

**CORPORATE  
OWNERSHIP & CONTROL**

**КОРПОРАТИВНАЯ  
СОБСТВЕННОСТЬ И КОНТРОЛЬ**

Postal Address:

Postal Box 36  
Sumy 40014  
Ukraine

Tel: +380-542-611025  
Fax: +380-542-611025  
e-mail: [alex\\_kostyuk@mail.ru](mailto:alex_kostyuk@mail.ru)  
[alex\\_kostyuk@virtusinterpress.org](mailto:alex_kostyuk@virtusinterpress.org)  
[www.virtusinterpress.org](http://www.virtusinterpress.org)

Journal Corporate Ownership & Control is published four times a year, in September-November, December-February, March-May and June-August, by Publishing House "Virtus Interpress", Kirova Str. 146/1, office 20, Sumy, 40021, Ukraine.

*Information for subscribers:* New orders requests should be addressed to the Editor by e-mail. See the section "Subscription details".

*Back issues:* Single issues are available from the Editor. Details, including prices, are available upon request.

*Advertising:* For details, please, contact the Editor of the journal.

*Copyright:* All rights reserved. No part of this publication may be reproduced, stored or transmitted in any form or by any means without the prior permission in writing of the Publisher.

*Corporate Ownership & Control*

ISSN 1727-9232 (printed version)  
1810-0368 (CD version)  
1810-3057 (online version)

Certificate № 7881

*Virtus Interpress. All rights reserved.*

Почтовый адрес редакции:

Почтовый ящик 36  
г. Сумы, 40014  
Украина

Тел.: 38-542-288365  
Факс: 38-542-288365  
эл. почта: [alex\\_kostyuk@mail.ru](mailto:alex_kostyuk@mail.ru)  
[alex\\_kostyuk@virtusinterpress.org](mailto:alex_kostyuk@virtusinterpress.org)  
[www.virtusinterpress.org](http://www.virtusinterpress.org)

Журнал "Корпоративная собственность и контроль" издается четыре раза в год издательским домом Виртус Интерпресс, ул. Кирова 146/1, г. Сумы, 40021, Украина.

*Информация для подписчиков:* заказ на подписку следует адресовать Редактору журнала по электронной почте.

*Отдельные номера:* заказ на приобретение отдельных номеров следует направлять Редактору журнала.

*Размещение рекламы:* за информацией обращайтесь к Редактору.

*Права на копирование и распространение:* копирование, хранение и распространение материалов журнала в любой форме возможно лишь с письменного разрешения Издательства.

*Корпоративная собственность и контроль*

ISSN 1727-9232 (печатная версия)  
1810-0368 (версия на компакт-диске)  
1810-3057 (электронная версия)

Свидетельство КВ 7881 от 11.09.2003 г.

*Виртус Интерпресс. Права защищены.*

## EDITORIAL

*Dear readers!*

This issue of the journal is devoted to several issues of corporate governance.

*Alexander M. Dühnfort, Christian Klein, Niklas Lampenius* review some of the initial ideologies regarding corporate governance, focusing in particular on the – in the literature dominating – Principal-Agent-Approach. They detail the implied assumptions and the thereof resulting consequences for corporate governance, including some resulting inconsistencies. Overall, they find that in the **discussion about ‘Corporate Governance’ the often referred to principal-agent-conflict is rarely defined with the necessary rigor, but find that the model seems to be applied to almost any situation loosely tied to the topic of corporate governance.**

*Nazrul Hisyam Ab Razak, Rubi Ahmad, Huson Joher Aliahmed* examine the impact of an alternative ownership/control structure of corporate governance on firm performance among government linked companies (GLCs) and Non-GLC in Malaysia. It is believed that government ownership serve as a monitoring device that lead to better company performance after controlling company specific characteristics. **They used Tobin’s Q as market performance measure while ROA is to determine accounting performance measure.** This study is based on a sample of 210 firms over a period from 1995 to 2005. They use panel based regression approach to determine the impact of ownership mechanism on **firm’s performance. Findings appear to suggest that there is a significant impact of government ownership on company performance after controlling for company specific characteristics such as company size, non-duality, leverage and growth. The finding is off significant for investors and policy maker which will serve as a guiding for better investment decision.**

*Michael Maingot, Daniel Zéghal* observe changes to the boards of directors, to the committees reporting to **the board, to the board of directors’ independence and adoption to certain charters and checklists in Canadian banks for the periods covering the years 2002-2004.** Our sample covers the eight largest domestic banks in Canada. Results indicate a reduction in board members and in the number of committees reporting to the board. However, it increased supervision by increasing the number of board committee meetings. Most of the banks in our sample have separated the role of Chairman and CEO, thereby increasing the independence of the board. There was also an improvement in the adoption of a new charter for the board of directors.

*Andrea Graf, Markus Stiglbauer* research an increasing demand for methods enabling investors to compare companies by means of country-specific

criteria. However, measures in Germany do not provide a broad spectrum of criteria for evaluating corporate compliance and governance transparency & disclosure. Their framework covers all rules of the German Corporate Governance Code as well as additional criteria, enabling investors to analyse how companies are managed. Furthermore, they raise quality criteria of social sciences to confirm our findings.

*Chia-Wei Chen, J. Barry Lin, Bingsheng Yi* examine how multiple directorships held by outside directors (busy outside directors) influence shareholder wealth in diversifying acquisitions. With a sample of 893 diversifying acquisitions from 1998 to 2004, they find a negative (positive) busy-director effect for diversifying acquisitions of public-targets (private-targets). Busy directors are negatively (positively) associated with the five-day cumulative abnormal returns in acquisitions involving public (private) targets, where merger-related agency problems are more likely. Their evidence support the notion that, in the case of diversifying acquisitions, increased managerial monitoring plays a more important role versus enhanced advising and business connection from busy directors.

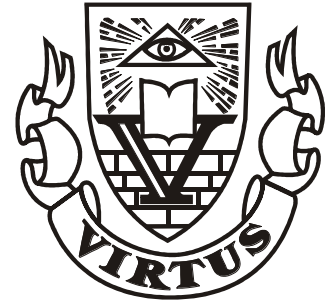
*C.N.V. Krishnan, Paul A. Laux* find that large-market-share law firms are regularly called upon to facilitate completion of large, legally-complex offers. Complex offers are often withdrawn but, controlling for complexity, large-share law firms are associated with enhanced deal completion. Further, they document that some law firms are consistently associated with deal completion over time, and that acquirers with good deal completion experience use **fewer different law firms. Acquirers’ risk-adjusted returns, though, are smaller around announcements of offers advised by large-share law firms. Post-offer long-run returns of the acquirers are also lower and often negative following offers advised by large-share law firms.** We find no evidence that particular law firms are consistently associated over time with strong returns. Our conclusion is that large law firms enhance deal completion in difficult situations, consistent with the aims of acquirer management. However, they find no systematic evidence that these popular law firms act as **“gatekeepers” in the sense of not wanting to be associated with value-destroying deals.**

*Theo Lynn and Mark Mulgrew* examine whether Irish occupational pension funds and investment managers use voting, engagement and intervention as monitoring strategies in relation to investee companies. Furthermore, the article examines whether there are significant differences in attitudes between the two groups across key themes relating to shareholder activism by occupational pension funds in order to identify whether potential agency problems may exist in relation to delegation and representation. The results of the research suggest low levels of monitoring by Irish occupational pension funds compared to investment managers which could be explained by delegation.

# CORPORATE OWNERSHIP & CONTROL

Volume 6, Issue 2, Winter 2008 (Continued - 4)

## CONTENTS



<b>Editorial</b>	<b>422</b>
<hr/>	
<b>THEORETICAL FOUNDATIONS OF CORPORATE GOVERNANCE REVISITED: A CRITICAL REVIEW</b>	<b>424</b>
<i>Alexander M. Dühnfort, Christian Klein, Niklas Lampenius</i>	
<b>GOVERNMENT OWNERSHIP AND PERFORMANCE: AN ANALYSIS OF LISTED COMPANIES IN MALAYSIA</b>	<b>434</b>
<i>Nazrul Hisyam Ab Razak, Rubi Ahmad, Huson Joher Aliahmed</i>	
<b>THE ADJUSTMENTS OF CORPORATE GOVERNANCE MECHANISMS IN CANADIAN BANKS FOLLOWING REGULATORY CHANGES</b>	<b>443</b>
<i>Michael Maingot, Daniel Zéghal</i>	
<b>MEASURING CORPORATE GOVERNANCE IN GERMANY: AN INTEGRATED FRAMEWORK ON COMPLIANCE AND TRANSPARENCY &amp; DISCLOSURE</b>	<b>456</b>
<i>Andrea Graf, Markus Stiglbauer</i>	
<b>TWO FACES OF BUSY OUTSIDE DIRECTORS</b>	<b>467</b>
<i>Chia-Wei Chen, J. Barry Lin, Bingsheng Yi</i>	
<b>LEGAL ADVISORS: POPULARITY VERSUS ECONOMIC PERFORMANCE IN ACQUISITIONS</b>	<b>475</b>
<i>C.N.V. Krishnan, Paul A. Laux</i>	
<b>PRELIMINARY EVIDENCE FROM MONITORING ACTIVITIES BY PENSION FUNDS AND INVESTMENT MANAGERS AND ATTITUDES TOWARDS SHAREHOLDER ACTIVISM BY PENSION FUNDS</b>	<b>501</b>
<i>Theo Lynn, Mark Mulgrew</i>	

# THEORETICAL FOUNDATIONS OF CORPORATE GOVERNANCE REVISITED: A CRITICAL REVIEW

*Alexander M. Dühnfort, Christian Klein\*, Niklas Lampenius*

## Abstract

In this paper we review some of the initial ideologies regarding corporate governance, focusing in particular on the – in the literature dominating – Principal-Agent-Approach. We detail the implied assumptions and the thereof resulting consequences for corporate governance, including some resulting inconsistencies. Overall, we find that in the **discussion about ‘Corporate Governance’ the often referred to principal-agent-conflict is rarely defined with the necessary rigor, but find that the model seems to be applied to almost any situation loosely tied to the topic of corporate governance.** We conclude that due to the missing theoretical rigor and the missed developments in the area of management theory the resulting corporate governance policy recommendations are often inconsistent and that the commonly applied theoretical framework for corporate governance discussions might not be the most suitable one for policy recommendations as well as for regulatory actions.

**Keywords:** corporate governance, theory, agents, principals

*\*Corresponding author. Lehrstuhl für Rechnungswesen und Finanzierung Institut für Betriebswirtschaftslehre (510 C) Universität Hohenheim, 70593 Stuttgart. cklein@uni-hohenheim.de*

## I. Theoretical foundations of corporate governance

Despite the dominance of the US-American school of thought in the corporate governance debate,<sup>1</sup> there are numerous approaches for the explanation and organization of corporate governance (Nippa, 2002), where most often the allocation of power and competence in the enterprise institutions is assumed to follow the American legal and political system. Hawley and Williams (1997) suggest a basic distinction between four different schools of thought, the principal-agent theory (the dominating approach), the stewardship approach, the stakeholder- approach, and the political approach. Despite the diversity of theories, their share in the debate varies and the principal agent theory plays a dominating role in the overall debate. We, in the following, focus on principal agent theory given its dominance in the ongoing debate regarding corporate governance. For a comprehensive overview on principal agent theory refer to Jost (2001b), Bamberg and Spremann (1989), Hay (2000, pp. 209), Meinhövel (1999, pp. 175), Suter (2000, p. 47), or Picot et al. (1999). In general, principal agent problems are the basis for “principal-agent theory” (PAT)<sup>2</sup>, Starting-point of PAT is the analysis of procedures that originate from the assignment of duties

and responsibilities (by principals) to other people (agents) when dividing labor (Meinhövel, 1999, p.7).

Furthermore, the design of monitoring and incentive systems is addressed, here the focus is on streamlining of interests of the agent – who has an informational advantage over the principal – with the principals’ interest – who is at an informational disadvantage (Schmidt and Terberger, 1997, p. 398). The model proposes the existence of relationships, which can be expressed as contracts between two individuals (principal and agent), where the agent commits himself to supply a service for the principal in exchange for a compensation. Both parties seek to maximize utility (Macharzina, 1995, p. 57). Adopted to a corporate governance context the principal-agent relationship is interpreted as the result of the separation of ownership (the investors) and control (the management), with the effect that in this complex environment it is impossible to capture all possible aspects contractually, i.e. the contracts are incomplete (Berle and Means, 1932; Coase, 1937; Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Boot and Macey, 1999; Jost, 2001a, 2001b).

One of the main elements of PAT is the concept of „agency-costs“. The concept is based on property rights theory (e.g. Demsetz, 1967) where the following central characteristics are assumed to hold:

- Goods are produced with multiple input factors
- Input factors are provided by multiple owners
- There exists a party that appears in all contracts (contractor)
- The contractor is entitled to renegotiate one single input factor, irrespective of the contracts concerning other input factors

<sup>1</sup> According to Shleifer and Vishny, „corporate governance mechanisms“ should be understood as “economic and legal institutions that can be altered through the political process”(Shleifer and Vishny, 1997)

<sup>2</sup> According to Jensen (1983, pp. 334) the principal-agent theory can be divided into „positive“ and a „normative“ school of thought. We focus on the positive principle-agent theory, as it plays a dominant part in the corporate governance debate.

- The contractor has the claim on the residual income
- The contractor has the right of selling his/her claim on the residual income

According to property rights theory it is extremely expensive (if not impossible) to map every singular relationship between owner and management to contracts in order to dissolve possible conflicts.

Therefore it is necessary to establish a structure to monitor the management. Separating ownership and management as a consequence induces costs as the principal has to streamline managerial action with his own objectives. These possible costs (for both parties) of the resulting state of uncertainty are referred to as „agency costs“ (Jensen and Meckling, 1976; Macharzina, 1995, pp. 57) and can be differentiated into monitoring costs, bonding costs, and residual loss (Meinhövel, 1999, p. 42). The overall goal is to minimize these costs. To achieve minimization a model is needed which allows the calculation of the respective costs and benefits. Jensen and Meckling (1976) provide such a model based on a contribution by Alchian and Demsetz (1972) and on very restrictive assumptions<sup>3</sup>, where the model is heavily dependent on the enterprise value as a result of the behavior of both parties. Agency costs are derived indirectly through the difference in equity value for a company with and without a monitoring system for the management. It is argued that managerial behavior changes if the managers' share in the company is reduced. A reduction of participation in the equity development then results in a higher consumption of resources by the manager or alternatively to a reduced dedication to corporate issues until the marginal utility of consumption is considered to be equal to the marginal utility of the foregone profit by the manager.<sup>4</sup> As a result managers with reduced profit sharing will consume more or achieve less, until an optimum is reached (Meinhövel, 1999, pp. 42). Given that potential shareholders are aware of this relationship they will pay more for the share if this managerial reaction could be ruled out – the difference in price is defined as agency costs. An underlying assumption for this proposition is that the individual risk preferences

and utility functions are known (Jensen and Meckling, 1976; Demougin and Jost, 2001, pp. 47).

Fama (1980) pursues an approach which analyzes the efficiency and viability of companies that separate ownership and management, where the separation is based on a characterization by Berle and Means (1932). Fama's approach is mainly based on the work of Alchian and Demsetz, where the company is seen as a set of contracts<sup>5</sup> with a „coordinator“<sup>6</sup> as central contractor who has the privilege to renegotiate contracts and a person with claims on the residual who is also capable of selling the residual claim. He assesses the transfer from a shareholder controlled to a manager controlled company, where costs that exceed the contractually agreed level of consumption are not sustained by the manager alone any more.

Based on Jensen and Meckling's approach to agency costs Fama evaluates conditions under which the manager assumes the discrepancy from the contractually fixed level of consumption, i.e. suffers economically if the contractual agreements are violated. The aim is to pass on all the generated costs to the agent, i.e. giving the agent the option of maximizing individual utility, and as a consequence the contractually fixed level of consumption does not need to be taken into further consideration, as it has already been accounted for by a reduced income of the manager. This is a necessary precaution since value destroying behavior will not be detected immediately as shareholders tend to diversify and cannot concern themselves with all internal details of each single venture in which they are invested (Fama, 1980, p. 291).

Given the diversification of equity holders the supervisory body, represented by the corporate board, is then directly responsible for monitoring activities, where apart from the company board members external members also have the opportunity to monitor the management. According to Fama (1980, pp. 293), internal supervisors which are members of the board have the advantage of having enhanced interest in the part-taking of monitoring activities given that discovering incompetence can be beneficial to their own career. This proposition fails, if board members collaborate in securing their own interests. In this case, external supervisors should be preferred, as they are highly qualified to supervise corporate top

<sup>3</sup> Permanent assumptions: all taxes are reduced to zero; debt is unavailable; all shares held by outsiders are nonvoting stock; it is not possible to issue convertible bonds, warrants or preference shares; no outside shareholder benefits from his share other than through the effects on company value or cash flows; dynamic aspects of multiple periods are ignored given that only a single financing decision has to be taken by the entrepreneur; the reimbursement of the owner-manager is constant; there is only a single manager (peak coordinator) with residual claims on the company; Non-permanent assumptions: company size is constant; monitoring is not possible; financing through external capital is not possible (Jensen and Meckling, 1976).

<sup>4</sup> Jensen and Meckling also include the consumption of non-monetary utility from i.e. the dimension of the office, air conditioning, thickness of the carpet, quality of relationships of the employees (Jensen and Meckling, 1976).

<sup>5</sup> “The firm is viewed as a set of contracts among factors of production, with each factor motivated by its selfinterest” (Fama, 1980, p. 289). “The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people” (Alchian and Demsetz, 1972, p. 777), “[...] and a centralized position of some party in the contractual arrangements of all other inputs” (Alchian and Demsetz, 1972, p. 778).

<sup>6</sup> This corresponds to the manager administering property rights and is borrowed from Alchian and Demsetz's (1972) terminology. His counterpart is the risk-bearer, which is, according to Fama, not the owner/shareholder but, as property is indeterminable, an abstract lobby group that bears the risk invoked by management operations (Fama, 1980, p. 290).

management given their own management activities. He further states that the cost effectiveness of the monitoring mechanisms is the responsibility of the board, i.e. “the Role of the board [...] is to provide relatively low-cost mechanism for replacing or reordering top managers” (Fama, 1980, p. 294). Fama (1980, pp. 295) overall expects a market effect that prevents the abuse of consumption at the workplace, when malpractice of the agent is governed through monetary incentives, such as for instance a contract which includes possible future work relationships or sanctions for diverging behavior. Fama (1980, pp. 296) postulates three necessary conditions to meet this directive:

- Information regarding the manager is derived from achievement in the past and present
- Appropriate evaluation of this information through the market
- The resulting consequences are powerful enough to achieve the desired effect on the manager

Based on the dependency of the future pay on present deviations from the optimal path the manager will abide to the contractually fixed level of consumption. If management is compensated, e.g. according to his marginal utility, costs will be rolled over to the agent in the long run (Fama, 1980, pp. 298; Meinhövel, 1999, p. 47).

## II. Contemporary issues with the theoretical foundations of corporate governance

Given the dominance of PAT (Jensen 1993; Jensen and Meckling; 1976; 1979) in the corporate governance debate, it is important to state that the assumptions for PAT are not a reflection of reality but are necessary to obtain a consistent theoretical framework. Observing the policy making on the other hand, it seems as if PAT is utilized to derive corporate governance policy despite its restrictive assumptions. This implies a faulty application of the theory on the one hand and does on the other hand indicate that policy making will potentially not be achieving what it initially was intended for. We in the following illustrate some of the assumptions and the implied consequences.

### A. Utility aspects

PAT in general is formulated as static model without the recognition of trust or information benefits from previous encounters. Information regarding the contracting partner is solely determined through information acquisition and evaluation of the concurrent contract. The common contractual negotiation phase, and thereby potential competitive advantages of either side, is entirely ignored. Additionally, the theory focuses mainly on monetary aspects such as fixed and variable wages or profit-sharing; aspects such as quality of output, work conditions/environment, sanctions, etc. are not part of the contracts. The agent is simply viewed as reactionist to the contractual agreement and is expected to adjust

the individual work effort, where the only market imperfection is information asymmetry regarding the completion of the task (Meinhövel, 1999, p. 122). PAT does also not include thoughts regarding the measurement of the work effort or the work quality of the agent. Traditionally it is assumed that higher work effort does lead to better results, which might not hold for all instances since activities exist that do cause higher work effort but do not increase utility, such as an increased research level that leads to a flood of noninterpretable information (Meinhövel, 1999, p. 135). Finally, motivational aspects such as non-monetary rewards from potentially expected promotions are disregarded, although for various situations<sup>7</sup> the change from being an agent to being a principal indicates that disregarding motivational aspects, particularly when considering motivational factors in long-term contractual agreements, seems problematic (Meinhövel, 1999, pp. 136). This argument is further strengthened given some experimental evidence indicating the relevance of motivational aspects (Sliwka, 2003). Overall, we are of the opinion that utility aspects are assigned too much importance given that the sole focus of the model is on the loss of utility. This implies that various other aspects of contractual agreements are ignored. A valid reason for hiring managers might for instance be the fact that they are more efficient at the task at hand (Schneider, 1995, p. 278), implying utility in the sense of time savings given the same output quality or economies of scale. In addition, frictions such as legal requirements might necessitate the hiring of a specialist, e.g. CPAs, tax accountants, or lawyers.

### B. Contractual agreements

Problematic are also the contradicting views of PAT on contractual obligations and the completion thereof. On the one hand, PAT assumes that contractual obligations are fulfilled according to the maxim „pacta sunt servanda“ (Neus, 1989, p. 10). On the other hand, PAT assumes the violation, at least partially, of some of the contractual obligations by the agent to compensate for the lost utility due to the contractual agreement.<sup>8</sup> The definition of the content of the contracts including a detailed list of all obligations of both sides of the contractual terms therefore seems of utter importance to allow for an effective enforcement. Further supporting the notion of detailed contracts is that for loosely defined contracts a violation of contractual obligations could be caused by a variety of other aspects not tied to the intentional breach of contract, such as for instance a perceived violation by the principal due to the principal’s inability to appropriately voice his/her intentions in the contractual agreement or a general misunderstanding of the contracting partners. As a result, such detailed contracts require a high level of knowledge regarding

<sup>7</sup> Such as a promotion of a lawyer from associate to the partner level of a law firm (Ferrall, 1990)

<sup>8</sup> Jensen and Meckling (1976) refer mainly to a reduced work effort.

the activities of the agent. The highly specialized work environments often result in agents being better informed regarding the task at hand than the principal leading to increased difficulties for the principal when formulating the contracts. Given these difficulties, implicit contracts<sup>9</sup> are supposed to alleviate the problem. Implicit contracts assume that the contractual agreement does not focus on the factual contractual content but on the intended content by the contracting parties. As a result the contracting parties have to consent on a particular utility level without an explicit formulation or negotiation of the latter. This informal contract does not allow for a substantial enforcement (legally or methodologically) (Meinhövel, 1999, p. 142). As a consequence the maxim “*pacta sunt servanda*” should be disregarded and contractual violations should be distinguished according to the inability to fulfill the contract, the impossibility to fulfill the contract, or the unwillingness to fulfill the contract, given that contract analysis studies indicate that for unforeseen incidents adhering to the fulfillment of contractual obligations is often suboptimal (Schäfer and Ott, 1995, pp. 371).

Last but not least, PAT ignores the value of the completion of a task to the principal entirely (Meinhövel, 1999, p. 139). This is of particular interest for cases where the principal has a personal interest in an adequate completion of the task. Minimal task requirements have, given a personal interest, no value to the principal. For a successful completion of the task minimal task requirements have then to be included in the contract to ensure that the detrimental impact of substandard task completion does not occur.

### C. Agency costs

The concept of agency cost based on the idea of „residual loss“ is criticized on the basis that measuring the maximal possible utility for the principal is difficult. Further, the difference between the factual and the maximal possible monetary utility is not known, and the only situation where this difference can be determined is when the optimal task completion is observable, i.e. if opportunity costs are factually existent and not just part of a fictive calculation. The existence of such opportunity costs would imply that the conditions for a competitive equilibrium are given and the equilibrium could be utilized as predictor for the maximal possible utility. The conceptual problem is that for competitive markets there is no information asymmetry and agency costs would then be zero, i.e. whenever opportunity costs are observable there is no control necessary since agency cost are zero and whenever the opportunity costs are not observable (necessitating a measure of control) agency costs cannot be determined (Schneider, 1995, pp. 278). Further criticism could include that the assumed agency cost relations are not explained or reasoned for

(Swoboda, 1991, p. 195) but non-monetary utility is derived and that taxation issues are ignored entirely.

### D. Market assumptions

In general the underlying market form regarding the principal-agent interaction is assumed to be a bilateral monopoly. A critical evaluation of this bold statement yields that this does not hold for all instances. It seems plausible for instance to assume a monopolistic situation in favor of the agent for some instances, e.g. due to particular skills, and vice versa for other situations. A monopolistic advantage of the agent would reduce the utility maximization potential of the principal drastically (Meinhövel, 1999, p. 121). Also, the lack of homogeneous information in these negotiations yields additional problems when utilizing traditional pricing theory, even necessitating the acknowledgement of the existence of alternative market environments for principal and agent before the signing of a contract (Meinhövel, 1999, p. 122). Finally, the traditionally assumed separation theorem does not hold for PAT problems, necessitating the evaluation and integration of the market structure when modeling the principal-agent relationship (Terberger, 1994, pp. 160).

Additionally, a fair and independent auction administrator is necessary for the formation of a price and, given it exists, the equilibrium (Schneider, 1995, p. 292). To be able to determine the equilibrium price a kind of „order book“ summarizing the demand and supply is necessary. Market transactions at a price in disequilibrium are excluded from the model on theoretical grounds and an equilibrium price on the contrary is the very unlikely event where all market participant have correctly decided on their forecast of the other market participants output. Further, it is assumed that investments can be split in infinitesimal small units and markets should allow for perfect hedges, i.e. trading of derivatives without any restrictions, to be able to converge to an equilibrium. These assumptions are clearly not given for equity and money markets and rule out the practical application of equilibrium theories to real market phenomena. Also, traditional arbitrage arguments do not offer additional insights regarding the applicability of equilibrium models but are a mere application of the consequences thereof (Schneider, 1995, p. 293). Statements such as the market equilibrium is reached when no further arbitrage is possible can be counter argued with arguments that „no arbitrage“ conditions ignore the fact that under uncertainty a set of cases exists where the elimination of all arbitrage strategies is impossible (Mandelbrot, 1971).

Schneider’s criticism further refers to the „theory of the firm“ as it is traditionally viewed by economic theory, where on an abstract level the theoretical price at various output levels is discussed (Schneider, 1995, p. 245). This abstract representation mainly deals with price-demand functions, assumed utility functions, the available income for households and price and quantity of a product. From an applied business point of view

<sup>9</sup> For further details on implicit contracts refer to Fama (1980).

some of the relevant aspects, such as investments, financing, organization, accounting, as well as the human capital (potentially acting irrational), are ignored (Schneider, 1995, p. 245). The assumed market structure is therefore not intended to depict reality but to detail some isolated effects in a highly stylized environment.

In general, model restrictions are part of almost any rigorously derived theory and do not diminish the achievement and quality of the model, but restrict the applicability to market situations. We find this to be of particular importance given that studies of the neoclassical labor market often utilize PAT – regardless of its restrictive premises – when evaluating the socio-economic situation. The outcome is then merely a result of the initial assumptions and a rigorous application of the model. An interpretation of the result or plan of action should always be treated with caution and evaluated in relation to the restrictive model assumptions.

### **E. Ethical aspects**

Evaluating PAT under ethical aspects reveals further issues when utilizing the theory as basis for corporate governance, where ethicists maintain a critical distance to PAT (Bowie and Freeman, 1992). „The widespread use of a social framework becomes the business of ethicists if there is some risk that this framework will lead to decisions that run counter to, or threaten to undermine, ethical values. [...] A case will be made that principal-agent analysis, in its current popularized form, does pose such a risk.“ (Dees, 1992, p. 26)

The main threats resulting from PAT are according to Dees an unintended interpretation through the recipients and the psychological consequences of the model's assumptions for the principal as well as the agent. According to Dees a generalization of normative statements from PAT to other contexts is problematic. Such a generalization would for instance be an interpretation of the statement that private efficiency is a result of optimal contracts as being equivalent to the statement that public efficiency is a result of optimal contracts. This generalization would, according to Dees explicitly, induce a threat to false sociopolitical recommendations such as a recommendation to enforce the inclusion of profit-sharing in employee contracts (Dees, 1992, pp. 31). The criticism also includes psychological consequences such as the fear of a theory induced negative behavior of principals towards future employees. It is assumed that this would decrease the level of trust within a society, which is regarded as highly counterproductive for the existence of a society, and disproportionately increase the importance of monetary aspects (Dees, 1992, pp. 38; Richter and Furubotn, 1996, p. 24).

Meinhövel (1999) evaluates this criticism as being too extreme granted that no economist does view PAT as a recipe for social reform. We on the other hand stress that even though corporate governance is mainly intended to address corporate management issues it would be fatal to ignore the interaction

between the corporation and various social (sub-)systems. We therefore stipulate that in the long run corporate governance does exert a substantial influence on society as a whole, which needs to be considered when deciding upon corporate governance rules.

As concluding remark we would like to emphasize that empirical validation studies of principal-agent models have been detailed on numerous accounts through experiments as well as field studies and the results have been heterogeneous not allowing for the evaluation of the aptness or inaptness of principal-agent arguments. Reasons for the inconsistent results might be the various fields of study and the various existing operationalizations, where each study seems to introduce new concepts regarding the operationalization of the factors, complicating a consistent evaluation of the overall concepts. In addition, the technical problems when measuring latent constructs regarding measurement error, uni-dimensional factor loadings, or causalities further complicate the issue. Overall, it can be stated that the theoretical foundations of corporate governance are often based on very restrictive assumptions dealing with the firm, with the separation of ownership and control, and the problem solutions of the contracting parties.

It is quite clear, that the more restrictive assumptions apply the less a model will meet the complex needs of reality, as a consequence, we have to agree with Fischer-Winkelmann (1996, p. 996) that corporate governance standards based on PAT reasoning should not be applied to market problems. In the following section the goals and mechanism of corporate governance are detailed further substantiating the argument.

### **III. Goals and mechanisms of corporate governance revisited**

Goals for any corporate governance policy are according to Nippa (2002, p. 21) optimal management and controlling. The corporate governance codex is in this context often referred to as „codes of best practice“, and optimum is defined through a maximization of subjective utility, the determination of optimal investment decisions, and an optimal reallocation of resources. Assuming homogenous information and the homo oeconomicus as applicable paradigm an optimization can be determined analytically (Weise, 1989; Frey, 1992; Tietzel, 1981). For any deviation from these traditional assumptions one or more of the mentioned optimizations problems are only solvable analytically under highly restrictive assumptions. Problematic, for instance, is that subjective utility in its strict definition exists only for individual ownership, given that more individuals are stakeholders the resulting utility can only be a weighted function of the subjective utility functions of the individuals. This implies that the resulting optimal solution includes various individual utility aspects and does not adhere



to the strict definition of subjective utility anymore. Also, an optimal investment allocation assumes the knowledge of all alternative investment opportunities, necessitating homogenous information. And last but not least an optimal reallocation assumes the understanding of the goals of the corporation. Given that the corporation is a legal entity the goals of the corporation turn into the goals of the representatives, i.e. the goals of the individuals in charge of the corporation, which are not necessary rational or derive their goals from a superior maxim (Macharzina, 1995, p. 340).

Beknowingst of the fact that PAT is most often the basis for a discussion of corporate governance and that the necessity of a corporate governance regulation is based on asymmetric information and bounded rationality it seems obvious that the above defined goals are not easily adhered to and an application of PAT does most likely not result in the detailed optimal allocation (Schneider, 1985; Nippa, 2002, pp. 21). Given a path of action is most often necessary the „minor“ issues associated with disregarding the existence of some of the implicit assumptions are often disregarded and corporate governance guidelines are often based on the paradigm of the homo oeconomicus (Nippa, 2002, p. 22).<sup>10</sup> In the light of the voiced criticism the discussion regarding „proper“ corporate governance increases in relevance. We in the following evaluate whether the commonly discussed corporate governance mechanisms are acceptable.

Commonly discussed corporate governance mechanisms include a assumed control through the board, control through the owners, control through institutional investors, control through the markets, control through payment schemes as incentive for the management, a market for corporate control, control through disclosure, and control through liability.

Particularly the market based mechanisms (control through the markets, control through the market for corporate control) are limited in their generalization through restrictive theoretical model assumptions. One important condition for a working managerial workforce market is the appropriate assessment of the managers“ quality through the market. This assumes perfect information efficiency, which has been questioned by many others in the first place (Wosnitza, 1991; Ballwieser and Schmidt, 1981; Hirschey, 1986) and seems particularly inappropriate given that the management has the motivation and the opportunity to manipulate the information flow (Flassak, 1995, p.135).

As to the functionality of the stock market to act as a means of control we find that market reactions are not necessarily tied to the observed managerial competence. For markets to reflect managerial

competence firstly the shareholders have to be able to evaluate the managerial achievement (they have to have the relevant information and the knowledge to be able to judge managerial performance) and secondly a distinction between systematic market behavior and managerial performance is necessary. We find it difficult to believe that both conditions are met for real markets. Additionally, when shares decrease in value, the management is not sanctioned immediately or the funds are not immediately reallocated to other investments. According to Flassak (1995, pp. 140) the loss in reputation is only of relevance for future capital increases and assumes that the company is in need of additional capital and has no other means of acquiring it. To ensure that this monitoring instrument is successful the management would have to be deprived of the option of selecting amongst different means of financing and the shareholders would have to be entitled with more rights to have a greater impact on managerial action. A common argument is also that monitoring is also achieved through the debt market. Here it is assumed that after consuming the free cash flow debt is the preferred means of financing where creditors are willing to provide the necessary capital and the necessary control. Whilst the management – according to shareholder value concepts – is supposed to ensure a high free cash flow, the monitoring is achieved through a high level of debt. The effect seems controversial when applied to scenario where a company is arguing in credit negotiations that the company invests on a regular basis, even when exceeding the own available resources, because this provides better means of control of the management. Additionally, analytically modeling of the theory has not yielded sound answers to the question regarding the ideal level of debt. Also the tested models are usually based on too restrictive assumptions to qualify for further generalizations (Hart, 1995, pp. 126; Suter, 2000, p. 129). Further, applying the idea of markets regulating the management to an LBO (Leveraged Buy Out) situation reveals an interesting paradox. With reference to the argument that a concentration of voting rights in the bought out company would exert direct influence (and thereby control) on the management, we question the seriousness of this statement, as an attribute of an LBO is that the management is part of the bought out company and owns a part of the equity capital. Now the issue of who is supposed to control whom arises. Overall, we are of the opinion that the capital market does not enforce the desired monitoring-effects.

The disciplinary mechanism through the market of corporate control, contrary to the control through the capital market discipline, is expected to be generated by the fear of acquisitions and the subsequent dismissal of the management. We are of the opinion that this mechanism can not work in the expected manner, as share prices underlie a multitude of influences. Granted that sometimes one of the models by chance corresponds to reality, it seems bold to grant those models the status of a „mechanism“ let alone be the

<sup>10</sup> For empirical evidence on the success or failure of legislative initiatives on corporate governance refer to Duehnfort (2004) for an example of the Italian legislative reform of capital markets beginning in 1996 as well as for a more detailed view on corporate governance.

basis for a debate about the reform of laws governing corporate and capital markets. Empirically the integrity of stock market facilitating companies and capital market supervisors is important to maintain the trust of the public in the capital markets. It is particularly interesting that the USA, being one of the main driving forces in the field of corporate governance, does not meet that standard. While trying to propagate their idea of corporate governance to the world through e.g. institutional investors (CalPERS etc.) or through the presence/dominance in international financial accounting bodies (like the IFRSB), the most important stock exchanges, the NYSE and likewise the Securities and Exchange Commission, faced harsh criticism. The NYSE for instance, due to the conduct of its yearlong head Grasso, had to restructure its business in 2003 to separate management (operation of trade) from monitoring capacities (Grass and Skorecki, 2003).

Control through liability has often been criticized as it is restricted to gross negligence or embezzlement only (Witt, 2002, p. 52). Law suits only occur for a few extreme situations such as for bankruptcy situations and the individual can be insured through a D&O (directors and officer's liability) insurance eliminating the control function of liability. Most commonly either the manager has to insure him/herself or he/she is insured by his company. For the latter the company could cover the entire premium or the manager could be asked to participate in the costs via a deductible, where the German corporate governance codex recommends the latter.

Control through payment schemes as incentives for managerial performance is closely related to the shareholder value approach. Given that the shareholder orientation and the resulting principles of shareholder value have been widely criticized in general and particularly that its application to European markets seems due to cultural difference problematic (Werder, 1997; Titzrath, 1997, p. 36; Hommelhoff, 1997, p. 20)<sup>11</sup> this approach in our opinion does also not achieve its intended purpose. Malik even speaks of a failure of the shareholder value approach, not because of its wrongful application but due to its fundamental flaws (Malik, 2002, pp. 26). One of the basic issues of the shareholder value concept is the focus on maximizing company value (Pfaff and Bärtl, 1999). Here the applicability of DCF-based methods and the evaluation of future cash flows and their discounting is problematic, since DCF-based methods depend on the CAPM where most assumptions of the model are far from being realistic and empirical evidence is indicating that there seems to be a problem with the model (Ballwieser, 2002, p. 738; Bamberg and

Dorfleitner, 2002, p. 878; Schierenbeck, 2000, pp. 387; Perridon and Steiner, 1995, pp. 237). Overall the valuation methods, whilst technically sound given numerous assumptions, allow for interesting bandwidths in resulting company values once the uncertain future expected cash flows and the appropriate risk assessments are estimated by different individuals. Also various technical issues regarding the proper discount rate, such as estimating the risk-free rate, the growth rate, or the risk-premium,<sup>12</sup> allow for interesting bandwidths of company values. Given that the company value is used as basis for performance based compensation and numerous possible outcomes exist it might have an adverse impact on the perceived control over their performance based compensation and/or might induce manipulative window dressing. Coenberg (2003, pp. 66), for instance, lists more than 250 different publicly reported illegal financial accounting manipulations for the year 2002. Resorting to equity options seems also not a suitable solution since active stock price manipulation seems possible, including the faking of trade activities, concealing essential information, or presenting information inaccurately, overall there is a broad spectrum of possibilities (Rosen, 2001). Additionally, empirical evidence does not conclusively indicate that including stock option plans in managerial compensation plans have a positive effect on shareholder wealth (Winter, 1998, p. 1139). A particularly interesting thought is brought forward by Cromme (2002), who demands a profit participation of the members of the supervisory board, which has lately been granted in Germany through recent changes in the law. This, in our opinion, seems to go against the initial intention of corporate governance given that the claim implies that members of the supervisory board, who are allegedly independent, now have the option to partake in short term profits. It seems questionable if they are under these circumstances likely to oppose actions that promise short term profits for sure but could impair the existence of the company in the long run.

Finally, the proposed corporate governance mechanisms of control through shareholders and institutional investors seem plausible but given that individual shareholders have limited possibilities of administering control we also regard this measure of control as being ineffective. We argue that the influence of shareholders consists mainly of voting rights and the option of selling shares, and for minority shareholders the influence, especially for big publicly owned firms, is very low and the difference between ownership and control is typically very distinct (Fama, 1980, p. 288). Institutional investors on the other hand attempt to bundle their voting rights to allow for substantial influence on management decisions.

Here the identification and accumulation of interests seems problematic, since every shareholder would have to agree to the concept that the merged

<sup>11</sup> The assumed disadvantage of the shareholders as postulated by Rappaport, is especially in Germany not given; additionally the structure of European capital markets (especially the shareholders structure) differs fundamentally from the USA and theory originating in the USA should be carefully applied to European markets (Werder, 1997, p. 13).

