

See similarities and differences in agency conflicts and how they are managed around the world

Evaluate corporate governance as a trade-off among costs and benefits that will not result in a single solution for all firms
The turn of the twenty-first century witnessed scandals and corporate fraud in the United States. The names of once well-respected companies like Enron, WorldCom, Tyco, and Adelphia filled the news. Enron, with stock worth $68 billion at its peak, became almost worthless in a matter of months, wiping out the retirement savings of thousands of employees and other stockholders. The story at WorldCom was similar. The once high-flying stock peaked at a market value of $115 billion after a string of acquisitions that included well-known phone company MCI. In 2002, WorldCom filed what was at the time the largest bankruptcy ever. After building one of the nation’s largest cable companies from scratch, the Rigas family of Adelphia was forced to endure the indignity of watching their own cable system carrying the image of Adelphia’s demise into millions of homes.

The common theme among these companies is the accusation of fraud, perpetrated by the manipulation of accounting statements. Shareholders, analysts, and regulators were kept in the dark as the companies’ financial situations became ever more precarious, resulting, in the end, in total collapse. How did this happen? Aren’t managers supposed to act in the interests of shareholders? Why did auditors go along with the fraud? Where were the boards of directors when all of this was happening?

There is an opportunity cost to bad governance; thus, by replacing bad governance with good governance, it is possible to increase firm value—in other words, good governance is a positive-NPV project. Hence, we begin by discussing various governance mechanisms that are designed to mitigate the agency conflicts between managers and owners. These agency conflicts cannot be removed completely by a firm’s governance mechanisms, so we next discuss regulations that are designed to prohibit managers from taking certain acts that are not in the interests of shareholders. We conclude the chapter with a discussion of corporate governance around the world.

Corporate Governance and Agency Costs

Any discussion of corporate governance—the system of controls, regulations, and incentives designed to prevent fraud—is a story of conflicts of interest and attempts to minimize them. As we saw in Chapter 16, the different stakeholders in a firm all have their own interests. When those interests diverge, we may have agency conflicts. That chapter emphasized the sources of conflicts between bondholders and shareholders. In this chapter, we focus on the conflicts between managers and investors.

The conflict of interest between managers and investors derives from the separation of ownership and control in a corporation. As we pointed out in Chapter 1, the separation of ownership and control is perhaps the most important reason for the success of the corporate organizational form. Because any investor can hold an ownership stake in a corporation, investors are able to diversify and thus costlessly reduce their risk exposures. This is especially true for the managers of a corporation: Because they are not also required to own the firm, their risk exposures are much lower than they would be if ownership and control were not separate.

Once control and ownership are separated, however, a conflict of interest arises between the owners and the people in control of a corporation. For example, in Chapter 22, we talked about mergers that are motivated by managers’ desire to manage a larger firm, gaining them more prestige and greater pay, even if that might not be in the best interests of shareholders. Other examples of agency problems are excessive perquisites, such as using corporate jets for family vacations, or not working as diligently as they...
would if it were their own business. Agency conflicts are likely to arise any time the manager does not internalize the full cost of his or her actions—just think about how you order at a restaurant when you are paying compared to when your parents are paying!

The seriousness of this conflict of interest depends on how closely aligned the interests of the managers and shareholders are. Aligning their interests comes at a cost—it increases the risk exposure of the managers. For example, tying managerial compensation to performance aligns managers’ incentives with investors’ interests, but then managers are exposed to the firm’s risk (because the firm might do poorly for reasons unrelated to the manager’s performance).

The role of the corporate governance system is to mitigate the conflict of interest that results from the separation of ownership and control without unduly burdening managers with the risk of the firm. The system attempts to align these interests by providing incentives for taking the right action and punishments for taking the wrong action. The incentives come from owning stock in the company and from compensation that is sensitive to performance. Punishment comes when a board fires a manager for poor performance or fraud, or when, upon failure of the board to act, shareholders or raiders launch control contests to replace the board and management. As we will see, these actions interact in complicated ways. For example, as a manager owns more stock in the firm, his incentives become better aligned, but, in addition to the increase in risk the manager must bear, the manager also becomes harder to fire because the block of stock gives him significant voting rights.

Let’s now take a closer look at the components of the corporate governance system.

### Concept Check
1. What is corporate governance?
2. What agency conflict do corporate governance structures address?

### Monitoring by the Board of Directors and Others
At first glance, one might think that there is a simple solution to the conflict of interest problem: monitor the firm’s managers closely. The problem with this reasoning is that it ignores the cost of monitoring. When the ownership of a corporation is widely held, no one shareholder has an incentive to bear this cost (because she bears the full cost of monitoring but the benefit is divided among all shareholders). Instead, the shareholders as a group elect a board of directors to monitor managers. The directors themselves, however, have the same conflict of interest—monitoring is costly and in many cases directors do not get significantly greater benefits than other shareholders from monitoring the managers closely. Consequently, in most cases, shareholders understand that there are reasonable limits on how much monitoring they can expect from the board of directors.

In principle, the board of directors hires the executive team, sets its compensation, approves major investments and acquisitions, and dismisses executives if necessary. In the United States, the board of directors has a clear fiduciary duty to protect the interests of the owners of the firm—the shareholders. Most other countries give some weight to the interests of other stakeholders in the firm, such as the employees. In Germany, this concept is formalized through a two-tier board structure that gives half of the seats on the upper board—called the supervisory board—to employees.

### Types of Directors
Generally, researchers have categorized directors into three groups: inside, gray, and outside (or independent). Inside directors are employees, former employees, or family members of employees. Gray directors are people who are not as directly connected to the firm as insiders are, but who have existing or potential business relationships with the firm.
For example, bankers, lawyers, and consultants who are already retained by the firm, or who would be interested in being retained, may sit on a board. Thus, their judgment could be compromised by their desire to keep the CEO happy. Finally, all other directors are considered outside directors and are the most likely to make decisions solely in the interests of the shareholders.

**Board Independence**

Researchers have hypothesized that boards with a majority of outside directors are better monitors of managerial effort and actions. One early study showed that a board was more likely to fire the firm’s CEO for poor performance if the board had a majority of outside directors. Other studies have found that firms with independent boards make fewer value-destroying acquisitions and are more likely to act in shareholders’ interests if targeted in an acquisition.

Despite evidence that board independence matters for major activities such as firing CEOs and making corporate acquisitions, researchers have struggled to find a connection between board structure and firm performance. Although the firm’s stock price increases on the announcement of its addition of an independent board member, the increased firm value appears to come from the potential for the board to make better decisions on acquisitions and CEO turnover rather than from improvements in the firm’s operating performance. Researchers have argued, however, that so many other factors affect firm performance that the effect of a more or less independent board is very difficult to detect.

Another reason why it may be difficult to explicate a relationship between board independence and firm performance is the nature of the role of the independent director. On a board composed of insider, gray, and independent directors, the role of the independent director is really that of a watchdog. But because independent directors’ personal wealth is likely to be less sensitive to performance than that of insider and gray directors, they have less incentive to closely monitor the firm. However, there has been a trend toward more equity-based pay for outside directors. As recently as the early 1990s, it was very common for directors to be paid a fixed annual cash fee plus perhaps an extra nominal fee per meeting attended. It is now standard for outside directors to be granted shares of stock and/or options to more closely align their interests with the shareholders they serve.

Incentives notwithstanding, even the most active independent directors spend only one or two days per month on firm business, and many independent directors sit on multiple boards, further dividing their attention. In fact, some studies have found value decreases when too many of a board’s directors are “busy,” meaning that they sit on three or more boards.

A board is said to be captured when its monitoring duties have been compromised by connections or perceived loyalties to management. Theoretical and empirical research support the notion that the longer a CEO has served, especially when that person is also chairman of the board, the more likely the board is to become captured. Over time, most

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of the independent directors will have been nominated by the CEO. Even though they have no business ties to the firm, they are still likely to be friends or at least acquaintances of the CEO. The CEO can be expected to stack the board with directors who are less likely to challenge her. When the CEO is also chairman of the board, the nominating letter offering a seat to a new director comes from her. This process merely serves to reinforce the sense that the outside directors owe their positions to the CEO and work for the CEO rather than for the shareholders.

The Sarbanes-Oxley Act of 2002 (SOX), which we discuss in more depth in Section 3.5, required that the audit committee of the board, charged with overseeing the audit of the firm’s financial statements, be composed entirely of independent directors. Following the implementation of SOX, major U.S. exchanges (NYSE and NASDAQ) changed their listing requirements such that firms listed on those exchanges must have a majority of independent directors on their board. The NYSE further required that the nominating committees and compensation committees of the board also be majority independent. The exchanges believed that these changes would reduce entrenchment and improve governance. However, all such changes come at a cost, because the other major role of the board is to advise managers on strategic issues. Independent directors, while unbiased, are also the least likely to be experts in the firm’s business, thus reducing their ability to advise.

Board Size and Performance

Researchers have found the surprisingly robust result that smaller boards are associated with greater firm value and performance. The likely explanation for this phenomenon comes from the psychology and sociology research, which finds that smaller groups make better decisions than larger groups. Most firms that have just gone public either as young companies or as older firms returning to public status after a leveraged buyout (LBO), choose to start with smaller boards. Boards tend to grow over time as members are added for various reasons. For example, boards are often expanded by one or two seats after an acquisition to accommodate the target CEO and perhaps one other target director.

Other Monitors

The board is complemented by other monitors, both inside and outside the firm. We discuss direct shareholder monitoring and action in Section 3.4, but other monitors include security analysts, lenders, the SEC, and employees within the firm itself.

Securities analysts produce independent valuations of the firms they cover so that they can make buy and sell recommendations to clients. They collect as much information as they can, becoming an expert on the firm and its competitors by poring over a company’s financial statements and filings. As a result, they are in a position to uncover irregularities first. Analysts often ask difficult and probing questions of CEOs and CFOs during quarterly earnings releases. Anyone can listen to these conference calls, which are typically simulcast on the company’s investor relations Web site.

Lenders also carefully monitor firms to which they are exposed as creditors. Loans and lines of credit also contain financial covenants designed to provide early warning signs of trouble. These covenants, such as requiring maintenance of a certain quick ratio or profitability level, are primarily designed to capture the firm’s ability to repay the loan. Nonetheless, they complement other signals of potential governance problems. A stockholder must keep in mind, however, that her interests are not perfectly aligned with the creditors’ interests. The creditor, lacking the ability to benefit from the positive side of

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taking risk, is particularly interested in minimizing risk, even at the expense of some positive-NPV projects.

Employees of the firm are most likely to detect outright fraud because of their inside knowledge. However, they do not always have strong incentives to report the fraud. They may personally benefit from the fraud, or they may fear retribution from “blowing the whistle.” Some states have whistle-blower statutes to protect employees who report fraud to the authorities; there are federal statutes to protect employees who expose fraud against the U.S. government.

The SEC is charged with the task of protecting the investing public against fraud and stock price manipulation. But while the SEC’s enforcement powers are extensive and carry with them the weight of criminal prosecution, its detection resources are limited. Out of necessity, the SEC must rely on the array of other monitors, each with vested interests in detecting governance problems, to alert it to potential wrongdoing.

3. What is the difference between gray directors and outside directors?

4. What does it mean for a board to be captured?

3.3 Compensation Policies

In the absence of monitoring, the other way the conflict of interest between managers and owners can be mitigated is by closely aligning their interests through the managers’ compensation policy. That is, by tying compensation to performance, the shareholders effectively give the manager an ownership stake in the firm.

Stock and Options

Managers’ pay can be linked to the performance of a firm in many ways. The most basic approach is through bonuses based on, for example, earnings growth. During the 1990s, most companies adopted compensation policies that more directly gave managers an ownership stake by including grants of stock or stock options to executives. These grants give managers a direct incentive to increase the stock price to make their stock or options as valuable as possible. Consequently, stock and option grants naturally tie managerial wealth to the wealth of shareholders.