<sup>12</sup> Determining a forward looking beta, the market return, or the risk-premium for non-listed companies proves to be a challenge.

position does not necessarily conform to his initial idea but is the consequence of the consensus. In addition, the transfer of blank voting rights might be abused (Dolce, 1998, p. 13). Finally, it should be noted that the often referred to control of institutional investors over corporations seems to be exerted through other means than voting rights given that the biggest institutional investor in the U.S. (CalPERS) did not exceed 0.5 percent of ownership for any firm in the year 1998 (Suter, 2000, pp. 125).

In conclusion only the mechanisms of „control through the (supervisory) board“ given the board is independent and not included in profit-sharing plans and the „control through disclosure“ are the only acceptable means of effective control. Based on the above arguments and the so far missing systematic evaluation of the overall utility of corporate governance initiatives as well as their costs (legal, implementation, control of the implemented regulations, etc.) the question regarding the economic efficiency of corporate governance arises. Nippa, for instance, postulates that corporate governance decreases economic efficiency due to the indirect and hidden costs (Nippa, 2002, pp. 29). On the other hand, the competition of various corporate governance systems indicates that there seems to be a consensus that one solution to the corporate governance problem exists.

#### IV. Conclusion and outlook

Overall, a critical review of the assumptions of PAT reveals that utility aspects seem to be overstressed, the proposed principal-agent relations seem unrealistic given real market environments, the theory lacks empirical validation, and ethical aspects seem to be underrepresented. The problematic assumptions regarding the contractual compliance, the missing arguments regarding the assumed agency cost relations, the problematic concept of the „residual loss“, the assumption of a company as a set of contracts, the unrealistic market equilibrium assumptions, and the missing taxation do not support that a straight forward application to real world problems is recommendable. In addition, human factors such as motivational aspects are regarded as non-relevant and technical problems, such as the measurability of the agent's effort are ignored, further questioning the applicability to real problems.

Despite the critical arguments regarding PAT and the assumed underlying mechanisms the theoretical constructs – albeit the continuous development of the areas of strategic management<sup>13</sup> as well as systemic management<sup>14</sup> – have continued to dominated the literature. Overall, the Jensen and Meckling (1976) approach is drawing its conclusions from traditional

microeconomics and could be considered to be approximately 30 years behind the concurrent development. In addition, the discussion regarding the „optimal“ corporate governance seems (mainly) to be driven by practitioners on the one and scientists on the other hand, where (most often) both parties seem to be isolated in their viewpoints of the issue. Managers and board of directors seem not too much interested in aligning corporate and individual goals and scientists seem to ignore the recent changes of corporate practices (Nippa, 2002, p. 4). It is further interesting that Jensen (1983) indicates, in reference to Simon (1962), that a system theoretical approach implies many difficulties.

„Unfortunately, the vast literature of economics that falls under the label of ‚Theory of the Firm‘ is not a positive theory of the firm, but rather a theory of markets. The organization or firm in that theory is little more than a black box that behaves in a value or profit-maximizing way. In most economic analyses, the firm is modeled as an entrepreneur who maximizes profits in an environment in which all contracts are perfectly and costlessly enforced. In this firm there are no „people“ problems or information problems, and as a result the research based on this model has no implications for how organizations are structured or how they function internally. The firm is, in effect, assumed to be an elementary component of the analysis even though in fact it is an exceedingly complex subsystem. This is not necessarily wrong. When it is appropriate for a scientist to treat a complex subsystem as an elementary component is a subtle and difficult issue. [...] Just as astronomers can usefully abstract from the complexities inside a star or a galaxy for certain purposes, the classical economic notion of the firm has usefully abstracted from the internal complexities of organizations. It has yielded a robust theory of markets that is of great value. However, precisely because the definition of the firm abstracts from most of the real problems and complexities of organizations, it provides no insights to the construction of a theory of organizations.

The concepts of marginal analysis, competition, opportunity cost, and equilibrium that have been useful in the development of a theory of markets will also be valuable in the development of a theory of organizations. They are not, however, enough to accomplish the job. This raises the question of what we use to replace the black box view of the firm.“ (Jensen, 1983, pp. 12)

Ten years later Jensen states:

„Financial economists have a unique advantage in working on these control and organizational problems because we understand what determines value, and we know how to think about uncertainty and objective functions. To do this we have to understand even better than we do know the factors leading to organizational failures (and successes): we have to break open the black box called the firm, and this means understanding how organizations and the people in them work. In short, we're facing the

<sup>13</sup> For details on strategic management developments refer for example to Welge and Al-Laham (1999).

<sup>14</sup> For details on systemic management refer for example to Gomez, P. (1981)

problem of developing a viable theory of organizations. To be successful we must continue to broaden our thinking to new topics and to learn and develop new analytical tools." (Jensen, 1993, p. 54) During this time interval management theory experienced tremendous change apparently without opening the black box „firm“. According to Nippa (2002, p. 4) the dominating role of capital, finance driven models, as well as the US-American point of view (with a tendency towards doctrine) were driving forces in the unreflected adoption of the premises, the simplifications, and assumed causal relationships. Jensen unfortunately did not specify the called for new analytical tools but given our critical review of PAT we are of the opinion that the new tools should not be based on traditional microeconomic theory given the model's intended usage is a recommendation of effective measures to enforce the intended means to standard setters. In addition, the referred to factors leading to failure or success are difficult to define and always in dependence on the assumed underlying model. Nicolai and Kieser (2002), for instance, detail in reference to a study by March and Sutton (1997) that it is empirically difficult to attribute economic success to certain factors, essentially claiming that the asked for factors have not been substantiated empirically as of yet. Basing a theory on assumed interactions and relationships amongst these factors is bound to fail when applied to real market problems.

## References

1. Alchian, A. and Demsetz, H. (1972): Production, Information Costs and Economic Organization, in: *The American Economic Review*, Vol. 62, 777-795.
2. Ballwieser, W. (2002): Der Kalkulationszinsfuß in der Unternehmensbewertung: Komponenten und Ermittlungsprobleme, in: *WPg*, 14, 736-743.
3. Ballwieser, W. and Schmidt, R.H. (1981): Unternehmensziele und Finanztheorie, in: Bohr, K. (1981): Unternehmensverfassung als Problem der Betriebswirtschaftslehre, Berlin.
4. Bamberg, G. and Dorfleitner, G. (2002): Is Traditional Capital Market Theory Consistent with Fat-Tailed Log Returns?, in: *ZfB*, 8, 868-878.
5. Bamberg, G. and Spremann, K. (Hrsg.) (1989): Agency Theory, Information and Incentives, Berlin.
6. Berle, A. and Means, G. (1932): *The Modern Corporation and Private Property*, Revised Edition, first printed 1932, New York, reprinted in 1968.
7. Boot, A. and Macey, J. (2004): Objectivity, proximity and adaptability in corporate governance, *Cornell Law Review*, Vol. 89, No.2, 356-393.
8. Bowie, N.E. and Freeman, R.E. (1992): *Ethics and Agency Theory*. New York .
9. Coase, R.H. (1937): The nature of the firm, in: *Economica*, Vol. IV (New Series), No.16, 386-405.
10. Coenenberg, A.G. (2003): Shareholder Value - Betriebswirtschaftliche Sicht und öffentliche Wahrnehmung, in: Fakultät für Wirtschaftswissenschaften der Technischen Universität München,
11. Verleihung der Würde eines Ehrendoktors der Fakultät für Wirtschaftswissenschaften der Technischen Universität München an die Professoren Roland Berger, Adolf G. Coenenberg.
12. Eberhard Witte, unveröffentlichte Beiträge der Akademischen Feier am am 15. Januar 2003.
13. Cromme, G. (2002): "Wir brauchen ehrbare Kaufleute", in: *Handelsblatt* 26.06.2002.
14. Dees, J. G. (1992): Principals, Agents and Ethics, in: Bowie, N.E. and Freeman, R.E. (1992): *Ethics and Agency Theory*, New York.
15. Demougins, D. and Jost, P. (2001): Theoretische Grundlagen der Prinzipal-Agenten-Theorie, in: Jost, P. (Hrsg.) (2001): *Die Prinzipal-Agenten-Theorie in der Betriebswirtschaftslehre*, Stuttgart, 45-81.
16. Demsetz, H.: Toward a Theory of Property Rights, in: *American Economic Review* 57 (1967), 347-359.
17. Dolce, R. (1998): *Corporate Government - Neues italienisches Kapitalmarkt- und Gesellschaftsrecht*, in:
18. Cian, G. et al. (Hrsg.) (1998): *Jahrbuch für italienisches Recht* 11, Heidelberg.
19. Duehnfort, A. (2004): *Mediale Unternehmensüberwachung - Ergebnis einer kritischen Analyse zu Begriffsinhalt und Anwendbarkeit von "Corporate Governance" am Beispiel Italiens*, Hamburg.
20. Fama, E.F. (1980): Agency Problems and the Theory of the Firm, in: *Journal of Political Economy*, Vol. 88, Nr. 2, 288-307.
21. Ferrall, C. (1990): Agents becoming principals: theory and estimation of a tournament model of promotions in partnerships, Ph.D. thesis, University of Minnesota
22. Fischer-Winkelmann, W.F. (1996): Empirische Analyse des Prüferwechsels im Kontext der Agency- und Signalling-Theorie - Stellungnahme, in: *ZfB*, Nr.8, 995-1005.
23. Flassak, H. (1995): *Der Markt für Unternehmenskontrolle - Eine ökonomische Analyse vor dem Hintergrund des deutschen Gesellschaftsrechts*, Bergisch-Gladbach.
24. Frey, B. (1992): *Economics as a Science of Human Behaviour - Towards a New Social Science Paradigm*, Boston.
25. Gomez, P. (1981): *Modelle und Methoden des systemorientierten Managements - eine Einführung*, Bern.
26. Grass, D. and Skorecki, A. (2003): New Yorker Börse steht Umbruch bevor, in: *FTD* v. 19.09.2003.
27. Hart, O. (1995): *Firms, Contracts, and Financial Structure*, Oxford.
28. Hawley, J.P. and Williams, A. T. (1997): The Emergence of Fiduciary Capitalism, in: *Corporate Governance*, Vol. 5, Nr. 4, 206-213.
29. Hay, P. (2000): US-amerikanisches Recht, München.
30. Hirschey, M. (1986): Mergers, Buyouts and Fakeouts, in: *American Economic Review*, Vol. 76, 317-322.
31. Hommelhoff, P. (1997): Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip? In: *ZfB-Ergänzungsheft*, 4, 97, 17-21.
32. Jensen, M. (1983): Organization Theory and Methodology, in: *The Accounting Review*, Vol. 58 (1983), 319-339.
33. Jensen, M. (1993): The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, *Journal of Finance*, Vol. 48(3), 831-880.
34. Jensen, M. and Meckling, W.H. (1976): Theory of the firm - Managerial Behaviour, Agency Costs and Ownership Structure *Journal of Financial Economics*, Vol. 3, 305 -360.

35. Jensen, M. and Meckling, W.H. (1979): Rights and Production Functions: An Application to Labor Managed Firms and Codetermination, *Journal of Business*, Vol. 52, No. 4.
36. Jost, P.-J. (2001a): Die Prinzipal-Agenten-Theorie im Unternehmenskontext, in: Jost, P.-J. (2001b).
37. Jost, P.-J. (Hrsg.) (2001b): Die Prinzipal-Agenten-Theorie in der Betriebswirtschaftslehre, Stuttgart.
38. Macharzina, K. (1995): Unternehmensführung: das internationale Managementwissen; Konzepte-Methoden-Praxis, Wiesbaden.
39. Malik, F. (2002): Die Neue Corporate Governance - Richtiges Top-Management, wirksame Unternehmensaufsicht, 3. Edition, Frankfurt/M.
40. Mandelbrot, B.B. (1971): When can price be arbitrated efficiently? A limit to the validity of the random walk and martingale models, in: *Review of Economics and Statistics*, Vol. 53, 225-236.
41. March, J.G. and Sutton, R.I. (1997): Organizational Performance as a dependent variable, in: *Organisation Science*, Vol. 8, 698-706.
42. Meinhövel, H. (1999): Defizite der Principal-Agent-Theorie, Lohmar.
43. Neus, W. (1989): Ökonomische Agency-Theorie und Kapitalmarktgleichgewicht, Wiesbaden.
44. Nicolai, A. and Kieser, A. (2002): Trotz eklantanter Erfolglosigkeit: Die Erfolgsfaktorenforschung weiter auf Erfolgskurs, in: *DBW*, H. 6, 579-596.
45. Nippa, M. (2002): Alternative Konzepte für effiziente Corporate Governance, In: Nippa, M. et al. (2002): *Corporate Governance*, Heidelberg.
46. Perridon, L. and Steiner, M. (1995): Finanzwirtschaft der Unternehmung, 8. Edition, München.
47. Pfaff, D. and Bärtl, O. (1999): Wertorientierte Unternehmenssteuerung - ein kritischer Vergleich ausgewählter Konzepte, in: Gebhardt, G. and Pellens, B. (Hrsg.): *Rechnungswesen und Kapitalmarkt*, ZbF-Sonderheft 41, 85-115.
48. Picot, A. et al. (1999): *Organisation. Eine ökonomische Perspektive*, 2. Edition, Stuttgart.
49. Richter, R. and Furubotn, E. (1996): *Neue Institutionenökonomik*, Tübingen.
50. Rosen, R.v. (2001): *Corporate Governance: Eine Bilanz*, *Die Bank* 2001, 283-287.
51. Schäfer, H.-B. and Ott, C. (1995): *Lehrbuch der ökonomischen Analyse des Zivilrechts*, 2. Edition, Berlin.
52. Schierenbeck, H. (2000): *Grundzüge der Betriebswirtschaftslehre*, 15. Edition, München.
53. Schmidt, R.H. and Terberger, E. (1997): *Grundzüge der Investitions- und Finanzierungstheorie*, 4. Edition, Wiesbaden.
54. Schneider, D. (1985): *Allgemeine Betriebswirtschaftslehre*, 2. Auflage der „Geschichte betriebswirtschaftlicher Theorie“, München.
55. Schneider, D. (1995): *Betriebswirtschaftslehre, Band 1: Grundlagen*, 2. Edition, München.
56. Semler, R. (1993): *Das Semco-System: Management ohne Manager - das neue revolutionäre Führungsmodell*, München.
57. Shleifer, A. and Vishny, R. (1997): A Survey of Corporate Governance, *The Journal of Finance*, 52/2, 737-783, 1997.
58. Simon, H.A. (1962): *The Architecture of Complexity*. *Proceedings of the American Philosophical Society*.
59. Sliwka, D. (2003): Anreize, Motivationsverdrängung und Principal-Agenten-Theorie, in: *Die Betriebswirtschaft*, 3, 293-307.
60. Suter, R. (2000): *Corporate Governance & Management Compensation - Wertsteigerung durch Lösung des Manager-Investoren-Konflikts*, Zürich.
61. Swoboda, P. (1991): *Betriebliche Finanzierung*, 3. Edition Würzburg.
62. Terberger, E. (1994): *Neo-institutionalistische Ansätze*, Wiesbaden.
63. Tietzel, M. (1981): Die Rationalitätsannahme in den Wirtschaftswissenschaften oder Der homo oeconomicus und seine Verwandten, in: *Jahrbuch für Sozialwissenschaft*, 32, 115-137.
64. Titzrath, A. (1997): *Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip?* In: *ZfB-Ergänzungsheft* 4/97, 31-43.
65. Weise, P. (1989): Homo oeconomicus und homo sociologicus: Die Schreckensmänner der Sozialwissenschaften, in: *Zeitschrift für Soziologie*, H. 2, p.148-161.
66. Welge, M.K. and Al-Laham, A. (1999): *Strategisches Management - Grundlagen, Prozess, Implementierung*, 2. Edition, Wiesbaden.
67. Werder, A.v. (1997): *Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip? - Ein betriebswirtschaftliches Statement*, in: *ZfB-Ergänzungsheft* 4/97, 9-17.
68. Winter, S. (1998): Zur Eignung von Aktienoptionsplänen als Motivationsinstrument für Manager, in: *zfbf* 50, H. 12, 1120-1142.
69. Witt, P. (2002): *Grundprobleme der Corporate Governance und international unterschiedliche Lösungsansätze*, in: Nippa et al. (2002): *Corporate Governance*, Heidelberg.
70. Wosnitza, M. (1991): *Das agency-theoretische Unterinvestitionsproblem in der Publikumsaktiengesellschaft*, Heidelberg.

# GOVERNMENT OWNERSHIP AND PERFORMANCE: AN ANALYSIS OF LISTED COMPANIES IN MALAYSIA

*Nazrul Hisyam Ab Razak<sup>a</sup>, Rubi Ahmad (PhD)<sup>b</sup>, Huson Joher Aliahmed (PhD)<sup>c</sup>*

## Abstract

The relationship between ownership structure and company performance has been issue of interest among academics, investors and policy makers because of key issue in understanding the effectiveness of alternative governance system in which government ownership serve as a control mechanism. Therefore, this paper examines the impact of an alternative ownership/control structure of corporate governance on firm performance among government linked companied (GLCs) and Non-GLC in Malaysia. It is believed that government ownership serve as a monitoring device that lead to better company performance after controlling company specific characteristics. **We used Tobin's Q as market performance measure while ROA is to determine accounting performance measure.** This study is based on a sample of 210 firms over a period from 1995 to 2005. we use panel based regression approach to **determine the impact of ownership mechanism on firm's performance. Findings appear to suggest that** there is a significant impact of government ownership on company performance after controlling for company specific characteristics such as company size, non-duality, leverage and growth. The finding is off significant for investors and policy marker which will serve as a guiding for better investment decision.

**Keywords:** Government ownership; Government linked companies; corporate governance

<sup>a</sup> Lecturer, Faculty of Economics and Management, Universiti Putra Malaysia

<sup>b</sup> Senior Lecturer, Faculty of Business and Accountancy, Universiti Malaya

<sup>c</sup> Senior Lecturer, Senior Lecturer, School of Accounting and Finance, Faculty of Business and Law, Deakin University, Melbourne, Australia.

## 1. Introduction

Modern corporate finance literature focuses on two important issue that govern the management activities and their behavior. These are ownership and control mechanism that ensure that the placement good governance mechanism may have positive impact on company value. Therefore, the relation between ownership structure and company performance has been an issue of interest among academics, investors and policy makers alike because of the importance of alternative governance system in which government ownership serve as a control mechanism.

In Malaysia, GLCs are defined as companies that have a primary commercial objective and in which the Malaysian Government has a direct controlling stake. GLCs and their controlling shareholders constitute a significant part of the economic structure of the Malaysian economy. GLCs account for approximately RM260 billion or approximately 36% and 54% respectively of the market capitalization of Bursa Malaysia and the benchmark Kuala Lumpur Composite Index. Though there is increasing empirical evidence on the impact of government ownership and company performance in developed markets but little attentions have been given in this modern developing

economies such as Malaysia to examine what constitutes governance structure and its impact on company's performance.

The objective of this study is two folds: first, this paper aims to determine whether or government ownership lead to better company performance after controlling company specific characteristics such as corporate governance, agency cost, growth, risk and profitability. Secondly, to ascertain whether or not other factors such as growth opportunities, leverage, size, and profitability factor have any impact on company performance beyond governance ownership. Hence this paper may shed new light into corporate finance literature on government involvement in company through government agency and their performances. Secondly, this research may contribute to the existing corporate finance literature review by providing a new data set on government linked companies for Malaysia

The reminder of this paper is organized as follows: Section 2 we will briefly discuss both theoretical foundation and empirical evidence. In Section 3, the data selection procedure and research methodology are outlined, meanwhile Section 4 present our results and analysis. And last but not least in Section 5 we summarize and conclude our research.

## 2. Literature reviews

The understanding on the empirical differences in corporate control particularly government involvement has advanced recently. However, search has been very limited for Malaysian capital market to ascertain whether or not the involvement of government in corporate control system provides additional explanation for company value. The relationship between ownership structure and company performance has been an important research topic during the last decades, and produced ongoing debate in the literature of corporate finance. Theoretical and empirical research on the relationship between ownership structure and company performance was originally motivated by the separation of ownership from control (Berle and Means, 1932) and currently by agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983). In agency theory, shareholders of company wish to maximize value while managers prefer self-interested strategies which are far from maximizing company value, and in the absence of either appropriate incentives or sufficient monitoring, managers can exercise their discretion to the detriment of owners.

In this circumstance, government ownership might provide a control mechanism to discipline the management self-interest behavior more inline with company objectives, hence improving performance. Seminal work on such issued was addressed by LaPorta (1999) who investigates the ultimate ownership control in company. He divided into five types of ultimate owners: (1) a family or an individual, (2) the State, (3) a widely held financial institution such as a bank or an insurance company, (4) a widely held corporation, or (5) miscellaneous, such as a corporative, a voting trust, or a group with no single controlling investors. State control is a separate category because it is a form of concentrated ownership in which the State uses companies to pursue political objectives, while the public pays for losses (Shleifer and Vishny (1997)).

In a related study, Claessen, Djankov and Lang (1999) investigate the separation of ownership and control in 2980 public companies in 9 East Asian countries. Their findings suggest that corporate control is typically enhanced pyramic structure and cross holding companies in all East Asian countries except Singapore where about half of the samples companies are controlled by state. Orden and Garmendia (2005) examined the relationship between ownership structure and corporate performance in Spanish companies. Ownership structure has been analyzed in terms of concentration of control and the type of investor exerting control. Company performances which used in research were return on assets (ROA) and return on equity (ROE). One of hypotheses findings is companies which under controlled government showed negative impact and have worse performance that other ownership structures.

More recently, Zeitun and Tian (2007) examined the impact of ownership structure mix on company performance and the default risk of a sample of 59 publicly listed companies in Jordan from 1989 to 2002. they documented that the ownership structure has significant impact on performance based on accounting measure however, government involvement are significantly negative related to the company's performance based on ROA and ROE (return on equity) but shows positively related to market performance based on Tobin's Q.

Similar study was done Gursoy and Aydogan (2000) on Turkish Market which address on main characteristics of ownership structure of the Turkish non-financial companies listed on the Istanbul Stock Exchange (ISE) and examine the impact of ownership structure on performance and risk-taking behavior. They describe form ownership structure into foreign ownership (FRGN), government ownership (GOV), cross ownership (CROSS), family ownership (FAM) and affiliation to a conglomerate (CONG). The results exhibit a negative relationship between t government ownership and company performance based on (ROA and ROE) after controlling leverage and size, meanwhile it's negative but significant with market measurement (share price to EPS, P/E).

The literature on government ownership and performance has been limited and no systematic pattern of relationship between government ownership and company performance has been uncovered. it could be due to fact that Government controlled companies may respond have different set of objective which not only to enhance national welfare or other non-profit considerations, but also a goal of value maximization. Ang and Ding (2005) compare the financial and market performance of Government Link Companies (GLC) with non-GLCs in Singapore through government agency (Temasek Holdings). The findings from their study suggest that the GLCs on average exhibit higher valuations than non-GLCs, even after controlling for company specific factors such as profitability, leverage, company size, industry and foreign ownership. However, Kumar (2003) compared the financial performance of state owned, private owned, and mixed state-private ownership companies in India from 1973 to 1989. Findings appear to be differing with Singapore based study and suggest that the most profitable companies were the private owned followed by mixed ownership. While state owned enterprises had the worst performance. A majority of other studies in India and abroad draw similar conclusions (Shleifer and Vishny, 1997; Shleifer, 1998).

Meanwhile in China, Tian and Estrin (2005) find that government ownership reduce corporate value due to political interference. Also in other paper done by Xu and Wang (1999) found that government enterprise perform worse in profitability than non-government. Wei (2005) examines the performance of domestic Chinese companies in various ownership categories versus foreign-invested enterprises (FIEs) based on

two nation-wide surveys conducted by the National Bureau of Statistics in 1998 and 2002. It was found that both domestic non-state-owned companies and foreign-invested enterprises performed better than state-owned enterprises.

Meanwhile, three categories of Chinese companies privately owned, collectively owned, and shareholding had higher performance levels than the foreign invested enterprises. For Europe country, especially in Germany, Companies which under Treuhand (govt.'s privatization agency) and Management KGs (government ownership organization) performed better than before privatization (Dyck and Wruck, 1998).

Bortolotti and Faccio (2006) studied on the change in government control of privatized companies in OECD countries. In their research, they use term of golden share which is defined as a set of State's special power and statutory constraints on privatized companies.<sup>1</sup> One of findings state dependent variable which state voting rights the ultimate voting rights held by government in company (i), in year (t) showed positive and significant after controlling country and company specific explanatory variables (which one of variables is ROE and market to book value). Meanwhile, Kirchmaier (2006) on corporate ownership structure and performance in Europe identified state ownership is a third larger shareholder in Italy and France. Summary results for both countries are find that state ownership showed negative relationship between performance and corporate governance and other control variables. It's happen according to them, major factor was the influences of politician on company decision making, as well as protection from market discipline.

As general and conclusion, we find that majority studies shown negative result when looking on government ownership and performance or company valuation. There are many reasons may lead to why government ownership results in poor financial performance. First, the government is guided by social altruism, which may not be in line with the profit motive. Second, the government is not the ultimate owner, but the agent of the real owners – the citizens. And it is not the real owners who exercise governance, but the bureaucrats. There is no personal interest that bureaucrats have to ensure that an organization is run efficiently or governed well since they do not have any benefits from good governance.

### 3 Data and methodology

In this paper, we examine the impact of government involvement as the governance mechanism that has an important impact on company performance of Malaysian GLCs and Non-GLC over an 11 year period

<sup>1</sup>Special power include (i) the right to appoints members in corporate board;(ii) the right to consent to or to veto the acquisition of relevant interests in the privatized companies; (iii) other rights such as to consent to the transfer of subsidiaries, dissolution of the company, ordinary management, etc.

from 1995 to 2005. We select a sample of 210 companies which met basic selection criteria. The basic criteria to deduce the sample companies are as follows:

1. companies are listed with Main Board of Bursa Malaysia
2. Complete set of data are available (Data stream, Worldscope, perfect analysis) from 1995 until 2005
3. All the financial based companies were excluded as these companies face a different set of regulation with different operational structure.

#### 3.1 Methodology

Following Multivariate regression, we use panel based data analysis to analyze the impact of government involvement on company performance. Panel based data analysis is more informative as compared to cross-sectional based regression as this my avoid certain assumption promulgated by simple multiple regression.

*Performance = f {Government ownership, Corporate Governance, Risk, Growth and Profitability }*

#### 3.2 Parametric Test

The parametric test of the differences in mean value of the characteristics of the sample companies (GLCs) and Non-GLC companies was conducted. The characteristics are Tobin-Q, ROE, ROA, size, leverage, profitability, growth opportunity, and government ownership agency cost ratio. This test will provide a clear cut evidence of existence of the difference between two groups of the companies.

#### 3.3 Operational Model

Panel based multivariate regression were used to analyze the relationship between the various specific characteristics and company performance. Model is based on two measures namely market based performance and accounting based performance. The operational form of the models is as follows:

##### Model 1

$$Tobin's\ Q = \beta_0 + \beta_1 Gowned + \beta_2 Size + \beta_3 nDual + \beta_4 Debt + \beta_5 AC + \beta_6 Growth + \beta_7 PM + \varepsilon_i$$

##### Model 2

$$ROA = \beta_0 + \beta_1 Gowned + \beta_2 Size + \beta_3 nDual + \beta_4 Debt + \beta_5 AC + \beta_6 Growth + \beta_7 PM + \varepsilon_i$$

#### 3.4 The variables and the expected relationships

In our study we use two dependent variables which are *Tobin Q* and *Return on Assets (ROA)*. *Tobin Q* is the market based performance measure is defined as the ratio between the market value of company plus total debt and total asset. Meanwhile *ROA* is a ratio of net income over total asset is used to proxy the corporate



based performance measure. Any increase or decrease in these two variables may signal about market perception about the effectiveness of companies' performance and effective utilization of asset more efficiency to increase performance.

For **Gowned**, this is a dummy variable is for companies having a government holding more than 20% of the voting shares. Studies by Ang and Ding (2005) and Dyck and Wruck (1998) find that with government owned share more than 20% will contribute better performance than non government owned company. Therefore, a positive result will be expected when it's related to company performance.

**Size** is one of control variables. Company size has an ambiguous effect a priori on the company performance. Larger company can be less efficient than smaller ones because of the loss of control by top manager over strategic and operational activities within company (Himmelberg, Hubbard, and Palia 1999, Sarkar and Sarkar 2000). Lang and Stulz (1994) suggests a decrease in company performance as company becomes larger and more diversified. We used the logarithm of total asset ( $\ln(\text{Total Assets})$ ) to control for company size and expected negative relationship with company performance.

For variable of **Debt**, we divided total debt (long and short term debt) by total debt in determine whether leverage have significant different with company performance. **Debt** financing may play a significant role in reducing management's discretionary control over free cash flow and their incentive to engage in non-optimal activities (Jensen, 1986, and Stulz, 1990). **Debt** also force managers to consume fewer perks and become more efficient to avoid bankruptcy, the loss of control as well as loss of reputation (Grossman and Hart, 1982). **Debt** contracting may result in improved company performance and reduced cost of external capital (John and Senbet, 1998). In short, **Debt** may help a positive disciplinary effect on company performance.

In content of agency costs, we used two variables which are **nonDual** and **AC** (which total expenses to sales). A dummy variable on one value is when chairman and CEO is different person when determine on nonDual variable. Rhoades (2001) found that companies with a separation of the two roles consistently have higher accounting return compared to those that have the roles combined. Role duality is not common in Malaysian corporations (PwC, 1998), but MCCG (Malaysian Code of Corporate Governance)

recommended companies to separate the two roles to ensure proper checks and balance on the top leadership of the corporation. Therefore, we expect that positive relationship between **nonDual** and performance. In AC, previous studied by Ang (2000) indicated that government with lower expense to sales ratio will lead to better performance in government linked companies in Singapore. In this situation we expect that a negative relationship between AC and company performance.

In explaining the **Growth** variable, Morck, Shleifer & Vishny (1998) argue that a high growth rate indicates greater flexibility in future investments and it will lead to better performance. Companies with their own cash reserve can use when company have a financial distress especially during crisis and with higher cash balance show company have better cashflow and at same time provide better performance. Therefore, we expect **Growth** to be positively related to company performance.

In profitability, we used **Profit Margin** is ratio of net income over sales. We want to know how efficient of company managed their sales for getting profit. A positive relationship between Profit Margin and company performance is expected.

#### 4. Result and analysis

While various forms of acceptable governance in each country evolve from a country's history values, and culture, certain characteristics of superior governance have been documented in the literatures (e.g., Shleifer and Vishny, 1997). We have consider the role of corporate governance and government control in the context of Malaysian companies and its capital market and examine the issue of value relevance of corporate governance and governmental control in assessing company value. We compare the financial performance of GLCs with non-GLCs, and determine whether government ownership and various governance measures contribute to accounting and market based company valuation, using panel and pooled regression analyses.

Before estimating the proposed models, the stationary normal distribution of the data, multicollinearity, autocorrelation and heteroskedasticity problems and some econometrics issues addressed. This section will provide results of the various econometrics tests that help detect these problems. In addition various remedies to these problems are also suggested.

**Table 1.** Normality Test Statistics Of 210 Malaysian companies

	Mean	Median	Std. Dev.	Skewness	Kurtosis	Jarque-Bera	Probability
TOBINQ	1.4922	1.0167	1.5246	4.2299	31.2301	83593.94	0.0000
ROA	0.0278	0.0345	0.1223	-3.9809	54.3881	260272.10	0.0000
GOWNED	0.1429	0.0000	0.3500	2.0412	5.1667	2056.01	0.0000
NGOWNED	0.8571	1.0000	0.3500	-2.0412	5.1667	2056.01	0.0000
SIZE	13.4739	13.4609	1.3647	0.1278	3.2416	11.91	0.0026
nDUAL	0.8758	1.0000	0.3299	-2.2783	6.1906	2978.25	0.0000

DEBT	0.4076	0.3757	0.3969	11.3182	210.8240	4206434.00	0.0000
AC	0.4571	0.2748	0.5638	2.6947	13.4908	13388.58	0.0000
GROWTH	0.1169	0.0743	0.1253	1.8319	7.4696	3214.82	0.0000
PM	0.0076	0.0626	4.1529	20.0851	958.4282	88016461.00	0.0000

#### 4.1 Results of Data on normality test

The findings of the normality tests are shown in Table 2. Results show that the variable are not are not normally distributed. Based on Jarque Bera, Skewness and Kortosis suggest that there is a problem of normality, therefore likely that the utilization of Ordinary Least

Square (OLS) to analyze the data would produce biased and imprecise estimators. Hence for this reason, the Generalized Least Square (GLS) method is more appropriate and can be expected to yield a much better result (Gujarati, 2002).

**Table 2.** Differences characteristics of GLC and Non-GLC companies

Variables	GLCs	Non-GLC	t-statistic	significant
no of company	30	180		
Observations	330	1980		
Market measurements				
Tobin's Q (TobinQ)	1.2865	1.5265	-2.6518	*
Accounting measurements				
Return on Assets (ROA)	0.0546	0.0233	4.3238	*
Control variables				
Size (Growth)	14.457	13.3100	14.7869	*
Leverage (Debt)	0.3610	0.4154	-2.3063	**
Other variables				
Non-Duality (ndual)	0.9970	0.8556	7.2896	*
Agency cost (AC)	0.1325	0.8451	-19.4068	*
Cash to Assets (Growth)	0.1340	0.1141	2.6773	*
Profitability (PM)	0.1481	-0.0158	0.6635	
*** significant at 0.01 level				
** significant at 0.05 level				
* significant at 0.1 level				

Table 2 present the mean difference of the characteristics of GLCs and Non-GLC companies. Findings appear to suggest a significant difference exist between two groups based on performance, governance ownership, leverage and risk, growth opportunities, agency cost. The hypothesis of no difference between the two groups is rejected at the conventional level. Results show that portfolios of control companies (nonGLCs) outperform GLCs for market performances (Tobin's Q). At the same time, result of test for Tobin's Q shows negative and significant at the 1% level. As mentioned earlier, government owned large percentage of market capitalization therefore, it will show big impact of decreasing in market price when crisis hit Malaysia until recovery section in 2000 onwards. This some how contradict with the findings by Ang and Ding (2005) and Singh and Siah (1998). They suggested that shown GLCs outperform non-GLCs on both counts of

profitability (ROA and ROE). For example, Ang and Ding's result in Singapore study shows that GLCs are able to achieve at least similar levels of profitability with that of and non-GLCs.

In the context of the difference in leverage, the study found that GLCs record lower debt ratio compare to non GLCs with negative correlation, significant at 5% level. Similarly growth opportunities for GLCs tend to be lower than nonGLCs. We also find that GLCs maintain a significantly higher cash to asset ratio than nonGLCs and positively correlated and significant at the 1% level. In measuring agency costs, we examining the expense to sales (Ang et al, 2000) and results show that GLCs in fact have lowers expenses at the 1% level. This finding supported by Pearson's correlation in Table 3 which show negative correlated and significant for both ratios.

**Table 4.** Fixed Panel Regression result for Tobin's Q and ROA as performance

Model 1: Tobin's Q with Fixed effect				Model 2: ROA with Fixed effect			
Variable	Coefficient	t-Statistic	Prob.	Variable	Coefficient	t-Statistic	Prob.
C	2.3027	10.0614(***)	0.0000	C	-0.1156	-5.3029(***)	0.0000
Gowned	0.1140	1.7750(*)	0.0760	Gowned	0.0223	3.6445(***)	0.0003
Size	-0.1066	-6.5991(***)	0.0000	Size	0.0082	5.3016(***)	0.0000
nDual	0.0131	0.2078	0.8354	NDual	0.0139	2.3013(**)	0.0215
Debt	0.7343	11.9148(***)	0.0000	Debt	-0.0394	-8.3389(***)	0.0000
AC	0.1898	4.9237(***)	0.0000	AC	0.0212	5.7367(***)	0.0000
Growth	1.8251	10.5691(***)	0.0000	Growth	0.2140	13.4237(***)	0.0000
PM	0.0000	0.1534	0.8781	PM	0.0007	22.8840(***)	0.0000
R-squared	0.2276			R-squared	0.3060		
Adj R-squared	0.2219			Adj R-squared	0.3008		
F-statistic	39.6916			F-statistic	59.3949		
Prob(F-stat)	0.0000			Prob(F-stat)	0.0000		

*Notes:*  
 \*\*\* Correlation is significant at the 0.01 level  
 \*\* Correlation is significant at the 0.05 level  
 \* Correlation is significant at the 0.1 level

In summary, we can conclude that GLCs tend to exhibit higher valuation than nonGLCs due to their ability to earn higher returns on their investments, including running more efficient and lower expenses operations nonGLCs. The results support our hypothesis that GLCs outperform nonGLCs not only in market based valuation measures, but also in accounting based measures of internal process efficiency.

#### 4.3 Panel and pooled regression analysis

To provide objectives evaluation of the impact of good governance as proxied by government ownership and control, the model includes 7 important variables to address corporate governance issue, size, role of CEO, leverage, growth opportunities, agency cost and profitability issues. Panel based regression is run over a period from 1995 to 2005 for both Findings are presents at the following Table.

$$Value = \beta_0 + \beta_1 Gowned + \beta_2 Size + \beta_3 nDual + \beta_4 Debt + \beta_5 AC + \beta_6 Growth + \beta_7 PM \dots (Eq.1)$$

##### 4.3.1 Result Based on Market measure

Findings from Model 1 based on Tobin's Q, a model fitness with the F-value of 39.6916 is significant at any level and adjusted R<sup>2</sup> is 22.19%. The joint null hypothesis of none of the variables are significant is rejected. The coefficients of the explanatory variables are consistent with the hypothesized objective in the Malaysian Context. Results support the contention that government ownership does provide an important impact on performance in Malaysia with a (t = 1.7750), significant at 10% level. This is consistency with findings by Ang and Ding (2005 et. al.) and Dyck and

Wruck (1998) who documented that government involvement through government agency will lead to better performance of company. The results also indicate a positive and significant (p<0.01) relationship between market performance and leverage factors (t = 11.9148), implying that the market perceive leverage as an effective mechanism to control management and improve performance. For agency costs, result appear to document a significant positive association between agency cost and company performance at 1% level (which t = 4.9237). However, this appears to be inconsistent with Ang and Ding (2000) who record a negative association between agency cost and company performance. While growth opportunities (cash to total assets), appear to have an important impact on company performance significantly at 1% indicate that cash rich companies will have more leverage in improving company's performance by engaging in growth activities. While cash rich company performance meet any due obligation and potential downfall. Surprisingly, both duality and Profit Margin are not found to have any significant impact on market based performance measure Tobin Q.

##### Result Based on Accounting Measure

Result from Model 2 which we use ROA as company performance (accounting measurement) shows that a model appropriateness with the F-value of 59.3949 is significant at any level of significant and also adjusted R<sup>2</sup> is 30.08%. The joint null hypothesis of the variables are significant is rejected except size and debt. These two variables seem are inconsistent with the hypothesized objective in the Malaysian Context. For example, in this result a positive relationship between size of company and performance (t- 3.6445 and significant at 1% level). It shows that company with

larger assets seems show better performance than small company. This result is consistency with finding by Ang and Ding (2005 et al.) and RosHaniffa (2000).

Meanwhile in debt ratio, a negative result ( $t = -8.3389$  and significant at 1% level) explain that company with lower debt show better performance and this result reliable with the findings of McConnell and Servaes (1995) and Weir et al (2002). As Model 1, results support the contention that government ownership does provide an important impact on performance in Malaysia with a ( $t = 3.6445$ ), significant at 1% level. This is consistency with findings by Ang and Ding (2005 et. al.) and Dyck and Wruck (1998) who documented that government involvement through government agency will lead to better performance of company. For agency costs, result appear to document a significant positive association between agency cost and company performance at 1% level (which  $t = 5.7367$ ). However, this appears to be inconsistent with Ang and Ding (2000) who record a negative association between agency cost and company performance.

For nonduality, a result show positive relationship ( $t = 2.3013$ ) at 5% level of significant shows that with separate person between Chairman and CEO will lead to better performance and align with MCCG recommend. While growth opportunities (cash to total assets) with  $t = 13.4237$ , appear to have an important impact on company performance significantly at 1% indicate that cash rich companies will have more leverage in improving company's performance by engaging in growth activities. While cash rich company performance meet any due obligation and potential downfall. Then, profit margin shows positive relationship with accounting performance with t-statistics is 22.8840 at 1% level of significant

## 5. Summary and conclusion

In this paper, we have discussed on the ownership/control structure of Malaysian company and its performance in generally and comparing GLCs and non GLCs specifically with some company specific characteristics. We take sample of 210 companies listed in Main Board in Bursa Malaysia. We then compute the Tobin's Q as proxy of company value (as market performance) and ROA as accounting performance. These two different measurements use to make comparison whether its show same or different result. Based from our study, we find that in market measurement, non GLC outperform GLCs but in accounting measurement, otherwise when GLCs perform better. As general, we can conclude that GLC is better than nonGLCs base on mean performance of company specific characteristics such debt, growth, agency cost and profitability.

Our main objective is to determine whether government involvement in company lead to better company performance after considering company specific characteristics such as risk, corporate

governance, growth and profitability. Result show government ownership of company performance better than non-government after controlling these specific characteristics for both measurements (market and accounting). This result is happened because government through Khazanah Nasional and other seven investment bodies as mentioned earlier is a major shareholder in main services and utilities provider to nation which including electricity, telecommunications, postal services, airlines, airport, public transport, water and sewerage, banking and financial services. With that, government will do something to avoid any circumstances from underperforms of their investment companies.

In finding from our studies, we believed that it may shed new light into corporate finance literature on government involvement in company through government agencies and their performances. Secondly, it may contribute to the existing corporate finance literature by providing a new data set on government linked companies for Malaysia

## References

1. Ang, J.S., Cole, R.A., Lin, J.W., 2000, "Agency Cost and Ownership Structure", *Journal of Finance* 55, 81-106.
2. Ang, J.S. and Ding, D.K (2005), "Government Ownership and the Performance of Government Linked Companies: The Case of Singapore", *Journal of Multiple Financial Management*, pp 1-25.
3. Berle, A.A. and G. Means (1932) *The Modern Corporation and Private Property* (Commerce Clearing House, New York).
4. Carter, D.A., Simkins, B.J., Simpson, W.G. (2002), "Corporate Governance, Board Diversity and Company Value", *Finance Review*, vol.38, pp.33-53.
5. Claessens, S., S. Djankov and L.H.P. Lang (1999), "Who Controls East Asian Corporations", The World Bank Working Paper.
6. Downen, R.J. (1995), "Board Director Quality and Firm Performance", *International Journal of the Economics of Business*, vol.2, pp.123-32.
7. Dyck, I.J. Alexander and Karen H. Wruck, 1997, "Organization Structure, Contract Design and Government Ownership: A Clinical Analysis of German Privatization", *Journal of Corporate Finance: Contracting, Governance and Organization*, vol. 4, pp. 265-299.
8. Fama, E.F. and M.C. Jensen (1983), "Separation of Ownership and Control", *Journal of Law and Economics*, Vol. 26, pp. 301-25.
9. Gursoy, G. and Aydogan, K (2002) , "Equity Ownership Structure Risk Taking and Performance: An Empirical Investigation in Turkish Listed Companies", *Emerging Market Finance and Trade*, vol. 38, no.6, pp.6-25.
10. Haniffa, R. and Hudaib, M (2006), "Corporate Governance Structure and Performance of Malaysian Listed Companies", *Journal of Business Finance and Accounting*, pp. 1-29.
11. Hannan, M. T. and Freeman, J. (1989), *Organization Ecology* (Cambridge, Massachusetts: Harvard University Press).
12. Hermalin, S. and Weirsbach, M (1991), "The Effect of Board Composition and Direct Incentive on Firm

- Performance”, *Financial Performance*, Vol. 20, pp. 101-12.
13. Jensen, M.C (1986), “Agency Cost of Free Cash Flow, Corporate Finance and Takeovers”, *American Review*, vol. 76, pp. 471-517.
  14. Kumar, J (2003), “Does Ownership Structure Influence Firm Value? Evidence from India”, *Journal of Financial Management*, pp 1-45.
  15. LaPorta, R., Lopez-de-Silanes, F. and Shleifer, A. (1999), “Corporate Ownership around the World”, *Journal of Finance*, vol.54, pp. 471-517.
  16. McConnell, J. and Servaes, H. (1995), “Equity Ownership and the Faces of Debt”, *Journal of Financial Economics*, vol. 27, pp. 595-613.
  17. Mehran, H. (1995), “Executive Compensation Structure, Ownership and Firm Performance”, *Journal of Financial Economics*, vol. 38, pp. 163-84.
  18. Morck, R., A. Shleifer and R. Vishny (1998), „Management Ownership and Market Valuation: An Empirical Analysis“, *Journal of Financial Economics*, Vol. 20 pp. 293-315.
  19. OECD (1999), „Corporate Governance in Asia: A Comparative Perspective“, *Conference Proceeding (Seoul, Korea)*.
  20. Orden, O.D and A. Garmendia (2005), “ Does it Matter Ownership Structure? Performance in Spanish Companies”, *Journal of European Financial Management*, pp .1-40
  21. Putrajaya Committee GLCs High Performance”s Summary of Transformation Manual, Mac 2007.
  22. Sabhlok, A., (2001), “ The Evolution of Singapore Business: A Case Study Approach”. *Working Paper* , Institute of Policy Studies, Singapore.
  23. Shleifer, A., Vishny, R.W., (1997), “ A Survey of Corporate Governance”, *Journal of Finance* 52, pp.737-783.
  24. Singh K., Siah, H.A., (1998), “The Strategies and Success of Government Linked Corporation in Singapore”. *Research Paper Series #98-06*, Faculty of Business Administration, National University of Singapore.
  25. Tian, L. and Estrin, S. (2005), “Retained State Shareholding in China PLCs: Does Government Ownership Reduce Corporate Value?”, *IZA Discussion Paper No. 1493*, IZA Born
  26. Titman, S. and Wessels, R. (1988), “The Determinants of Capital Structure”, *Journal of Finance*, vol 43, pp. 1-19.
  27. Weir and McKnigh, P. (2003), “Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies”, *Journal of Business Finance and Accounting*, vol. 29, pp. 579-611.
  28. Zeitun, R. and Tian, G.G. (2007), “Does Ownership Affect a Firm”s Performance and Default Risk in Jordan?”, *Corporate Governance*, vol. 7, no. 1, pp. 66-82.

## Appendix

**Table 3.** Pearson correlation matrix

	Gowned	Ngowned	Size	TobinQ	Duality	Debt	ROA	TEpTAs	CashToAs	PM
Gowned	1.0000	-1.0000(***)	0.2942(***)	-0.0551(***)	0.1500(***)	-0.0480(*)	0.0896(***)	-0.2746(***)	0.0556(***)	0.0138
		0.0000	0.0000	0.0081	0.0000	0.0212	0.0000	0.0000	0.0075	0.5071
Ngowned		1.0000	-0.2942(***)	0.0551	-0.1500(***)	0.0480(**)	-0.0896(***)	0.2746(***)	-0.0556(***)	-0.0138
			0.0000	0.0081	0.0000	0.0212	0.0000	0.0000	0.0075	0.5071
Size			1.0000	-0.2344(***)	0.0088	0.1175(***)	0.0586(***)	-0.2003(***)	-0.1290(***)	0.0338
				0.0000	0.6727	0.0000	0.0048	0.0000	0.0000	0.1041
TobinQ				1.0000	-0.0170	0.1402(***)	0.1962(***)	0.1389(***)	0.2111(***)	0.0127
					0.4137	0.0000	0.0000	0.0000	0.0000	0.5429
Duality					1.0000	0.0275	0.0693(***)	0.0613(***)	0.0206	-0.0423(**)
						0.1863	0.0009	0.0032	0.3228	0.0421
Debt						1.0000	-0.1719(***)	0.0995(***)	-0.1566(***)	-0.0393(*)
							0.0000	0.0000	0.0000	0.0590
ROA							1.0000	0.0839(***)	0.2297(***)	0.1737(***)
								0.0001	0.0000	0.0000
AC								1.0000	0.1187(***)	0.0015
									0.0000	0.9418
Gowth									1.0000	0.0392(*)
										0.0598
PM										1.0000

\*\*\* Correlation is significant at the 0.01 (2-tailed)

\*\* Correlation is significant at the 0.05 (2-tailed)

\* Correlation is significant at the 0.1 (2-tailed)

### A. MARKET CAPITALIZATION AND SHAREHOLDING LEVELS OF LISTED GLCS

No	Company	Market Cap (RM millions)	Total Govt Shareholding (%)
1	Malayan Banking Berhad	44,708	63.5
2	Telekom Malaysia Berhad	34,871	63.8
3	Tenaga Nasional Berhad	32,966	73.7
4	M.I.S.C Berhad	29,387	72.1
5	Sime Darby Berhad	14,214	57.3

6	Petronas Gas Berhad	14,148	89.8
7	PLUS Expressways Berhad	13,350	77.0
8	BCH Berhad	12,495	47.9
9	Golden Hope Plantations Berhad	5,466	78.8
10	Malaysia Airline System	4,838	80.8
11	Proton Holdings Berhad	4,586	68.8
12	Petronas Dagangan Berhad	3,954	78.0
13	Island & Pennisular Berhad	3,781	56.3
14	UMW Holdings Berhad	2,523	58.6
15	Kumpulan Guthrie Berhad	2,224	82.5
16	Affin Holdings Berhad	2,112	54.3
17	Malaysian Airports Holdings Berhad	1,639	77.3
18	Bintulu Port Holdings Berhad	1,568	71.3
19	POS Malaysia	1,471	35.4
20	NCB Holdings Berhad	1,298	60.2
21	UEM World Berhad	1,291	50.8
22	MIDF Berhad	1,259	40.1
23	Boustead Holdings Berhad	1,004	71.3
24	BIMB Holdings Berhad	963	67.6
25	CCM Berhad	881	69.4
26	Malaysian Nasional Reinsurance Bhd	714	69.3
27	MNI Holdings Berhad	707	84.6
28	UDA Holdings Berhad	692	56.7
29	MRCB	542	30.6
30	Pelangi Berhad	429	43.2
31	Time Engineering Berhad	336	51.9
32	Malaysia Building Society Berhad	252	79.1
33	Faber Group Berhad	127	41.4
34	Formosa Prosonic Industries Berhad	111	28.5
35	Central Industrial Corporation Berhad	66	38.6
36	Ya Horng Electronics (M) Berhad	51	29.6
37	Hunza Consolidation Berhad	47	19.1
38	D'Nonce Technology	41	24.4
39	Johan Ceramics Berhad	31	73.4

## B. MARKET CAPITALIZATION OF SUBSIDIARIES OF GLCs

No	Company	Holding Company	Market Cap (RM millions)
40	CIMB Berhad	BCHB (formerly Commerce Asset Holdings Berhad)	4,371
41	Highlands & Lowlands Berhad Kumpulan	Guthrie Berhad	2,176
42	Sime UEP Properties Berhad	Sime Darby Berhad	1,739
43	UEM Builders Berhad	UEM World Berhad	1,002
44	Time Dotcom Berhad	Time Engineering Berhad	974
45	Boustead Properties Berhad	Boustead Holdings Bhd	939
46	Tractors Malaysia Holding Berhad	Sime darby Berhad	785
47	Pharmaniaga Berhad	UEM World Berhad	551
48	Guthrie Ropel Berhad	Kump Guthrie	467
49	Sime Engineering Services Berhad	Sime Darby Berhad	441
50	UAC Berhad	Boustead Holdings Bhd	366
51	Negara Properties (M) Berhad	Golden Hope Plantations Berhad	280
52	Cement Industries of Malaysia Berhad	UEM World Berhad	231
53	Sykt Takaful Malaysia Berhad	BIMB Holding Berhad	172
54	Vads Berhad	Telekom Malaysia Berhad	163
55	Acoustech Berhad	Formosa Prosonic Industries Berhad	131
56	Mentakab Rubber Company (Malaya) Berhad	Golden Hope Plantation Berhad	129
57	Opus International Group PLC	UEM World Berhad	128

# THE ADJUSTMENTS OF CORPORATE GOVERNANCE MECHANISMS IN CANADIAN BANKS FOLLOWING REGULATORY CHANGES

*Michael Maingot\*, Daniel Zéghal\**

## Abstract

The recent scandals on corporate governance have forced the regulatory bodies to issue new corporate governance mechanisms. These new governance mechanisms include banks. The purpose of this study was to observe changes to the boards of directors, to the committees reporting to the board, to the board of directors' independence and adoption to certain charters and checklists in Canadian banks for the periods covering the years 2002-2004. Our sample covers the eight largest domestic banks in Canada. Results indicate a reduction in board members and in the number of committees reporting to the board. However, it increased supervision by increasing the number of board committee meetings. Most of the banks in our sample have separated the role of Chairman and CEO, thereby increasing the independence of the board. There was also an improvement in the adoption of a new charter for the board of directors.

**Keywords:** Corporate governance, regulatory bodies, board of directors, committees of the board.

*\*Telfer School of Management, University of Ottawa, 55 Laurier St. East, Ottawa, Ontario, Canada K1N 6N5*

*Email: maingot@telfer.uottawa.ca, zeghal@telfer.uottawa.ca*

*Acknowledgements: The paper has benefited from the comments of the participants of the EAA Conference in Göteborg, Sweden in 2005, the Department of Business Studies at the Aarhus School of Business, in Denmark in December 2006 and the participants at the Irish Accounting and Finance Association Conference in Tralee, Ireland in May 2007.*

*The financial support of the CGA Accounting Research Centre at the University of Ottawa is gratefully acknowledged.*

## 1. Introduction

The purpose of this paper is to observe how corporate governance changes in Canadian banks in response to regulatory modifications during the years 2002, 2003 and 2004, after the wave of corporate scandals of 2001. The main focus of our research is to observe the changes to the board of directors, the changes to the committees reporting to the board, the changes to the board of directors independence, and the adoption of certain charters and corporate governance guidelines of the Toronto Stock Exchange (TSE), Ontario Securities Commission (OSC) and the Bank Act 1991. Since the 5 largest banks in Canada are also listed on the New York Stock Exchange (NYSE), they therefore, must comply with the NYSE Corporate Governance Guidelines and the corporate governance procedures dictated by the Sarbanes – Oxley Act of 2002.

From the end of World War II until the end of the mid 1980s, little attention was paid to the role of the board in the governing of the corporation, or indeed to any aspect of corporate governance. In fact, the term “corporate governance” was not even used until well into the 1980s (Bliss, 1987, CIMA 2000, Leblanc and Gillies 2005). Corporate governance has recently received much attention due to high profile scandals such as Adelphia, Enron, World Com, Parmalat and Nortel (Brown and Caylor, 2006; Leblanc and Gillies 2005).

Some of the earliest considerations of corporate governance came from the United States (US). The Threadway Commission issued a report on fraudulent financial reporting in 1987 (Threadway Report 1987) which influenced the Securities and Exchange Commission (SEC) to incorporate in its listing agreement from 1988, that all SEC regulated companies should have an audit committee with a majority of non-executive directors (CIMA 2000).

Corporate governance has received wide attention recently in both practice and in academic research (Brown 1999; Levitt 1998; Beasley, Carcello and Hermanson 1999; De Zoort and Salterio (2001); Xie et al (2003); Eng and Mak (2003); Ho and Wong (2001); Beasley et al (2000); Levitt, 1999, 2).

In response to the wave of scandals, the regulatory bodies that govern capital markets issued new directives on good corporate governance. In the United Kingdom (UK), the Cadbury Report (1993) recommended that public companies have at least three independent directors and that the boards of these companies appoint an audit committee comprised of independent directors. In Canada, the MacDonald Commission (1988) required all public companies to have an audit committee composed entirely of independent directors.

The Bank Act (1991), in Canada, provides regulations on corporate governance of Canadian banks. The Toronto Stock Exchange (TSE) has also prepared guidelines on corporate governance

consisting of 14 points which deal specifically with the powers of the board, the review procedures required for good governance and the roles of committees (Dey, 1994). The Ontario Securities Commission (OSC), in the province of Ontario, Canada, has also provided guidance on corporate governance best practice, but it is not mandatory (OSC – Multilateral Instrument 58-101). Since many Canadian companies, including Canadian banks, are listed on the New York Stock Exchange (NYSE) they must comply with the corporate governance guidelines issued there. In July 2002, in response to the Enron and World Com scandals, the Sarbanes – Oxley Act was enacted in an effort to maintain investor confidence and combat fraud on the market. The act introduced measures to strengthen the composition and independence of audit committees (Sarbanes – Oxley Act of 2002 [2002], 107<sup>th</sup> session of the United States Congress). A summary of the regulations on corporate governance mechanisms in Canada and the US is given in Appendix I. The main purpose of these regulations and laws is not only to strengthen corporate governance, but also, to effectively delineate the rights and responsibilities of each group of stakeholders of the company (Levitt 2000b; Ho and Wong, 2001; Blue Ribbon Committee, 1999; Cohen and Hanno, 2000).

The rest of the paper is organized in the following way. Section II examines and describes the characteristics of the banking sector in Canada. Section III presents the research methodology and how the data are gathered from the proxy statements and the annual reports on the websites of the banks, while Section IV gives a review of the literature. Section V analyzes the data and discusses the results of our findings. The conclusion is given in Section VI.

### Characteristics of the Banking Sector in Canada

As of February 2003 the Canadian banking industry is comprised of 18 domestic banks and 25 foreign bank subsidiaries. In total, these institutions have over 1.79 trillion dollars in assets, which represent more than 70% of all assets in the Canadian financial service sector. “Canada’s banks operate through an extensive network that includes over 8,000 branches and close to 18,000 automated banking machines (ABMs) across the country.”<sup>2</sup> The 5 largest banks dominate the market with 88% of all banking assets under their control (see Table 1). The other 13 domestic banks hold less than 6% of total assets. Therefore, it is not surprising that studies on the Canadian banking industry often concentrate on the 5 leading banks.

In 2003, the banking sector made 11.9 billion dollars in net income. The main source of revenue for the banking industry is net interest income, the difference between interest paid on liabilities (such as deposits) and interest received on assets (such as

mortgages). However, the contribution of non-interest income to revenue has increased over the years. Non-interest income includes fees for services such as “mutual fund and wealth management, securities underwriting, derivatives trading, asset securitization, brokerage transactions, ABM transactions, credit card transactions, foreign exchange and deposit services.”<sup>3</sup> Historically, 48% of all bank earnings are paid in taxes, 15% are reinvested into the business while the other 37% are distributed to shareholders<sup>4</sup>. In recent years the 5 largest Canadian banks have demonstrated consistent performance as measured by their net income and have enjoyed a rising trend in the total asset size of their portfolio. It is also important to note that these banks have significant international operations, which account for almost one third of their gross revenue.<sup>5</sup> Furthermore, the big five have also implemented automation and strict management control systems to drive cost down.

Banks are among Canada’s leading employers. In 2000, the industry employed over 268,210 Canadians and had a Canadian payroll of approximately \$16.1 billion. This means that the good and bad fortunes of the banking sector greatly influence the employment picture of the Canadian economy. In addition, in 2002 the six major domestic banks paid \$5.8 billion in taxes to all levels of government.<sup>6</sup>

Since this industry is one of the key factors in a healthy Canadian economy, it is heavily regulated and supervised by a government agency. The Office of the Superintendent of Financial Institutions (OSFI) is the federal agency principally responsible for supervising all federally regulated financial institutions and pension plans. OSFI’s role is to safeguard policyholders, depositors and pension plan members from undue loss, and to advance and administer a regulatory framework that contributes to public confidence in a competitive financial system.<sup>7</sup>

The banking sector of the Canadian economy is a very competitive mature industry with high barriers of entry. The main barriers of entry are the need for: sophisticated knowledge of risk management, advanced technology and a large capital investment. The existing banks derive stability from their large diversification into different financial products and their exposure to international markets, such as the United States. The fortune of Canadian banks has been helped by the strong credit culture in Canada and the population’s ability to adopt new technologies into their way of life. The Canadian banks are one of the

<sup>2</sup> Ministry of Finance, [http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

<sup>3</sup> Ministry of Finance, [http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

<sup>4</sup> Canadian Banking Association, <http://www.cba.ca/en/viewDocument.asp?fl=6&sl=111&tl=&docid=400&pg=1>

<sup>5</sup> Ministry of Finance, [http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

<sup>6</sup> Canadian Banking Association, <http://www.cba.ca/en/viewDocument.asp?fl=6&sl=111&tl=&docid=400&pg=1>

<sup>7</sup> Ministry of Finance, [http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)



most technologically advanced in the world. For example: “Canada has the highest number of ABM per capita in the world and benefits from the highest penetration levels of electronic channels such as debit cards, internet banking and telephone banking.”<sup>8</sup> In addition, Canada’s banks play an important role in the national clearing and settlement system, which is among the most efficient payment systems in the world. In 2001, the system cleared over 4.4 billion transactions worth over \$33 trillion for all Canadian institutions.<sup>9</sup>

As of February 2003, 25 foreign bank branches were operating in Canada. The recent increase in the number of foreign bank branches stems directly from new legislation passed in 1999 allowing foreign banks to establish operations in Canada without having to set up Canadian-incorporated subsidiaries.<sup>10</sup> Most of the foreign branches are from some of the largest banks in the world but, as of yet, they have not been able to penetrate the Canadian market. These banks represent only 5% of all banking assets in Canada, but there has been a recent trend upwards in the growth of their assets in Canada.

## Methodology and Data

### Sample Selection

The sample for this paper is drawn from the banks listed on the Toronto Stock Exchange. While there are 43 chartered banks currently operating in Canada, only 8 met the required criteria of the study. These criteria were:

1. The subject bank must be a widely held bank. Hence, no single shareholder can own more than 10% of the total shares of the bank. This excludes all bank subsidiaries. This selection criterion was added because bank subsidiaries do not have the same disclosure requirements or the same corporate governance mechanisms as widely held banks and the aim of the study was to keep the type of banks constant. Simply put, this selection criterion allowed the study to compare “apples with apples”.
2. The bank must be traded on a stock exchange. This selection criterion was added to guarantee that the bank would publish an annual report and an annual proxy statement available to the public, and thus allow the study to keep the sources of information between banks constant.
3. The bank must be chartered in Canada. This excludes all foreign subsidiaries and thus focuses the study on Canadian chartered banks.

Although the 3 selection criteria above reduce the sample size to 8 banks, the researchers believe that they are necessary to keep as many variables as possible constant and to better narrow the focus of the study. The 8 banks selected are: Royal Bank of Canada (RBC), Toronto-Dominion Bank (TD), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal (BMO), National Bank of Canada (NBC), Laurentian Bank of Canada (LBC) and Canadian Western Bank (CWB). Table 2 shows the sample selected and it should be noted that it accounts for 94.24 percent of the total assets of all Canadian banks.

There are only 8 widely held chartered domestic banks in Canada and all of these banks disclosed their corporate governance information on the web. This is not surprising since they are public corporations listed on the TSE. In addition, the 5 largest banks in Canada are listed on the NYSE and the 2 largest banks in Canada are also listed on other foreign stock exchanges.

The other 35 banks are subsidiaries of either other banks or of large corporations. Although most parent companies disclose corporate governance information, their subsidiaries in Canada offer little valuable information on their governance structure. Only 4 bank subsidiaries divulge the names of their board of directors. Furthermore, only 2 subsidiaries publish annual reports, and of these two, HSBC Canada is obliged to reveal this information because it is listed on the TSE.

### Source of Data

The Internet was the major data collection device used to research corporate governance of Canadian banks. There were 3 sources of data that disclosed corporate governance information: the corporate governance section of the website, the 2002, 2003, 2004 annual reports available on the website and the 2002, 2003, 2004 proxy circulars, also available on the website. The annual reports and the proxy circulars were found to be the most useful data source.

Methodology Used to Construct the Tables for 2002, 2003 and 2004

#### Size of Board

The number of candidates for re-election was counted from the annual reports and proxy statements.

#### Diversity of Board Members

The pictures of women and visible minorities presented in the annual reports and proxy statements were examined. The methodology is supported in the literature (Brammer et al 2007; Bernardi et al 2005; Bernardi et al 2002).

<sup>8</sup> Ministry of Finance,  
[http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

<sup>9</sup> Ministry of Finance,  
[http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

<sup>10</sup> Ministry of Finance,  
[http://www.fin.gc.ca/toce/2002/bank\\_e.html](http://www.fin.gc.ca/toce/2002/bank_e.html)

**Table 1.** Banks in Canada Ranked by Asset Size (in \$100,000 of CDN)

Ranking by Assets		Name of Financial Institution	Total Assets (as of 2004-02-29)	Percentage of total assets	Cumulative % of total assets
World (2002)	Canada (2004)				
51	1	Royal Bank of Canada	427,628	23.88%	23.88%
64	2	Toronto-Dominion Bank (The)	313,306	17.50%	41.38%
60	3	Bank of Nova Scotia (The)	288,955	16.14%	57.52%
65	4	Canadian Imperial Bank of Commerce	286,745	16.01%	73.53%
66	5	Bank of Montreal	268,919	15.02%	88.55%
149	6	National Bank of Canada	80,514	4.50%	93.05%
7	7	HSBC Bank Canada	37,798	2.11%	95.16%
	8	Laurentian Bank of Canada	16,925	0.95%	96.10%
1	9	Citibank Canada	13,494	0.75%	96.86%
21	10	ING Bank of Canada	13,020	0.73%	97.58%
19	11	Société Générale (Canada)	9,779	0.55%	98.13%
	12	Amicus Bank	5,484	0.31%	98.44%
	13	Canadian Western Bank	4,315	0.24%	98.68%
		OTHERS	23,695	1.32%	100%
		Total of All Banks in Canada	1,790,576.66		

- A bank is defined as a financial institution that accepts deposits in Canada  
- Domestic banks are bolded. Foreign banks in voluntary liquidation were excluded.  
- Assets Size for 2004 - Source: <http://www.osfi-bsif.gc.ca/eng/institutions/banks/financial/index.asp>  
- Top 150 World Banks Ranked by Asset Size - Source: *The Banker*, July 2003

**Table 2.** Sample Selected

Bank	Total Asset's (in \$100,000)	Percentage of total assets	Number of Employees
RBC	427,628	23.88%	59,575
TD	313,306	17.50%	41,934
BNS	288,955	16.14%	44,294
CIBC	286,745	16.01%	42,000
BMO	268,919	15.02%	33,993
NBC	80,514	4.50%	13,910
LBC	16,925	0.95%	3,167
CWB	4,315	0.24%	873

*Number of Committees*

The annual reports and proxy statements were examined and the number of committees were counted.

*Number of Corporate Governance Meetings*

A count was done after an examination of the annual reports and the proxy statements.

*Size of Committees*

The number of members in each committee reporting to the board was obtained by

counting the names in the proxy statements and annual reports under each committee report.

*Independence of the Board of Directors*

The two sources of data for determining the independence of the board members are the annual reports and the proxy statements. The types of independent board members identified are unrelated directors, unaffiliated

directors, and directors not from management.

#### *Separation of the Role of Chairman and Chief Executive Officer*

The information on the split of the roles is obtained for the annual reports and the proxy statements. The subject bank receives a positive rating of 1 if the role of chairman and CEO has been separated. Otherwise, the bank receives a negative rating of 0.

#### *Adoption of TSE Corporate Governance Guidelines*

The sources of data were the annual reports and proxy statements. The scoring is similar to what is used in item 7 above.

#### *Adoption of Charters by the Committees and the Board of Directors*

The sources of data are the annual reports and proxy statements. The scoring is similar to that used in item 7 above.

### **Review of Literature**

The subject of corporate governance is of enormous importance. There is a great deal of disagreement about how good or bad existing governance mechanisms are. Favourable assessments of the US corporate governance system are given by Easterbrook and Fischel (1991) and Romano (1993a). The United States, Germany, Japan and the United Kingdom have some of the best corporate governance systems in the world (Shliefer and Vishny, 1997). The latter authors, as well as others (Jensen and Meckling, 1976; Fama and Jensen, 1983a, b), believe that corporate governance is a straightforward agency problem arising because of the separation of ownership and control in the corporate (and non-corporate) world.

The emphasis on corporate governance and strengthening of corporate governance has received considerable publicity because of the highly publicized financial reporting frauds or scandals mentioned earlier (eg. Blue Ribbon Committee Report 1999; Sarbanes-Oxley Act 2002; Bebchuck and Cohen 2004). There have been a spate of earnings restatements (Loomis 1999; Wu 2002; Palmrose and Scholz 2002; Larker et al 2004). Academic research has found an association between weak governance and poor financial reporting quality, earnings manipulation and weak internal controls (eg. Dechow et al 1996; Beasley, 1996; Beasley et al 1999; Beasley et al 2000; Carcello and Neal, 2000; Forker 1992). Throughout the world, there is an attempt to improve corporate governance over the financial reporting process. Legislation and guidelines have been introduced in Canada, the UK and the US to strengthen the financial reporting process.

Although there are extensive studies on the subject of corporate governance, there is practically no research on corporate governance in the Canadian banking sector. Most studies on corporate governance in the banking sector concentrate on American banks. Not surprisingly, the researchers at the Federal Reserve have been the main publishers of such reports.

*Adams and Mehran (2003)* have found that, in general, banks' board size are larger and are comprised of a higher percentage of outside directors than manufacturing firms. They also report that banks have more committees and that these committees meet more frequently than those of manufacturing firms. In addition, the CEOs of banks receive a proportionally higher percentage of their annual compensation in the form of salary and bonuses than their manufacturing counterparts. Furthermore, bank CEOs hold less equity in the company than do manufacturing CEOs.

*John and Qian (2003)* attempt to explain the compensation discrepancies between banks and other firms. They follow the general theory that, as leverage increases, shareholders will tend to encourage risky behavior. Since banks are highly leverage firms, if the executive motivations are closely aligned with those of shareholders they would engage in risky investments to the detriment of fixed claimants (ie: depositors and bondholders). Therefore, to negate this effect, bank executives are paid a higher proportion of their compensation in cash to increase their risk averseness and minimize the agency costs of debt.

This would be consistent with the *Macey and O'Hara (2003)* argument that banks should be governed by the Franco-German approach that has the interest of the long-term stakeholders, such as depositors, in mind instead on the Anglo-American approach that seeks to maximize shareholder value. They also argue that the major stakeholders (ie: depositors) disregard excessive risk taking by the bank because their deposits are federally insured. Therefore, bank regulators, in charge of deposit insurance, act as one of the mechanisms of corporate governance control since they attempt to minimize bank failures.

This last argument probably stems from the *Booth, Cornett and Tehranian (2002)* study that suggest that, as one method of monitoring corporate governance increases, the other methods of monitoring become less necessary. In this study, they observe that industries with extensive regulations tend to have less market-based corporate governance mechanisms, and yet, be equally well governed as those in less regulated industries. They conclude that monitoring by regulators helps to reduce the agency conflict of managers. This view is endorsed by *Pi and Timme (1993)* who observe that the most important corporate control mechanism in banks is regulatory intervention.

The results of these studies are quite interesting. Yet, one cannot automatically infer the corporate governance mechanism of Canadian banks from those of American banks. Furthermore, the studies highlighted above do not attempt to observe the evolution of corporate governance after regulatory changes.

## Analysis and Discussion of Results

**Table 4.** Number of Directors on the Board

Bank Name	2004	2003	2002
RBC	17	18	19
TD	15	16	16
BNS	15	18	20
CIBC	18	20	21
BMO	16	15	15
NBC	15	18	20
LBC	13	15	15
CWB	12	12	13
Average Size	15.1	16.5	17.4
Std. Dev.	2.0	2.5	3.0
Minimum Size	12 (CWB)	12 (CWB)	13 (CWB)
Maximum Size	18 (CIBC)	20 (CIBC)	21 (CIBC)

### Size of Board

Table 4 shows that the size of the board of directors of Canadian banks is well above the required number of 7

## Diversity of the Board of Directors

**Table 5.** Number of Women on the Board

Bank Name	2004	2003	2002
RBC	3	3	3
TD	3	2	3
BNS	3	3	3
CIBC	3	3	4
BMO	3	3	3
NBC	5	5	5
LBC	3	3	3
CWB	1	1	1
Average	3.0	2.9	3.1
Proportion	21%	18%	18%

The number of women on the board and the number of visible minorities on the board are presented in Tables 5 and 6 respectively. Our evidence suggests that the degree of diversity present in the boards of Canadian banks is very low. The number of women shows an average of 3 women on the board and between 18 to 21 percent. This is slightly higher than the rest of the country which is between 8 and 12 percent and have been relatively constant over the last ten years (Leblanc and Gillies, 2005). This compares well with the study by Bernardi et al (2002) which found that women make up 11.9 percent of Fortune 500 corporate boards of directors which is consistent with Daum's (2000) finding that women make up 12 percent of S&P boards. Opinions are mixed for the low number of women and visible minorities on the board. It appears that recruitment of new board members is mainly done through the "old boys club" and less women or minorities have access to such a network. One tends to believe the latter explanation.

There does not appear to be any link between

members demanded by the Bank Act (1991). The larger banks tend to have more directors than the smaller banks. A simple explanation for this discrepancy is that, since larger banks have more assets and are more diversified, they need more supervision and input from the board of directors. However, from Table 4, one observes that both the average size of the board and the standard deviation show a downward trend in all the banks. This reduction might be an indication that the board of directors is attempting to be more efficient or that the board wishes to give individual directors more decision-making powers. These results corroborate the findings of Leblanc and Gillies (2005) who found that the average size of boards in Canada is declining because boards are becoming more functional and less decorative (prestige). In the past, they claimed that Canadian banks had large boards exceeding 50 members in the 1950s, but they have reduced board membership size to between 10 and 15 members to make the boards more efficient and effective.

**Table 6.** Number of Visible Minorities on the Board

Bank Name	2004	2003	2002
RBC	0	1	1
TD	0	0	0
BNS	1	1	1
CIBC	0	1	1
BMO	1	1	1
NBC	0	0	0
LBC	0	n/a	n/a
CWB	n/a	n/a	n/a
Average	0.3	0.7	0.7
Proportion	2%	4%	4%

asset size and percentage of women on the board of directors. The National Bank of Canada has the largest percentage of women board members, while Canadian Western Bank has the lowest percentage. When it comes to visible minorities, all banks lack diversity, although the smaller banks (NBC, CWB and LBC) seem to fare worst in this category, since they do not have any minority members on their boards. The number of visible minorities on the board has decreased both on an average basis and a proportional basis (Table 6). For the years 2002 and 2003, the averages were slightly higher in Canada (0.7) than what was found by Brammer et al (2007), in their recent UK study on Gender and Ethnic Diversity Among UK Corporate Boards, where they found that the average size of the board was 0.2 for non-whites. The Bernardi (2005) study in the US was slightly higher at between 13.1 percent and 9.4 percent.

**Number of Committees**

**Table 7.** Number of Committees

Bank Name	2004	2003	2002
RBC	4	4	5
TD	4	4	3
BNS	5	6	6
CIBC	4	4	4
BMO	5	5	5
NBC	3	3	6
LBC	3	4	5
CWB	4	4	4
Average	4.0	4.3	4.8
Std. Dev.	0.76	0.89	1.04

Table 7 shows that the number of committees is decreasing over the years. From the evidence we obtained, this reduction is due to the fact that the banks are merging committees together to create committees with combined duties. The most common mergers are the Human Resource Committee and Nominating Committee or the Corporate Governance Committee and the Conduct Review Committee. The reason given for these mergers is that the board wishes to increase the power and efficiency of the committees.

**Number of Committee Meetings**

**Table 8.** Number of Meetings of the Conduct Review / Risk Committee

Bank Name	2004	2003	2002
RBC	6	7	8
TD	7	9	8
BNS	1	2	2
CIBC	9	12	15
BMO	4	12	11
NBC	5	5	6
LBC	9	10	7
CWB	2	2	3
Average	5.4	7.4	7.5
Std. Dev.	2.97	4.07	4.17

**Table 9.** Number of Meetings of the Corporate Governance Committee

Bank Name	2004	2003	2002
RBC	4	2	6
TD	6	6	4
BNS	4	3	3
CIBC	8	6	9
BMO	8	10	7
NBC	5	5	6
LBC	12	6	6
CWB	4	4	5
Average	6.4	5.3	5.8
Std. Dev.	2.83	2.43	1.83

**Table 10.** Number of Meetings of the Board of Directors

Bank Name	2004	2003	2002
RBC	10	12	12
TD	13	12	10
BNS	10	10	9
CIBC	19	15	13
BMO	12	18	13
NBC	13	15	14
LBC	17	14	18
CWB	6	6	7
Average	12.5	12.8	12.0
Std. Dev.	4.11	3.65	3.38

**Table 11.** Number of Meetings of the Audit Committee

Bank Name	2004	2003	2002
RBC	11	8	10
TD	4	9	8
BNS	6	8	5
CIBC	9	11	7
BMO	6	6	7
NBC	12	12	8
LBC	7	5	11
CWB	4	4	4
Average	7.4	7.9	7.5
Std. Dev.	3.02	2.80	2.33

**Table 12.** Number of Meetings of the Human Resource Committee

Bank Name	2004	2003	2002
RBC	3	3	6
TD	8	9	6
BNS	5	4	4
CIBC	7	5	4
BMO	8	12	8
NBC	6	7	9
LBC	12	8	6
CWB	4	4	5
-----	-----	-----	-----
Average	6.6	6.5	6.0
Std. Dev.	2.83	3.17	1.77

Companies usually report the number of board meetings and committee meetings in the proxy statement, and we interpret this as a measure of board and committee activity. Tables 8, 9, 10, 11 and 12 present the number of meetings, the average number of meetings and the standard deviation of the Conduct Review/Risk Committee, the Corporate Governance Committee, the Board of Directors, the Audit Committee and the Human Resource Committee.

Examining the 5 tables, one notices that the number of meetings of the board and of the committees varies widely among the banks. There does not appear to be a link between asset size and the number of corporate governance meetings. However, from the evidence we obtained, there seems to be a direct link

between the number of meetings and committee membership compensation. The highest paid committee, the Audit Committee has the highest number of meetings among the four committees, while the Conduct Review and Risk Committee, with the lowest paid members, has the fewest meetings.

Since the audit committee consists mainly of outside directors (Dey, 1994), it can help to reduce the amount of information that is withheld. Agency theory predicts the establishment of audit committees as a means of attenuating agency costs (Ho and Wong, 2001).

Table 10 shows that the average number of meetings of the Board of Directors is increasing from 12.0 in 2002 to 12.5 in 2004, while the range is from 6 to 19. The increase in board meetings and committee meetings is a good indication that the board and the committees are increasing their supervision of management. A major part of corporate governance is to provide oversight of the operations of management – the monitoring function. This can be viewed as an agency problem because of the separation of ownership and control. The interests of the shareholders and the managers of the corporation are not the same. The former want the maximization of shareholder wealth while the latter are the agents of the shareholders and are more interested in maximizing their own wealth through high salaries, bonuses, options and various perks. It is the role of the board of directors to control these “agency costs” in the interest of the shareholders [Jensen and Meckling (1976); Fama and Jensen 1983a, b); Leblanc and Gillies (2005)].