Many studies have examined firms’ compensation policies. One of the earlier studies examined the sensitivity of managers’ compensation to the performance of their firms. The authors found that for every $1000 increase in firm value, CEO pay changed, on average, by $3.25. Most of this increase came from changes in the value of their stock ownership ($2). The rest was driven by options, bonuses, and other compensation changes. The authors of the study argued that this seemed too small a sensitivity to provide managers with the proper incentives to exert extra effort on the behalf of shareholders. Recall, however, that increasing the pay-for-performance sensitivity comes at the cost of burdening managers with risk. As a consequence, the optimal level of sensitivity depends on the managers’ level of risk aversion, which is hard to measure.

Pay and Performance Sensitivity

Figure 3.1 shows the dramatic rise in CEO pay during the economic expansion of the 1990s. The median cash pay, consisting of salary and bonuses, rose only moderately. Instead, the factor contributing most to the climb in CEO total compensation was the sharp increase in the value of stock and options granted each year. The median value of

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This figure shows the median cash pay, stock and option grants, and other pay (for example, long-term incentive payouts and deferred compensation) for CEOs of the 1600 largest public companies (thousands of dollars) over the period 1993 through 2007.

Options granted rose from less than $200,000 in 1993 to more than $1 million in 2001. Not surprisingly, the substantial use of stock and option grants in the 1990s greatly increased managers’ pay-for-performance sensitivity. Consequently, recent estimates put this sensitivity at $25 per $1000 change in wealth. In more recent years, however, firms have been reducing the fraction of stock and option grants in executive compensation packages (see Figure 3.1), suggesting that that level of sensitivity might have been too high.

Besides increasing managers’ risk exposure, increasing the sensitivity of managerial pay and wealth to firm performance has some other negative effects. For example, often options are granted “at the money,” meaning that the exercise price is equal to the current stock price. Therefore, managers have an incentive to manipulate the release of financial forecasts so that bad news comes out before options are granted (to drive the exercise price down) and good news comes out after options are granted. Studies have found evidence that the practice of timing the release of information to maximize the value of CEO stock options is widespread.

More recently, Erik Lie has found evidence suggesting that many executives have engaged in a more direct form of manipulating their stock option compensation: backdating their option grants. Backdating refers to the practice of choosing the grant date of a stock option retroactively, so that the date of the grant would coincide with a date when the stock price was lower than its price at the time the grant was actually awarded.

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the stock price was at its low for the quarter or for the year. By backdating the option in this way, the executive receives a stock option that is already in-the-money, with a strike price equal to the lower price on the supposed grant date.

The use of backdating suggests that some executive stock option compensation may not truly have been earned as the result of good future performance of the firm. Furthermore, unless it is reported in a timely manner to the IRS and to shareholders, and reflected in the firm’s financial statements, backdating is illegal. In mid-2006, SEC and U.S. Justice Department investigations into alleged backdating were ongoing for more than 70 firms. New SEC rules require firms to report option grants within two days of the grant date, which may help prevent further abuses.

5. What is the main reason for tying managers’ compensation to firm performance?

6. What is the negative effect of increasing the sensitivity of managerial pay to firm performance?

### Concept Check

#### Managing Agency Conflict

Even with the benefits of separating ownership and control, there are still examples of corporations in which the top managers have substantial ownership interests (for example, Google). One might conjecture that such corporations have suffered less from the conflict of interest between managers and shareholders.

Academic studies have supported the notion that greater managerial ownership is associated with fewer value-reducing actions by managers. But while increasing managerial ownership may reduce perquisite consumption, it also makes managers harder to fire—thus reducing the incentive effect of the threat of dismissal. Therefore, the relationship between managerial ownership and firm value is unlikely to be the same for every firm, or even for different executives of the same firm. Shareholders will use all of the tools at their disposal to manage the agency conflict. Thus, if managers have small ownership stakes, shareholders may use compensation policies or a stronger board to create the desired incentives. Harold Demsetz and Kenneth Lehn argue that if you look at a group of firms at any time, you should not necessarily see any relationship between ownership and value, unless you are able to control for all of the other, sometimes unobservable, parts of the governance system, including the risk aversion of the manager. More recent studies have supported their position.

### Direct Action by Shareholders

If all else fails, the shareholders’ last line of defense against expropriation by self-interested managers is direct action. Recall that shareholders elect the board of directors. Typically, these elections look like those in the former Soviet Union—there is only one slate of candidates and you vote “yes” or “no” for the slate as a whole. When shareholders are angry about the management of the company and frustrated by a board unwilling to

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take action, however, they have a variety of options for expressing that displeasure at their disposal.

**Shareholder Voice.** First, any shareholder can submit a resolution that is put to a vote at the annual meeting. A resolution could direct the board to take a specific action, such as discontinue investing in a particular line of business or country, or remove a poison pill. Such resolutions rarely receive majority support, but if large shareholders back them, they can be embarrassing for the board.\(^\text{12}\) Some large public pension funds, such as the California Public Employees’ Retirement System (CalPERS), take an activist role in corporate governance. Typically, these funds target firms that are taking actions without considering the concerns of the stockholders; for example, they may privately approach the board of the firm and ask it to reverse its course. The explicit threat at that stage is that if the board fails to comply, the pension fund will put the issue to a shareholder vote. Studies have reported that such activist investors are usually successful in achieving their goals without having to take matters public.\(^\text{13}\)

Recently, shareholders have started organizing “no” votes. That is, when they are dissatisfied with a board, they simply refuse to vote to approve the slate of nominees for the board. The most high-profile example of this type of action occurred in 2004 with the Walt Disney Company. Major shareholders were dissatisfied with the recent performance of Disney under long-time CEO and chairman, Michael Eisner. They began an organized campaign to convince the majority of Disney shareholders to withhold their approval of the reelection of Eisner as director and chairman of the board. When the votes were counted, about 43% of Disney’s shareholders had voted to withhold approval of Eisner. While Eisner technically had won reelection, a 43% “no” vote is practically unprecedented in large public companies. The signal was clear, and an embarrassed Eisner and the Disney board decided that Eisner would remain CEO, but relinquish the chairman title. Shortly thereafter, Eisner announced plans to retire completely in 2006.