### Size of Committees

**Table 13.** Number of Members on the Conduct Review / Risk Committee

Bank Name	2004	2003	2002
RBC	6	6	7
TD	6	5	6
BNS	6	5	4
CIBC	5	5	6
BMO	6	6	6
NBC	7	7	7
LBC	5	5	6
CWB	4	4	4
Average	5.6	5.4	5.8
Std. Dev.	0.92	0.92	1.16

**Table 15.** Number of Members on the Audit Committee

Bank Name	2004	2003	2002
RBC	6	6	8
TD	6	5	6
BNS	7	6	8
CIBC	6	6	8
BMO	6	6	6
NBC	6	6	5
LBC	5	5	6
CWB	4	5	5
Average	5.8	5.6	6.5
Std. Dev.	0.89	0.52	1.31

**Table 14.** Number of Members on the Human Resource Committee

Bank Name	2004	2003	2002
RBC	6	6	8
TD	6	5	5
BNS	6	6	7
CIBC	5	5	5
BMO	4	4	4
NBC	6	7	6
LBC	4	5	6
CWB	6	6	6
Average	5.4	5.5	5.9
Std. Dev.	0.92	0.92	1.25

**Table 16.** Number of Members on the Corporate Governance Committee

Bank Name	2004	2003	2002
RBC	4	6	6
TD	6	6	5
BNS	5	5	5
CIBC	5	5	5
BMO	5	5	4
NBC	7	7	7
LBC	4	5	6
CWB	6	6	6
Average	5.3	5.6	5.5
Std. Dev.	1.04	0.74	0.93

From Tables 13, 14, 15 and 16, we observe that the number of members of each committee is decreasing. This is consistent with the goal of the board of directors of increasing efficiency and empowering individual directors. There are many reasons for this, but probably the most important one is that committees are becoming more functional and less decorative (Leblanc and Gillies, 2005). Another reason is the

increase in the definition, through the law, regulation and guidelines, of the responsibilities and duties of the members in the various committees. However, there is a negative aspect to this in that a smaller committee could also be prone to manipulation by influential directors or be less able to provide substantive oversight of management.

### Independence of Board of Directors

**Table 17.** Percentage of Unrelated Directors

Bank Name	2004	2003	2002
RBC	82%	89%	84%
TD	93%	81%	81%
BNS	80%	83%	80%
CIBC	89%	90%	86%
BMO	94%	93%	93%
NBC	73%	72%	75%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	87%	87%	86%
Std. Dev.	7.53%	7.36%	6.86%

**Table 18.** Percentage of Unaffiliated Directors

Bank Name	2004	2003	2002
RBC	88%	89%	84%
TD	93%	81%	81%
BNS	80%	83%	80%
CIBC	89%	90%	86%
BMO	94%	93%	93%
NBC	80%	67%	65%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	89%	86%	84%
Std. Dev.	5.61%	9.00%	9.48%

**Table 19.** Percentage Directors not from Management

Bank Name	2004	2003	2002
RBC	88%	89%	89%
TD	93%	94%	88%
BNS	87%	89%	90%
CIBC	94%	95%	95%
BMO	94%	93%	93%
NBC	93%	94%	95%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	92%	92%	92%
Std. Dev.	2.80%	2.38%	2.77%

In recent years, it has become the custom in various countries for regulators to classify directors as “unrelated” “versus related”, “outside directors”, “non-management directors”, “affiliated” versus “unaffiliated directors” (Canada), “independent” versus “non-independent” (US, Australia and New Zealand) or “executive” versus “non-executive” (UK) and to recommend that the majority of directors be outsiders (Dey, 1994; Leblanc and Gillies, 2005). The definitions of the terms used in Canada are given by the TSE and the Bank Act (1991). The assumption is that if a director is independent he or she is somehow able to keep a check on management. On the other hand, if a director is not independent he or she can hardly be trusted to act in the best interest of the company and its shareholders.

Tables 17, 18 and 19 show that all of the subject banks have a very high percentage of independent directors. In general, Canadian banks have made a

determined effort to create an independent board of directors. The Bank Act (1991) has been responsible for this, by stipulating that more than half of the members of the board must be unaffiliated directors. Another motivation for such a high percentage of independent members is the fact that shareholders demand it, although the TSE guidelines did not require that all members (but a majority) of the board of directors be independent. The percentage of unrelated directors, unaffiliated directors and directors not from management has not hit the magic figure of 100 percent. The proportion of independent directors has increased over the three year period. This is due to the fact that the board is asking related directors to step down in order to decrease the size of the board, while maintaining its board independence.

### Separation of Role of Chairman and Chief Executive Officer

**Table 20.** Separate role of Chairman and CEO

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	0
BNS	1	0	0
CIBC	1	0	0
BMO	0	0	0
NBC	1	1	0
LBC	1	1	1
CWB	1	1	1
Total	7/8	5/8	3/8

One of the most strongly debated issues in corporate governance is whether the positions of chair and CEO of a company should be held by one or two people (Leblanc and Gillies, 2005). Properly executing the duties of the chair of the board has become very time consuming and critical to the effective management of the board of directors. In many companies, particularly in the US, it is not unusual for the role of chairman of the board and CEO to be combined. In such a case, it is not surprising that persons holding the combined position become extremely powerful within their companies. The person who occupies both roles (CEO duality) could tend to withhold unfavourable information to outsiders. Fama and Jensen (1983) argue that any adverse consequences could be eliminated by market forces.

**Table 21.** TSE Corporate Governance Guidelines

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	1
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	1	1	1
LBC	1	1	1
CWB	0	0	0
Total	7/8	7/8	7/8

### **Adoption of Charters by the Board of Directors and the Committees**

**Table 22.** Charter for the board of directors

Bank Name	2004	2003	2002
RBC	1	0	0
TD	1	1	0
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	0	0	0
LBC	0	0	0
CWB	1	1	1
Total	6/8	5/8	4/8

Table 22 presents the information about banks which have charters for the board of directors. The charter formally defines the duties and responsibilities of the board. One observes that initially 4 banks had charters in 2002, and this has increased to 6 banks in 2004. Two small banks continue without charters for all years in our study and before that.

Table 23 shows that the charters of the committees have been in place for at least three years. This is not surprising, because investors have long ago demanded to know the role of each committee within the corporate governance framework, since an ever increasing amount of important work of the board of

However, Forker (1992) makes the point that a dominant personality in both roles poses a threat to monitoring quality, and is, of course, harmful to the quality of disclosure.

Table 20 shows that most banks have conformed to the demands of the market of improving the independence of the board by separating the roles of the chairman and the CEO. The chairman is appointed to run the board, while the CEO is appointed to run the company. The board can “hire and fire” the CEO and monitor the activities of the company. It must have a leader different from the person whose performance it is assessing. There must always be some “creative tensions” between the chairman and the CEO (Leblanc and Gillies, 2005).

### **Adoption of the TSE Corporate Governance Guidelines**

Table 21 presents the information about compliance or non compliance with the 14 points suggested by the TSE. The banks that decided to adopt them have done so before 2001, and the one bank that did not, has not changed its policy.

**Table 23.** Charter of the Committees

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	1
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	1	1	1
LBC	1	1	1
CWB	1	1	1
Total	8/8	8/8	8/8

directors is done by committees of the board. The board has delegated a lot of its work to the various committees which report back to the chairman and the board.

### **Conclusion**

It is apparent that certain aspects of the corporate governance mechanisms of Canadian Banks have changed over the 2002-2004 period, thus demonstrating that governance is not static but dynamic. The banks reduced their board size while maintaining the number of women directors on the



board. They also decreased the number of committee members as well as the number of committees reporting to the board. The latter was achieved by merging certain committees together, most notably the Human Resource committee with the Nominating committee or the Corporate Governance committee with the Conduct Review committee. These reductions were implemented to enhance the efficiency of the board and thus increase the board's supervision of management. The increased supervision could also be observed by the fact that the number of board meetings and committee meetings had increased since 2002.

The independence of the board has remained stable or has increased depending on if one looks at the term unrelated director or unaffiliated director. By 2004 seven out of the eight banks had separated the role of Chairman and CEO. This is in stark contrast to 2002, when only three of the eight banks had implemented this regulatory suggestion. This separation will no doubt increase the independence of the board. There is also improvement, over the time period, in the adoption of a new charter for the board of directors. The adoption of a charter for the committees and the addition of the TSE guidelines in the banks annual reports remained constant for the period.

## References

- Adams, Renee, Hamid Mehran. (2003) Is corporate governance different for bank holding companies?, *Economic Policy Review*, Federal Reserve Bank of New York: New York, Vol. 9, No. 1, p. 123
- Beasley, M.S. (1996). An empirical analysis of the relation between the board of director composition and financial statement fraud. *Accounting Review*. 71(October): 443-466.
- Beasley, M., J. Carcello and D. Hermanson (1999). *Fraudulent financial reporting: 1987-1997. An Analysis of U.S. public companies.* New York: Committee of Sponsoring Organizations of the Threadway Commission.
- Beasley, M., J. Carcello, D. Hermanson and P.D. Lapedes (2000). *Fraudulent financial reporting: Consideration of industry traits and corporate governance mechanisms.* *Accounting Horizons*. 14 (December): 441-454.
- Bebchuck and Cohen (2004). *The Cost of Entrenched Boards.* Working Paper. Harvard Law School.
- Bernardi, R.A., D.F. Bean, and K.M. Weippert (2005). *Minority membership on boards of directors: The case for requiring pictures of boards in annual reports.* *Critical Perspectives on Accounting*, 16(8), 1019-1033.
- Bernardi, R.A., D.F. Bean and K.M. Weippert (2002). *Signalling gender diversity through annual report pictures: A research note on image management.* *Accounting, Auditing and Accountability Journal*, 15(4), 609-616.
- Bliss, Michael (1987). *Northern Enterprise: Five Centuries of Canadian Business*, Toronto, McClelland and Stewart.
- Blue Ribbon Committee (1999). *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.* New York: New York Stock Exchange and National Association of Securities Dealers.
- Booth, J.R., M.M. Cornett and H. Tehranian, (2002): "Board of directors, ownership and regulation"; *Journal of banking and finance*, 26, 1973-1996.
- Brammer, S., A. Millington and S. Pavelin (2007). *Gender and ethnic diversity among UK corporate boards.* *Corporate Governance*, 15(2), 393-403.
- Brown, D.A. (1999). *Public accounting at a crossroads.* Available on the web at <http://www.osc.gov.on.ca/en/about/>.
- Brown, Lawrence D. and Marcus L. Caylor (2006). *Corporate governance and firm valuation.* *Journal of Accounting and Public Policy*. 25, 409-434.
- Cadbury, A. (1993). *Highlights of the Committee on Financial Aspects of Corporate Governance*, in D. Prentice and P.R.J. Holland, eds., *Contemporary Issues in Corporate Governance* (Oxford, Clarendon Press).
- Carcello, J. and T.L. Neal (2000). *Audit committee composition and auditor reporting.* *The Accounting Review* (October): 453-468.
- CIMA (2000). *Corporate Governance.* The Chartered Institute of Management Accountants, London.
- Cohen, J. and D. Hanno (2000). *Auditors' consideration of corporate governance and management control philosophy in preplanning and planning judgments.* *Auditing: A Journal of Practice and Theory*, Fall: 133-146.
- Daum, J.H. (2000). *A "snapshot in time" of Internet boards, Directors and Boards*, 2(3), 48-53.
- Dechow, P.M., R.G. Sloan, and A.P. Sweeney (1996). *Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC.* *Contemporary Accounting Research* (Spring): 1-36.
- Dey.P. (1994). *Where were the directors? Guidelines for improved corporate governance in Canada.* Toronto: Toronto Stock Exchange
- De Zoort, F.T. and S. Salterio (2001). *The effects of Corporate Governance experience and financial reporting and audit knowledge of committee members' judgments.* *Auditing: A Journal of Practice and Theory*, 20 (September): 31-47.
- Easterbrook, Frank, and Daniel Fishel (1991). *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, Mass.).
- Eng, L.L. and Y.T. Mak (2003). *Corporate governance and voluntary disclosure.* *Journal of Accounting and Public Policy*, 22: 325-345.
- Fama, Eugene, and Michael Jensen (1983a). *Separation of ownership and control.* *Journal of Law and Economics*, 26, 327-349.
- Forker, John J. (1992). *Corporate Governance and Disclosure Quality.* *Accounting and Business Research*, 22(86), 111-124.
- Ho, Simon, S.M. and Kar Shun Wong (2001). *A study of the relationship between corporate governance structures and the extent of voluntary disclosure.* *Journal of International Accounting, Auditing and Taxation*, 10: 193-156.
- Jensen, Michael and William Meckling (1976). *Theory of the Firm: Managerial behaviour, agency costs, and ownership structure.* *Journal of Financial Economics*, 3, 305-360.
- John, Kose, Yiming Qian. (2003) *Incentive features in CEO compensation in the banking industry,* *Economic Policy Review*, Federal Reserve Bank of New York: New York, 9(1), 123.
- Joint Committee on Corporate Governance (JCCG),

2001. Beyond Compliance: Building a Governance Culture, Final Report, November 2001, Toronto.
30. Larker, D., S. Richardson and I. Tuna (2004). Does corporate governance really matter? Working paper, The Wharton School.
31. Leblanc, Richard and James Gillies (2005). Inside the Boardroom. John Wiley and Sons Canada Ltd., Mississauga, Ontario.
32. Levitt, A. (1998). The numbers game. Available on the web at <http://www.rutgers.edu/accounting/raw/aa/newsarc/pr101898.htm>.
33. Levitt, A. (1999). Levitt plays up shareholder rights to directors. Investor Relations Business, April 12, 2.
34. Levitt, A. (2000b). Remarks before the conference on the rise and effectiveness of new corporate governance standards. Available on the web at <http://www.sec.gov/news/speeches/spch449.htm>.
35. Loomis, C.J. (1999). Lies, damned lies, and management earnings. Fortune (August 2).
36. Macey, Jonathan R., and Maureen O'Hara. (2003) The corporate governance of banks, Economic Policy Review - Federal Reserve Bank of New York. New York: Apr. 9(1), 91.
37. Macdonald, William A. (1988). Commission to Study the Public's Expectations of Audits, CICA, Toronto.
38. Palmrose, Z. and Scholz (2002). The accounting causes and legal consequences of non-GAAP reporting evidence from restatements. Contemporary Accounting Research Conference (November).
39. Pi, L. and S. Timme, (1993): "Corporate Control and Bank efficiency"; *Journal of financial research*, 20, 509-530.
40. Romano, Roberta (1993a). The Genius of American Corporate Law (American Enterprise Institute Press, Washington, D.C.).
41. Sarbanes, P. and M. Oxley (2002). Sarbanes-Oxley Act of 2002. Washington, DC: U.S. Congress.
42. Shliefer, Andrei and Robert W. Vishny (1997). A Survey of Corporate Governance. The Journal of Finance. Vol. LII, No. 2 (June): 737-783.
43. Treadway, James C. (1987). National Commission on Fraudulent Financial Reporting.
44. Wu, M. (2002). Earnings restatements: A capital market perspective. Working paper, New York University.
45. Xie, Biao, Wallace N. Davidson and Peter J. Da Dalt (2003). Earnings management and corporate governance: The role of the board and the audit committee. Journal of Corporate Finance, 9: 295-316.

Web sites:

46. Bank of Montreal: [www.bmo.com](http://www.bmo.com)
47. Bank of Nova Scotia: [www.scotiabank.com](http://www.scotiabank.com)
48. Canadian Banking Association: [www.cba.ca](http://www.cba.ca)
49. Canadian Imperial Bank of Commerce: [www.cibc.com](http://www.cibc.com)
50. Canadian Western Bank: [www.cwbank.com](http://www.cwbank.com)
51. Laurentian Bank of Canada: [www.laurentianbank.com](http://www.laurentianbank.com)
52. Ministry of Finance: [www.fin.gc.ca](http://www.fin.gc.ca)
53. National Bank of Canada: [www.nbc.ca](http://www.nbc.ca)
54. New York Stock Exchange: [www.nyse.com](http://www.nyse.com)
55. Office of the Superintendent of Financial Institutions: [www.osfi-bsif.gc.ca](http://www.osfi-bsif.gc.ca)
56. Ontario Securities Commission: [www.osc.gov.on.ca](http://www.osc.gov.on.ca)
57. Royal Bank of Canada: [www.rbc.com](http://www.rbc.com)
58. Toronto-Dominion Bank: [www.td.com](http://www.td.com)
59. Toronto Stock Exchange: [www.tse.ca](http://www.tse.ca)

Law:

*Bank Act*, [1991], c. 46

*Sarbanes-Oxley Act of 2002*, [2002], 107<sup>th</sup> session of the United States Congress

## Appendix I

### Regulations on Corporate Governance Mechanism

#### *Summary of the Bank Act*

##### *Board of directors*

The bank's board of directors must have a minimum of 7 members, of which, at least half for foreign banks or two-thirds for domestic banks must be Canadian residents. (art. 159). In addition, no more than two-thirds of the board members may be affiliated with the bank. (art. 163). Article 160 lists a series of category of people who are disqualified as board members. Qualified directors may be elected for a term of 3 years. (art. 166) At least 5% of the shareholders must nominate a board member to be placed on the ballot (art. 143). The specific duties of the board of directors is listed in article 157.

##### *Meeting of the board*

The board must meet at least four times during the financial year. (art. 180). The meeting cannot be held unless a majority of the members present are Canadian residents and unless, at least one unaffiliated member is present. (art. 183).

##### *Affiliation*

The Superintendent has discretionary powers to determine which board members are affiliated with the bank. Normally, an affiliated director is someone who has sufficient commercial, financial or business ties with the bank, which can affect his judgment (art.162)

##### *Directors and Officers Authority*

The chief executive officer is appointed from members on the board of directors (art. 196). In addition, two or more offices of the bank may be held by the same person (art. 197). The board of directors may also delegate some of their powers to the bank officers, but there are certain limits on the extent of the delegation of power (art. 198). The directors fix their remuneration and the remuneration of employees by by-law (art. 199).

##### *Conduct Review Committee*

The directors may appoint to committee members from the board (art. 193). The conduct review committee consists of at least three board members of which the majority are not affiliated with the bank. None of the committee members may be employees or officers from the bank. This committee has an obligation to review all transactions with related parties and to ensure the board is complying with the corporate governance regulation of the Bank Act. (art. 195).

##### *Audit Committee*

The shareholders of the bank have the duty of appointing a firm of accountants to act as auditors for the bank (art. 314). The auditing firm must be independent, that is, members of the accounting firm may not be on the board of directors and may not own a material interest in the bank. (art. 315). The shareholders of the bank may, by ordinary resolution, revoke the appointment of an auditor (art. 317). At least three members of the board must be on the audit committee of which the majority must not be affiliated with the bank. None of the members may be employees or officers of the bank (art. 194).

##### *Conflict of interest*

Any director, with a material interest in a specific transaction

between the bank and another entity, must disclose it to the board of directors (art. 202). When conflict of interest is present the said director must abstain himself of any board meetings dealing with that matter. A director who knowingly contravenes this regulation ceases to hold office and may not serve on another board of directors of a financial institution for five years. (art. 203). A director or an officer is considered an insider (art. 265) and thus must disclose to the appropriate authority all security transactions dealing with the bank.

#### *Permitted Related Party Transaction*

A bank may enter into a transaction with a director of the bank (art. 496) as long as the board approves the transaction and the loan does not exceed 50% of the regulatory capital of the bank (art. 497). The terms and condition of the loan to a director cannot be more favorable than market terms and condition (art. 501). In addition, if the bank has reasons to believe that a party with which they are transacting is a related party it must ask for a written letter of disclosure from the said party. (art. 504)

#### Summary of the Toronto Stock Exchange (TSE) Corporate Governance Guidelines

The TSE Corporate Governance Guidelines, consisting of 14 points, are voluntary. These guidelines deal specifically with the powers of the board, the review procedures required for good governance and the roles of the committees.

#### Powers of the board of directors:

The board of directors should explicitly assume responsibility for stewardship of the company. Thus, the board should approve all corporate objectives and develop a description of its responsibilities. Furthermore, the board should be comprised of a majority of unrelated directors. Therefore, the circumstances of each individual director should be examined annually to determine their relationship to the firm. In addition, the board should be structured in such a way that it can function independently from management. To improve the independence of the board an orientation program should be provided to new board members and a system should exist to permit individual directors to engage outside advisers at the expense of the corporation.

#### *Role of the committees:*

Firms should have a committee for nominating new directors and a committee responsible for corporate governance issues. Committee members should be outside directors of whom a majority should be unrelated. More specifically, the audit committee should have well-defined responsibilities and be composed of outside directors. This committee should have direct communication channels with internal and external auditors and also have oversight responsibility for the system of internal control.

#### Review procedures:

A process should be implemented to assess the effectiveness of the board, its committees and its individual directors. The board should also review its size and the potential for its reduction. In addition, the board should review the adequacy and form of directors' compensation.

#### Summary of the New York Stock Exchange (NYSE) Corporate Governance Guidelines

The NYSE has imposed certain corporate governance procedures on firms that are listed on its exchange. First, a majority of directors must be independent and it is the Board which determines the independence of these directors. Furthermore, to reduce the influence of management on the Board, the NYSE insists that non-management directors meet at regularly scheduled executive sessions without management.

Second, the nominating committee, the corporate governance committee and the compensation committee must be composed entirely of independent directors. These three committees must have a written charter that addresses the committee's purpose and responsibilities. The charter must also adopt guidelines for an annual performance evaluation of the committee. Third, the audit committee must be comprised of at least three members, all of whom must be independent. The audit committee must also have a charter addressing its purpose, responsibilities and annual performance evaluation. In addition, the NYSE specifies that the listed firms must have an internal audit function. These corporate governance procedures were put in place by the NYSE to increase investor confidence in its exchange.

#### Summary of the Sarbanes-Oxley Act

The U.S. Congress enacted the Sarbanes-Oxley Act in 2002 to restore public confidence in the capital markets. Its main focus is to impose legal liabilities on the CEO and CFO of the company. However, it also imposes new corporate governance procedures such as forcing firms to draft and implement a written code of ethics that applies to all senior financial officers and CEO's. The act also adds new responsibilities to the audit committee. It is now charged with the task of developing policies for pre-approval of audit and permitted non-audit services. It also has the task of developing procedures to protect whistle blowers when the complaint concerns accounting or auditing matters. In addition, the act also restricts lending to its directors and executive officers. The U.S. government hopes that these regulations will strengthen corporate governance in the American market.

#### Summary of the Ontario Security Commission (OSC) – Multilateral Policy 58-201

The Multilateral Policy 58-201 provides guidance on corporate governance best practice but it is not mandatory. The OSC reviewed the guidelines of other regulatory bodies to develop this policy. The corporate governance procedures suggested are as follows. First, a majority of the board should be composed of independent directors. These independent directors should hold separate regularly scheduled meetings at which management are not in attendance. Furthermore, the chair of the board should be an independent director. Second, the Board should adopt a written mandate that explicitly assumes responsibility for the stewardship of the firm. This includes overseeing the strategic planning process, implementing succession planning and ensuring the integrity of the internal control process. Third, the board should adopt clear position descriptions for directors, the chair of the board, the chair of each committee and the CEO. Fourth, new directors should receive an orientation course and board members should be provided with the opportunity to advance their knowledge. Fifth, a code of conduct should be implemented and the board should be responsible for monitoring the firm's compliance to it. This code should deal with conflict of interest, proper use of company assets, fair dealings with shareholders and compliance with the law. Sixth, the nominating committee should have a written standard delineating its responsibilities and it should be composed entirely of independent directors. This committee should be responsible for nominating new directors, identifying the qualifications needed for the board and assessing the appropriate size of the board. Seventh, the compensation committee should also have a written charter defining its responsibilities and be composed of entirely independent members. Eight, directors should be allowed to hire outside advisers at the expense of the firm. Lastly, the board should review its own effectiveness as well as the effectiveness of each of the committees. These OSC recommendations are meant to increase the corporate governance mechanism of publicly trade companies in Canada.

## MEASURING CORPORATE GOVERNANCE IN GERMANY: AN INTEGRATED FRAMEWORK ON COMPLIANCE AND TRANSPARENCY & DISCLOSURE

*Andrea Graf\**, *Markus Stiglbauer\*\**

### Abstract

Compliance as well as transparency and voluntary corporate disclosure are essential within the concept of 'good' corporate governance. Consequently, there is an increasing demand for methods enabling investors to compare companies by means of country-specific criteria. However, measures in Germany do not provide a broad spectrum of criteria for evaluating corporate compliance and governance transparency & disclosure. Our framework covers all rules of the German Corporate Governance Code as well as additional criteria, enabling investors to analyse how companies are managed. Furthermore, we raise quality criteria of social sciences to confirm our findings.

**Keywords:** corporate governance, ratings, compliance, transparency, disclosure

*\* Corresponding Author:*

*University of Regensburg, Faculty of Business, Economics and Information Systems, Chair of Department of Management and Organization Design, Universitaetsstr. 31, 93040 Regensburg, Germany, Tel.: +49-941-943-2681, Fax: +49-941-943-4206, Email: andrea.graf@wiwi.uni-regensburg.de*

*\*\* Research Assistant and Doctoral Candidate, University of Regensburg, Faculty of Business, Economics and Information Systems, Department of Management and Organization Design*

### Introduction

The demand for methods facilitating the comparison of firm-specific corporate governance is constantly increasing. Focussing on 'good' corporate governance, compliance as well as transparency & disclosure are specific core elements within this concept (Bönnner and Rausch, 2008). Corporate governance ratings in Germany have focussed so far on compliance, considered as the sum of arrangements within a company (Baetge and Brembt, 2008) meeting legal rules and voluntary guidelines (Menziez, Tüllner and Martin, 2008). In contrast, there is still sparse research on and interest in the field of transparency & disclosure. This is a critical deficiency, as corporate governance is considered to be a vital information - equitable with financial figures - when companies are evaluated by investors (Deane, 2006; Arnsfeld and Growe, 2006). Since German governance ratings also show lacking transparency themselves (Bassen, Klein and Zöllner, 2006) we try to answer the following research question:

Which aspects of corporate governance should German listed firms report on exactly?

Aiming to close this gap for the German market we developed an integrated framework which consists of a Compliance Scorecard (CS) and a Transparency & Disclosure Scorecard (TDS). Both scorecards are based on international empirical findings concerning information on corporate governance investors want to know from companies. However, corporate

governance has to be evaluated from a national point of view and therefore differences in governance among countries have to be taken into account by governance ratings. Until now, cross-national governance ratings haven't been able to meet both the national and international requirements (Koehn and Ueng, 2007). Responding to this lack of appropriate instruments, our framework covers the rules of the German Corporate Governance Code (GCGC) which are stated to be relevant for investors. Furthermore, we analysed the corporate governance reportings of German firms listed in the Prime Standard segment of the Frankfurt Stock Exchange and identified additional criteria German companies should meet with their governance reportings. Financial analysts might use our framework as an additional instrument to evaluate the corporate governance of German stock corporations. Moreover, the developed criteria may give managers a valuable insight what investors generally expect from their corporate governance reporting. Consequently, we assume our framework to have the potential to support firms by implementing best (corporate governance) practices.

### 1. Corporate Governance Ratings, Transparency & Disclosure and Firm Performance

Ratings are an objective measure to evaluate specific abilities and/or characteristics of an economic unit (Oelerich, 2005). Therefore, ratings hold the important

function to gain transparency on how companies are managed and consequently to facilitate the comparison of firm-specific governance for investors as well as creditors. That way, these groups might better assess the risks incorporated by an investment (Fischer and Holzkämper, 2005). Thus, summarizing corporate governance quality in one or few ratios improves market efficiency (Arnsfeld and Growe, 2006). Classifying corporate governance ratings on their purpose, literature differentiates between compliance (checking if firms meet legal rules and voluntary guidelines) and performance (systematic and effective evaluation of corporate governance-specific activities and modalities and their effect on companies' performance). In our framework, we go beyond that differentiation by establishing further criteria on transparency & disclosure.

As stated before, ratings by firms of the corporate governance industry (Rose, 2007) like the ones of Governance Metrics International (GMI), Standard & Poor's (S&P) or the Institutional Shareholder Services (ISS) have difficulties in taking national differences in corporate governance systems into account. Unsurprisingly, Koehn and Ueng (2007) comparing companies in a cross-national study with the help of ISS's governance rating, could't find distinct results on how strong governance rating scores are correlated with companies' performance. Since the implementation of the GCGC, there has been a tradition for scientific corporate governance ratings in Germany. The scientific approaches intend to assess the quality of firm-specific corporate governance and try to find possible relations between corporate governance and firm performance. In general, scientific corporate governance ratings don't focus on specific firms. They mainly target on identifying drawbacks in corporate governance and try to obtain correlations between specific corporate governance mechanisms (Werder and Grundei, 2003). As Table 1 shows, most ratings have an exclusive focus on compliance and do not cover all the rules of the GCGC. However, this so-called 'box-ticking' approach excluding additional variables doesn't measure 'good' corporate governance (Van den Berghe and Levrau, 2003). Nevertheless, there is only a minority of ratings covering additional criteria on corporate governance apart from the rules of the GCGC.

#### **Insert Table 1 about here**

Transparency & disclosure comprises the availability of firm-specific (corporate governance) information being presented to the capital markets (Bushman, Piotroski and Smith, 2004). From a theoretical perspective, transparency & disclosure is a main component of 'good' corporate governance. Table 2 presents empirical findings confirming its significance on capital markets.

#### **Insert Table 2 about here**

So far, there hasn't been a study in Germany analyzing the correlation between corporate governance reporting and corporate performance (Zöllner, 2007). However, there are studies trying to analyse perceived quality of companies' investor relations from an analyst point of view (Schachel and Vögtle, 2006). One finding is a significant positive correlation between companies' investor relations and firm size (Gohlke, Schiereck and Tunder, 2006), which was analysed not to be a consequence of smaller companies' lower budgets for their communication departments (Königs and Schiereck, 2006) but rather a lower emphasis of smaller firms on communication topics (Graf and Stiglbauer, 2007).

## **2. An Integrated Framework to Measure Corporate Governance in Germany**

The development of the framework is described considering the following aspects: (1) solicited versus unsolicited ratings, (2) data collection and (3) disclosure of main categories and subcategories.

(1) Koehn and Ueng (2007) criticise unsolicited governance ratings for not considering internal information from companies within the rating process. Contrary to this, we have a different comprehension of transparency & disclosure encouraging companies to offer corporate governance information on a voluntary basis. According to this, we don't think that solicited ratings (where rating agencies are mainly paid by the rated companies which possibly expect a positive rating) contain an information surplus for the capital markets (particularly in reference to corporate governance). On this account, we prefer unsolicited ratings due to their objectivity (Bassen, Pupke and Zöllner, 2006). Reference may also be established to the findings of Bannier and Tyrell (2006) reporting that only firms having positive private information request a solicited rating, in order to reveal this information. As a consequence, these companies should have better solicited ratings than the ones without positive private information. Empirical findings by Behr and Güttler (2008) confirm this assumption. They demonstrate that unsolicited ratings convey new information to the stock market especially when companies' ratings change over time. Focusing on solicited governance ratings in Germany like the one of Werder and Talaulicar (2008), the authors also suspect the following bias: companies with better compliance to the rules of the GCGC send back their questionnaire more often than companies with lower compliance.

(2) The way of data collection is a further criterion for categorizing corporate governance ratings. Our framework follows the so-called modeling approach. This means that data is collected for the purpose of the rating only (Dallas, 2004) by evaluating all published firm-specific data being accessible to an interested investor. Werder and Grundei (2003) emphasize the importance of analysing private information within German corporate governance ratings, like annual reports, articles of incorporation, companies' website,

declarations of conformity (following § 161 of the German Stock Corporation Act) and the corporate governance report (following rule 3.10 GCGC). We have included these suggested documents in the content analysis within our study.

(3) The disclosure of main categories and subcategories in empirical ratings is our final criterion. Corporate governance ratings are often criticised as being intransparent on their criteria (Bassen, Klein and Zöllner, 2006) and to rather represent a conglomerate of different corporate governance mechanisms (Larcker, Richardson and Tuna, 2005) than giving companies advice where to improve exactly. In contrast, we will present the entire TDS as well as parts of the CS in section 3. Additionally we will present the process of developing the main categories and subcategories of our framework. We also give empirical findings to validate our choice of categories in section 4. Table 3 presents our integrated framework to measure German corporate governance.

Insert Table 3 about here

### 3. A deductive-inductive approach to develop main categories and subcategories

The six main categories of the CS correspond to those of the GCGC. In order to identify substantiated subcategories of the CS we conducted an in-depth analysis. Several studies reported different numbers of recommendations and suggestions of the GCGC (Claussen and Bröcker, 2002; Peltzer, 2002; Seibt, 2002). Therefore, we decided to do a systematic analysis of the GCGC evaluating each sentence for the term “shall”, which is generally an indication for a recommendation (Werder and Talaulicar, 2003). As a result we have found 77 recommendations in the GCGC version of 2006. As a next step, we identified the suggestions by search for the signal words “should” and “can” (indications for suggestions). We found 17 suggestions in the GCGC version of 2006. Our final result of 94 subcategories is similar to findings of Werder and Talaulicar (2007) who are analysing compliance to the GCGC annually. As the GCGC is updated every year we recommend researchers to proceed alike.

For establishing the TDS two experts in the field of German corporate governance developed six main categories and 38 associated subcategories independent of each other. They evaluated companies' survey-specific private data (already mentioned in section 2) from the year 2007 in regards to international standards for corporate governance reporting. After having discussed their individual results they designed the TDS together following empirical and theoretical findings, mentioned in section 4, and derived from information both experts identified repeatedly in the private data. They also included information only one expert identified to be relevant - but only, if both experts agreed on its

importance. Mayring (2003) is calling this procedure a deductive-inductive approach. Table 4 presents our final TDS.

Insert Table 4 about here

### 4. Compliance and Transparency & Disclosure Scorecard: Disciplined Inquiry

Social sciences apply three criteria to disciplined inquiry: objectivity, reliability and validity (Denzin and Lincoln, 1994). In order to meet these relevant criteria, we now present how we integrated them in our research and thus confirmed the quality of our findings.

Developing and applying content analysis systems, one must be aware of a classic dilemma: coding schemes may be very complex becoming unwieldy or thus simple that they become meaningless (Harris, 1996). Our intention was to balance complexity (as to maximize its theoretical relevance) and simplicity (as to maximize its reliability) in our framework. Our set of categories directly originates from a well-established body of theoretical knowledge (see section 4).

We're reaching *objectivity* of our rating through a high level of standardisation. This implies a high standard for the coding as well as the interpretation process. Thus, we allow the application of both instruments independent from coders' (un)conscious behavior patterns. A further point was the standardisation of evaluation. Assigning clear values to single subcategories (conformity counted with 1–non-conformity counted with 0), makes the instruments very robust against mistakes of coding and at the same time enhances its selectivity (Hofmann, 2006) by reducing space for interpretations. This binary splitting of the decision process also helps to increase intercoder reliability: the higher the number of subcategory characteristics the lower reliability scores (Spiegelman, Terwilliger and Fearing, 1953; Schutz, 1958).

Here are some additional words to the scoring of our framework: a first step is summarizing single subcategory scores and building scores on each of the main categories. When comparing different firms on only one main category, these scores can be on an absolute or relative basis. When comparing companies across different main categories we recommend to build relative scores due to different numbers of subcategories and also for better calculation e.g. in SPSS. Furthermore, the absolute main category scores can be summarized to an overall score for the CS and TDS. Interpreting the results is as follows: the higher main category or overall scores the higher the compliance or transparency & disclosure level and vice versa. We didn't further weight the single main categories of the CS and TDS as there are no empirical findings which intend any weighting. However, weighting of our category scheme is possible, if assessors of our framework find it necessary to meet

coders' individual purpose.

Holsti describes *reliability* of coded data as a function of the training during which coders familiarize themselves with the concepts (Holsti, 1969). We tested both scorecards for intercoder reliability (Krippendorff, 1980). As there doesn't exist a unitary 'best' coefficient for intercoder reliability that corrects measures like Holsti's R (Holsti, 1963) on chance agreements, we were calculating a set of coefficients mainly used in communication research (Milne and Adler, 1999; Srnka and Koeszegi, 2007; Zwick, 1988): Scott's pi ( $\pi$ ), Cohen's kappa ( $\kappa$ ) and Krippendorff's alpha ( $\alpha$ ) (Scott, 1955; Cohen, 1960; Krippendorff, 1980). Literature gives recommendations how results of coefficients for intercoder reliability should be interpreted. The theoretical span of all calculated coefficients lies between +1.00 (perfect agreement) and -1.00 (completely non-agreement) (Milne and Adler, 1999). Values of  $\pi$  and  $\kappa$  increasing +0.70 are regarded as good agreement (Fleiss and Cohen, 1973; Bakeman and Gottman, 1986). Values higher than +0.80 are suggested as very good agreement (Popping, 1988; Funkhouser and Parker, 1968). Milne and Adler (1999) similarly to  $\pi$  and  $\kappa$  suggest  $\alpha$ -values between +0.75 and +0.80 as good agreement and levels above +0.80 as very good agreement.

In a first step, two coders were trained in the use of the coding system, determining explicitly the classification of each subcategory. In a second step, they tested independently the CS on 23 firms listed in the selection index TecDAX on the Frankfurt Stock Exchange. Finally, we compared the coders' results by calculating the above mentioned intercoder reliability coefficients. Table 4 shows the results (in brackets) of our test for intercoder reliability on TecDAX. All categories excepting  $\alpha$  for categories I, II, IV and the overall level had good or very good intercoder agreement levels.

#### Insert Table 5 about here

However, intercoder coefficients always have to be interpreted according to the coding object and its characteristics (Wirtz and Caspar, 2002). Looking on the dichotomous characteristics of our subcategories we didn't find the results to be satisfying enough. Moreover, according to Zwick (1988) also marginal differences between coders should be taken under suspicion. As we were not able to readapt the categories due to the presetting of the GCGC, our focus was on the coding process, our coding scheme as well as the coders themselves. Remarkably, 18.09% of the subcategories had reliability scores less than +0.70 for all coefficients. 27.66% had reliability scores under +0.70 for at least one coefficient. Though, we were analyzing and discussing inconsistencies between the two coders in detail (Cohen, 1960). We identified some systematic differences between the coders' approach. Table 6 demonstrates our findings.

#### Insert Table 6 about here

We reconciled disagreements between the coders and readapted our coding scheme and tested it again (according to Mayring, 2003) on 137 firms listed in the selection indices DAX, TecDAX, MDAX and SDAX. Subsequently, we found better intercoder agreement levels (Table 5). See for example the nearly equal results of pi and kappa which are based on similar distributions of both coders' random sums (Wirtz and Caspar, 2002). Summarizing, we assume the CS as being highly reliable for all categories; therefore we had no reason for further adaptations.

We also tested TDS for intercoder reliability on the same 23 firms listed in the selection index TecDAX. Following the same steps like testing the CS, we received results presented in Table 7.

#### Insert Table 7 about here

The results for all categories, also for Krippendorff's  $\alpha$  on all categories had good or very good intercoder agreement levels. We only found some minor differences in the coders' operations, e.g. one coder in some cases evaluated in some cases codes of ethics as firm-specific corporate governance codes which in fact didn't base on the GCGC (Number VI.1 TDS). Nevertheless, we readapted our coding scheme as a consequence of these minor deviations.

Content analysis is considered as being valid to the extent its interferences are upheld in the face of independently obtained evidence (Krippendorff, 1980). Corporate governance ratings are often criticized not to be checked for validity, when they are (further) developed (Bassen, Klein and Zöllner, 2006). We picked up that critique on missing inclusion of empirical and theoretical findings: several experts in the field of corporate governance were involved in the rating process to validate our approach. Many publications already stated on the content of the GCGC (Pfitzer, Oser and Orth, 2005). As the CS contains exactly its main categories and subcategories, we're now focusing on empirical and theoretical findings pointing out the relevance of the TDS.