**Shareholder Approval.** In addition to electing the directors of the company, shareholders must approve many major actions taken by the board. For example, target shareholders must approve merger agreements and, in some cases, so must bidder shareholders. Even in cases where bidder shareholders are not required to approve a merger directly, listing requirements on the NYSE, for example, demand that shareholders approve any large issue of new shares, such as might be necessary in a stock-swap merger. Normally, approval is perfunctory, but it cannot be taken for granted. As we saw in Chapter 22, after Hewlett-Packard CEO Carly Fiorina negotiated the merger of HP and Compaq, the Hewlett family used their board seats and voting bloc to oppose the deal.

A recent movement, which gained momentum and regulators’ interest during the 2008 financial crisis, is to let shareholders have a “say-on-pay” vote. Typically, this is a non-binding vote to approve or disapprove of the compensation plan for senior executives each year. In 2009, the SEC moved to require recipients of federal bailout money to give shareholders an advisory say-on-pay vote and some legislators planned bills extending this requirement to all public companies. Nonetheless, as of mid-2009, no executive’s pay package had failed to win approval by shareholders, despite shareholder anger over losses during the financial crisis.

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\(^\text{12}\)See D. Levit and N. Malenko, “Non-Binding Voting for Shareholder Proposals,” SSRN working paper (2009), for a theoretical analysis of the informativeness and effectiveness of such votes.

Shareholder Activism at *The New York Times*

The New York Times Company, publisher of *The New York Times*, is closely controlled by the Ochs-Sulzberger family, which owns most of the Class B voting shares, allowing it to elect 70% of the board members. However, in December 2007 and January 2008, two hedge funds working together started acquiring a large stake in the publicly traded Class A shares. The two funds, Harbinger Capital Partners and Firebrand Partners, initially acquired 5% of the shares, subsequently raising the stake to 19%. The funds also filed to nominate four dissident directors to the NYT Co. board, arguing that the *Times* was moving too slowly to develop digital content and should shed non-core assets. After initially resisting, the Company agreed to accept two of the funds’ nominees and the funds withdrew their competing proxy statement. Over the two-month period starting when the funds began their activism, the stock price of the Company increased by close to 30%. This episode is indicative of two emerging trends in investor activism: hedge funds taking a more activist role and working in concert to effect change at a company, and an increased willingness of targeted companies to negotiate a settlement with activists (see Figure 3.2).


**FIGURE 3.2**

Recent Proxy Contest Outcomes

This figure illustrates the outcomes of formal proxy contests for board seats. More companies are choosing to settle with dissidents, rather than take the matter to shareholder vote.

**Proxy Contests.** Perhaps the most extreme form of direct action that disgruntled shareholders can take is to hold a proxy contest and introduce a rival slate of directors for election to the board (see Figure 3.2). This action gives shareholders an actual choice between the nominees put forth by management and the current board and a completely different slate of nominees put forth by dissident shareholders. One early study of proxy contests found that the announcement of a contest increased firm stock price by 8% on average, even if the challenge was eventually unsuccessful and the incumbents won reelection.14

Management Entrenchment

Given the importance of shareholder action in corporate governance, researchers and large investors alike have become increasingly interested in measuring the balance of power between shareholders and managers in a firm. Over time, the tools that managers can use to entrench themselves have evolved, including anti-takeover protections such as those discussed in Chapter 22. The Investor Responsibility Research Center (IRRC) collected information on 24 different characteristics that can entrench, or give more power, to managers vis-à-vis shareholders. These provisions include state anti-takeover statutes, poison pills, staggered boards, and restrictions on the ability of shareholders to call special meetings themselves.

Researchers have begun using data from the IRRC as a way to measure how entrenched managers are. One study found that firms with more restrictions on shareholder power performed worse than firms with fewer restrictions during the 1990s. Other studies have found connections between the degree of entrenchment and the compensation offered to managers, and even to the value of acquisitions made. While the index offered by the IRRC does not capture every aspect of corporate governance, many practitioners are finding it to be a useful summary measure of the degree to which managers are entrenched and less likely to have their actions checked by shareholders.

The Threat of Takeover

Many of the provisions listed in the IRRC index concern protection from takeovers. As we discussed in Chapter 22, one motivation for a takeover can be to replace poorly performing management. When internal governance systems such as ownership, compensation, board oversight, and shareholder activism fail, the one remaining way to remove poorly performing managers is by mounting a hostile takeover. Thus, the effectiveness of the corporate governance structure of a firm depends on how well protected its managers are from removal in a hostile takeover.

An active takeover market is part of the system through which the threat of dismissal is maintained. In fact, some research has suggested that an active takeover market complements a board's own vigilance in dismissing incompetent managers. That research found that boards are actually more likely to fire managers for poor performance during active takeover markets than they are during lulls in takeover activity. This finding also has implications internationally because some countries have much more active takeover markets than others. In particular, hostile takeovers are far more common in the United States than in other countries.

Concept Check

7. Describe and explain a proxy contest.
8. What is the role of takeovers in corporate governance?

3.5 Regulation

So far, we’ve focused on those parts of the corporate governance system that have evolved over time as economic responses to the need for shareholders to mitigate the conflict of interest between themselves and managers. For example, boards of directors came into being long before there was any regulation of the governance of a company, and CEOs have long appointed independent directors to their boards without being required to do so. Nonetheless, from time to time, government has added to existing requirements by passing laws that force minimum standards of governance. A well-known example is the Sarbanes-Oxley Act of 2002 (SOX).

In the wake of the massive failures of large public companies and corporate fraud scandals mentioned in the introduction to this chapter, Congress rushed to enact legislation to fix what it saw as inadequate safeguards against malfeasance by managers of public corporations. The result was the Sarbanes-Oxley Act. Prior to SOX, the largest overhaul of securities markets and introduction of regulation came in response to the stock market crash of 1929 and the Great Depression that followed. The Exchange Acts of 1933 and 1934, among other things, established the Securities and Exchange Commission (SEC) and prohibited trading on private information gained as an insider of a firm.

The Sarbanes-Oxley Act

One of the most critical inputs to the monitoring process is accurate information. If a board of directors has inaccurate information, it cannot do its job. The overall intent of SOX was to improve the accuracy of information given to both boards and to shareholders. We discussed SOX at length in section 8 of Chapter 2. To summarize, SOX had three main components: (1) it overhauled incentives and independence in the auditing process, (2) stiffened penalties for providing false information, and (3) required companies to validate their internal financial control processes.

More specifically, to reduce incentive conflicts in auditing, SOX

- put strict limits on the amount of non-audit fees (consulting or otherwise) that an accounting firm can earn from the same firm that it audits.
- required that audit partners rotate every five years.
- called on the SEC to force companies to have audit committees that are dominated by outside directors and required that at least one outside director have a financial background.

SOX also stiffened the criminal penalties for providing false information to shareholders:

- The CEO and the CFO must personally attest to the accuracy of the financial statements.
- Penalties for providing false or misleading financial statements can be as much as $5 million and imprisonment can be a maximum of 20 years.
- CEOs and CFOs must now return bonuses or profits from the sale of stock or the exercise of options during any period covered by statements that are later restated.

Finally, SOX requires senior management and the boards of public companies to be comfortable enough with the process through which funds are allocated and controlled, and outcomes monitored throughout the firm, to be willing to attest to their effectiveness and validity.
INTERVIEW WITH LAWRENCE E. HARRIS

As Chief Economist of the U.S. Securities and Exchange Commission from 2002 to 2004, Dr. Lawrence E. Harris was the primary advisor to the SEC on all economic issues. He participated extensively in the development of Sarbanes-Oxley (SOX) regulations. Currently Dr. Harris holds the Fred V. Keenan Chair in Finance at the University of Southern California’s Marshall School of Business.

**QUESTION:** Why is legislation such as Sarbanes-Oxley necessary to protect shareholders?

**ANSWER:** Public investors will supply capital to entrepreneurs seeking to fund new business ventures only if they believe it will be used wisely. Regrettably, history has shown that management too often has violated that trust.

The interests of managers and shareholders often conflict. To solve this agency problem, shareholders rely upon information produced by corporate accounting systems. Sarbanes-Oxley mandated accounting and audit standards to improve the quality of corporate financial disclosure.

Opponents of governance regulation believe that shareholders can—and should—take care of themselves. Unfortunately, shareholders often cannot exercise the control necessary to solve agency problems that they could not have anticipated when the firm was first founded. The firm’s governance structure, which may have been sensible when the firm was a small company funded primarily by its founders, may no longer be appropriate for a large, widely held corporation operating in the modern economy. Management with little ownership stake may be entrenched, and the directors may be conflicted. When shareholders cannot solve their agency problems, the government must intervene with the lightest possible hand.

**QUESTION:** What are the costs and benefits of Sarbanes-Oxley?

**ANSWER:** Good corporate disclosure is essential to public finance. SOX improved the quality of disclosure by strengthening accounting and auditing standards. By requiring the CEO and CFO to sign accounts and attest to their accuracy, SOX also put teeth into enforcement if fraud is discovered.

What many people perceive as costs of SOX are really expenditures that weak firms avoided. All well-managed firms must ensure the integrity of their accounting. SOX merely requires that people adopt existing best practice. Many companies were already fully compliant with SOX in most essential respects.

Critics claim that SOX made going public more difficult for small firms by increasing the cost of being a public firm. But a public firm must have secure control mechanisms to protect shareholders. SOX may decrease the number of firms that go public, but it will also decrease the losses suffered by public investors.

SOX established the Public Company Accounting Oversight Board (PCAOB) to regulate auditors. Previous efforts at self-regulation failed because accountants would not discipline their peers. Following numerous notable failures, Congress stepped in and created the PCAOB.

**QUESTION:** Is SOX a good law?

**ANSWER:** Regulators are blamed for failing to regulate when crises occur, but they do not bear the costs of their regulations. This asymmetry often causes them to underestimate the costs of their regulations and thus adopt unnecessary regulations. The problem is greatest when political considerations force Congress to write regulations that would be better written by well-informed specialists in regulatory agencies such as the SEC. Congress wrote SOX in response to the financial accounting crises that greatly offended the public. Although SOX permits the SEC to essentially rewrite any provision that it determines not to be in the public interest, under the circumstances, it could not do so.

SOX is generally good regulation, but it has some notable unintended consequences. The power it gives audit firms over their corporate clients allows them to interpret SOX to their advantage and thereby increase the work necessary to comply with SOX. SOX also imposes unnecessary costs upon mutual funds. Investment companies are subject to SOX because they are public corporations, but they do not face the same accounting problems that operating companies face. In its haste to appease the public, Congress failed to be as discriminating as it could have been.

The Cadbury Commission

It is difficult to determine definitively whether the costs of SOX outweigh its benefits: Even if we could measure the total direct and indirect costs of a law, we could never accurately estimate how much fraud is deterred by that law. One place to turn to for guidance...
is the experiences of other countries. The following quote from *The Independent*\(^{18}\) sounds like it was written to describe the motivation behind the Sarbanes-Oxley legislation:

> Prompted by public concern over a string of unexpected collapses of recently audited firms and over big rises in executive pay, exchanges and public officials rode a wave of public outrage to institute corporate governance reforms to strengthen the independence of the board and address the conflicts of interest in the auditing process.