The TDS contains six main categories and 38 subcategories. Some subcategories represent specific rules of the GCGC which can be evaluated from the outside. Indeed, scientists state consistently that compliance on rules of the GCGC shouldn't be interpreted automatically as real practice inside companies (Werder and Talaulicar, 2003; Laufer, 2006). As the GCGC is updated every year the subcategories of the TDS should be checked according to the year of evaluation. Additionally, we have developed further and in part stricter rules on transparency & disclosure exceeding the formal standards and benchmarks of the GCGC. The Society of Investment Professionals in Germany (DVFA - Deutsche Vereinigung für Finanzanalyse und Asset Management) was the first organisation having developed a Scorecard for German Corporate

Governance (the DVFA-Scorecard). This scorecard contains additional subcategories to the GCGC numerous investors and financial analysts are asking for (Frank, 2005) and has already been tested for validity (Bassen, Pupke and Zöllner, 2006). We identified seven subcategories that capital markets expecting German listed firms to report (Arnsfeld and Growe, 2006): thus, we integrated them in the TDS. We also integrated a further single criterion, namely installing a specific representative, responsible for compliance on the rules of the GCGC within the company. This criterion is part of the so-called equi-card developed by the University of Applied Sciences Osnabrück which has also been tested for validity (Arnsfeld and Growe, 2006). Recent studies are coming along with this criterion as an important component in corporate governance reporting (Baetge and Brembt, 2008).

As stated in section 2, we are now giving empirical findings to validate our choice of categories. Category I in detail analyzes the Declaration of Conformity to the GCGC, German listed firms have to release yearly, following § 161 of the German Stock Corporation Act (AktG). We're attaching importance to this category, since § 161 AktG doesn't call for a real 'comply or explain': companies only have to declare which recommendations (not suggestions) they do and which they don't follow. Therefore we analyze if companies explain voluntarily not to follow specific recommendations. Furthermore, this category covers reporting on suggestions of the GCGC. Following international standards, the suggestions of the GCGC accelerate the progress of corporate governance in Germany (Graf and Stiglbauer, 2007).

The GCGC also recommends a separate Corporate Governance Report within the traditional components of companies' annual reports (Rule 3.10 GCGC) to give additional information although non-quantifiable but equally crucial (Brotte, 1997). Empirical studies report on the high relevance of the Corporate Governance Report as an instrument to communicate on firm-specific corporate governance both for companies and investors (Achleitner, Bassen and Pietzsch, 2001; Ergo Kommunikation, 2005).

By analyzing category III we come up with the increasing international relevance of corporate internet reports for financial reporting (Geerings, Bollen and Hassink, 2003; Abdelsalam, Bryant and Street, 2007; for Germany see Stöblein and Mertens, 2008). The central element of corporate governance internet reporting is the companies' website (Matheson and Reynolds, 2004). Thus, the GCGC covers several rules on electronic media being an additional evidence for its increasing importance (Meckel et al, 2008).

Management compensation has extensively been discussed in Germany (Ruess, 2004; Kann and Just, 2006) as well as on international platforms (Bebchuk and Fried, 2006; Main et al, 2008). In general, research indicates disclosure on remuneration of companies' management teams as fundamental information for

investors (Meckel et al, 2008; Stöblein and Mertens, 2008).

Investors also demand for data on the qualification and experience of companies' management teams. Category V highlights this expectation on corporate governance reporting including also information on the question if board members are independent of each other (Parum, 2005). Recently, a study by Meckel et al. (2008) indicated that institutional investors in Germany put special emphasis on the quality of management when evaluating companies.

Developing a firm-specific corporate governance code based on the GCGC is an interesting opportunity for companies to adapt its structures to the GCGC. Furthermore, a specific commitment on corporate governance may be interpreted as a significant signal for continuity and strategic security outside the company. Those codes are not substituting the rules of the GCGC, quite the contrary, they must be considered as complementary to them (Hütten, 2002).

## 5. Conclusion

Our framework meets the increasing economic relevance of unsolicited corporate governance ratings. Against critics on unsolicited ratings, it has great potential to reduce information asymmetries on the German capital market (Behr and Güttler, 2008). International private governance ratings haven't met this requirement so far. Best practices of international guidelines don't consider national specifications in corporate governance systems to a sufficient degree. Firstly, starting with a literature review we identified a lack of transparency within existing German governance ratings themselves. It also became obvious that these ratings don't cover all governance aspects which are relevant for the German capital market. Secondly, we pointed out the increasing relevance of transparency & disclosure in governance reporting. Referring to our initial research question, which aspects of corporate governance German listed firms should report on our framework covers national specifications of the German corporate governance system integrating all recommendations and suggestions of the GCGC. Additionally, it contains international standards on corporate governance reporting which companies can follow voluntarily, including corporate governance internet reporting, compensation systems and board integrity. Documenting the quality of our findings, we presented the whole process of developing our framework. Thus, our framework is highly significant and easy to handle. Both scorecards represent an alternative framework to measure German corporate governance. On the one hand companies get to know numerous subcategories investors expect from companies to report on corporate governance. On the other hand it enables companies to enhance and adapt their corporate governance quality.



## References

1. Abdelsalam, Omneya H., Stephanie M. Bryant and Donna L. Street. 2007. An Examination of the Comprehensiveness of Corporate Internet Reporting Provided by London-Listed Companies. *Journal of International Accounting Research*, 6(2): 1-33.
2. Achleitner, Ann-Kristin, Alexander Bassen and Luisa Pietzsch. 2001. Kapitalmarktkommunikation für Wachstumsunternehmen. Stuttgart, Schäffer-Poeschel.
3. Aksu, Mine and Arman Kosedag. 2006. Transparency and Disclosure Scores and their Determinants in the Istanbul Stock Exchange. *Corporate Governance: An International Review*, 14(4): 277-296.
4. Arnsfeld, Torsten and Sebastian Growe. 2006. Corporate Governance-Ratings in Deutschland. *Finanz Betrieb*, 8(11): 715-720.
5. Baetge, Jörg and Tobias Brembt. 2008. Compliance in der Finanzberichterstattung. *Zeitschrift Führung + Organisation*, 77(3): 153-155.
6. Bakeman, Roger and John M. Gottman. 1986. Observing interaction. An introduction to sequential analysis. Cambridge, Cambridge University Press.
7. Bannier, Christina E. and Marcell Tyrell. 2006. Modeling the role of credit rating agencies - Do they spark off a virtuous cycle? Finance and Accounting Working Paper, 160, J.W. Goethe-University Frankfurt.
8. Bassen, Alexander, Dirk Pupke and Christine Zöllner. 2006. Corporate Governance Rating auf Basis der DVFA-Scorecard. *Finanz Betrieb*, 8(9): 551-557.
9. Bassen, Alexander, René Klein and Christine Zöllner. 2006. Ratingsysteme der Corporate Governance: Eine kritische Bestandsanalyse. *Zeitschrift Führung + Organisation*, 75(2): 81-87.
10. Bassen, Alexander, Maik Kleinschmidt, Stefan Prigge and Christine Zöllner. 2006. Deutscher Corporate Governance Kodex und Unternehmenserfolg. *Die Betriebswirtschaft*, 66(4): 375-401.
11. Bebchuk, Lucian A. and Jesse M. Fried. 2006. Pay without Performance: Overview of the issues. *Academy of Management Perspectives*, 20(1): 5-24.
12. Behr, Patrick and André Güttler. 2008. The informational content of unsolicited ratings. *Journal of Banking & Finance*, 32(4): 587-599.
13. Bönner, Arno and Stephan Rausch. 2008. Ist Governance messbar? *Zeitschrift für Corporate Governance*, 3(4): 156-160.
14. Brotte, Jörg. 1997. US-amerikanische und deutsche Geschäftsberichte. Wiesbaden, Gabler.
15. Bushman, Robert M., Joseph D. Piotroski and Abbie J. Smith. 2004. What Determines Corporate Transparency? *Journal of Accounting Research*, 42(2): 207-225.
16. Chipalkatti, Niranjana, Quan V. Le and Meenakshi Rishi. 2007. Portfolio Flows to Emerging Markets: Do Corporate Transparency and Public Governance Matter? *Business and Society Review*, 112(2): 227-249.
17. Claussen, Carsten and Norbert Bröcker. 2002. Der Corporate Governance Kodex aus der Perspektive der kleinen und mittleren Börsen-AG. *Der Betrieb*, 55(23): 1199-1206.
18. Cohen, Jacob. 1960. A coefficient of agreement for nominal scales. *Educational and Psychological Measurement*, 30(1): 37-46.
19. Dallas, George S. 2004. Methodological Overview: Perspective of an External Analyst. In Dallas, eds., Governance and risk. New York: 20-38.
20. Deane, Stephen. 2006. Corporate Governance: From Compliance Obligation to Business Imperative. *Corporate Governance Advisor*, 14(4): 13-20.
21. Denzin, Norman K. and Yvonna S. Lincoln. 1994. Handbook of qualitative research. Thousand Oaks, Sage.
22. Drobetz, Wolfgang, Andreas Schillhofer and Heinz Zimmermann. 2004. Ein Corporate Governance Rating für deutsche Publikumsgesellschaften. *Zeitschrift für Betriebswirtschaft*, 74(1): 5-25.
23. Durnev, Art and E. Han Kim. 2007. Explaining Differences in the Quality of Governance Among Companies: Evidence from Emerging Markets. *Journal of Applied Corporate Finance*, 19(1): 16-24.
24. Ergo Kommunikation. 2005. Corporate Governance Survey 2005. Köln and Frankfurt a.M., Ergo Kommunikation.
25. Fischer, Jochen and Hilko Holzkämper. 2005. Die Rolle des Rating Advisors. In Everling, Oliver and Jens Schmidt-Bürgel, eds., Kapitalmarkting: 73-91.
26. Fleiss, Joseph L. and Jacob Cohen. 1973. The equivalence of weighted kappa and the intraclass correlation coefficient as measures of reliability. *Educational and Psychological Measurement*, 33(3): 613-619.
27. Francis, Jennifer, Dhananjay Nanda and Per Olsson. 2008. Voluntary Disclosure, Earnings Quality, and Cost of Capital. *Journal of Accounting Research*, 46(1): 53-99.
28. Frank, Ralf. 2005. Corporate Governance in Deutschland. *GoingPublic*, 9(12): 44-45.
29. Funkhouser, G. Ray and Edwin B. Parker. 1968. Analyzing Coding Reliability: The Random-Systematic-Error Coefficient. *Public Opinion Quarterly*, 32(1): 122-128.
30. Geerings, J., Laury H. H. Bollen and Harold F. D. Hassink. 2003. Investor relations on the Internet: a survey of the Euronext zone. *The European Accounting Review*, 12(3): 567-579.
31. Gohlke, Felicia, Dirk Schiereck and Ralph Tunder. 2006. Durch Finanzanalysten wahrgenommene Qualität der Investor Relations deutscher Unternehmen. Working Paper, 4-2006, European Business School.
32. Graf, Andrea and Markus Stiglbauer. 2007. Deutscher Corporate Governance Kodex: Eine Analyse der Qualitätssicherungs- und erweiterten Kommunikationsfunktion. *Zeitschrift für Planung & Unternehmenssteuerung*, 18(3): 279-300.
33. Harris, Karen L. 1996. Content analysis in negotiation research: A review and guide. *Behavior Research Methods, Instruments & Computers*, 28(3): 458-467.
34. Hofmann, Bernd. 2006. Die Ausgestaltung des bankinternen Ratingverfahrens als Ansatzpunkt zur Risikooptimierung. *Zeitschrift für Betriebswirtschaft*, 76(6): 651-680.
35. Holsti, Ole R. 1963. The Quantitative Analysis of Content. In North, Robert C. et al, eds., Content Analysis: 37-53.
36. Holsti, Ole R. 1969. Content analysis for the social sciences and humanities. Reading et al, Addison-Wesley.
37. Hütten, Christoph. 2002. Unternehmenseigener Corporate-Governance-Kodex - Zulässigkeit und Sinnhaftigkeit in Zeiten von TransPuG und Deutschem Kodex. *Betriebs-Berater*, 57(34): 1740-1742.
38. Jin, Li and Stewart C. Myers. 2006. R<sup>2</sup> around the world: New theory and new tests. *Journal of Financial Economics*, 79(2): 257-292.

39. Kann, Jürgen v. and Clemens Just. 2006. Offenlegung der Vorstandsgehälter und keine Ende? Der Aufsichtsrat, 3(11): 1.
40. Koehn, Daryl and Joe Ueng. 2007. Corporate Governance Ratings: General Concerns and Specific Problems in the European Context. *Corporate Ownership & Control*, 5(1): 58-65.
41. Königs, Anke and Dirk Schiereck. 2006. Controlling der Finanzkommunikation in deutschen Großunternehmen. *Zeitschrift für Controlling & Management*, 50(6): 376-380.
42. Krippendorff, Klaus. 1980. Content Analysis. Beverly Hills, Sage.
43. Lambert, Richard, Christian Leuz and Verrecchia Robert E. 2007. Accounting Information, Disclosure, and the Cost of Capital. *Journal of Accounting Research*, 45(2): 385-420.
44. Larcker, David F., Scott Richardson and A. İrem Tuna. 2005. How Important is Corporate Governance? Working Paper, Wharton School.
45. Laufer, William S. 2006. Illusions of compliance and governance. *Corporate Governance: International Journal of Business in Society*, 6(3): 239-249.
46. Main, Brian G. M., Calvin Jackson, John Pymm and Vicky Wright. 2008. The Remuneration Committee and Strategic Human Resource Management. *Corporate Governance. An International Review*, 16(3): 225-238.
47. Matheson, David and Evan Reynolds. 2004. Web site posting of SEC and corporate governance materials: Required postings and practical advice. *Computer & Internet Lawyer*, 21(6): 12-16.
48. Mayring, Philipp. 2003. Qualitative Inhaltsanalyse. Weinheim and Basel, Beltz.
49. Meckel, Miriam, Christian Fieseler, Kathrin Mohr and Hedrik Vater. 2008. Unternehmenskommunikation und Corporate Governance als qualitative Erfolgsfaktoren in der Kapitalmarktpraxis. *Zeitschrift für Corporate Governance*, 3(2): 59-64.
50. Menzies, Christof, Jörg Tüllner and Alan Martin. 2008. Compliance Management. *Zeitschrift Führung + Organisation*, 77(3): 136-142.
51. Milne, Markus J. and Ralph W. Adler. 1999. Exploring the reliability of social and environmental disclosures content analysis. *Accounting, Auditing & Accountability Journal*, 12(2): 237-256.
52. Nowak, Eric, Roland Rott and Till G. Mahr. 2004. Rating börsennotierter Unternehmen auf Basis des Deutschen Corporate Governance Kodex. *Die Wirtschaftsprüfung*, 57(18): 998-1010.
53. Oelerich, Andreas. 2005. Robuste Ratingverfahren, Wiesbaden, Gabler.
54. Orens, Raf and Nadine Lybaert. 2007. Does the financial analysts' usage of non-financial information influence the analysts' forecast accuracy? Some evidence from the Belgian sell-side financial analyst. *International Journal of Accounting*, 42(3): 237-271.
55. Parum, Eva. 2005. Does Disclosure on Corporate Governance Lead to Openness and Transparency in How Companies are Managed? *Corporate Governance: An International Review*, 13(5): 702-709.
56. Peltzer, Martin. 2002. Handlungsbedarf in Sachen Corporate Governance, *Neue Zeitschrift für Gesellschaftsrecht*, 5(13): 593-599.
57. Pfitzer, Norbert, Peter Oser and Christian Orth. 2005. Deutscher Corporate Governance Kodex. Stuttgart, Schäffer-Poeschel.
58. Popping, Roel. 1988. On Agreement Indices for Nominal Data. In Saris, Willem E. and Irmtraud Gallhofer eds. *Sociometric Research, Vol. 1 Data Collection and Scaling*. Basingstoke et al, MacMillan Press.
59. Rose, Paul. 2007. The Corporate Governance Industry. *Journal of Corporation Law*, 32(4): 887-926.
60. Ruess, Annette. 2004. Gespielte Offenheit? *Wirtschaftswoche*, 58(25): 80-83.
61. Schachel, Ingo and Marcus Vögtle. 2006. Wirkungen von Investor Relations-Arbeit am deutschen Aktienmarkt. *Finanz Betrieb*, 8(9): 580-589.
62. Schutz, William C. 1958. On Categorizing Qualitative Data in Content Analysis. *Public Opinion Quarterly*, 22(4): 503-515.
63. Scott, William A. 1955. Reliability of content analysis: The case of nominal scale coding. *Public Opinion Quarterly*, 19(3): 321-325.
64. Seibt, Christoph H. 2002. Deutscher Corporate Governance Kodex und Entsprechens-Erklärung (§161 AktG-E). *Die AktienGesellschaft*, 47(5): 249-259.
65. Spiegelman, Marvin, Carl Terwilliger and Franklin Fearing. 1953. The Reliability of Agreement in Content Analysis. *Journal of Social Psychology*, 37(2): 175-187.
66. Srnka, Katharina J. and Sabine T. Koeszegi. 2007. From Words To Numbers: How to Transform Qualitative Data into Meaningful Quantitative Results. *Schmalenbach Business Review*, 59(1): 29-57.
67. Stöblein, Martin and Peter Mertens. 2008. Situierete und rollenorientierte Anspruchsgruppenkommunikation im Netz. *Zeitschrift Führung + Organisation*, 77(4): 200-207.
68. Van den Berghe, Lutgart A. A. and Abigail Levrau. 2003. Measuring the Quality of Corporate Governance: In Search of a Tailormade Approach? *Journal of General Management*, 28(3): 71-86.
69. Werder, Axel v. and Jens Grundei. 2003. Evaluation der Corporate Governance. In Hommelhoff et al, eds., *Handbuch Corporate Governance*: 675-695.
70. Werder, Axel v. and Till Talaulicar. 2005. Kodex Report 2005: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb*, 58(16): 841-846.
71. Werder, Axel v. and Till Talaulicar. 2007. Kodex Report 2007: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb*, 60(16): 869-875.
72. Werder, Axel v. and Till Talaulicar. 2008. Kodex Report 2008: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb*, 61(16): 825-832.
73. Wirtz, Markus and Franz Caspar. 2002. Beurteilerübereinstimmung und Beurteilerreliabilität. Göttingen et al, Hogrefe.
74. Zimmermann, Jochen, Igor Goncharov and Jörg-Richard Werner. 2006. Does Compliance with the German Corporate Governance Code Have an Impact on Stock Valuation? An empirical analysis. *Corporate Governance: An International Review*, 14(5): 432-445.
75. Zöllner, Christine. 2007. Interne Corporate Governance. Wiesbaden, Gabler.
76. Zwick, Rebecca. 1988. Another Look at Interrater Agreement. *Psychological Bulletin*, 103(3): 374-378.

77.

## Appendix

**Table 1.** German Scientific Corporate Governance Ratings

Study	Criteria of rating and purpose	
Drobetz, Schillhofer and Zimmermann (2004)	5 main categories, 30 subcategories based on the DVFA Scorecard, parts of the GCGC, CalPers-Principles, Deminor Corporate Governance Checklist	P
Nowak, Rott and Mahr (2004)	63 criteria based on the GCGC	C
Bassen, Pupke and Zöllner (2006)	5 categories, 41 subcategories, DVFA Scorecard	C
Bassen, Kleinschmidt, Prigge and Zöllner (2006)	6 main categories, 83 subcategories based on recommendations and suggestions of the GCGC	P
Zimmermann, Goncharov and Werner (2006)	62 criteria based on the GCGC	P
Arnsfeld and Growe (2006)	37 overall, 29 subcategories based on critical rules of the GCGC for all companies of the selection indices DAX, TecDAX, MDAX and SDAX (Werder and Talaulicar 2005), 5 subcategories of the DVFA Scorecard, 3 subcategories of Drobetz, Schillhofer and Zimmermann (2004); known as “equi-card”	C
Werder and Talaulicar (2008)	103 criteria based on the GCGC	C
Purpose of rating: C = compliance, P = Performance		

**Table 2.** Transparency & Disclosure on Capital Markets, Recent Findings

Study	Findings
Aksu and Kosedag (2006)	Successful companies share more information with the environment than less successful companies
Jin and Myers (2006)	Positive association between share price synchronicity and a lack of transparency
Schachel and Vögtle (2006)	Good investor relations activity implies better stock performance
Durnev and Kim (2007)	Positive association between transparency and business valuation
Chipalkatti, Le and Rishi (2007)	Positive association between corporate transparency and portfolio flows in emerging capital markets
Lambert, Leuz and Verrecchia (2007)	If more corporate disclosure reduces the amount of managerial appropriation, this generally reduces firms’ cost of capital
Orens and Lybaert (2007)	Analysts who use more forward-looking information and more internal-structure information offer more accurate forecasts
Francis, Nanda and Olsson (2008)	Firms with good earnings quality have more expansive voluntary disclosures than firms with poor earnings quality

**Table 3.** Integrated Framework to Measure German Corporate Governance

Compliance Scorecard (CS), GCGC Version 2006			Transparency & Disclosure Scorecard (TDS)		
	Category	Criteria		Category	Criteria
I	Shareholders and the General Meeting	8	I	Declaration of Conformity to GCGC	7
II	Cooperation between Management Board and Supervisory Board	8	II	Corporate Governance Report	5
III	Management Board	17	III	Corporate Governance Internet Reporting	8
IV	Supervisory Board	38	IV	Compensation System	8
V	Transparency	10	V	Board Quality, Independence and	6
VI	Reporting and Audit of the Annual Financial Statements	13	VI	Corporate Governance Commitment and firm-specific Corporate Governance Code	4
Σ		94	Σ		38

**Table 4.** Transparency & Disclosure Scorecard (TDS)

Transparency & Disclosure Scorecard (TDS) [A = Suggestion of GCGC; E = Recommendation of GCGC]			
I	Declaration of Conformity to GCGC		
1			Does the declaration of conformity refer to the underlying version of the GCGC?
2			Does the declaration of conformity refer to the previous financial year concerning conformity?
3			Does the declaration of conformity refer to the upcoming financial year concerning conformity?
4			Is the declaration of conformity dated, to recognize, what is the firms' actual quality of corporate governance?
5			Is it possible to relate explicitly every rule of the GCGC being declared to its according number of the GCGC?
6		Stricter 3.10 S2 GCGC	Does the company explain deviations from recommendations of the GCGC?
7	A	3.10 S3 GCGC	Does the company refer to the suggestions of the GCGC voluntarily?
II	Corporate Governance Report		
1	E	3.10 S1 GCGC	Do management board and supervisory board report on corporate governance in the annual report (Corporate Governance Report)?
2			Do management board and supervisory board report on compliance to the GCGC rules?
3			Does the Corporate Governance Report contain substantial information on firm-specific corporate governance beyond the Declaration of Conformity?
4			Where do management board and supervisory board report on corporate governance in the annual report?
5			Do management board and supervisory board provide information on planned actions and developments on corporate governance in the reporting year?
III	Corporate Governance Internet Reporting		
1			Where does the company report on corporate governance on the companies website? Is it easy to find relevant information or is important information rather hidden?
2	E	3.10 S4 GCGC	Are Declarations of Conformity published on the companies website up to five years?
3		IV.1 DVFA	Does the company publish its articles of incorporation in the internet?
4			Is it possible to download the Corporate Governance Report separately?
5			Is it possible to download the current version of the GCGC or is there a link to the website of the Commission of the GCGC?
6	E	6.7 GCGC	Does the company announce dates of the essential and recurrent publications in a financial calendar timely?
7		Connection to 7.1.1 S2 GCGC	Does the company publish quarterly reports?
8	A	6.8 S3 GCGC	Does the company also publishes relevant corporate governance information in English?
IV	Compensation System		
1	E	Connection to 4.2.5 (1) GCGC, § 315 Abs. 2 Nr. 4 HGB	Does the company disclose its compensation system for the members of the management board in its Compensation Report separately?

2		Connection to 4.2.3 (4) und 4.2.5 (1) GCGC	Does the company explain the main features in the compensation system for the members of the management board?
3		Connection to 4.2.4 GCGC	Does the company does without having an opting-out in reporting on management compensation?
4	E	4.2.5 (2) S1 GCGC	Does the company report the value of long run incentives with risky character?
5	E	4.2.5 (2) S2 GCGC	Does the company report on the value of pension reserves or pension funds?
6	E	4.2.5 (3) S2 GCGC	Does the Compensation Report contain information on incidental services?
7	E	5.4.7 (3) S1 GCGC	Does the company report on the compensation of the members of the supervisory board on an individual basis and is their compensation divided in fixed and variable components?
8		V.3 DVFA	Does the company give any information on success-based incentives to managers below top management?
V	Board Quality, Independence and Integrity		
1		II.6 DVFA	Does the company publish information on sideline jobs of members of the management board?
2			Does the company publish information on sideline jobs of members of the supervisory board?
3		III.15 DVFA	Does the company publish information on how often every member of the supervisory board takes part on meetings of the supervisory board?
4			Does the company publish the biography of every member of the management board?
5			Does the company publish the biography of every member of the supervisory board?
6		III.6 DVFA	Does the company publish profiles of potential new members of the supervisory board before recommending them for election in the shareholders meeting?
VI	Corporate Governance Commitment and firm-specific Corporate Governance Code		
1		I.2 DVFA	Does the company publish a firm-specific corporate governance code based on the GCGC?
2		I.3 DVFA	Does the company make a commitment on durable adaption to the GCGC in the future?
3			Does the company report on planned actions in corporate governance in the future?
4		I.3 equi-card	Does there exist a representative, responsible compliance to the rules of the GCGC within the company?

**Table 5.** Testing for intercoder reliability, Compliance Scorecard

Category	R	$\pi$	$\kappa$	$\alpha$
I	.969 (.940)	.925 (.858)	.907 (.859)	.897 (.700)
II	.960 (.935)	.916 (.865)	.916 (.866)	.877 (.725)
III	.986 (.977)	.916 (.890)	.916 (.890)	.914 (.850)
IV	.974 (.943)	.920 (.821)	.920 (.822)	.903 (.657)
V	.993 (.987)	.959 (.920)	.959 (.920)	.951 (.891)
VI	.999 (1.000)	.992 (1.000)	.992 (1.000)	1.000 (1.000)
Overall level of agreement	.980 (.961)	.930 (.865)	.930 (.865)	.913 (.744)

in brackets: reliability scores on TecDAX before readapting the coding scheme

**Table 6.** Discovered reasons for intercoder differences, Compliance Scorecard

No.	Reasons for intercoder differences and consequences
1	Wrong declaration of code number through firms <u>Consequence:</u> Wrong coding due to missing proof on correctness
2	Accumulative declaration of code numbers through firms, but additional verbal description of its content <u>Consequence:</u> Wrong coding (= complete compliance or exclusion of several code numbers, obviously only one code number has been concerned)
3	Accumulative declaration of code number through firms without additional verbal description of its content <u>Consequence:</u> Wrong coding (= compliance or exclusion of only one code number; a strict approach has to comply or exclude several code numbers)
4	Drawing conclusions on recommendations/suggestions due to the exclusion of similar (concerning contents) recommendations/suggestions obviously not declared as conformity/non-conformity <u>Consequence:</u> Wrong coding without proving exactly, which code number being concerned
5	Declaration of conformity includes references on two calendar years and two versions of the GCGC <u>Consequence:</u> Wrong coding, without differentiation between calendar years and GCGC versions
6	Suggestions coded as conform, but no assignment in fact was possible to single suggestions <u>Consequence:</u> Compliance on suggestions rated as too positive comparing to firms who don't give any information on suggestions
7	Updated declaration of conformity in annual reports including different information comparing to original declaration <u>Consequence:</u> Wrong coding due to inconsistent data
8	Information on suggestions only in annual reports <u>Consequence:</u> Wrong coding due to sole observation of declaration of conformity

**Table 7.** Testing for intercoder reliability, Transparency & Disclosure Scorecard

Category	R	$\pi$	$\kappa$	$\alpha$
I	.907	.781	.781	.798
II	.913	.819	.819	.857
III	.946	.843	.844	1.000
IV	.902	.779	.780	.882
V	.942	.883	.883	.855
VI	.902	.783	.783	.763
Overall level of agreement	.920	.830	.830	.875

## TWO FACES OF BUSY OUTSIDE DIRECTORS

*Chia-Wei Chen\**, *J. Barry Lin\*\**, *Bingsheng Yi\*\*\**

### Abstract

In this study, we examine how multiple directorships held by outside directors (busy outside directors) influence shareholder wealth in diversifying acquisitions. With a sample of 893 diversifying acquisitions from 1998 to 2004, we find a negative (positive) busy-director effect for diversifying acquisitions of public-targets (private-targets). Busy directors are negatively (positively) associated with the five-day cumulative abnormal returns in acquisitions involving public (private) targets, where merger-related agency problems are more likely. Our evidence support the notion that, in the case of diversifying acquisitions, increased managerial monitoring plays a more important role versus enhanced advising and business connection from busy directors.

**Keywords:** boards of directors, busy outside directors, diversifying acquisitions, agency problems

\**Tungshai University, Taichung, Taiwan*

\*\**School of Management, Simmons College, Boston, USA*

\*\*\**California State University-Dominguez Hills, Carson, California, USA*

### 1. Introduction

Multiple directorships held by an outside director signal the reputation and superior talent of this director (Fama (1980) and Fama and Jensen (1983)). Consistent with this argument, Ferris, Jagannathan, and Pritchard (2003) and Fich and Shivdasani (2006), among others, report that the likelihood for an outside director to obtain more board seats is related to the performance of the firm in which he or she serves on the board. However, Fich and Shivdasani (2006) report a negative association between firm performance and multiple directorships held by outside directors. They suggest that serving on numerous boards can result in overstretched directors and therefore contaminates the functioning of the board.

There are two competing arguments on the value of directorships held by outside directors. On the one hand, multiple directorships are indicative of the strong reputation and experience of a director. Outside directorships provide directors with access to learn different management skills or to establish business networks (Mace (1986)). Therefore these directors have a greater diversity of experience and consequently become valuable advisors to the firms in which they serve on the board. On the other hand, multiple board memberships force outside directors to serve less frequently on the board and as a result shirk their responsibilities in carefully monitoring the manager's activities. Accordingly, the value of multiple directorships relies on a trade-off between ineffective monitoring and superior advising. While several studies report supporting evidence for either the costs (i.e. ineffective monitoring) or the benefits (i.e. valuable advising) of multiple directorships, under what circumstances do the costs dominate the benefits

and vice versa?<sup>11</sup> Answers to this question can explain the inconsistent findings regarding the relationship between multiple directorships and shareholder wealth and, in addition, offer a comprehensive view for shareholders or regulators in evaluating the issue of limiting the number of directorships held by outside directors. However, this question has not been addressed as yet in the literature.

With a sample of 893 diversifying acquisitions involving both public and private targets from 1998 to 2004, we attempt to decompose the value of multiple directorships in this paper. In particular, we suggest that the benefits (costs) of multiple directorships are most pronounced when agency conflicts are low (high). Low agency conflicts indicate less need for monitoring. In other words, the costs from ineffective monitoring are reduced. In contrast, firms with high agency conflicts need effective monitoring from outside directors to protect shareholder wealth. Multiple board memberships can reduce the effectiveness of an outside director's monitoring and therefore the potential benefits from valuable advising of multiple directorships becomes unclear.

Acquiring a public or private target could be driven by managerial motive such as hubris or empire building (Roll (1986) and Moeller, Schlingemann, and Stulz (2004)) of a bidding firm.<sup>12</sup> Publicly listed firms

<sup>11</sup> Ferris, Jagannathan, and Pritchard (2003), for example, find no evidence that multiple directorships held by directors causes these directors to shirk their responsibilities to serve on board committees. Harris and Shimizu (2004) report a positive association between multiple directorships and shareholder wealth. Fich and Shivdasani (2006) and Ahn, Jiraporn, and Kim (2008), in contrast, report a negative association.

<sup>12</sup> The choice between a public and a private target could also be related to the availability of target's information (Chang (1998)), or

are generally larger, better known, and more prestigious than private firms. Merger-related agency problems are more likely in acquisitions of public firms than in acquisitions of private firms. Consequently, effective monitoring from outside directors, who play an important role in protecting the interests of shareholders, becomes more important in acquisitions of public targets. As diversifying acquisitions involve elevated levels of information asymmetry, the superior knowledge and experience from outside directors are particularly valuable in evaluating the target and in protecting shareholder wealth during acquisition. Therefore, multiple directorships enhance the knowledge and experience of an outside director but hamper the effectiveness of an outside director's monitoring.

In the acquisition of private targets, where acquisition-related agency problems are less likely, while the costs of ineffective monitoring from outside directors with multiple directorships are diminished, the benefits from superior advising can be especially valuable. In contrast, for acquisition of public targets, the costs of ineffective monitoring from outside directors with multiple directors are severe, while the benefits of superior advising are reduced or hidden. Consistent with this notion, our results indicate that busy outside directors (i.e. outside directors with at least three directorships) are significantly and positively associated with shareholder wealth during diversifying acquisitions of private targets but negatively associated with shareholder wealth during diversifying acquisitions of public targets. These findings remain when alternative measures of agency conflicts, multiple directorships, and acquirer returns are applied. For Private-target acquirers, firms with a busy board obtain 1.68% (1.65%) higher CARs than acquirers without a busy board. This result indicates that a busy board is beneficial to shareholder wealth. As a contrast, for acquirers targeting public firms, the difference between CARs for acquirers with and without a busy board is insignificant in both mean and median, which are all negative. Thus the existence of a busy board has important implications for both investors and M&A arbitrageurs.

The remainder of this paper is organized as follows. Section 2 describes our sample selection process, data sources, and variables. Empirical results and robustness tests are reported in Section 3. Section 4 summarizes and concludes this paper.

---

target's bargaining power (Ang and Kohers (2001)), among other factors. However, our sample indicates governance index (Gompers, Ishii, and Metrick (2003)) is positively and significantly correlated with target's public status. Furthermore, in our robustness tests, we create two interactive terms, *percentage of busy outside directors\* $g$  index ( $\leq Q1$ )* and *percentage of busy outside directors\* $g$  index ( $\geq Q3$ )*, to capture the relationship between multiple directorships and shareholder wealth in firms with high and low agency conflicts measured by governance index. Similar to our findings in Table 3, busy outside directors are beneficial in firms with low agency conflicts.

## 2. The Sample and Variables

### A. Sample Selection

We obtain a sample of diversifying acquisitions from the Securities Data Company's (SDC) U.S. Mergers and Acquisitions Database. An acquisition is defined as diversifying if the target and the acquirer do not share a Fama-French industry. In addition, the sample meets the following criteria: (1) The announcement date is within the time frame from 1998 through 2004; (2) The acquirer controls less than 50% of the shares of the target at the announcement date and controls 100% of the shares after the transaction; (3) The deal value is equal to or greater than \$1 million; and (4) Data on acquirer stock prices, accounting variables, and director information are available from CRSP, COMPUSTAT, and EDGAR data retrieval system. Using these criteria, we obtain a sample of 893 firm-year diversifying acquisitions. Within these 893 observations, 290 are public targets acquired by 190 firms and 603 are private targets acquired by 370 firms.

### B. Key Variables

#### B.1. Board Characteristics

We apply two variables to capture multiple directorships held by outside directors: busy board indicator and the percentage of busy outside directors. Outside directors are directors without affiliation with the firm other than their directorships. Outside directors are defined as busy if they hold at least three directorships. Busy board indicator is 1 if 50% or more than 50% of outside directors are busy. These two measures eliminate the potential impact caused by outside directors with numerous seats. However, if individual directorship has its own value, these two measures may underestimate the relationship between shareholder wealth and multiple directorships. To address this issue, we employ the average directorships held by outside directors as an additional alternative measure for the multiple directorships in our robustness tests.

Percentage of outside directors is computed as the number of outside directors divided by the number of total directors on the board. Yermack (1996) reports an inverse association between board size and firm value. We use the number of directors on the board as a measure of board size. Morck, Shleifer, and Vishny (1988) find a linkage between management ownerships and firm value. Beasley (1996) in addition reports a relationship between outside director ownerships and likelihood of financial statement fraud. We add the percentage of shares held by outside directors into our analyses to control for these effects.

#### B.2 Abnormal Returns

We measure bidder announcement return by market model adjusted stock returns around initial acquisition announcements. We compute three-day and five-day cumulative abnormal returns (CARs) during the windows (-1, +1) and (-2, +2) encompassed by the event day, where event day 0 is the acquisition



announcement date.<sup>13</sup> We use the CRSP equal-weighted return as the market return and estimate the market model parameters over the period from event day -210 to event day -11.

### B.3 Control Variables

As cumulative abnormal returns (CARs) can be affected by several factors, we control for acquirer and deal characteristics in our analyses. Firm size for example has been found to relate to acquirer returns (Moeller, Schlingemann, and Stulz (2004)). We measure firm size by market capitalization as well as total assets. Tobin's q can affect shareholder wealth during acquisitions (Lang, Stulz, and Walkling (1991) and Moeller, Schlingemann, and Stulz (2004)). We calculate Tobin's q as market value of assets over book value of assets. Leverage and free cash flow are related to managerial motivation (Jensen (1986)). We calculate leverage as a firm's book value of long-term and short-term debts over market value of total assets. Free cash flow is calculated as operating income before depreciation minus interest expenses, income taxes, and capital expenditures scaled by book value of total assets. All these variables are measured at the year-end prior to the acquisition announcement.

Acquirer's pre-announcement stock price run-up potentially affects acquirer's return during acquisitions (see e.g., Masulis, Wang, and Xie (2006)). We measure it as acquirer's buy-and-hold abnormal return during the period (-210, -11) with the CRSP value-weighted market index as the benchmark. Method of payment (Myers and Majluf (1984) and Travlos (1987)), and relative deal size (Asquith, Bruner, and Mullins (1983) and Moeller, Schlingemann, and Stulz (2004)) have been found to relate to shareholder wealth during acquisitions. We measure relative deal size as deal value over bidder's market capitalization at the year-end prior to announcement date. Finally, we include an intrastate indicator in our analyses. It is 1 if acquiring and target firms are within the same state and 0 otherwise. The acquirer and target within the same state potentially suffer less information asymmetry and therefore affect acquirer's return during acquisitions.

## 3. Empirical Results

### A. Univariate Tests

#### A.1 Summary Statistics

Table 1 reports summary statistics for the full sample and for the 2 sub-samples based on the public status of the targets. Studies, such as Chang (1998), Ang and Kohers (2001), and Fuller, Netter, and Stagemoller (2002), report that the acquirers of private targets gain while the acquirers of public targets do not gain or even suffer a loss. The average three-day (five-day) cumulative abnormal return (CAR) is -0.65% (-0.34%)

for the full sample. However, the CARs for acquirers targeting private firms are 0.04% and 0.45%, while they are -2.09% and -1.97% for acquirers targeting public firms. The differences are statistically significant at the 1% level. This evidence confirms the findings from earlier studies.

[Insert Table 1 about here]

There are also significant differences, as expected, in the board characteristics between the two sub-samples. Public-target group has a mean 33% of busy outside directors versus 28% for the private-target group. The difference of 5% is significant at the 1% level. Public-Target group also has significantly higher average directorship for outside directors. These firms have larger boards, but lower outside director ownership. Interestingly, there is no significant difference in the percentage of outside directors between the two groups. In other words, the percentage composition of the board does not differ (but a higher percentage of the outside directors for the public-target acquiring firms are busy). It is of significance that board differences are seen in the characteristics of the directorship of the outside directors.

In terms of acquirer characteristics, firms acquiring public targets are substantially larger (about 37% higher in market capitalization and 238% higher in total assets), use more leverage, and have lower growth opportunity (as seen in lower Tobin's q). There is no significant difference in free cash flow or pre-announcement stock run-up. When we compare deal characteristics, we observe more across-state deals, and larger relative deal size for the Public-target group.

### A.2 Busy Board and Announcement Returns

In Panel A of Table 2, we separate our sample into acquiring firms with and without a busy board. While both the mean and median five-day CARs for firms with busy board are positive, they are both negative for non-busy board firms. The difference in mean is insignificant, while the difference in median is significant at the 10% level, indicating, albeit weakly, that there is potentially a busy board effect. However, as discussed earlier, there is strong theoretical argument for the notion that busy outside directors play different roles in acquiring firms involving target's different public status.