In actuality, this passage was written near the end of 1991, and it described what happened in the United Kingdom in 1991. Following the collapse of some large public companies, the U.K. government commissioned Sir Adrian Cadbury to form a committee to develop a code of best practices in corporate governance. Sir Cadbury, in introducing his recommendations, reportedly said the following:

> The fundamental issue is one of pressure. There is pressure on the company to show the results that the market expects. There is pressure on the auditors who don't want to lose their jobs. The question is whether a structure can emerge out of the dialogue which is robust enough to give the shareholders what they ought to get and what they can rely upon. Internal controls are a part of the legitimate expectations of those who receive accounts.\(^{19}\)

The problems that the Cadbury Commission identified are the same as those that SOX attempted to address in the United States ten years later. Perhaps not surprisingly, the resulting recommendations were quite similar as well. According to the commission’s findings, audit and compensation committees should be made up entirely of independent directors or, at least, have a majority of them. The CEO should not be chairman of the board, and at the very least there should be a lead independent director with similar agenda-setting powers. Auditors should be rotated, and there should be fuller disclosure of non-audit work. Unlike SOX, these recommendations were not backed up by the force of law. Rather, companies could adopt them or instead explain why they chose not to adopt them in their annual reports. Some researchers have studied firms that adopted the Cadbury recommendations versus those that did not. The results are mixed. While one study found that those firms that separated the position of CEO and chairman performed better, another found no relationship between the independence of key board committees and firm performance in the post-Cadbury era.\(^{20}\)

**Insider Trading**

One aspect of the conflict of interest between managers and outside shareholders that we have not yet addressed is *insider trading*. Insider trading occurs when a person makes a trade based on privileged information. Managers have access to information that outside investors do not have. By using this information, managers can exploit profitable trading opportunities that are not available to outside investors. If they were allowed to trade on their information, their profits would come at the expense of outside investors and, as a

\(^{18}\text{S. Pincombe, “Accountancy and Management: Auditors Look to Pass the Buck as Pressure for Reform Increases,” *The Independent* (London), November 12, 1991, p. 21.}\)

\(^{19}\text{Ibid.}\)

result, outside investors would be less willing to invest in corporations. Insider trading regulation was passed to address this problem.

In the United States, regulation against insider trading traces back to the Great Depression—specifically, to the Exchange Act of 1934. Insiders of a company are defined broadly to include managers, directors, and anyone else who has access to material non-public information, including temporary insiders—for example, lawyers working on a merger deal or commercial printers contracted to print the merger agreement documents. Whether information is material has been defined in the courts as referring to whether the information would have been a significant factor in an investor’s decision about the value of the security. Some examples include knowledge of an upcoming merger announcement, earnings release, or change in payout policy. The law is especially strict with regard to takeover announcements, prohibiting anyone (whether an insider or not) with non-public information about a pending or ongoing tender offer from trading on that information or revealing it to someone who is likely to trade on it.

The penalties for violating insider trading laws include jail time, fines, and civil penalties. Only the U.S. Justice Department—on its own or at the request of the SEC—can bring charges that carry the possibility of a prison sentence. However, the SEC can bring civil actions if it chooses. In 1984, Congress stiffened the civil penalties for insider trading by passing the Insider Trading Sanctions Act, which allowed for civil penalties of up to three times the gain from insider trading.

Martha Stewart and ImClone
A famous recent insider trading case, which was widely reported in the media, involved Martha Stewart, self-made billionaire and CEO of a media empire built around her name. Stewart sold 3928 shares of ImClone Systems in December 2001, just before the Food and Drug Administration announced that it was rejecting ImClone’s application to review a new cancer drug. The SEC investigated, alleging that Stewart sold the shares after receiving a tip from her broker that the ImClone founder and his family had been selling shares. Even though Stewart was not an employee of ImClone, insider trading laws prohibited her from trading on information gained through a tip, as the origin of the information violated the duty of trust. Nonetheless, in the end, Stewart was charged only with lying to a federal officer and conspiracy to obstruct justice (the investigation of her trades). She was convicted and served five months in prison and another five months of home confinement. In addition, she was fined $30,000.


Concept Check
10. What is insider trading, and how can it harm investors?

Corporate Governance Around the World
Most of our discussion in this chapter has focused on corporate governance in the United States. Yet, both the protection of shareholder rights and the basic ownership and control structure of corporations vary across countries. We explore some of those differences here.

Protection of Shareholder Rights
Recent events notwithstanding, investor protection in the United States is generally seen as being among the best in the world. The degree to which investors are protected against expropriation of company funds by managers and even the degree to which their rights are enforced vary widely across countries and legal regimes. In an important study,
researchers collected data on aspects of shareholder rights across more than 30 countries. They claimed that the degree of investor protection was largely determined by the legal origin of the country—specifically, whether its legal system was based on British common law (more protection) or French, German, or Scandinavian civil law (less protection). This purported link between legal origin and investor protection has been challenged by other researchers, however, who demonstrate that formal legal protection for investors is a relatively recent development in Great Britain itself. In the late nineteenth and early twentieth centuries, there was essentially no formal legal protection of minority investors.

Controlling Owners and Pyramids

Much of the focus in the United States is on the agency conflict between shareholders, who own the majority of a firm but are a dispersed group, and managers, who own little of the firm and must be monitored. In many other countries, the central conflict is between what are called “controlling shareholders” and “minority shareholders.” In Europe, many corporations are run by families that own controlling blocks of shares. For most practical purposes, blocks of shares in excess of 20% are considered to be controlling, as long as no one else has any large concentration of shares. The idea is that if you own 20% and the other 80% is dispersed among many different shareholders, you will have considerable say in the operation of the firm; other shareholders would have to coordinate their activities to try to outvote you—a formidable challenge.

In these firms, there is usually little conflict between the controlling family and the management (it is often made up of family members). Instead, the conflict arises between the minority shareholders (those without the controlling block) and the controlling shareholders. Controlling shareholders can make decisions that benefit them disproportionately relative to the minority shareholders, such as employing family members rather than the most talented managers or establishing contracts favorable to other family-controlled firms.

**Dual Class Shares and the Value of Control.** One way for families to gain control over firms even when they do not own more than half the shares is to issue dual class shares—a scenario in which companies have more than one class of shares and one class has superior voting rights over the other class. For example, a class B share might have ten votes for every one vote of a class A share. Controlling shareholders—often families—will hold all or most of the shares with superior voting rights and issue the inferior voting class to the public. This approach allows the controlling shareholders to raise capital without diluting their control. Dual class shares are common in Brazil, Canada, Denmark, Finland, Germany, Italy, Mexico, Norway, South Korea, Sweden, and Switzerland. In the United States, they are far less common. Some countries, such as Belgium, China, Japan, Singapore, and Spain, outlaw differential voting rights altogether.

**Pyramid Structures.** Another way families can control a corporation without owning 50% of the equity is to create a pyramid structure. In a pyramid structure, a family first creates a company in which it owns more than 50% of the shares and therefore has a controlling interest. This company then owns a controlling interest in another company. The investor controls both companies, but may own as little as 25% of the second company.

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the shares of a third company, then the family would control all three companies, even though it would own only 12.5% of the third company. The farther you move down the pyramid the less ownership the family has, but it still remains in complete control of all the companies. Although this example is stylized, a variety of pyramid structures based on this idea are quite common outside the United States.

Figure 3.3 details the actual pyramid controlled by the Pesenti family in Italy as of 1995. The Pesenti family effectively controls five companies primarily concentrated in the construction industry—Italmobiliare, Italcementi, Franco Tosi, Cementerie Siciliane, and Cementerie de Sardegna—even though it does not have more than 50% ownership of any one of them. In this case, the family uses a pyramid structure plus shares with special voting rights to control companies even when its ownership share is as little as 7%.

A controlling family has many opportunities to expropriate minority shareholders in a pyramid structure. The source of the problem is that as you move down the pyramid, the difference between the family’s control and its cash flow rights increases. Cash flow rights refer simply to the family’s direct ownership stake and, therefore, the portion of the cash flows generated by the firm that the family has a right to. Notice that Italcementi gets 74% of the dividends of Cementerie Siciliane; Italmobiliare gets 32% of the dividends of Italcementi. Finally, the Pesenti family has rights to 29% of the dividends of

FIGURE 3.3
Pesenti Family Pyramid, 1995

Each box contains both ownership and voting rights (which can differ when preferred stock with superior voting rights is used). The first set of numbers (in blue) indicates the rights of the preceding company one step up the pyramid. The second set of numbers (in red) shows the effective rights of the Pesenti family in that company. For example, Italmobiliare controls Italcementi through its 54% voting block, but it owns only 32% of the company. The Pesenti family’s investment in Italmobiliare gives it a 10% ownership of Italcementi but, because it is controlled by Italmobiliare, 45% of the effective voting rights in Italcementi.

Italmobiliare. Thus, the family receives only \(29\% \times 32\% \times 74\% = 7\%\) of the dividends of Cementerie Siciliane but still controls it.

A conflict of interest arises because the family has an incentive to try to move profits (and hence dividends) up the pyramid—that is, away from companies in which it has few cash flow rights and toward firms in which it has more cash flow rights. This process is called tunneling. An example of how this might occur is if the Pesenti family would have Cementerie Siciliane enter into an agreement to be supplied by Italmobiliare at prices that are extremely favorable to Italmobiliare. Such a move would reduce Cementerie Siciliane’s profits and increase Italmobiliare’s profits.

Of course, if you are a minority shareholder in one of these subsidiaries, you would rationally anticipate this expropriation and so you would pay less for the shares of firms in which a family has control, especially if it is low in the pyramid. In effect, you would factor in your expected loss from being a minority shareholder rather than a controlling shareholder. Many studies have confirmed this intuition, finding sharp differences between the value of controlling blocks and minority shares.\(^{24}\) Thus, controlling shareholders pay for their control rights because the firm effectively faces a higher cost of equity for outside capital.

### The Stakeholder Model

The agency costs and the ways to control them that we have discussed are general to all companies anywhere in the world. However, the United States is somewhat of an exception, in that it focuses solely on maximizing shareholder welfare. Most countries follow what is called the **stakeholder model**, giving explicit consideration to other stakeholders—in particular, rank-and-file employees. As noted earlier, countries such as Germany give employees board representation. Others have mandated **works councils**, local versions of labor unions that are to be informed and consulted on major corporate decisions. Finally, some countries mandate employee participation in decision making in their constitutions. Table 3.1 summarizes employee standing in the governance of firms in some OECD (Organization for Economic Co-operation and Development) countries.

### Cross-Holdings

While in the United States it is rare for one company’s largest shareholder to be another company, in many countries, such as Germany, Japan, and South Korea, it is the norm. In Japan, groups of firms connected through cross-holdings and a common relation to a bank are known as **keiretsu**. Monitoring of each company comes from others in the group holding blocks of its stock and primarily from the main bank of the group, which as a

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TABLE 3.1
Employee Participation in Corporate Governance in OECD Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Employees Appoint Some Board Members</th>
<th>Works Councils Mandated by Law</th>
<th>Constitutional Reference to Employee Participation in the Management of the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Austria</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Belgium</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Canada</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Denmark</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Finland</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>France</td>
<td>No</td>
<td>Yes</td>
<td>Constitutional right</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Greece</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Hungary</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Ireland</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Italy</td>
<td>No</td>
<td>No</td>
<td>Constitutional right</td>
</tr>
<tr>
<td>Japan</td>
<td>No</td>
<td>No</td>
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<tr>
<td>Mexico</td>
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<tr>
<td>Netherlands</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>New Zealand</td>
<td>No</td>
<td>No</td>
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<tr>
<td>Norway</td>
<td>Yes</td>
<td>No</td>
<td>Constitutional right</td>
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<tr>
<td>Poland</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>Portugal</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Slovak Republic</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>South Korea</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Spain</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Sweden</td>
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<td>Switzerland</td>
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<tr>
<td>Turkey</td>
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<td>No</td>
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<tr>
<td>United Kingdom</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>United States</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

*Source: Organization for Economic Co-operation and Development, Survey of Corporate Governance Developments in OECD Countries (2004).*

creditor monitors the financial well-being of the group companies closely. In South Korea, huge conglomerate groups such as Hyundai, Samsung, LG, and SK comprise companies in widely diversified lines of business and are known as chaebol. For example, SK Corporation has subsidiary and group companies in energy, chemicals, pharmaceuticals, and telecommunications. An important difference between the South Korean chaebol and the Japanese keiretsu is that in South Korea the firms do not share a common relationship with a single bank.