[Insert Table 2 about Here]

As shown on Panel B of Table 2, acquirers targeting private firms have higher mean CARs than acquirers targeting public firms regardless of the existence of a busy board. However, the difference is relatively large in acquirers with a busy board, implying that a busy board has a strong but opposite impact on acquirer returns depending on target's

<sup>13</sup> For a random sample of 500 acquisitions from 1990 to 2000, Fuller, Netter, and Stagemoller (2002) find that the announcement dates provided by SDC are correct for 92.6% of the sample and are off by no more than two trading days for the remainder. Thus, using a five-day window over event days (-2, +2) captures most, if not all, of the announcement effect.

public status. Focusing on the Private-target acquirers, firms with a busy board obtain 1.68% (1.65%) higher CARs than acquirers without a busy board. This result indicates that a busy board is beneficial to shareholder wealth. As a contrast, for acquirers targeting public firms, the difference between CARs for acquirers with and without a busy board is insignificant in both mean and median, which are all negative. Apparently, the superior knowledge and experience from busy outside directors with multiple directorships fail to enhance shareholder wealth of acquirers involving public targets, while they do enhance shareholder wealth for private-target acquirers. We do not find significantly lower CARs due to ineffective monitoring for acquirers with a busy board targeting public firms. We note that the group without a busy board potentially could include acquirers with some busy outside directors. As a result, we fail to observe the impact caused by ineffective monitoring documented by Fich and Shivdasani (2006) and others.

### **B. Multivariate Analyses**

In Table 3, we incorporate variables related to acquirer returns and discussed in previous section into regressions. For the full sample, the coefficients for both busy board and the percentage of busy outside directors are insignificant. However, when acquisitions are separated by target's public status, we observe clear differences between the two sub-samples. Acquirers targeting private firms obtain additional 2.51% in five-day CARs if they have a busy board and obtain about additional 0.05% in five-day CARs if their percentage of busy outside directors increases by 1%. For acquirers targeting public firms, they lose 2.59% in five-day CARs if they have a busy board and lose about 0.07% in five-day CARs if their percentage of busy outside directors increases by 1%. The coefficients for both busy board and the percentage of busy outside directors indicate multiple directorships play important but opposite roles during diversifying acquisitions for acquirers targeting private firms versus acquirers targeting public firms.

#### **[Insert Table 3 about Here]**

Coefficients for both busy board and the percentage of busy outside directors are all significant at least at 5% level in regression (3), (4), (5) and (6), suggesting busy outside directors are beneficial (costly) to acquirers of private (public) targets. If the choice between target's public statuses is related to managerial motivation, the results in Table 3 indicate that superior knowledge and experience from outside directors with multiple directorships enhance shareholder wealth when firms acquire a private target where managerial oversight is a less critical issue. On the contrary, the benefits from superior advising are reduced or even dominated by the costs of ineffective monitoring when firms acquire public targets where board oversight is critical.

The opposite signs for coefficients of percentage

of outside directors indicate outside directors in general could be either beneficial or costly as well. For firms acquiring private (public) targets, one percent increases in the percentage of outside directors reduces (increases) five-day CARs by about 0.07% (0.11%). If directorships signal reputation, knowledge, and experience, outside directors with less than three directorships could be effective monitors. However, fewer or no outside directorships may limit their opportunity to learn experience or to provide additional service to the board through their business connection. Therefore, if advising is desired and managerial oversight is less important, the monitoring function from these non-busy outside directors does not necessarily enhance shareholder wealth. Their limited skills in advising may not enhance shareholder wealth. As a result, we observe a negative (positive) association between the percentage of outside directors and acquirer's CARs of private (public) targets. Our results indicate an interesting picture: while generic outside directors have a negative valuation effect, busy outside directors have a positive valuation effect in diversifying acquisition of private targets. Acquisitions of public targets exhibit the exact opposite pattern. In terms of control variables, several of them are insignificant in our regression results. However, similar to previous studies, CARs are sensitive to payment method and target's public status. In particular, CARs drop about 3.3% for acquirers targeting public firms and choosing stock payment. CARs are also negatively associated to the relative deal size in all sample acquisitions or acquisitions involving public targets, consistent with Moeller, Schlingemann, and Stulz (2004). This finding indicates increased empire-building and managerial hubris (Roll (1986) and Moeller, Schlingemann, and Stulz (2004)) at larger firms. For acquirer's pre-announcement stock price run-up, we also observe negative coefficient similar to Masulis, Wang, and Xie (2006). Finally, our results indicate that acquisitions in which acquirers and targets are located in the same state are positively associated with CARs, but this association is only significant for acquisitions involving public targets.

### **C. Robustness Tests**

To verify whether our findings remain consistent, we provide regression results as shown in Table 4 with alternative measures of agency conflicts, busy outside directors, cumulative abnormal returns, and diversification acquisitions. In Panel A, we employ governance index (Gompers, Ishii, and Metrick (2003)) to proxy for the degree of agency conflicts. In particular, we define acquirers with governance index within the highest (lowest) 25% as firms with high (low) agency conflicts. Similar to the results in Table 3, busy outside directors are positively (negatively) associated with five-day CARs in firms with low (high) agency conflicts. Although the association is only significant for acquirers suffering less agency conflicts, this evidence indicates the benefits of multiple directorships.

**[Insert Table 4 about Here]**

In Panel B, we apply the average number of directorships held by outside directors to proxy for busy outside directors. Although this measure can be biased by numerous directorships held by outside directors, it allows us to analyze whether individual directorship has its own value. Our results indicate that if the average directorships held by outside directors increased by one additional directorships, five-day CARs around diversifying acquisitions will increase (decrease) by about 1.12% (1.82%) for acquisitions of private (public) targets. This evidence not only supports our results in Table 3 but also suggests the value of advising increases with the number of directorships held by an outside director. In Panel C, we replace five-day CARs by three-day CARs (-1, 1). In Panel D, we use the CRSP value-weighted return as the market return to estimate the market model parameters. Since acquirers may have several acquisitions within a short time, it potentially biases the calculation of market model parameters. Therefore, in Panel E, we eliminate acquirers with more than one acquisition within a year. Finally, in Panel F, we define a diversifying acquisition as an acquisition in which acquirer and target do not share the same 2-digit SIC code. Once again, similar results are obtained.

**4. Summary and Conclusions**

This paper provides direct empirical evidence to document the benefits as well as the costs of multiple directorships (busy directors). Our findings provide strong and robust evidence that the association between shareholder wealth and outside directors with multiple directorships depends on the trade-off between valuable advising and ineffective monitoring from these directors. In particular, if managerial oversight is required to protect shareholder wealth, as likely in the case of an acquisition of a public target, the costs from ineffective monitoring dominates the benefits from valuable advising of outside directors with multiple directorships. The negative association between busy outside directors and shareholder wealth is observed. On the contrary, if benefits from valuable advising and extensive business association are more important, as in the case of an acquisition of a private target, such benefits may reduce or even dominate the costs from ineffective monitoring and therefore enhance shareholder wealth. This paper shed a clear light in the opposite roles played by busy outside directors in relation to diversifying acquisitions of public versus private targets. These results have important implications for investors as well as M&A arbitrageurs.

**References**

1. Ahn, Seoungpil, Pornsit Jiraporn, and Young Sang Kim, 2008, Multiple directorships and acquirer returns, Working paper, National University of Singapore.
2. Ang, James, and Ninon Kohers, 2001, The take-over market for privately held companies: The US experience, *Cambridge Journal of Economics* 25, 723-748.
3. Asquith, Paul, Robert F. Bruner, and David W. Mullins Jr., 1983, The gains to bidding firms from merger. *Journal of Financial Economics* 11, 121-139.
4. Beasley, Mark S., 1996, An empirical analysis of the relation between the board of director composition and financial statement fraud, *The Accounting Review* 71, 443-465.
5. Chang, Saeyoung, 1998, Takeovers of privately held targets, method of payment, and bidder returns, *Journal of Finance* 53, 773-784.
6. Fama, Eugen F., 1980, Agency problems and the theory of the firm, *Journal of Political Economy* 88, 288-307.
7. Fama, Eugene F., and Michael C. Jensen, 1983, Separation of ownership and control, *Journal of Law and Economics* 26, 301-325.
8. Ferris, Stephen P., Murali Jagannathan, A.C. Pritchard, 2003, Too busy to mind the business? Monitoring by directors with multiple board appointments, *The Journal of Finance* 58, 1087-1112.
9. Fich, Eliezer M., and Anil Shivdasani, 2006, Are busy boards effective monitors? *The Journal of Finance* 61, 689-724.
10. Fuller, Kathleen, Jeffrey Netter, and Mike Stegemoller, 2002, What do returns to acquiring firms tell us? Evidence from firms that make many acquisitions, *Journal of Finance* 57, 1763-1794.
11. Gompers, Paul, Joy Ishii, and Andrew Metrick, 2003, Corporate governance and equity prices, *Quarterly Journal of Economics* 118, 107-155.
12. Harris, Ira C. and Katsuhiko Shimizu, 2004, Too busy to serve? An examination of the influence of overboarded directors, *Journal of Management Studies* 41, 775-798.
13. Jensen, Michael C., 1986, Agency costs of free cash flow, corporate finance, and takeovers, *American Economic Review* 76, 323-329.
14. Lang, Larry H.P., Rene M. Stulz, and Ralph A. Walkling, 1991, A test of the free cash flow hypothesis: The case of bidder returns, *Journal of Financial and Quantitative Analysis* 40, 693-719.
15. Mace, Myles L., 1986, *Directors: Myth and reality*, Harvard University Press, Boston, MA.
16. Masulis, Ronald W., Cong Wang, and Fei Xie, 2007, Corporate governance and acquirer returns, *The Journal of Finance*, Forthcoming.
17. Moeller, Sara B., Frederik P. Schlingemann, and Rene M. Stulz, 2004, Firm size and the gains from acquisitions, *Journal of Financial Economics* 73, 287-329.
18. Morck, Randall, Andrei Shleifer, and Robert W. Vishny, 1988, Management ownership and market valuation: An empirical analysis, *Journal of Financial Economics* 20, 293-315.
19. Myers, Stewart C., and Nicholas S. Majluf, 1984, Corporate financing and investment decisions when firms have information that investors do not have, *Journal of Financial Economics* 13, 187-221.
20. Roll, Richard, 1986, The hubris hypothesis of corporate takeovers, *The Journal of Business* 59, 197-216.
21. Travlos, Nickolaos G., 1987, Corporate takeover bids, method of payment, and bidding firm's stock returns,

*Journal of Finance* 52, 943-963.*Financial Economics* 40, 185-211.

22. Yermack, David, 1996, Higher market valuation of companies with a small board of directors, *Journal of*

**Table 1.** Summary Statistics

The sample consists of 893 diversifying acquisitions from 1998 to 2004. Among these diversifying acquisitions, 290 (603) are public (private) targets acquired by 190 (370) firms. Diversifying acquisitions are acquisitions in which acquirers and targets do not share a Fama-French industry. CAR (-1, 1) and CAR (-2, 2) are three-day and five-day cumulative abnormal returns in percentage points calculated using the market model. The market model parameters are estimated using the return data for the period (-210, -11). Outside directors are directors without affiliation with the firm other than their directorships. Outside directors are defined busy if they hold at least three directorships. If 50% or more than 50% of outside directors are busy, the board is defined as a busy board. Average directorships of outside directors is calculated as the total number of directorships held by outside directors divided by the number of outside directors. Board size measures the number of directors, including inside, outside, and gray directors. Outside director ownership is the percentage of shares held by outside directors. Market capitalization, measured in millions, is calculated as the number of shares outstanding multiplied by the stock price at the year end prior to the announcement date. Acquirer's pre-announcement stock price run-up is acquirer's buy-and-hold abnormal return during the period (-210, -11) with the CRSP value-weighted market index as the benchmark. Free cash flow is calculated as operating income before depreciation minus interest expenses, income taxes, and capital expenditures scaled by book value of total assets. Leverage is the book value of long-term debts and short-term debts over market value of total assets. Tobin's q is market value of assets over book value of assets. All-cash deal, intrastate and public status are dummy variables. All-cash deal is 1 for purely cash-financed deals and 0 otherwise. Intrastate is 1 if acquirer and target firms are in the same state and 0 otherwise. Public status is 1 if target is a public firm and 0 if target is a private firm. Relative deal size is deal value over acquirer's market capitalization. \*, \*\*, and \*\*\* stand for statistical significance based on two-sided tests at the 10%, 5%, and 1% level, respectively.

Variable	Full Sample	Public target (1)	Private target (2)	Difference (1) - (2)	t statistics
<i>Abnormal returns:</i>					
CAR (-1, 1)	-0.65	-2.09	0.04	-2.13***	-4.19
CAR (-2, 2)	-0.34	-1.97	0.45	-2.42***	-3.91
<i>Board characteristics:</i>					
Percentage of busy outside directors	0.30	0.33	0.28	0.05***	2.81
Percentage of outside directors	0.66	0.65	0.66	-0.01	-0.61
Average directorships of outside directors	2.11	2.24	2.05	0.19***	3.37
Board size	9.46	10.4	9.00	1.40***	6.60
Outside director ownership	0.83	0.62	0.92	-0.30*	-1.92
<i>Acquirer characteristics:</i>					
Acquirer's market capitalization	23949	29311	21370	7941**	1.97
Acquirer's pre-announcement stock price run-up	0.25	0.19	0.28	-0.09	-1.43
Free cash flow	0.08	0.08	0.08	0.00	-0.47
Leverage	0.13	0.15	0.12	0.03**	2.51
Total assets	13565	25982	7676	18306***	4.86
Tobin's q	2.31	1.90	2.51	-0.61***	-2.78
<i>Deal characteristics:</i>					
All-cash deal (dummy)	0.27	0.30	0.25	0.05	1.62
Intrastate	0.24	0.19	0.26	-0.07**	-2.55
Relative deal size	0.10	0.16	0.06	0.10***	7.72

**Table 2.** Announcement Abnormal Returns and Busy Board

Table 2 presents the CAR (-2, 2) of each group with and without a busy board. A board is defined as busy if 50% or more than 50% of outside directors hold at least three directorships. The sample consists of 893 diversifying acquisitions from 1998 to 2004. Among these diversifying acquisitions, 290 (603) are public (private) targets acquired by 190 (370) firms. Diversifying acquisitions are acquisitions in which acquirers and targets do not share a Fama-French industry. CAR (-2, 2) is five-day cumulative abnormal return in percentage points calculated using the market model. The market model parameters are estimated using the return data for the period (-210, -11). \*, \*\*, and \*\*\* stand for statistical significance based on two-sided tests at the 10%, 5%, and 1% level, respectively.

		Busyboard (1)	Non-busyboard (2)	Difference (1) - (2)	t/z statistics
Panel A: All sample					
All sample	Mean	0.26	-0.57	0.83	1.27
	Median	0.73	-0.53	1.26*	1.76
	N	249	644		
Panel B: Comparison by target's public status					
Public target	Mean (1)	-2.27	-1.84	-0.43	0.40

	Median (2)	-0.74	-1.43	0.69	0.30
	N	90	200		
Private target	Mean (3)	1.69	0.01	1.68**	2.09
	Median (4)	1.60	-0.05	1.65**	2.27
	N	159	444		
Difference	(1) – (3)	-3.96***	-1.85**		
	(2) – (4)	-2.34***	-1.38***		
t statistics		3.30	2.56		
z statistics		3.20	3.11		

**Table 3.** Busy Outside Directors and Acquirer Returns in Acquiring Firms

The sample consists of 893 diversifying acquisitions from 1998 to 2004. Among these diversifying acquisitions, 290 (603) are public (private) targets acquired by 190 (370) firms. Diversifying acquisitions are acquisitions in which acquirers and targets do not share a Fama-French industry. The dependent variable is the acquirer's five-day (-2, 2) cumulative abnormal return in percentage points calculated using the market model. The market model parameters are estimated using the return data for the period (-210, -11). Outside directors are directors without affiliation with the firm other than their directorships. Outside directors are defined busy if they hold at least three directorships. If 50% or more than 50% of outside directors are busy, the board is defined as a busy board. Board size measures the number of directors. Outside director ownership is the percentage of shares held by outside directors. Acquirer's pre-announcement stock price run-up is acquirer's buy-and-hold abnormal return during the period (-210, -11) with the CRSP value-weighted market index as the benchmark. Free cash flow is calculated as operating income before depreciation minus interest expenses, income taxes, and capital expenditures scaled by book value of total assets. Leverage is the book value of long-term debts and short-term debts over market value of total assets. Tobin's q is market value of assets over book value of assets. All-cash deal, stock deal, intrastate, and public status are dummy variables. All-cash deal is 1 for purely cash-financed deals and 0 otherwise. Stock deal is 1 for deals at least partially stock-financed and 0 otherwise. Intrastate is 1 if acquirer and target firms are in the same state and 0 otherwise. Public status is 1 if target is a public firm and 0 if target is a private firm. Relative deal size is deal value over acquirer's market capitalization. Market capitalization, measured in millions, is calculated as the number of shares outstanding multiplied by the stock price at the year end prior to the announcement date. The *t*-statistics is reported in parenthesis. \*, \*\*, and \*\*\* stand for statistical significance based on two-sided tests at the 10%, 5%, and 1% level, respectively.

Variable	All sample		Public target		Private target	
	(1)	(2)	(3)	(4)	(5)	(6)
Busy board	0.803 (1.09)		-2.590** (-2.19)		2.510*** (2.70)	
Percentage of busy outside directors		1.020 (0.76)		-6.766*** (-3.12)		4.927*** (2.93)
Percentage of outside directors	-0.994 (-0.55)	-1.153 (-0.62)	8.994*** (3.05)	10.95*** (3.61)	-6.467*** (-2.86)	-7.429*** (-3.23)
Log (board size)	0.558 (0.44)	0.480 (0.38)	3.188 (1.39)	2.951 (1.30)	0.080 (0.05)	-0.327 (-0.22)
Outside director ownership	-0.022 (-0.16)	-0.027 (-0.19)	-0.160 (-0.71)	-0.139 (-0.62)	-0.040 (-0.22)	-0.062 (-0.34)
Acquirer's pre-announcement stock price run-up	-1.261*** (-3.33)	-1.253*** (-3.31)	-2.860*** (-3.32)	-3.038*** (-3.55)	-0.830** (-1.99)	-0.799* (-1.91)
Free cash flow	5.273 (1.24)	5.074 (1.19)	-3.084 (-0.30)	-1.221 (-0.12)	4.870 (1.04)	4.606 (0.99)
Leverage	0.367 (0.14)	0.455 (0.17)	-1.801 (-0.39)	-2.688 (-0.59)	-2.163 (-0.63)	-2.030 (-0.60)
Log (total asset)	-0.174 (-0.67)	-0.168 (-0.64)	-0.156 (-0.36)	-0.005 (-0.01)	-0.223 (-0.69)	-0.312 (-0.95)
Tobin's q	0.011 (0.09)	0.027 (0.22)	0.434 (1.44)	0.417 (1.41)	-0.119 (-0.88)	-0.080 (-0.59)
Intrastate	1.022 (1.36)	1.044 (1.39)	2.672* (1.75)	2.561* (1.69)	0.499 (0.58)	0.506 (0.59)
Relative deal size	-3.612** (-2.05)	-3.587** (-2.03)	-5.803*** (-2.67)	-5.747*** (-2.68)	2.812 (0.89)	3.233 (1.03)
All-cash deal			1.513 (1.24)	1.480 (1.23)	0.966 (1.07)	1.016 (1.12)
Public*Stock deal	-3.080*** (-2.75)	-3.114*** (-2.78)				
Public*All-cash deal	-0.476 (-0.38)	-0.478 (-0.38)				
Private*Stock deal	-0.524 (-0.59)	-0.552 (-0.62)				
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.07	0.07	0.22	0.24	0.06	0.06

**Table 4.** Alternative Measures of Multiple Directorships, Returns, and Diversifying Acquisitions

Table 4 applies alternative measures of agency conflicts, multiple directorships, cumulative abnormal returns, and diversifying acquisitions into the same regressions in Table 3. In Panel A, governance index (Gompers, Ishii, and Metrick (2003)) is applied to capture firms with high agency conflicts (i.e. governance index  $\geq$  Q3) and low agency conflicts (i.e. governance index  $\leq$  Q1). In Panel B, busy board indicator and percentage of busy outside directors are replaced by the average directorships held by outside directors. It is calculated as the total number of directorships held by outside directors divided by the number of outside directors. Panel C uses three-day cumulative abnormal return as the dependent variable. Panel D uses the CRSP value-weighted return as the market return. In Panel E, acquirers with multiple acquisitions within a year are excluded. In Panel F, a diversifying acquisition is defined as an acquisition in which acquirer and target do not share the same 2-digit SIC code. Description of additional variables is provided in Table 5. The *t*-statistics is reported in parenthesis. \*, \*\*, and \*\*\* stand for statistical significance based on two-sided tests at the 10%, 5%, and 1% level, respectively.

Variable	All sample		Public target		Private target	
Panel A: Governance index (Gompers, Ishii, and Metrick (2003)) to proxy agency conflicts						
Percentage of busy outside directors	-0.633		-5.414*		1.753	
	(-0.38)		(-1.89)		(0.86)	
Percentage of busy outside directors	3.608*		2.813		4.872*	
* governance index ( $\leq$ Q1)	(1.76)		(0.77)		(1.89)	
Percentage of busy outside directors	-1.594		-5.022		-1.176	
* governance index ( $\geq$ Q3)	(-0.75)		(-1.29)		(-0.45)	
Additional variables	Yes		Yes		Yes	
R <sup>2</sup>	0.09		0.21		0.09	
Panel B: Average directorships held by outside directors						
Average directorships of outside Directors	0.183		-1.823**		1.118**	
	(0.42)		(-2.54)		(2.04)	
Additional variables	Yes		Yes		Yes	
R <sup>2</sup>	0.07		0.19		0.05	
Panel C: CAR (-1, 1)						
Busy board	0.425		-1.979*		1.707**	
	(0.69)		(-1.77)		(2.29)	
Percentage of busy outside directors	-0.263		-5.265**		2.399*	
	(-0.23)		(-2.55)		(1.77)	
Additional variables	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.09	0.09	0.19	0.21	0.04	0.04
Panel D: Value-weighted CAR (-2, 2)						
Busy board	0.437		-2.779**		2.045**	
	(0.60)		(-2.37)		(2.19)	
Percentage of busy outside directors	0.104		-7.127***		3.692**	
	(0.08)		(-3.31)		(2.19)	
Additional variables	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.07	0.07	0.23	0.25	0.05	0.05
Panel E: Exclude multiple acquisitions						
Busy board	0.872		-2.574		2.703**	
	(0.85)		(-1.62)		(2.01)	
Percentage of busy outside directors	0.720		-7.079**		4.573*	
	(0.37)		(-2.18)		(1.94)	
Additional variables	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.14	0.14	0.33	0.34	0.13	0.13
Panel F: 2-digit SIC code						
Busy board	1.017		-1.651		2.572***	
	(1.41)		(-1.44)		(2.76)	
Percentage of busy outside directors	1.184		-4.947**		4.798**	
	(0.90)		(-2.37)		(2.84)	
Additional variables	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.07	0.07	0.19	0.20	0.06	0.06

## LEGAL ADVISORS: POPULARITY VERSUS ECONOMIC PERFORMANCE IN ACQUISITIONS

**C.N.V. Krishnan\*, Paul A. Laux\*\***

### Abstract

Law firms provide extensive intermediation in corporate acquisitions, including negotiation, certification, and drafting of contracts and agreements. Using a broad sample of U.S. acquisition offers, we find that large-market-share law firms are regularly called upon to facilitate completion of large, legally-complex offers. Complex offers are often withdrawn but, controlling for complexity, large-share law firms are associated with enhanced deal completion. Further, we document that some law firms are consistently associated with deal completion over time, and that acquirers with good deal completion **experience use fewer different law firms**. Acquirers' risk-adjusted returns, though, are smaller around announcements of offers advised by large-share law firms. Post-offer long-run returns of the acquirers are also lower and often negative following offers advised by large-share law firms. We find no evidence that particular law firms are consistently associated over time with strong returns. Our conclusion is that large law firms enhance deal completion in difficult situations, consistent with the aims of acquirer management. However, we find no systematic evidence that these popular law firms act as "gatekeepers" in the sense of not wanting to be associated with value-destroying deals.

**Keywords:** Law firms, Market-share, M&A deal completion, Post-merger Returns

\* *Department of Finance, Weatherhead School of Management, Case Western Reserve University, 10900 Euclid Avenue, Cleveland, OH 44106, Tel: 216-368-2116, Email: cnk2@cwru.edu*

\*\**Weinberg Center for Corporate Governance and Department of Finance, Lerner College of Business & Economics, University of Delaware, Newark, DE 19711, Tel: 302-831-6598, Email: laux@udel.edu.*

*For helpful comments, we thank George Dent, Stephen Fraidin, Douglas Lichtman, Jonathan Macey, Andrew Morriss, Maureen O'Hara, the Honorable Leo Strine, David Wilkins, and seminar participants at the Harvard University Law School Program on the Legal Profession, and at the University of Delaware.*

Parties to mergers and acquisitions often engage law firms to advise on the structure of the deal, on the negotiation and drafting of contracts, and on corporate law, regulatory and antitrust issues. Such work supports an industry with more than 2000 firms and around 14,000 lawyers as of 2002, according to specialties listed in a standard legal directory. Due to extensive information asymmetries, skilled intermediaries are expected to be important in deal situations, so the prominence of the merger and acquisition (M&A) legal advisory industry is not surprising. What is more surprising is that little work focuses on transactions microstructure, and very little statistical evidence has been brought to bear on the role played by legal advisors.

The lack of research into the importance of lawyers in M&A deals stands in contrast to a large body of research on investment bankers acting as financial advisors. Of particular relevance here is the finding that deal characteristics have been found to be material to the engagement of investment bankers (Servaes and Zenner, 1996), and bankers' incentives have been found to be material to deal outcomes (Rau, 2000). Lawyers activities also seem likely to be material. For example, given their central role in

negotiation protocol, due diligence, and contract drafting, the intermediation activities of lawyers seem likely to be material to the process of closing or failing to close an acquisition.

Some have suggested that M&A lawyers' activities are material even beyond deal completion, to the value created or destroyed in an acquisition. Observers have long noted that a substantial part of the work of lawyers grows out of efforts to economize on transactions costs, or at least to exploit their presence. For example, George Stigler, after commenting on the topic in many ways over his career, sums up in his memoir, claiming that lawyers would not exist without transactions costs (Stigler, 1988). Generally, in the presence of transactions costs, the Coase theorem implies that processes for the allocation of property rights can affect real-valued outcomes. With M&A services specifically in mind, Gilson (1984) draws on this Coasian tradition to propose that lawyers are (or can be) "transaction costs engineers", adding to the value created in a transaction by virtue of their central role in crafting acquisition agreements. In contrast, others have suggested that lawyers themselves are a significant source of transactions costs. Thus, we address the following questions as well: do the lawyers

play a more important and positive role as "transaction costs engineers" and use their expertise to enhance the value for their clients? Indeed, do the large well-known and well-respected law firms act as "gatekeepers" in the sense of avoiding engagements on value-destroying deals?

In this article, we study the statistical influences of M&A legal advisors on deal completion outcomes and on the characteristics of the deals that are completed. Understanding these influences should be of interest to both financial economists and practitioners. Complementing the financial economics reasoning above, some key questions to which our research suggests answers are: Are the activities of such lawyers, necessary though they may be, actually impediments to getting the deal done, as sometimes suggested by managers?<sup>14</sup> Or are acquirers' legal advisors mere tools of managers, finding a way to complete even bad deals, as suggested by the fact that acquirers' lawyers are hired by managements that initiated these deals? Can law firms build their businesses by emphasizing deal completion? Can they build their businesses by emphasizing "good deal" completion via gatekeeping and/or transaction cost engineering?

More broadly, our article provides empirical evidence on industry structure and economic effects of legal advisors to acquirers in mergers and acquisitions, based on an extensive sample of offers announced over 1994-2000. We choose that time period for two reasons. Most importantly, although our three-year post-merger stock-return data need could have allowed extension of the sample until 2003, the temporal decline in stock market levels and M&A activity early in the new century, though soon reversed, led to the closings of a number of high-profile law firms, especially firms associated with software and technology clients in California. The most striking example is perhaps Brobeck, Phleger & Harrison, which closed after growing from a regional firm to more than 1000 lawyers in more than 10 cities at the height of the tech boom, with profits of more than \$750,000 per partner. We want to guard against our

<sup>14</sup> See, for example, the quote at the beginning of Coates and Subramanian (2000). The implied negative view of lawyers' work seems especially powerful if lawyers' compensation is determined mainly by hours worked rather than deal-completion results, as has been traditional. More recently, however, changes in compensation structure have reduced the dependence on hourly billings somewhat. One news-writer has claimed that an 80 percent hourly fee/20 percent contingent fee split has become "typical" (Welsh, 2000). A partner at Wachtell Lipton Rosen and Katz has been quoted as saying that the firm sometimes "bases its fee in part on the amount involved in the transaction and firm's contribution to the accomplishment of the client's objective" (Starbuck, 1993). Whether law firm compensation is on an hourly basis or based on client goals (e.g., for acquirers, successful deal completion), the incentives of legal advisors do not appear to be fully aligned with shareholder value enhancement. We test this in Section IV.

results being skewed or muddled by this sharp industry-wide break early in the new century. Second, mergers of law firms themselves have accelerated since 2000, inducing sharp but non-economic market share changes due to firm name changes and named-firm exits from our database. No central index of the name changes exists, so we cannot reliably sort the name-change-induced changes in market share from the economic changes that are our interest. With this sample, we provide an analysis of the legal advisory industry for mergers during a healthy and growing period.

We find that, for our sample period, the legal advising industry is characterized by a very small number of dominant firms with 2 to 8 percent share of the announced value of offers, a few prominent contenders with 1 to 2 percent market-share, and many smaller players. These market-share cohorts are relatively stable over our sample period, suggesting that only a few firms have the capability to advise on many large and complex offers at the same time, even though many firms can and do handle one or two offers in a year.<sup>15</sup> The largest firms, as a group, increase their market-share somewhat at the end of the 1990s, even though very few small law firms become large firms.

Large market-share law firms are engaged in more legally complex deals as compared to small and medium market-share law firms, but, after controlling for deal complexity and for target legal advisor size, they complete these deals efficiently. These deals involve large and profitable acquirers. However, acquirers' abnormal stock returns around the offer announcement are smaller and often statistically zero for offers in which big-market-share law firms are involved on behalf of the acquirers, as compared to the more positive acquirers' abnormal stock returns around offer announcements in which small-market-share law firms are involved. The post-offer long-run returns of the acquirers are often negative for offers in which the big market-share law firms are involved. We find that some law firms are able to consistently cause or be associated with high rates of deal completion over time, but we find no evidence of such consistent performance/association when it comes to long-run returns. Finally, we find that acquirers whose bids were

<sup>15</sup> Over longer periods than our sample period, the identity of the market leaders has shifted. Many of the current leading service providers came to the fore only in the 1970's and 1980's. Two reasons have been suggested in our discussions with practitioners. One is that some former top law firms were either unable or unwilling to advise on hostile offers, and the firms that ramped up to handle this business remained as the market leaders afterward. Another is that the local law firms that handled much corporate business in previous decades were loathe to facilitate transactions that might reduce the potential for future fees from their client (e.g., if taken over). Investment banks that saw business opportunities in takeovers, responded by encouraging the growth of more transaction-oriented law firms whose future business depended on the market for corporate control rather than a small set of long-term clients.



not all successful tend to employ a significantly greater number of different law firms than acquirers who have had a 100 percent success rate, suggesting that acquirers whose bids had been unsuccessful tend to shop around for law firms that can close deals more efficiently. On the other hand, we find that negative post-acquisition long run returns do not cause bidders to spread their business across a greater number of law firms.

These cross sectional and time series patterns fit together sensibly. Large, profitable acquirers engage large-market-share well-known law firms for difficult deals, and those law firms build their businesses by enhancing their deal completion skills. Deal completion is something acquirer managements value highly, judging by their penchant to change law firms when they experience less than 100 percent deal completion success. We find evidence that the large law firms possess deal completion expertise even in difficult situations. However, we find no evidence that law firms possess any consistent value-added "transaction costs engineering" capability that gets reflected in returns around the time of the M&A deals. Neither do we uncover evidence that the large and prestigious law firms act as "gatekeepers" by avoiding engagement on value destroying deals. Managers (who hire the law firms) apparently do not expect or require this capability from their legal advisors, judging by their tendency to rehire firms that are involved with bad economic outcomes but not those with bad deal completion outcomes.

The remainder of this paper is organized as follows. Section I explains why law firms are economically important in mergers and acquisitions. Section II describes the industry structure of M&A legal advisors. Sections III and IV focus on acquirers' lawyers and, respectively, analyze the deal completion efficiency and the stock returns effectiveness of the big and small market-share law firms. Section V reports on the time-series relations between law firm market-share and deal completion/stock returns. Section VI concludes.

## **I. The importance of legal intermediaries**

In mergers and acquisitions lawyers act as intermediaries between the acquirer and the target. They compose and negotiate the legal documents underlying the merger. Lawyers also act as intermediaries between the firms and government entities, including courts and the system of corporate law. They organize the necessary regulatory compliance and disclosure activities. Both types of intermediary roles are emphasized in the casebooks used in training business lawyers (see, for example, Gilson and Black, 1996). Lawyers are also increasingly involved in intermediary roles that have traditionally been considered the domain of bankers, such as deal generation and financing (Welsh, 2000).

Legal intermediaries could have a wide variety of influences on M&A outcomes. We focus on two

important ones that may potentially leave systematic tracks in the data available for a statistical study. First, lawyers may effectively rent their reputations to a transaction (Ribstein, 2004), acting as a certifier on the client's behalf. Through their central role in negotiations, lawyers help collect, structure, convey, and add confidence to information that needs to pass between the parties, thereby enabling deal completion. Lawyers' most explicit certifications pertain to matters within their legal expertise (such as valid and binding procedures and forms, for example). In specific cases, these direct certifications may be crucial, as in the case of a target with substantial and difficult-to-assess environmental liabilities. Indirect certifications of law firms may be central in other cases --- that is, the mere fact that a top-tier law firm is willing to be involved. Some anecdotal evidence suggests this may be so---some top-tier business law firms of the 1970s are said to have avoided the hostile takeovers of the 1980s out of concern for their reputations.

Additionally, as discussed in the introduction, Gilson (1984) argues business lawyers are transactions cost engineers, crafting agreements that allow the parties to behave as if perfect-market assumptions apply. The central role of lawyers in the due-diligence process surrounding mergers certainly suggests this possibility. Lawyers can add value by writing contracts that align the expectations of the parties, minimize the incentives for opportunistic behavior, and set incentives to supply useful information at lowest cost. For example, the timing and nature of non-disclosure agreements is central to enabling information to pass between the parties. Overall, these activities can create value by minimizing the deadweight costs of transacting.

Thus, lawyers, through their roles as deal certifiers --- or "gatekeepers," to use currently popular language --- and as transactions cost engineers have the potential to affect the economics of mergers and acquisitions. If these mechanisms for economic effects are important, their tracks should be evident in deal outcomes. Given the central roles often played by legal advisors during the negotiation and contracting process, efficient deal completion is one important outcome that might be affected. The acquiring firm management, at least, would prefer a high likelihood of deal completion. Further, if effective lawyering helps the parties achieve perfect market outcomes, as Gilson (1984) argues, then the likelihood of completing good deals might be increased, where good deals are those that add value. From the point of view of acquiring firm shareholders, the tendency to add value in this way can be assessed by examining the short-run stock returns around the acquisition announcement. Such a measure would incorporate the short-run value effects of the deal as well as the market's assessment of post-deal value creation. An alternate measure is the post-offer long-run stock returns of the acquirer. Long-run returns would capture any unexpected effects of lawyers' activities that carry through the closing of the transaction to the period following that, or, more

likely, effects of lawyers' ability assess their non-public information about the deal and their choice to avoid (or not avoid) engagements on long-run value-destroying deals.

Although the role of lawyers in M&A work has not been the subject of much statistical study, one significant recent exception is Subramanian (2007), which provides evidence that advice from more-experienced law firms has benefits in freeze-out merger situations. Subramanian finds that lawyering is associated with effects on both deal completion and deal value. Our results obtain for a very broad sample of mergers (not freeze-outs only), and are less sanguine concerning the value that might be created. Additionally, a few other studies have examined specific acquisition agreement provisions that are likely influenced by legal advice, and found that they tend to be used in economically beneficial ways (e.g., Coates, 2001, Bates and Lemmon, 2003, and Gilson and Schwartz, 2005).

Our major focus is therefore to study the statistical associations of law firms with deal completion and acquirer's stock returns. If legal advisors have statistical associations with these economic outcomes, then it is interesting to know whether the prominence or success of the law firm is affected. Deal-completions efficiency and returns effectiveness are the shorthand nomenclature we use below. Therefore, we relate law firms' market-share to "efficiency" in closing deals and "effectiveness" in terms of the deals' returns. Additionally, given the lack of any systematic evidence on the roles played by legal advisors in mergers and acquisitions, we begin by laying out the industry structure of legal advisors in the mergers and acquisitions market.

## II. Law firm market shares in M&A advisory work

In this section, we study the market-shares of law firms that are active in mergers and acquisitions, examine who are the biggest service providers, who their clients are, and how their market-shares change from year to year.

We use data from the Thomson Financial SDC Platinum "Mergers and Acquisitions" database. We first screen for all M&A offers for the period 1994-2000. Many SDC records include little or no information beyond the identities of the parties, and we discard all records that do not contain valid data for the value of the proposed deal. Many records do not identify the acquirer's legal advisor. We discard these as well. Some records identify more than one acquirer's advisor to an offer. When calculating market-share league tables, it is common practice to give full credit to each advisor when an offer is advised by more than one firm. Considering this shared credit, we define a law firm's market-share as the dollar value of the engagements on which it advises as a proportion of the dollar value of all engagements in a calendar year, whether or not the offer is subsequently withdrawn. An

engagement is defined as an acquirer-law-firm/offer-record combination. Of the 47,021 such engagements, the names of the legal advisor(s) are included in only 10,028 engagements corresponding to 7766 distinct offers. We nonetheless believe that market shares give a more appropriate impression when the  $47,021 - 10,028 = 36,993$  no-name offers are also included as part of the market for the purpose of computing law-firm-market-shares, because no-name-law-firm engagements altogether account for 37.5 percent of the total value of offers in an average year. Therefore, we compute market shares using all 47,021 engagements, treating the no-name engagements as a discrete group.

To obtain a sample with data fields for cross-sectional analysis, additional screens are necessary. Our next screen requires offer characteristics and acquirer particulars from COMPUSTAT to be available for each offer. This reduces the sample to 9895 engagement events corresponding to 7640 distinct offers (that is, a reduction of 126 offers versus the less-stringent sample described above). For several of these deals, the acquirer law firm is listed in the SDC M&A database as either "in-house attorneys" or "independent". After screening out such deals, we are left with 9677 legal advisor engagement corresponding to 7477 offers. For analysis at the deal level, we average market shares for advisors to an offer when there is more than one law firm.

For analyses at the law firm level, we aggregate engagement-level lawyer characteristics (such as market share) and offer/client characteristics across all a firm's engagements in a year. When doing so, we fully credit each of multiple advisors to each offer (that is, consistent with common practice in computing league tables). When aggregated this way, the cross-sectional sample of acquirers' legal advisors contains 1820 law firm-year combinations.

Stock returns data are needed for some of our analyses, so we subject the sample to an additional screening in which we require Center for Research in Security Prices (CRSP) data for acquiring firms. We compute acquirers' abnormal returns both around the offer and in the long-run post-offer (covering 750 days from the day of the offer). When we analyze the cross-section of offers in this final sample, we have 3042 distinct offers corresponds to 3805 acquirers' legal advisor engagements advised by/in 1088 law firm-years, under the convention of full credit for the offer to each of multiple advisors.<sup>16</sup> Some of our analyses involve both acquirer and target legal advisors. For these analyses, we describe the additional screens necessary in a subsequent section.

<sup>16</sup> For one analysis involving short-run abnormal returns of the acquirer firms around offer announcements, we are restricted to 2894 unique offers because we impose an additional screen that daily returns for the acquirer firms be available from CRSP beginning 255 days prior to the event window to estimate market model parameters.

Some firms with extremely prominent merger and acquisitions advisory practices are themselves very large and broad (for example, Skadden, Arps, Slate, Meagher & Flom), while others are smaller and more focused (for example, Wachtell Lipton Rosen & Katz). Some large/prestigious law firms have only a moderate market share in M&A advisory work (for example, Clifford Chance and Gibson Dunn & Crutcher). Garicano and Hubbard (2002) find that, in general, corporate law practices tend to exist as part of non-specialized law firms. Since we want to focus on the market for M&A advisory services and the

associated economic effects, we adopt a classification scheme for reporting purposes that distinguishes among firms with a major presence in the market for M&A services, firms with a substantial but lesser presence, and firms that dabble.

For reporting purposes, we initially classify law firms in each year as: "one-deal firms", those that are involved in just one acquisition offer; "small firms", those that are involved in more than one acquisition offer in a year but which have market-share less than or equal to one percent; and "large firms", those that have more than one percent market-share.

**Table I.** Summary Statistics for Acquirer Legal Advisors: Market shares

The table describes market shares of legal advisors to acquirers in our sample of 10,028 engagement events (defined as a law-firm M&A-offer combination), corresponding to 7766 unique M&A offers made during the period 1994-2000, for which the names of acquirer legal advisors were non-missing, where full credit is given to each of multiple advisors to an offer. The sample is from the SDC Mergers and Acquisitions database. No-name offers are included when computing shares of known firms. PANEL A shows descriptive statistics for each law firm cohorts. One-deal firms advise on only one offer in a year. "Small" firms advise on more than one acquisition deal in a year and have a dollar market-share of less than or equal to 1 percent in the year. "Large" firms advise on more than 1 percent dollar market-share in a year. PANEL B shows the year-by-year number of firms that comprise the small and large law firm cohorts, the number of deals per firm, and the average dollar market-share for the small and large law firms. PANEL C shows the proportion of law firms that migrate each year from the small (large) law firm cohort to the large (small) law firm cohort.

**PANEL A:** Summary statistics by market-share cohort across all sample years

Law firm cohort	Number of advising law firms, Average per year	Number of offers advised by all firms, Total during 1994-2000	Percentage market-share per firm, Average during 1994-2000
One-deal firms	144	1003	0.02 percent
Small firms	104	4572	0.14 percent
Large firms	18	4453	2.61 percent
All, excluding no-name offers	266	10028	2.77 percent

**PANEL B:** Summary statistics by market-share cohort for each year

Law firm cohort	1994		1995		1996		1997		1998		1999		2000	
	No. firms (deals)	Mean share	No. firms (deals)	Mean share	No. firms (deals)	Mean share	No. firms (deals)	Mean share	No. firms (deals)	Mean share	No. firms (deals)	Mean share	No. firms (deals)	Mean share
Small firms	92 (351)	0.13%	104 (438)	0.15%	73 (388)	0.15%	109 (760)	0.14%	130 (975)	0.11%	137 (995)	0.12%	79 (665)	0.19%
Large firms	16 (403)	2.21%	13 (415)	2.66%	16 (433)	2.43%	15 (588)	2.71%	18 (685)	2.94%	21 (898)	2.78%	20 (1031)	2.69%

**PANEL C:** Stability of law firm cohorts

Law firm cohort (FROM cohort)	Proportion migrated to the other cohort during year					
	1995	1996	1997	1998	1999	2000
Small firms	0.00%	4.21%	5.97%	1.98%	5.79%	2.34%
Large firms	7.41%	2.11%	4.48%	6.93%	1.65%	3.13%

Table I provides descriptive statistics on the volume of advisory work during the period 1994-2000 for each of these market-share cohorts. Panel A shows that there are 18 large law firms that advise on roughly the same number of offers in an average year as do all the small firms combined, even though there are about five times as many small firms. Even more striking, the average market-share of a big law firm is almost 19 times the average market-share of a small law firm.

Panel B shows that the number of offers per year and law firms in both cohorts tends to grow over the years, as should be expected given the growth in mergers and acquisitions over the period (Holmstrom and Kaplan, 2001). More striking, the market-shares of typical firms in the large law firm cohort also grow over the years, at the expense of the small firm cohort. For example, the average large firm advises on 2.21 percent of announced offer value in 1994, but on 2.69 percent in 2000---an increase of about 20 percent over starting year's figure. This impression is confirmed by a t-test (not shown in the table): the mean year-over-year change in share for small firms is significantly negative, and the mean change in share for large firms is significantly positive, both at the five percent level. Even so, Table I is evidence the market for advisory services is not concentrated during the sample period. The Herfindahl index (sum of squared market-shares, not shown in the table) is below 400 for every year, which is far below conventional standards for even a moderately concentrated industry.<sup>17</sup> The impression of an unconcentrated industry is not driven by the presence of one-deal law firms or offers with no named legal advisors: the Herfindahl index is also small when computed using data on the small firms and large firms alone.

Panel C shows that the market-share changes evident in Panel B do not detract from the appropriateness of our characterization of the industry in terms of market-share cohorts. Only a few firms change from one cohort to the other over time; the industry structure seems stable in our sample period. The large firm cohort contains some disproportionately dominant firms. Table II shows that Skadden Arps is the most dominant firm in the acquisitions market, holding a 3-1/2 to 8-1/2 percent share in every sample year.<sup>18</sup> Simpson Thacher and Sullivan Cromwell often hold similar shares, especially towards the end of our sample period. These three firms have generally increased their market-shares over the years in our sample period. A few other large law firms become

contenders for dominant status every once in a while --- for instance, Fried Frank in 1995, Wachtell Lipton in 1997 and Davis Polk in 1999.

---

<sup>17</sup> Industries for which the Herfindahl Index is between 1000 and 1800 points are considered to be moderately concentrated, and those in which this index is in excess of 1800 points are considered to be concentrated (see the U.S. Department of Justice and the Federal Trade Commission Horizontal Merger Guidelines, 1997).

<sup>18</sup> For conciseness, we sometimes follow the convention of identifying law firms by two names (generally, the first two named partners) where it would not lead to confusion. This is often roughly consistent with common practice for referring to the firms, though their formal names are generally longer.

**Table II.** Descriptive Statistics for Very Large Share Legal Advisors

The table shows the dollar market-shares (in percentages) of six of the largest acquirer law firms in our sample for each year from 1994 through 2000. The sample contains 10,028 engagement events (defined as a law-firm M&A-offer combination), where full credit is given to each of multiple advisors to an offer. All figures represent proportion of the dollar value of all engagement events announced that year, including deals that are subsequently withdrawn. Legal advisors are identified by the first two proper names in the law firm name.

Law firm	Market-share						
	1994	1995	1996	1997	1998	1999	2000
Davis Polk	2.55	2.92	2.48	2.41	2.64	5.47	1.94
Fried Frank	1.67	5.48	1.89	2.19	2.46	2.02	2.61
Wachtell Lipton	1.31	2.32	3.36	4.71	4.84	4.58	3.37
Simpson Thacher	2.11	2.86	2.25	3.33	5.85	5.89	5.08
Sullivan Cromwell	2.44	3.21	2.88	3.85	3.67	4.40	6.30
Skadden Arps	4.49	5.31	5.31	4.47	8.59	3.88	6.22

These dominant firms and others that are nearly in their class are also large by standards other than market-share. Table II shows that the ten firms with the largest average market-share over all the years of our sample employ an average of 600 lawyers per firm and generate average revenue of \$600 million in 2000, or about \$1 million per lawyer.<sup>19</sup> Overall, the structure of the industry is in keeping with Rosen's (1992) observation concerning developments in the industrial organization of the legal profession more generally, in that small highly-paid groups of law firms have emerged.

<sup>19</sup> These firms are Cleary Gottlieb, Cravath Swaine, Davis Polk, Dewey Ballantine, Fried Frank, Shearman Sterling, Simpson Thacher, Skadden Arps, Sullivan Cromwell, and Wachtell Lipton. Data on number of lawyers is from the Martindale Hubbell Directory on Lexis Nexis, and data on revenues is from the American Lawyer. It must be noted, however, that firms such as Skadden Arps and Wachtell Lipton were not dominant law firms in the M&A market prior to the acquisition boom of the 1980's. Thus, the law firms names and their market share status reported in this article holds for our sample period, but not necessarily for earlier periods.

**Table III.** Summary Statistics on Legal Advisors' Clients and Associated Financial Advisors

The table shows the average acquirer firm size (measured by total assets in billions on dollars), the average acquirer firm profitability (measured by operating income as a percentage of sales) and the average number of employees in thousands, as well as the average investment bank league table score, averaged across all "small" and "large" law firms in our final sample of acquisition offers. "Small" firms advise on more than one acquisition deal in a year and have a dollar market-share of less than or equal to 1 percent in the year. "Large" firms advise on more than 1 percent dollar market-share in a year. The investment bank decile rank is based on the bank's dollar market-share of acquisition offers announced in a year; it ranges from 1 through 10, based on deciles, with 10 denoting the most reputable investment banks in the sense of being in the top market share decile. The cross-sectional sample analyzed in this table consists of 1820 law firm/years (from 7477 offers that generate 9677 legal advisor engagements), after screening out deals in which the acquirer law firm was listed in the SDC M&A database as either "in-house attorneys" or "independent".

Law-Firm Cohort	Number of Law-firm/years	Average Acquirer Total Assets (\$ billion)	Average Acquirer Profitability	Average Number of Acquirer Employees (in 1000s)	Average Investment Bank Decile Rank
Small firms	712	82.03	-14.60%	14.25	2.78
Large firms	117	168.41***	9.80%***	29.81***	4.48***
All firms, including one-deal firms	1820	112.61	0.01	20.69	3.07

\*, \*\*, and \*\*\* denote significantly different from the other cohort at the 10, 5 and 1 percent level respectively.

Table III provides another descriptive view of large versus small firms, in terms of the nature of the clients and investment bankers with which they work. The clients of large law firms are also large, having nearly \$170 billion in assets and 30 thousand employees on average, significantly more than the clients of small law firms. The investment banks with which they work are prestigious; having an average league table score that is significantly greater than that of the investment banks that work with the small law firms.

Overall, the tabulation of market-shares for acquirer legal advisors results in several general characterizations.

- The advisory industry is not concentrated overall, but there are a few dominant firms with shares of two to eight percent of a year's announced offer value. These dominant firms are generally the same ones from year to year. About 10 to 15 additional firms advise on one to two percent of announced offer value in any given year.

- The advisory industry does not show any strong tendency to become more concentrated during our sample period, although the largest 20 or so firms have experienced modest increases in market-share during the sample period. This tendency is strongest for the four to six dominant firms.

- Large market-share firms are engaged by larger and more profitable acquirers and work with more reputable investment bankers.

Why do large profitable acquirers prefer to employ large market-share law firms, and why are they successful in maintaining and even enhancing their market-share over the years? The most obvious conjecture is that they are capable of providing the appropriate services, using the internal human capital and networks of relationships they have developed

over a long period of time. After all, it seems plausible that the small law firms, and especially those that advise on only one deal, would not be capable of handling the negotiation and drafting issues for a large acquisition. Moreover, they would have little experience or reputation to bring to bear to encourage or certify the sorts of information flows between the parties that are envisioned for "transaction cost engineering." Among other things, management probably hopes to engage a legal advisor of sufficient competence to handle specific legal dimensions of the situation, of sufficient reputation and skill to either reduce or exploit the information barriers between the parties, and of appropriate stature and cost to be a defensible choice should there be subsequent problems. One prominent legal practitioner with whom we have discussed the matter opined that a prominent law firm is an acquirer's way of signaling serious intent.

In subsequent sections, we go beyond this conjecture to examine whether the large law firms actually are associated with different economic outcomes than the smaller firms. We begin by examining their success on a criterion that is clearly of central concern to acquirer management: deal completion.

### III. Deal completion efficiency

In this section, we show that large market-share law firms are more effective in completing the acquisition offers upon which they advise, considering the nature of those deals. This relationship is not a simple one, however, because large firms tend to advise on more complex deals that are inherently more likely to fail. To accomplish our goal in this section, we begin by developing observable indicators of a deal's legal complexity, and working out an overall measure of

deal complexity that is directly related to deal failures. We next show that large firms advise on more complex deals by this measure, and that firms which complete all their deals advise on less complex deals. Finally, we show that the large law firms complete deals efficiently after controlling for deal complexity.

#### A. Features that affect deal completion

From the point of view of acquirer management, which makes the decision on engaging an advisor, deal complexity has many dimensions. Our goal in this section is not to fully explore all the aspects of complexity, but rather to develop a list of observable indicators for a usable index of deal complexity. First, Servaes and Zenner (1996) establish that economic deal complexity is positively correlated with the size of the transaction. A related measure could be the proportion of a target sought to be acquired in a transaction. Third, stock deals may be more complex from the acquirer's point of view, because stock prices are affected by stock price reaction at the time of the announcement of the deal, and from the acquirer legal advisor's point of view because of the possibility that stock-based acquisitions can be alleged to be market timed by the acquirer (see Loughran and Vijh, 1997). Fourth, deals are more legally complex when the target is a public company because the law stipulates that shareholders be given some ability to affect the outcome of the acquisition bid. An acquirer's legal advisor can increase the probability of success by negotiating lockups of various sorts (for example, stock or asset

lockups, and/or breakup and termination fees (see Bates and Lemmon, 2003). Fifth, hostile bids are more difficult to complete than friendly bids. Friendly transactions represent at least a partially cooperative exercise; hostile transactions are entirely competitive. Lastly, offers with multiple bidders are more complex than single-bidder offers. Running a successful auction adds a level of transactional complexity that also may differentiate between types and experience of counsel.

For our analysis, we use (a) *SIZE*, the dollar value of the transaction, (b) *PCTDES*, the percentage of target ownership desired, as expressed in the offer (c) *CASH*, a dummy variable equal to one in cases where terms of payment are 100 percent cash, (d) *TPRIV*, a dummy variable equal to one in cases where the target is a private company, (e) *HOSTILE*, a dummy variable equal to one for hostile bids (marked as such in the SDC database), and (f) *MULTIBID*, a dummy variable equal to one for deals with multiple bidders.

To begin, we estimate a binomial probit using data on all 7477 acquisition offers in our final sample, based on the model:

$$\Pr(WITHDREW) = \beta_0 + \beta_1 \ln(SIZE) + \beta_2 PCTDES + \beta_3 CASH + \beta_4 TPRIVATE + \beta_5 HOSTILE + \beta_6 MULTIBID + \varepsilon, \quad (1)$$

where *WITHDREW* is an indicator variable equal to 1 for deals that are withdrawn and 0 otherwise, and  $\Pr(\cdot)$  indicates a probability.

**Table IV.** Offer Withdrawal as a Function of Deal Characteristics

The table shows coefficient estimates for the binomial probit specification:

$$\Pr(WITHDREW) = \beta_0 + \beta_1 \ln(SIZE) + \beta_2 PCTDES + \beta_3 CASH + \beta_4 TPRIVATE + \beta_5 HOSTILE + \beta_6 MULTIBID + \varepsilon,$$

where *WITHDREW* is an indicator variable equal to 1 for deals that are withdrawn and equal to 0 otherwise,  $\ln(SIZE)$  is the natural log of the dollar size of the proposed acquisition, *PCTDES* is proportion of target ownership desired, *CASH* is a 100% cash deal indicator, *TPRIVATE* is a private target indicator, *HOSTILE* is an indicator for hostile deals, marked as such in the SDC database, and *MULTIBID* is an indicator for deals that have multiple bidders. The cross-sectional sample analyzed in this table consists of 7477 offers. Maximum-likelihood-based z-statistics, based on standard errors that are corrected for heteroskedasticity and autocorrelation, are shown in parenthesis.

Explanatory variables	Coefficient estimate (p-value)
$\ln(SIZE)$	0.199 (6.75)***
<i>PCTDES</i>	0.006 (2.00)**
<i>CASH</i>	-0.314 (-2.68)***
<i>TPRIVATE</i>	-0.820 (-4.62)***
<i>HOSTILE</i>	2.357 (12.93)***
<i>MULTIBID</i>	0.862 (3.06)***
<i>Intercept</i>	-4.418 (-13.24)***
<i>Pseudo R</i> <sup>2</sup>	0.15

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

Table IV shows that the probability of a deal not being completed is significantly positively related to the size of the deal, to the percentage of the target desired by the bidder, to less-than 100 percent cash as the means of payment, to whether the target is a public firm, to hostile deals, and to multiple bidder offer situations. In other words, a deal is more likely to be withdrawn if it is a "complex" deal by all of our complexity indicators.

We have checked for the statistical importance of other measures of deal complexity. First, target firms incorporated under the Delaware law could be operating in a more legally complexity environment, given the extensive body of Delaware case law that applies. On the other hand, more certainty could be the effect of the extensive precedents. We checked whether a dummy variable that equals one for target firms incorporated under the Delaware law is significantly associated with deal withdrawals, and found no such association. Second, deal withdrawal rates could exhibit industry effects. M&A transactions involving regulated target firms could be more difficult to bring to successful conclusions because of the regulatory approvals needed. Following Agrawal and Knoeber (1996), we designate M&A offers involving target firms in the railroad, public utility, banking, finance, or insurance industries (two-digit SICs of 40, 48, 49, 60, 61, or 63) as regulated industries, for which a dummy variable takes the value of 1. However, this dummy variable is not significantly associated with deal withdrawals. Third, M&A offers within industries in which there has been a significant number of challenges under antitrust laws as a proportion of the total number of offers announced are industries in which, one could conjecture, it would be more difficult to bring M&A offers to successful conclusions. Following the evidence set out in Eckbo (1992), we designate the food and drugs, paper, chemicals, petroleum, rubber, concrete, metal, machinery, electronics, and transport equipment industries (two-digit SICs of 20, 26, 28, 29, 30, 32, 33, 34, 35, 36, and 37) as the industries in which horizontal mergers have been most challenged; these are industries for which a dummy variable takes the value of one. However, this dummy variable is not significantly associated with deal withdrawals.

### **B. Legal advisors and deal complexity**

A deal-specific probability of failure can be computed as the fitted value of the probit given by equation (1). This is a weighted average of the complexity characteristics, where the weights are determined by the covariances of the deal characteristics to withdrawal rates. In subsequent analysis, we use this fitted value as an index of deal complexity. We also compute the average of all deal-specific complexity estimates all the engagements for each law firm/year to obtain a law firm/year specific estimate of the complexity of the deals on which each firm advises. We denote this measure as *COMPLEXITY* for each law firm each year. *COMPLEXITY* encapsulates all the situational features

that contribute to deal failure into a single index, facilitating further analysis.<sup>20</sup>

<sup>20</sup> Deal complexity is economically and statistically distinct from legal advisor prominence, even though more prominent firms tend to advise on more complex deals. For example, deal size (an element of complexity) is positively related to offer withdrawal even when large-share firms advise.



**Table V.** Legal Advisors and Deal Complexity

The table shows the average dollar value of acquisition (*SIZE*), the average of the percentage of target desired to be acquired in a deal (*PCTDES*), 100% cash deal indicator (*CASH*), private-target indicator (*TPRIVATE*), hostile deal indicator (*HOSTILE*), multiple-bidder deal indicator (*MULTIBID*), and average probability of deal failure, or *COMPLEXITY*, for the 2 market-share acquirer-law-firm cohorts. The cross-sectional sample analyzed in this table consists of 1820 law firm/years (from 7477 offers that generate 9677 legal advisor engagements). “Small” firms advise on more than one acquisition deal in a year and have a dollar market-share of less than or equal to 1 percent in the year. “Large” firms advise on more than 1 percent dollar market-share in a year.

Law firm cohort	Number of law firm/years	Average <i>SIZE</i> (in \$ million)	Average <i>PCTDES</i>	Average <i>CASH</i>	Average <i>T-PRIVATE</i>	Average <i>HOSTILE</i>	Average <i>MULTIBID</i>	Average <i>COMPLEXITY</i>
Small firms	712	515	94.5%	0.388	0.233	0.042	0.013	0.057
Large Firms	117	10313***	93.8%	0.495**	0.137***	0.086**	0.009	0.099***
All firms, including one-deal firms	1820	1266.57	94.8%	0.374	0.232	0.046	0.012	0.058

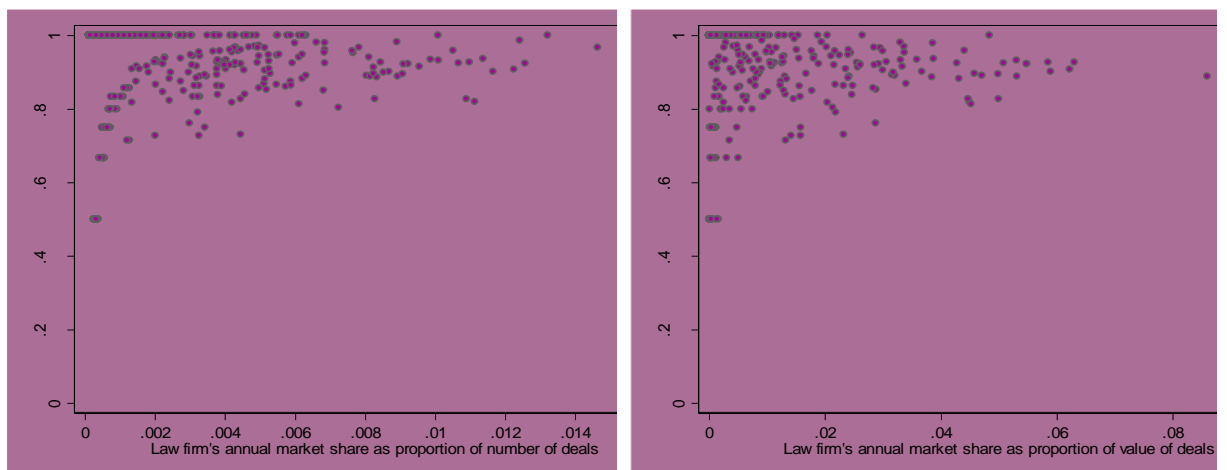
\*, \*\*, and \*\*\* denote significantly different from the other cohort at the 10, 5 and 1 percent level respectively.

Table V describes the types of deals the large and small market-share acquirer legal advisors are called upon to advise on, showing that large market-share law firms are involved in significantly larger deals and in a significantly higher proportion of hostile offers. Large law firms are also involved in significantly higher proportion of deals in which the target is a public firm. These are deal features that are significantly associated with failures. However, large law firms are also associated with significantly more 100 percent cash deals than the small law firms; and this feature is associated with deal success. One can conjecture that

the mode of payment for the target -- via cash or via stock or a combination of both -- at least partly endogenously determined, perhaps influenced by the advice of the acquirer law firm. In any case, the last column shows that large law firms are associated with significantly more legally-complex deals than the smaller law firms. The more legally-complex deals are, by definition, more likely to fail. Next, we investigate whether large law firms enhance deal completion. If they do, then we have one explanation for their market-shares, and why they continue to remain big year after year.

**Figure 1.** Scatter-Plots of Legal Advisors’ Deal Completion Rates and Market-Shares

The scatter-plots show deal completion efficiency (on the vertical axis) against law firm’s market-share of number of offers in a year (the left scatter plot) and against law firm’s market-share of the dollar value of offers in a year (the right scatter plot). The market-value-based definition of market share in the right plot is the definition used in other the analyses in this paper. The cross-sectional sample analyzed in the figure consists of 7477 offers that generate 9677 legal advisor engagements for/in 1820 law firm/years.



**C. Legal advisors and deal completion**

Figure 1 depicts the relationship of deal completion rate to market-share with scatter-plots of deal completion efficiency against the market-share of law firms---measured both as a proportion of the number of offers announced and of the dollar value of deals announced in a year. The plots show that extremely small market-share firms tend to complete all their deals. If we were to ignore this group of perfectly efficient law firms, deal completion efficiency appears to be positively related to market-share in a curvilinear fashion. Therefore, to understand the relation between deal completion efficiency and market-share, we must account for deal complexity and also understand the "perfect" law firms, that is, those that have 100 percent deal completion efficiency and which seem to follow their own distribution, based on the scatter-plots. In the following subsections, we describe our analyses that provide such an understanding.

**D. Perfect deal completion efficiency and deal complexity**

To gain insight as to what makes some law firms "perfect" in terms of deal completion efficiency, we run two binomial probit regression specifications, in which an indicator variable for these firms is regressed on market-share and deal complexity. The indicator is

*PERFECT*, a dummy variable equal to one for law firms that have 100 percent deal completion efficiency in a year, and zero otherwise. In Specification A, *PERFECT* is regressed on the log of market-share and the complexity of the deals done by a law firm. The reason for the log specification is that it allows us to additively break down a firms' log market-share, using the definition of a market-share, into three log components: average deal size, number of deals, and the value of deals advised by all law firms in a year. A probit using the breakout version of market-share is Specification B, allowing each component to have its own separate effect. Formally, the two specifications are:

$$Pr(PERFECT) = \delta_0 + \delta_1 \ln(SHARE) + \delta_2 COMPLEXITY + \omega_1, \tag{2a}$$

$$Pr(PERFECT) = \delta_0 + \delta_{11} \ln(AVGSIZE) + \delta_{12} \ln(NUMDEALS) + \delta_{13} \ln(TOTMKT) + \delta_2 COMPLEXITY + \omega_2, \tag{2b}$$

where *SHARE* is acquirer's law-firm's market-share of acquisition offers in a year, *AVGSIZE* is the average dollar value of acquisitions on which it advises, *NUMDEALS* is the number of deals on which it advises, *TOTMKT* is the total value of all acquisition offers in the sample that year. The  $\delta$ 's are probit slope coefficients and  $\omega$ 's are error terms.

**Table VI.** Analysis of Legal Advisors with Perfect Deal Completion Efficiency

The table shows coefficient estimates for two different probit specifications:

$$Pr(PERFECT) = \delta_0 + \delta_1 \ln(SHARE) + \delta_2 COMPLEXITY + \omega_1,$$

$$Pr(PERFECT) = \delta_0 + \delta_{11} \ln(AVGSIZE) + \delta_{12} \ln(NUMDEALS) + \delta_{13} \ln(TOTMKT) + \delta_2 COMPLEXITY + \omega_2,$$

where *PERFECT* is an indicator variable equal to 1 for a law firm that completes all deals on which it advises in a year, *SHARE* is the acquirer law firm's market-share, *AVGSIZE* is the average dollar value of acquisition offers on which it advises, *NUMDEALS* is the number of offers on which it advises, *TOTMKT* is the total value of acquisition offers in the sample that year, and *COMPLEXITY* is a computed measure of the firm's average deal complexity based on Table IV (the fitted value of the probit regression specification). The cross-sectional sample analyzed in this table consists of 1820 law firm/years. Maximum-likelihood-based *t*-statistics, after correcting standard errors for heteroskedasticity and autocorrelation, are shown in parenthesis.

Explanatory Variable	Coefficient estimate ( <i>t</i> -statistic)	Coefficient estimate ( <i>t</i> -statistic)
$\ln(SHARE)$	-0.312 (-15.84)***	
$\ln(AVGSIZE)$		0.225 (0.78)
$\ln(NUMDEALS)$		-0.638 (-16.37)***
$\ln(TOTMKT)$		0.577 (1.79)*
COMPLEXITY	-2.116 (-3.29)***	-4.810 (-7.21)***
Intercept	-1.278 (-7.43)***	-2.911 (-1.03)
Pseudo $R^2$	0.26	0.33

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

Table VI shows the probit estimates for our sample of 1820 law firm-years. In Specification A, the results indicate that the perfectly efficient firms (those with 100 percent deal completion efficiency) tend to be smaller law firms that are involved in less complex deals. Specification B confirms this result by showing that the perfectly efficient firms tend to be ones that do fewer, less complex deals. To some extent, the finding that perfect firms do fewer deals is mechanical: the more offers advised by even a highly competent firm, the higher the probability that one fails, all else equal. Specification B adds the finding that these deals tend to occur in hot markets, that is, years in which the aggregate value of acquisition deals is large. We conjecture that one additional reason these firms are able to complete their deals is that the market (not just the client) is very anxious to have them completed, given the "merger waves" nature of the market for corporate control (Andrade, Mitchell and Stafford, 2001).

These results help explain the clustering of perfect deal completion efficiency that we found in the scatter plots from Figure 1: deal completion perfection is more likely when a law firm does a small number of less complex deals. This is also consistent with our earlier finding (Table V) that large law firms tend to be involved more in more complex deals. Finally, the probit analysis confirms what is suggested by the scatter-plots: there is something economically different about the perfect firms. Therefore, we need to track them separately in our final analysis of the relation between market-share and deal completion efficiency.

### E. Deal completion efficiency, deal complexity and legal advisors

Figure 1 appears to indicate that large market share law firms complete more of their deals in general, but a distinct cohort of *PERFECT* firms, which tend to be small, complete all its deals. In this section we apply a variation on the previous section's analysis of the

*PERFECT* firms to net out their effects, thereby better understanding the remaining part of the market.

We run the following two-stage regression for our sample of 1820 law firm-years:

$$\ln(\text{EFFICIENCY}) = \lambda_0 + \lambda_1 \ln(\text{SHARE}) + \lambda_2 \ln(\text{TA\_SHARE}) + \lambda_3 \text{COMPLEXITY} + \lambda_4 \text{PERFECT} + v, \quad (3a)$$

$$\text{Pr}(\text{PERFECT}) = \mu_0 + \mu_1 \ln(\text{SHARE}) + \mu_2 \text{COMPLEXITY} + \mu_3 \ln(\text{TOTMKT}) + \varepsilon, \quad (3b)$$

where, in the first equation, *EFFICIENCY* is the proportion of successful (non-withdrawn) acquisition offers on which a law firm advises in a year. In addition to regressors to register the influence of *COMPLEXITY* and *PERFECT* on *EFFICIENCY* in the system's first equation, we also include *TA\_SHARE*, the average market share of the acquisition target legal advisors faced by the average acquirer law firm for the offer. *TA\_SHARE* is based on market shares in work for the targets of acquisition offers during the particular year (computed similarly to the method we have already described for the acquirer lawyer shares). Some law firms (such as Wachtell Lipton Rosen & Katz) specialize in defending against acquisitions, and acquirer lawyers who routinely face such target-specialist law firms may bear a reduced probability of deal completion.

The second equation just above is a specification of the *PERFECT* model from the previous section. In the first equation, *PERFECT* is, of course, endogenous. It is therefore instrumented using the fitted values of the second (probit) equation above. From our previous analysis of a similar equation, we retain  $\ln(\text{TOTMKT})$  as an exogenous variable excluded from the other equation; identification is also aided by the non-linearity of the probit. Thus, in this regression system, *PERFECT* is a control variable that helps us characterize interesting relationships involving the remaining larger, more economically important group of non-*PERFECT* firms.

**Table VII.** The Relation between Deal Completion Efficiency and Legal Advisor Prominence Controlling for Perfect Law Firms

The table shows maximum likelihood regression coefficients of the following 2-stage regression for 2 different specifications, without and after controlling for target law firm market share:

$$\ln(\text{EFFICIENCY}) = \lambda_0 + \lambda_1 \ln(\text{SHARE}) + \lambda_2 \ln(\text{TA\_SHARE}) + \lambda_3 \text{COMPLEXITY} + \lambda_4 \text{PERFECT} + v,$$

$$\text{Pr}(\text{PERFECT}) = \mu_0 + \mu_1 \ln(\text{SHARE}) + \mu_2 \text{COMPLEXITY} + \mu_3 \ln(\text{TOTMKT}) + \varepsilon,$$

where *SHARE* is a law firm's market-share of M&A advisory business in a particular year, *EFFICIENCY* is the proportion of offers on which a firm advises in a year that are not withdrawn, *COMPLEXITY* is a computed measure of the firm's average deal complexity based on Table IV, and *PERFECT* is an indicator variable equal to 1 for a law firm that completes all deals on which it advises in a year. The total value of acquisition offers of the sample the year,  $\ln(\text{TOTMKT})$ , is the instrumental variable that is used in the first stage probit regression but not in the second stage OLS regression. The cross-sectional sample analyzed in this table consists of 1820 law firm-years. Maximum-likelihood-based *t*-statistics, after correcting standard errors for heteroskedasticity and autocorrelation, are shown in parenthesis.

Explanatory Variable	Stage 1	Specification 1	Specification 2
		Stage 2	Stage 2
	<i>Probability (PERFECT)</i>	<i>ln(EFFICIENCY)</i>	<i>ln(EFFICIENCY)</i>
<i>ln(SHARE)</i>	-0.468 (-15.19)***	0.009 (7.81)***	0.022 (8.07)***
<i>ln(TA_SHARE)</i>			-0.002 (-2.81)***
<i>COMPLEXITY</i>	-1.514 (-2.84)***	-0.283 (-3.85)***	-0.038 (-6.44)***
<i>ln(TOTMKT)</i>	0.570 (1.60)		
<i>PERFECT</i>		0.251 (15.42)***	0.294 (15.81)***
<i>Intercept</i>	-2.309 (-10.91)***	-0.148 (-10.23)***	-0.238 (14.47)***
Pseudo R <sup>2</sup>	0.40	0.63	0.65

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

The regression coefficients, along with the heteroskedasticity-corrected test statistics, are shown in Table VII. The relationship between efficiency and market-share is significantly positive: the large market-share law firms are more efficient after controlling for deal complexity and the tendency of the *PERFECT* firms to be involved in less complex deals.

The regression results tie in tightly to the pattern we observe in the scatter plots shown in Figure 1. Once we segregate the small cluster of perfect firms in this manner, there is a positive relationship between market-share and efficiency. This relationship is robust to the inclusion of a target law firm regressor, which is, itself, found to be associated with a negative effect on deal-completion efficiency.

As a simple check of our findings above, we note that, among non-*PERFECT* firms doing deals of more than median complexity, the mean deal completion rate for law firms with more than 1 percent market-share is 90 percent, whereas the mean efficiency for smaller firms is only 81 percent.

As additional robustness checks of the result that large-market-share acquirer legal advisors enhance deal completion of complex deals, we change the regression specification to (a) use offer-by-offer rather than by law-firm-year data, (b) use lagged market shares of law firms, in order to reduce any concerns of reverse-causality or look-ahead bias, (c) include the lagged average *COMPLEXITY* of deals advised on by the acquirer-law-firm in the past year, to measure the

impact of past experience with difficult deals, and (d) exclude the *PERFECT* law firms. Note that excluding the *PERFECT* law firms enables us to focus on those law firms that are more economically significant -- that is, those that advise on a large number of deals, sometimes in less-than-ideal market conditions.

Table VIII reports the results of several specifications of the following logit regression equation as estimated for the full sample of 7477 offers:

$$\Pr(\text{DEAL\_COMPLETE}) = \lambda_0 + \lambda_1 \ln(\text{LAG\_SHARE}) + \lambda_2 \text{DEAL\_COMPLEXITY} + \lambda_3 \ln(\text{LAG\_SHARE}) \times \text{LAG\_COMPLEXITY} + v, \quad (4)$$

where *DEAL\_COMPLETE* is an indicator variable for deal completion, *LAG\_SHARE* and *LAG\_COMPLEXITY* are, respectively, the previous year's acquirer law firm market-share and the law firm's average deal complexity from the previous year. These firm-oriented regressors register the importance of a firm's past experience and reputation, in terms of advising on a lot of merger business and also in terms of advising on difficult situation. An interaction term is also included, to allow for the possibility that advising on a large market share of difficult situations is important for later efficiency. *DEAL\_COMPLEXITY*, the offer-specific (and current) complexity measure of the deal is included as a control variable.

**Table VIII.** The Relation between Deal Completion Efficiency and Legal Advisor Prominence: Excluding Perfect Law Firms

This table shows maximum likelihood regression coefficients for several specifications of the following logit regression equation:

$$\Pr(DEAL\_COMPLETE) = \lambda_0 + \lambda_1 \ln(LAG\_SHARE) + \lambda_2 DEAL\_COMPLEXITY + \lambda_3 \ln(LAG\_SHARE) \times LAG\_COMPLEXITY + v,$$

where *LAG\_SHARE* and *LAG\_COMPLEXITY* are respectively the acquirer law firm's market-share of M&A advisory business and the fitted average deal complexity of all deals advised on, in the previous year, and *DEAL\_COMPLEXITY* is the fitted complexity measure of the deal. The sample over which the regression is run excludes the "perfect" law firms and includes 4449 deals. Heteroskedasticity-consistent *t*-statistics are shown in parenthesis.

Explanatory Variable	Coefficient estimate ( <i>t</i> -statistic)	Coefficient estimate ( <i>t</i> -statistic)	Coefficient estimate ( <i>t</i> -statistic)
<i>ln(LAG_SHARE)</i>	0.207 (7.79)***	0.108 (3.80)***	0.286 (5.17)***
DEAL_COMPLEXITY	-8.387 (-15.61)***	----	-14.502 (-3.48)***
<i>ln(LAG_SHARE)</i> <i>X</i> <i>LAG_COMPLEXITY</i>	----	1.057 (5.18)***	0.096 (1.72)*
<i>Pseudo R</i> <sup>2</sup>	0.18	0.17	0.20

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

Several restricted and unrestricted versions are reported in the table. In the first column, the regressors are lagged market share of the acquirer legal advisor and the complexity of the particular deal. Both regressors are highly statistically significant, based on heteroskedasticity-consistent standard errors. Deals advised by larger law firms are more likely to be completed. More complex deals are less likely to be completed.

Does law firm experience, and especially experience with complex deals, aid in deal completion? The logit specifications in the second and third columns show that it does. These models include the interaction cross-product term to capture the combined statistical influence of large lagged market share and lagged experience on complex deals. The positive effect of lagged market share on deal completion is significantly incremented when the law firm has previously been working on complex deals, according to the significant positive coefficient (at either the one percent or ten percent level, depending on whether *DEAL\_COMPLEXITY*, which accounts for a large amount of cross-sectional variation and is correlated with *LAG\_COMPLEXITY*, is included).<sup>21</sup>

The interaction of the quantity and quality of a law firm's experience even appears to be useful in building the firm's business: a regression of deal complexity on lagged legal advisor share (not reported in the table) shows an extremely highly statistically significant positive coefficient: larger law firms tend to be engaged for more complex deals in the next year. We explore this issue in a subsequent section.

To summarize the findings of this section, large market-share law firms are involved in more complex deals. Deals are less likely to be withdrawn, *ceteris paribus*, when large firms are advising. This result fits well with our earlier finding that large firms are engaged by larger, more profitable clients. Large law firms enhance the production of something that is quite important to acquirer management, a successfully concluded acquisition, and so tend to be engaged by the management of well-heeled acquirers. The ability to facilitate deal completion is arguably of substantial benefit to law firms in sustaining large market-shares. What we have not yet shown, and proceed to examine next, is whether large-share legal advisors tend to be associated with acquisitions that are beneficial to the shareholders as well.

#### IV. Returns effectiveness

As discussed in the introduction, Gilson (1984) argues that legal advisors in acquisitions deals might add

significant as a determinant of deal completion, and that the interaction term is offset as expected.

<sup>21</sup> To further explore this finding, we have additionally considered the arguably-offsetting effect of the target firm's legal advisors on deal completion. In a logit that also includes terms for the target legal advisors' market share and complexity experience, we find (not reported in the table) that the acquirer law firm's characteristics remain statistically

value to transactions in three major ways. First, they can write contracts that align the expectations of the parties, or else find ways to make such alignment unnecessary. Second, they can write contracts that minimize the incentives for opportunistic behavior. Third, they can engage in an agreement negotiation process that provides incentives to develop the proper set of common information at the lowest cost. Gilson argues that these are all ways in which law firms can directly add value for their clients in their role as "transaction costs engineers". Legal advisors may also be associated with shareholder value enhancing deals indirectly, in much the same way that top investment banks are thought to be associated with high-quality IPOs---they can try to associate themselves only with deals that they perceive to be value-creating. They are likely to do so if they judge that this will protect or enhance their market-shares. In this way, law firms may play a "gatekeeper" role. In this section, we investigate law firms "effectiveness" in being associated with returns for their M&A acquirer clients, both in the short-run and the long-run.