**Concept Check**

11. How does shareholder protection vary across countries?
12. How can a minority owner in a business gain a controlling interest?
The Trade-Off of Corporate Governance

Corporate governance is a system of checks and balances that trades off costs and benefits. As this chapter makes clear, this trade-off is very complicated. No one structure works for all firms. For example, it would be hard to argue that having Larry Page as a controlling shareholder of Google was bad for minority investors. For Google, the alignment of incentives assured by Larry Page’s large stake in Google appeared to outweigh the costs of having such a large shareholder. In other cases, however, this is unlikely to be true.

The costs and benefits of a corporate governance system also depend on cultural norms. Acceptable business practice in one culture is unacceptable in another culture, and thus it is not surprising that there is such wide variation in governance structures across countries.25

It is important to keep in mind that good governance is value enhancing and so, in principle, is something investors in the firm should strive for. Because there are many ways to implement good governance, one should expect firms to display—and firms do display—wide variation in their governance structures.

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### 3.3 Compensation Policies
- By tying managers’ compensation to firm performance, boards can better align managers’ interests with shareholders’ interests. Care must be taken to make sure managers do not have incentives to try to manipulate the firm’s stock price to garner a big compensation payout.

### 3.4 Managing Agency Conflict
- Ownership of a company’s stock by management can reduce managers’ perquisite consumption. However, moderate holdings of shares can have a negative effect by making the managers harder to fire (reducing the threat of dismissal), without fully aligning their interests with those of shareholders.
- If a board fails to act, shareholders are not without recourse. They can propose an alternate slate of directors or vote not to ratify certain actions of the board.
- A board and management can adopt provisions, such as staggered boards and limitations on special shareholder meetings, that serve to entrench them. These provisions also have the effect of limiting the efficacy of a hostile takeover bid.
- Despite the defenses that a determined management can erect, one source of the threat of dismissal comes from a hostile acquirer, which can take over a firm and fire the management, even if the board fails to do so.

### 3.5 Regulation
- Regulation is an important piece of the total corporate governance environment. Regulation can be beneficial by reducing asymmetric information between managers and capital providers and thus reducing the overall cost of capital. Regulation also carries with it costs of compliance and enforcement. Good regulation balances these forces to produce a net benefit for society.
- The most recent overhaul of U.S. governance regulation is the Sarbanes-Oxley Act of 2002. The act was intended to improve shareholder monitoring of managers by increasing the accuracy of their information.
- It overhauls incentives and independence in the auditing process.
- It stiffens the penalties for providing false information.
- It forces companies to validate their internal financial control process.
- The Exchange Acts of 1933 and 1934 are the basis of insider trading regulation. Over time, the SEC and the courts have developed interpretations of the law that:
  - Prohibit insiders with a fiduciary duty to their shareholders from trading on material non-public information in that stock.
  - Prohibit anyone with non-public information about a pending or ongoing tender offer from trading on that information or revealing it to someone who is likely to trade on it.
### 3.6 Corporate Governance Around the World

- Corporate governance, regulations, and practices vary widely across countries.
- Some studies suggest that countries with common-law roots generally provide better shareholder protection than countries with civil-law origin.
- Ownership structures in Europe and Asia often involve pyramidal control of a group of companies by a single family. In these situations, the controlling family has many opportunities for expropriation of minority shareholders through tunneling.
- Dual class shares with differential voting rights allow a controlling shareholder or family to maintain control of a company or group even if their cash flow rights are relatively small. Dual class shares are common outside the United States.
- Most countries give employees some role in governing a firm. Employee involvement usually takes the form of board seats or works councils that are consulted before major decisions.
- It is common outside the United States for a company's largest shareholder to be another company. These cross-holdings create incentives for firms to monitor each other.

### 3.7 The Trade-Off of Corporate Governance

- It is important to keep in mind that good governance is value enhancing and so, in principle, is something investors in the firm should strive for. Because there are many ways to implement good governance, one should expect firms to display—and firms do display—wide variation in their governance structures.

### Critical Thinking

1. Why is governance important in a corporation?
2. Why would a gray director be compromised as a monitor?
3. Why can we not simply rely on regulators to monitor managers?
4. How can compensation design help mitigate agency problems?
5. Why is managerial ownership not always value improving?
6. What are shareholders’ options to confront managers who they believe are damaging shareholder value?
7. Should insider trading be illegal?
8. How is it possible for an entity with low cash flow interest in a company to exercise control?
All problems in this chapter are available in MyFinanceLab.

Corporate Governance and Agency Costs

1. What inherent characteristic of corporations creates the need for a system of checks on manager behavior?
2. What are some examples of agency problems?
3. What are the advantages and disadvantages of the corporate organizational structure?

Monitoring by the Board of Directors and Others

4. What is the role of the board of directors in corporate governance?
5. How does a board become captured by a CEO?
6. What role do security analysts play in monitoring?
7. How are lenders part of corporate governance?
8. What is a whistle-blower?

Compensation Policies

9. What are the advantages and disadvantages of increasing the options granted to CEOs?

Managing Agency Conflict

10. Is it necessarily true that increasing managerial ownership stakes will improve firm performance?
11. How can proxy contests be used to overcome a captured board?
12. What is a say-on-pay vote?
13. What are a board’s options when confronted with dissident shareholders?

Regulation

14. What is the essential trade-off faced by government in designing regulation of public firms?
15. Many of the provisions of the Sarbanes-Oxley Act of 2002 were aimed at auditors. How does this affect corporate governance?
16. What are the costs and benefits of prohibiting insider trading?
17. How do the laws on insider trading differ for merger- versus non-merger-related trading?

Corporate Governance Around the World

18. Are the rights of shareholders better protected in the United States or in France?
19. How can a controlling family use a pyramidal control structure to benefit itself at the expense of other shareholders?