**A. Short-run effectiveness**

Lawyers' importance in structuring a transaction, and the associated value created by eliminating information asymmetries and incentive conflicts, may apply only around the time of the deal if counsel plays little role in post-closing integration and

implementation. If this is the case, the link between law firm prominence and acquirer shareholder value can be best measured by the acquirer's abnormal returns around the offer announcement. The window over which returns are measured should be wide enough to allow for the fact that the market may not know the lawyer's identity on the exact offer date, but narrow enough to avoid excessive noisiness due to other causes of returns.

Following Schwert (2000), the acquirer's short-run prediction error on any day *t* is calculated as  $\epsilon_{it} = R_{it} - \beta_i R_{mt}$ , where  $R_{it}$  is the daily return on the acquirer's stock,  $R_{mt}$  is the return on the CRSP NYSE/AMEX/Nasdaq value-weighted index, and  $\beta_i$  is the firm's market-model beta. As in Schwert, the intercept in this market model is constrained to be zero to eliminate any distortion in the abnormal returns caused by a positive intercept term due to strong prior performance of the bidder that does not continue during the event period. The market model estimated using over the days (-255, -64) relative to the offer announcement day.

The focus of our analysis is on cumulative prediction errors over days -63 through +126 around the offer announcement date. We refer to this measure of abnormal returns around the announcement as the market-model abnormal returns, *MMAR*.

**Table IX.** Acquirer Legal Advisor Market-Share and Effectiveness

Panel A shows the average effectiveness (deal by deal) measured as the percent market-model adjusted cumulative abnormal return (intercept suppressed) over days -63 through +126 of acquirers around the offer announcement, *MMAR*, associated with various acquirer law firm market-share cohorts. In parentheses are heteroskedasticity-consistent *t* statistics to test the null hypothesis of zero abnormal return. In square brackets are the difference-in-means *t*-statistics vis-à-vis effectiveness of the small law firms (0.1 to 0.5 percent market share). The sample examined in this Panel consists of 2894 unique offers with all required CRSP and SDC data.

Panel B shows the average *MMAR*, associated with various acquirer and target law firm market-share cohort combinations. The cross-sectional sample analyzed in this table consists of 1952 unique offers with all required SDC and CRSP data including target law firm names. The number of deals in each cell is shown in square brackets.

Panel C shows regression coefficients for the regression specification:

$$MMAR = \gamma_0 + \gamma_1 \ln(LAG\_SHARE) + \gamma_2 LAG\_COMPLEXITY + \gamma_3 TECH + \mathbf{v},$$

where the dependent variable *MMAR* is the market model abnormal return, *LAG\_SHARE* is acquirer law firm's market-share of M&A advisory business in the previous year, *LAG\_COMPLEXITY* is the mean complexity of the legal advisor's deals from the previous year, and *TECH* is an indicator variable set to one if the deal is in a technology industry. This sample excludes the "perfect" law firms from the previous year and is run over 1519 firm-months. Each observation represents the outcome of one offer. Regressions are estimated by weighted least squares, with heteroskedasticity-consistent *t*-statistics shown in parenthesis.

*PANEL A*

Cohort of law firms with market-share	Number of deals	<i>MMAR</i> (-63, 126)
0.1 to 0.5 percent	1006	9.48 (6.75) ***
0.5 to 1 percent	373	9.33 (2.86) *** [-0.05]

Table IX continued

1 to 1.5 percent	272	2.88 (0.87) [-1.83] *
1.5 to 2.5 percent	279	3.10 (1.27) [-2.26] **
> 2.5 percent	606	4.88 (2.90) *** [-2.10] **
All firms including the 1 deal Law firms	2894	7.50 (8.71) ***

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

## PANEL B

Acquirer Law firm market share	Target Law firm market share		
	< 0.5 percent	0.5 - 5 percent	> 5 percent
< 0.5 percent	8.68 (6.04) *** [832]	7.20 (2.13) ** [176]	15.16 (3.18) *** [54]
0.5 - 5 percent	8.18 (2.56) *** [227]	5.26 (2.04) ** [255]	5.74 (1.68) * [116]
> 5 percent	3.19 (0.79) [82]	2.85 (0.91) [151]	0.05 (0.01) [59]

## PANEL C

Explanatory Variable	Coefficient estimate (t-statistic)	Coefficient estimate (t-statistic)
$\ln(LAG\_SHARE)$	-2.52 (-5.18) ***	-2.50 (-5.16) ***
LAG_COMPLEXITY	0.278 (0.79)	0.253 (0.71)
TECH		-0.085 (-2.65) ***
R <sup>2</sup>	0.18	0.20

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

We find that large-share law firms exhibit negative effectiveness in being associated with large returns. Table IX provides the details. In constructing Panel A, we measure the abnormal return for each offer in our final sample, and then average across legal advisor market-share cohorts. Each offer counts as one data point in this analysis. When an offer is advised by multiple law firms, we average their market-shares, in effect, treating the team as a single firm. To present a more detailed picture as compared to earlier tables,

Panel A breaks out the large firm and small firm cohorts into more specific market-share buckets.

Panel A shows that effectiveness, as measured by short-run abnormal returns around the offer date (*MMAR*) is generally lower for larger market-share cohorts. The small-share law firm cohorts are associated with significantly positive *MMARs*, while the large-share cohorts (except the most dominant firms) are associated with (statistically) zero *MMARs*. Although the dominant law firms are associated with significantly positive *MMARs*, the magnitude of the

average abnormal return for their client firms is lower than that for the small-share law firm clients.

In untabulated results we find that the same pattern of law-firm-market-share and returns effectiveness also holds for the short-run market-adjusted returns computed by the cumulative abnormal returns (over and above the value-weighted CRSP market index) from day -63 before the offer announcement to day +126 after the announcement. The significance of the mean abnormal returns is also similar when we compute the event-study  $z$ -statistics instead of heteroskedasticity-consistent  $t$ -statistics reported in the table. Additionally, we note that our findings are not driven by the more detailed cohort breakout used in this table. Difference of means tests for the cohort with greater than 1 percent share versus the 0.1 to 0.5 percent share cohort generally reject the null at 5 percent significance level.

If acquirer lawyers are in fact effective in being associated with strong short-run returns, their influence might be offset by the influence of strong legal advisors on the other side. We perform several analyses to check on the relation between acquirer law firm size and returns effectiveness for their clients, after controlling for target law firm size.

Panel B shows a contingency table analysis of the mean  $MMAR$  within 9 classes defined by small, medium and large acquirer versus target legal advisors. Our earlier results on the relation between acquirer law firm size and acquirer returns are confirmed: as acquirer law firm size increases,  $MMAR$  decreases, irrespective of the target's advisor. For deals associated with small-share acquirer law firms, acquirer  $MMAR$ s are significantly positive. For deals associated with large-share acquirer law firms (dollar market shares of greater than or equal to 5 percent), acquirer  $MMAR$ s are insignificantly different from zero. The magnitudes of average  $MMAR$ s also monotonically decreases as we move from one acquirer-law-firm-size cohort to the next bigger cohort. This pattern holds regardless of the target law firm size. No pattern is apparent across target law firm size. Thus, the negative relation between law firm size and effectiveness as measured by the client's abnormal returns, hold after accounting for target law firm market share. Most certainly, there is no evidence that larger market-share cohorts are associated with superior transactions cost engineering that results in short-run value creation around the offer.

Panel C provides regression results that substantiate the impression from the descriptive statistics, and also demonstrate additional economically interesting aspects of the situation. The regression specification used is:

$$MMAR = \gamma_0 + \gamma_1 \ln(LAG\_SHARE) + \gamma_2 LAG\_COMPLEXITY + \gamma_3 TECH + \xi, \quad (5)$$

where the dependent variable  $MMAR$  is the market model abnormal return around deal announcements around each offer as described above,  $LAG\_SHARE$  is acquirer law firm's market-share of

M&A advisory business in the previous year,  $LAG\_COMPLEXITY$  is a computed measure of the law firm's average deal complexity in the previous year.  $TECH$  is an indicator variable set to one if the deal is in a technology industry, included because returns to tech stocks were especially strong over our sample period.<sup>22</sup> As before, in these regression analyses, we exclude the perfect firms, use a deal-by-deal sample architecture, and use lagged variables to alleviate any concerns about reverse-causality.

The first column of Panel C shows the market share regressor is associated with a statistically-strong negative coefficient, confirming the univariate results. Past experience with complex deals is not significant, suggesting perhaps that investors view the legal advisors as having been chosen to handle the degree of complexity. In the second column, we additionally include the tech-industry dummy variable as a regressor. Indeed, we find that the law firms associated with most value creation around the deal dates do a significant amount of their work for tech firms. Market share, however, retains its strong negative coefficient estimate, evidence that lack of a control for tech deals is not the source of this result in the first column. Additionally, the tech-dummy is associated with a negative coefficient. Thus, it is unlikely that association with tech deals alone is the source of our report of positive returns associated with certain smaller law firms' advisory work.

## B. Long-run effectiveness

Transaction engineering by lawyers could conceivably involve the creation of governance or other structural devices, the influence of which becomes apparent only over time. Masulis, Wang and Xie (2007), for example, have found that antitakeover charter and bylaw provisions are a determinant of firm's success over time as bidders. Most typically, an acquirers' provisions would stay in place for the combined firm, but the merger represents a breakpoint at which such structures can be reassessed and that carry through the closing of the deal to influence post-closing performance. Alternatively, in a gatekeeping role, prestigious law firms may want to be associated only with deals that they perceive as value-creating in the long run. If this is the case or if there is less than complete efficiency in the market, the link between law firm prominence and acquirer shareholder value can be measured by the acquirer's post-offer long-run abnormal stock returns.

To study such issues, we need to measure long-run returns for acquirer firms. Each particular measure in the literature has its drawbacks.

<sup>22</sup> Tech firms are defined as those with issuer SIC codes 3571, 3572, 3575, 3577, 3578 (computer hardware), 3661, 3663, 3669 (communications equipment), 3674 (electronics), 3812 (navigation equipment), 3823, 3825, 3826, 3827, 3829 (measuring and controlling devices), 3841, 3845 (medical instruments), 4812, 4813 (telephone equipment), and 4899 (communication services).



Buy-and-hold abnormal returns are appealing because the implied investment strategy is both simple and representative of the returns a long horizon investor might earn. However, Fama (1998) and Mitchell and Stafford (2000) argue that cumulative abnormal returns and calendar time methods are less likely to yield spurious rejections of market efficiency than buy-and-hold returns, partly because buy and hold returns can exaggerate small initial differences through compounding. Moreover, distributional properties of parametric test statistics for cumulative abnormal returns are better understood.

In view of these concerns and our desire for robust inferences, we employ three different measures of long run abnormal returns. Informally, we refer to these together as "effectiveness" in producing or being associated with long run returns. We measure abnormal returns as a) *BHAR*, buy-and-hold market-adjusted returns with compounding, b) *CAR*, cumulative market-adjusted returns without compounding, and c) *FFAR*, calendar-time Fama and French (1992) three-factor-adjusted returns. To avoid any survivorship bias, we use  $n$  days of data (where  $n < 750$ ) for acquirers that are delisted from CRSP before 750 days after the offer announcement.

For *BHAR*, we measure the sample average and use non-parametric tests to evaluate statistical significance. For *CAR*, we use the CRSP value-weighted NYSE/AMEX/Nasdaq index as the market proxy. For *FFAR*, the three factors are *RM*, the excess return on the CRSP value-weighted NYSE/AMEX/Nasdaq market index, *SMB*, the return on a zero investment portfolio formed by subtracting the return on a small firm portfolio from the return on a big firm portfolio, and *HML*, the return on a zero investment portfolio calculated as the return on a portfolio of high book-to-market stocks minus the return on a portfolio of low book-to-market stocks.<sup>23</sup> We use the for market adjustments. The Fama and French time-series regression model

$$r_{it} = \alpha_i + b_i \times RM_t + s_i \times SMB_t + h_i \times HML_t + \zeta_{it}, \quad (6)$$

where  $r_i$  is the excess return on stock or portfolio  $i$  over each time period (time subscripts are suppressed), and  $\delta$  is an error term. The coefficients  $b$ ,  $s$  and  $h$  are time-invariant risk-loadings. We follow Fama (1998) and Mitchell and Stafford (2000) in using this model in calendar-time fashion. We compute a full-sample calendar time regression by adding each acquirer's stock to a virtual portfolio on the offer announcement date, and then estimating the Fama and French regression model using the time-series of portfolio returns. The regression intercept  $a$  measures the mean per-period risk-adjusted abnormal return for the

sample portfolio. As Gompers and Lerner (2003) emphasize, the resulting  $a$  estimates have an interpretation analogous to that of Jensen's alpha in a CAPM framework. A similar method for calculating calendar time post-event monthly abnormal returns is employed in Moeller, Schlingemann and Stulz (2004) to evaluate gains from acquisitions.

For all our long-run returns effectiveness measures, we calculate post-offer returns beginning with, alternatively, the day prior to the announcement of the acquisition offer or the 26th trading day after the announcement. Our results are generally about the same in either case. We do not generally know whether the identity of the legal advisor is public information at the time of the announcement, so we compute returns assuming that the advisor is known at the same time as the offer and, alternatively, that the advisor is not known until one month later. Our results are generally about the same in either case.

<sup>23</sup> We are grateful to Kenneth French for making the necessary factor portfolio returns available from his web site at [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html).

**Table X.** Market-share and Long run effectiveness

The first 6 columns show the average effectiveness measured in terms of post-offer long-run abnormal returns for acquirers: market-adjusted buy-and-hold abnormal returns (*BHAR*), market-adjusted cumulative abnormal returns (*CAR*), or cumulative Fama French three-factor-model-adjusted abnormal returns from a calendar time regression (*FFAR*), associated with various acquirer law firm market-share cohorts over the years 1994-2000. Long-run abnormal returns are measured over days -1 to +750 or, alternatively, +26 to +750 around the announcement of an acquisition offer. The long-run abnormal returns are reported as annualized percent returns. The final sample analyzed in the table consists of 3042 unique offers with required SDC and CRSP data for long-run returns. In parentheses are sign-test *z* statistics (for *BHAR*) and heteroskedasticity-consistent *t* statistics (for *CAR* and *FFAR*) to test the null hypothesis of zero abnormal return. In square brackets are the difference-in-means *t*-statistics vis-à-vis effectiveness of the small law firms (0.1 to 0.5 percent market share).

Cohort of law firms with market-share	Number of Deals	Effectiveness (average long run abnormal returns, as percentages) for 3 returns measures and 2 returns windows measured in days relative to the offer					
		<i>BHAR</i>		<i>CAR</i>		<i>FFAR</i>	
		-1, 750	26, 750	-1, 750	26, 750	-1, 750	26, 750
0.1 to 0.5 percent	1013	9.08 (4.57)***	8.98 (4.19)***	14.13 (5.55)***	13.99 (5.81)***	16.2 (1.80)*	16.2 (2.00)**
0.5 to 1 percent	380	-13.99 (-5.80)*** [-3.50]***	-12.12 (-5.90)*** [-3.23]***	7.41 (0.60) [-1.21]	6.37 (0.32) [-1.38]	7.80 (0.58) [-2.28]**	7.80 (0.83) [-2.19]**
1 to 1.5 percent	273	-6.13 (-3.62)*** [-2.05]**	-7.37 (-4.83)*** [-2.05]**	-4.24 (-0.16) [-2.71]***	-4.08 (-0.18) [-2.75]***	-7.23 (-1.31) [-1.49]	-7.23 (-0.82) [-1.43]
1.5 to 2.5 percent	283	-12.68 (-3.62)*** [-3.13]***	-9.63 (-2.29)** [-2.81]***	-1.52 (-0.42) [-3.04]***	-0.31 (0.00) [-2.83]***	-13.9 (-1.57) [-0.40]	-13.9 (0.63) [-0.29]
> 2.5 percent	606	-0.52 (-3.54)*** [-1.38]	-0.56 (-3.13)*** [-1.52]	-2.29 (-0.35) [-3.85]***	-2.25 (-0.42) [-3.87]***	-7.23 (-0.05) [-1.50]	-7.23 (-0.68) [-1.46]
All firms including the 1 deal Law firms	3042	-0.43 (-9.16)***	-0.27 (-8.87)***	6.73 (4.70)***	6.54 (4.72)***	7.80 (0.75)	7.80 (0.85)

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

Table X reports *BHAR*, *CAR* and *FFAR*, calculated over two windows. Both windows end 750 trading days after the announcement, or three years. Long-run return effectiveness, as measured by the post-offer long-run abnormal returns (*BHAR*, *CAR* and *FFAR*) is generally lower for larger market-share cohorts. Depending on the measure, post-offer long-run abnormal returns for some large-share law firm cohorts are significantly negative. Large-share cohort effectiveness measures are most often significantly lower than small-share cohort effectiveness measures. Thus, the table shows a consistent pattern in which the long-run returns of large-share-law-firms' clients are worse than those of small-share law-firms' clients.

In untabulated results, we find that the same pattern of law-firm-market-share and returns effectiveness also holds when, for the long-run returns, we employ Fama and French's adjustment in traditional event study fashion, with risk loadings

computed from data during an estimation period ending 45 days prior to the announcement. In this case, the estimated risk-loadings computed with the pre-announcement data, along with post-announcement data on the factor portfolios, are applied to risk-adjust the post-event returns for each acquirer stock *i*. From these post-event risk-adjusted returns, *FFAR*, for each stock is computed (but not reported in the table). Additionally, we note that our findings are not driven by the more detailed cohort breakout used in this table. Difference of means tests for the cohort with greater than one percent share versus the 0.1 to 0.5 percent share cohort generally reject the null at five percent significance level. Thus, there is no evidence that larger market-share cohorts are associated with superior transactions cost engineering or gatekeeping that results in superior long-run returns effectiveness.

To summarize our findings so far, big market-share law firms are called upon by the large

successful firms to facilitate the completion of complex acquisition deals. After controlling for deal complexity, these law firms are efficient in bringing these deals to successful conclusions. We also find that acquirers' abnormal stock returns around the offer announcement are significantly smaller (and often statistically zero) and the post-offer long-run returns often negative for completed deals in which prestigious large-market-share law firms are involved on behalf of those acquirers. This contrasts with more positive acquirers' abnormal stock returns, both around offer announcements and also post offer, for completed deals in which small-market-share law firms are involved on behalf of the acquirers<sup>24</sup>. In other words, the data does not suggest that law firm incentives are effectively aligned with either a gatekeeping role or the transactions costs engineering role for M&A lawyers, both of which entail shareholder value enhancement.

## V. Do law firms succeed via efficiency and effectiveness?

Thus far we have demonstrated that large market-share law firms are asked to advise acquirers on legally complex acquisition offers. They are associated with enhanced deal completion efficiency, but not with enhanced value creation for the acquirers. Thus, they appear to be efficient at producing one outcome of great interest to acquirer management---deal completion. However, they are not effective at producing valuable transaction cost engineering as reflected in stock performance, though this would, presumably, also be of interest to management.

In this section, we provide an explanation. In a nutshell, some law firms appear to be able to consistently associate themselves with efficient deal completion. On the other hand, there is no evidence that any cohort of law firms consistently causes or associates itself with effectiveness in the sense of strong stock returns for the acquirer. Given no evidence of persistent success in effectiveness, we cannot suggest that transaction cost engineering of a type that affects returns is something that particular law firms can excel at producing. Firms that want to build market-share could then reasonably concentrate on deal completion efficiency, something that they can produce. Furthermore, their employers care about deal completion efficiency: we show that acquirers that have had unsuccessful bids tend to employ significantly more different law firms than acquirers that are always successful in their bids. This implies that unsuccessful bidders tend to change their legal advisors more often than the successful bidders. On the other hand, we do not find that acquirers who experience negative post-acquisition abnormal stock returns employ more different law firms than acquirers

who experience positive post-acquisition abnormal stock returns.

To demonstrate persistence (or the lack thereof) in efficiency and effectiveness, we work with a restricted set of offers in our data set for which there is a unique, single legal advisor. We remove deals advised by several firms to avoid crediting any one of them with time series effects that might actually be due to one or more of the others. If these advisor "teams" were stable over time, we could credit effects to the team, but they are not. This issue does not arise in our earlier cross-sectional analysis, where we do treat a team on any deal as a law firm with average characteristics. In the time series setting, this approach is conservative---we will only report effects if they are evident with our cleanest, most restrictive data. This most-restricted sample is a panel of 851 law firm/years, in which the firms act as the sole advisor on offers in at least two years over 1994-2000.

<sup>24</sup> Because hostility reflects a tactical choice with extensive implications, we have also replicated our analyses for the sample of hostile offers only. Our central conclusions hold for the hostile sample as well.

**Table XI.** Consistency over Time in Deal Completion Efficiency and Long-run Returns Effectiveness

Panel A reports regression tests of the general form:

$$EFFICIENCY\_INDICATOR = \theta_{0,effic} + \theta_{1,effic} LAGGED\_EFFICIENCY + \theta_{2,effic} COMPLEXITY + \eta_{effic}$$

where *EFFICIENCY\_INDICATOR* is either *EFFICIENCY*, the proportion of non-withdrawn offers for a law firm in a year, in which case estimation is by ordinary least squares, or, alternatively, *EFFICIENCY\_INDICATOR* is *PERFECT*, our indicator for zero deals withdrawn, in which case estimation is by maximum likelihood probit. *LAGGED\_EFFICIENCY* is the proportion of last year's deals completed. Panel B reports regression tests of the form:

$$EFFECTIVENESS\_INDICATOR = \theta_{0,effect} + \theta_{1,effect} LAGGED\_EFFECTIVENESS + \eta_{effect}$$

where *EFFECTIVENESS\_INDICATOR* is the short-run returns measure, *MMAR*, or one of our three long-run returns measures (*BHAR*, *CAR*, or *FFAR*) measured over one of two time periods relative to the offer, either day -1 to +250, or days +26 to +250. *LAGGED\_EFFECTIVENESS* refers to the same returns measure and time period as for the left-hand side, but applied to the same firm's deals in the *previous* year. The  $\theta$ s are coefficients, and  $\eta$ s are error term. In both panels, the tests are applied to a panel sample of 851 law firm/years where each observation summarizes offers in a year from our final sample for which a particular law firm is the unique legal advisor. For ordinary least square regressions, heteroskedasticity consistent *t* statistics are in parentheses. For probits, standard maximum-likelihood-based *t* statistics are in parentheses.

Panel A. Tests of consistency over time in deal completion efficiency

<i>EFFICIENCY_INDICATOR</i>	<i>EFFICIENCY</i>	<i>PERFECT</i>	<i>EFFICIENCY</i>	<i>PERFECT</i>
Regressor:				
<i>LAGGED_EFFICIENCY</i>	0.839 (12.92)***	21.711 (15.09)***	0.766 (8.93)***	18.917 (12.33)***
<i>COMPLEXITY</i>			-0.225 (-2.33)**	-12.550 (-5.19)***
<i>INTERCEPT</i>	0.152 (2.40)**	-20.355 (-14.58)***	0.237 (2.69)***	-16.840 (-11.13)***

Panel B. Tests of consistency over time in long-run returns effectiveness

<i>EFFECTIVENESS_INDICATOR</i>	<i>MMAR</i> (-63,126)	<i>BHAR</i> (-1, 250)	<i>BHAR</i> (26, 250)	<i>CAR</i> (-1, 250)	<i>CAR</i> (26, 250)	<i>FFAR</i> (-1, 250)	<i>FFAR</i> (26, 250)
Regressor:							
<i>LAGGED_EFFECTIVENESS</i>	-0.016 (-0.28)	-0.004 (-0.05)	-0.062 (-1.13)	-0.052 (-0.86)	-0.076 (-1.18)	-0.028 (-0.47)	-0.034 (-0.51)
<i>INTERCEPT</i>	0.069 (5.22)***	0.022 (0.31)	0.013 (0.33)	0.005 (0.22)	0.005 (0.25)	-0.166 (5.99)***	-0.149 (-6.07)***

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

Table XI reports our results. Panel A shows results for time-consistency in efficiency, and Panel B shows results for effectiveness. Specifically, in Panel A, we report several regression tests of the general form:

$$EFFICIENCY\_INDICATOR = \theta_{0,effic} + \theta_{1,effic} LAGGED\_EFFICIENCY + \theta_{2,effic} COMPLEXITY + \eta_{effic} \quad (7)$$

where *EFFICIENCY\_INDICATOR* is either the proportion of non-withdrawn offers for a particular law firm in a particular year, in which case estimation is by

ordinary least squares, or, alternatively, *EFFICIENCY\_INDICATOR* is *PERFECT*, our indicator for zero deals withdrawn, in which case estimation is by maximum likelihood probit. *LAGGED\_EFFICIENCY* is the proportion of last year's deals completed, and *COMPLEXITY* is the same as defined earlier. The  $\zeta$ s are coefficients, and  $\epsilon_{effic}$  is an error term. We estimate various versions of equation (7), excluding some coefficients in some versions.

Panel A shows that the coefficient on *LAGGED\_EFFICIENCY* is always positive and

strongly statistically significant, whatever the measure of current efficiency. The first two specifications show this point without any additional control variables, whereas the third and fourth specifications show that the point also holds when controlling for *COMPLEXITY*. In all these tests, last year's more efficient firms tend to be this year's more efficient firms. The conclusion is that law firms can produce, or at least consistently associate themselves with, deal completion efficiency.

In Panel B, we report similar regression tests, but where the acquirer's abnormal returns around the offer and in the long run post-offer is the focus. We estimate seven regressions of the form:

$$EFFECTIVENESS\_INDICATOR = \theta_{0, effect} + \theta_{1, effect} LAGGED\_EFFECTIVENESS + \eta_{effect}, \quad (8)$$

where *EFFECTIVENESS\_INDICATOR* is short-run *MMAR* measured over days -63 through +126 relative to the offer announcement, or,

alternatively, long-run *BHAR*, *CAR* or *FFAR* measured over one of two time periods relative to the offer: either day -1 to +250, or days +26 to +250. We use shorter windows for long-run analysis than for our previous analyses in order to avoid overlapping returns periods in this time-series analysis. *LAGGED\_EFFECTIVENESS* is the same returns measure and time period as for the left-hand side, but applied to the same firm's deals in the previous year. Thus, the regression tests for persistence over time in law firm's long-run returns effectiveness.

None of the seven specifications reported in Panel B shows any evidence of persistence in producing or being associated with strong long-run returns. All the regression coefficients are near zero and statistically insignificant. Overall, law firms do show evidence of being able to produce, or at least consistently be associated with, efficient deal completion. This is not the case when it comes to long-run returns effectiveness.

**Table XII.** Relationship between Acquirers' Law Firm Choices and Legal Advisor Efficiency/Effectiveness

The table reports means and difference of means tests for the number of different lawyers used by acquirers represented in our final sample of 3042 acquisition offers over 1994-2000. The table reports on several sub-samples, described in the table, formed by distinguishing GOOD versus BAD acquirer outcomes of various types. GOOD acquirer outcomes are defined, alternatively, as acquirers experiencing no withdrawn offers, experiencing positive long-run market adjusted cumulative abnormal returns (*CAR*(-1, 750)), experiencing positive long-run market adjusted buy-and-hold returns (*BHAR*(-1, 750)), and experiencing positive Fama-French-factor adjusted returns (*FFAR*(-1, 750)). BAD acquirer outcomes are defined, respectively, as acquirers outside the GOOD subsample on each criterion.

	No. withdrawn offers vs. some withdrawn offers	Positive <i>CAR</i> (-1, 750) vs. negative <i>CAR</i> (-1, 750)	Positive <i>BHAR</i> (-1, 750) vs. negative <i>BHAR</i> (-1, 750)	Positive <i>FFAR</i> (-1, 750) vs. negative <i>FFAR</i> (-1, 750)
Total number of <i>different</i> law firms used by acquirers that experience BAD efficiency or effectiveness outcome	3.22 <i>N</i> =101	1.67 <i>N</i> =668	1.63 <i>N</i> =951	1.73 <i>N</i> =947
Total number of <i>different</i> law firms used by acquirers that experience GOOD efficiency or effectiveness outcome	1.69 <i>N</i> =1457	1.70 <i>N</i> =890	1.77 <i>N</i> =607	1.63 <i>N</i> =611
Difference	1.53	-0.03	-0.14	0.10
t statistic	(9.44) <sup>***</sup>	(-0.48)	(-2.41) <sup>**</sup>	(1.85)

\*, \*\*, and \*\*\* denote significantly different from zero at the 10, 5 and 1 percent level respectively.

In Table XII, we provide some suggestive evidence that deal completion efficiency is valued by clients. The table compares the number of different law firms used by acquirers that experience no withdrawn deals (that is, 100 percent deal completion effectiveness) to the number of different law firms used by bidders with lower deal completion success. Acquirers that have had unsuccessful bids use a significantly larger number of different law firms, on average---more than three as compared to about one

and two-thirds for bidders that had 100 percent success, over the full sample period. This result suggests the possibility of acquirers shopping for law firms that can improve deal completion. Since this result could be affected by systematic differences in the number of deals, type of deals, and so on, we have investigated several normalized versions of the number of different lawyers, with no change in the conclusion. In particular, we normalized the number of different law firms employed by a bidder by the number of deals

attempted by the bidder, the average number of law firms employed by the bidder per deal, and by both number of deals and the average number of law firms employed per deal. Our results do not change.

The table also reports the number of different lawyers used by acquirers that experience positive versus negative post-acquisition long-run returns. In this analysis, we do not examine only short-run returns because *MMAR* is positive for any law-firm-size cohort. For two of the three returns measures (*CAR* and *FFAR*) the difference is insignificant, and for the third measure (*BHAR*), the difference, though statistically significant, is small and opposite to the hypothesized direction. Thus, acquirers do not appear to shop for law firms to create post-acquisition shareholder value.

Our earlier finding that large market-share law firms working for the acquirers are associated with deal completion but not long run returns thus seems natural. Table XI shows that law firms are able to consistently produce only deal completion. Table XII suggests that clients care only about deal completion. Thus, large law firms produce what their employers seem to care about the most -- deal completions. This helps the law firms to build their businesses.

## VI. Conclusion

The process of attempting to combine two corporations is fraught with information asymmetries and other difficulties, so intermediaries can be important. Prior research has examined the role of investment bankers (Servaes and Zenner, 1996 and Rau, 2000), but not that of legal advisors. There are several reasons to suspect that legal advisors are also economically important intermediaries. First, prior research finds that legal advisors are material to economic outcomes in IPOs (Beatty and Welch, 1996); if anything, the potential for lawyers to make a difference would seem greater in acquisition situations than in the tightly-prescribed process of the IPO of an S.E.C.-regulated client. After all, in merger situations, a wide variety of tactics, responses, forms, and constraints may apply under state and federal corporate laws as well as the laws of non-U.S. jurisdictions. Second, a large body of research beginning with LaPorta, de Silanes, Shleifer and Vishny (1998) finds that legal institutions are material to economic outcomes. Some of this evidence shows that particular legal institutions are material to acquisition-related outcomes (for example, Coles and Hoi, 2003, Nowak, 2001). It seems reasonable to expect that the activities of the agents most closely associated with these institutions might be associated with economic effects.

In this paper, we first characterize the market for legal advisory services in terms of size and market-shares in the second half of the 1990s. This characterization provides a ranking of firms in terms of their prominence, which is useful for our other investigations. The advisory industry has one perennial largest firm, Skadden Arps, which often advises on more than five percent of the value of all offers in our

sample. Sullivan Cromwell and Simpson Thacher generally carry a two- to four-percent share, and a few other large firms are almost as large in market-share. Around a hundred other "small" firms in any year advise on several-to-many deals totaling to less than a one percent market-share apiece. Firm-specific market-shares are fairly stable across over sample period- the late nineties. Bigger firms do larger deals, work with more prominent investment bankers, and work for larger, more profitable clients.

Legal intermediaries play a central role in the negotiation and drafting of the documents that define a deal, from non-disclosure agreements near the start of the process to the eventual acquisition agreement. Given this role, a clear possibility exists that lawyers' activities could be material to the eventual closure or withdrawal of the deal. Knowing this, clients interested in completing a deal might reasonably engage higher-quality legal talent for more difficult deals. We investigate, and find that, after accounting for the influence of variables correlated with the difficulty of the legal issues involved, large market-share law firms are significantly more likely to be associated with successful deal completions. This suggests that market-share is an index of the ability to facilitate deal completion, and measures law firm quality in this sense. Even if high-share law firms are hired in situations that are difficult in ways that we cannot observe (as is likely), the fact that they complete more of such deals is direct evidence of economic effects of their activities.

Lawyers may also be associated with shareholder value creation. Gilson (1984) suggests that lawyers as, transaction costs engineers, could structure agreements and negotiations to mitigate asymmetric information, thereby enabling counter-parties to act as they would in a frictionless market. Additionally, well-known and prestigious law firms may want to associate themselves only with value-creating transactions that enhance their reputations in the market. Presumably, then, the better deals would tend to be completed and structured in an economically advantageous manner for the shareholders. We find that clients of large market-share law firms (the acquirers) tend to experience lower stock returns both in the short run and in the long run, and that there is little consistency over time. The market for M&A advisory services does not exhibit evidence of transactions costs engineering or gatekeeping roles played by large market-share law firms, at least as reflected in stock returns. This even seems natural, for the clients are really the managers of large and profitable corporations, not their shareholders. The law firms with large market-shares in the M&A business are associated with delivering what their managerial clients want -- deal completion -- and not necessarily with what their clients' principals presumably want --shareholder value creation. Indeed law firm compensation, whether based on an hourly rate or on the accomplishment of client goals (which, for acquirers, is successful deal completion), skews their incentives that way.

## References

1. Agrawal, A. and C. Knoeber, 1996, Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders, *The Journal of Financial and Quantitative Analysis* 31, 377-397.
2. Andrade, G., M. Mitchell, and E. Stafford, 2001, New Evidence and Perspectives on Mergers, *Journal of Economic Perspectives* 15, 103-120.
3. Bates, T. and M. Lemmon, 2003, Breaking Up is Hard to Do: An Analysis of Termination Fee Provisions and merger Outcomes, *Journal of Financial Economics* 69, 469-504.
4. Beatty, R. and I. Welch, 1996, Issuer Expenses and Legal Liability in Initial Public Offerings, *Journal of Law and Economics* 39, 545-603.
5. Coates, J., 2001, Explaining Variation in Takeover Defenses: Blame the Lawyers, *California Law Review* 89, 1301.
6. Coates, J. and G. Subramanian, 2000, A Buy-Side Model of M&A Lockups: Theory and Evidence, *Stanford Law Review* 53, 307.
7. Coles, J. and C.K. Hoi, 2003, New Evidence of the Market for Directors: Board Membership and the Pennsylvania Senate Bill 1310, *Journal of Finance* 58, 197-230.
8. Eckbo, B.E., 1992, Mergers and the Value of Antitrust Deterrence, *Journal of Finance* 47, 1005-1029.
9. Fama, E., 1998, Market Efficiency, Long Run Returns and Behavioral Finance, *Journal of Financial Economics* 49, 283-306.
10. Fama, Eugene and Kenneth French, 1992, The Cross-Section of Expected Stock Returns, *Journal of Finance* 47, 427-465.
11. Garicano, L. and T. Hubbard, 2002, Specialization, Firms, and Markets: The Division of Labor Within and Between Law Firms, University of Chicago working paper.
12. Gilson, R., 1984, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, *Yale Law Journal* 94, 239-313.
13. Gilson, R. and A. Schwartz, 2005, Understanding MACs: Moral Hazard in Acquisitions, *Journal of Law, Economics and Organization* 21, 330-358.
14. Gilson, R. and B. Black, 1996, *The Law and Finance of Corporate Acquisitions* (Foundation Press, New York, New York).
15. Gompers, P. and J. Lerner, 2003, The Really Long Run Performance of Initial Public Offerings: The Pre-Nasdaq Evidence, *Journal of Finance* 58.
16. Holmstrom, B. and S. Kaplan, 2001, Corporate Governance and Merger Activity in the United States: Making Sense Out of the 1980s and 1990s, *Journal of Economic Perspectives* 15, 121-144.
17. La Porta, R., F. Lopez de Silanes, A. Shleifer, and R. Vishny, 1998, Law and Finance, *Journal of Political Economy* 106, 1113-1155.
18. Loughran, T. and A. Vijh, 1997, Do Long-Term Shareholders Benefit from Corporate Acquisitions?, *Journal of Finance* 52, 1765-90.
19. Masulis, R., C. Wang, and F. Xie, 2007 (forthcoming), Corporate Governance and Acquirer Returns, *Journal of Finance*.
20. Mitchell, M. and E. Stafford, 2000, Managerial Decisions and Long-term Stock Price Performance, *Journal of Business* 73, 287-329.
21. Moeller, S., F. Schlingemann, and R. Stulz, 2004, Firm Size and Gains from Acquisitions, *Journal of Financial Economics* 73, 201-228.
22. Nowak, E., 2001, Recent Developments in German Capital Markets and Corporate Governance, *Journal of Applied Corporate Finance* 14.
23. Rau, P.R., 2000, Investment Bank Market-Share, Contingent Fee Payments and the Performance of Acquiring Firms, *Journal of Financial Economics* 56, 293-324.
24. Ribstein, L.E., 2004, Limited Liability of Professional Firms after Enron, *Journal of Corporation Law* 29.
25. Rosen, S., 1992, The Market for Lawyers, *Journal of Law and Economics* 35, 215-247.
26. Schwert, G.W., 2000, Hostility in Takeovers: In the Eyes of the Beholder?, *Journal of Finance* 55, 2599-2640.
27. Servaes, H. and M. Zenner, 1996, The Role of Investment Banks in Acquisitions, *Review of Financial Studies*, 787-815.
28. Starbuck, W., 1993, Keeping a Butterfly and an Elephant in a House of Cards: The Elements of Exceptional Success, *Journal of Management Studies* 30, 885-921.
29. Stigler, G., 1988, *Memoirs of an Unregulated Economist* (New York, New York).
30. Subramanian, G., 2007 (forthcoming), Post-Siliconix Freezeouts: Theory and Evidence, *Journal of Legal Studies* 36.
31. Welsh, C., 2000, Corporate Lawyers Have Become the New Deal-Makers, *Knight Ridder/Tribune Business News*, Sunday Business November 5.

## PRELIMINARY EVIDENCE FROM MONITORING ACTIVITIES BY PENSION FUNDS AND INVESTMENT MANAGERS AND ATTITUDES TOWARDS SHAREHOLDER ACTIVISM BY PENSION FUNDS

Theo Lynn\*, Mark Mulgrew\*

### Abstract

There is widespread support for the proposition that pension funds can, should and do play an important role in monitoring management in the companies in which they invest. This article examines whether Irish occupational pension funds and investment managers use voting, engagement and intervention as monitoring strategies in relation to investee companies. Furthermore, the article examines whether there are significant differences in attitudes between the two groups across key themes relating to shareholder activism by occupational pension funds in order to identify whether potential agency problems may exist in relation to delegation and representation. The results of the research suggest low levels of monitoring by Irish occupational pension funds compared to investment managers which could be explained by delegation. Furthermore significant differences in perceptions were identified in relation to the perceived importance of “Anti-takeover measures”, “Improving information flow to shareholders” and “Remuneration” to pension funds, when compared against the rankings for the impact of pension funds to each of these particular areas.

**Keywords:** corporate governance, pension funds, institutional shareholders, investment managers, agency problems

\**Dublin City University*

### Introduction

Following the exposure of corporate scandals and malfeasance in the late nineties and continuing into the millennium, it was not surprising that McKinsey (2002) found that 80% of the institutional investors surveyed would pay a premium for well-governed companies. Reliance on market forces, legal rules, and managerial holdings did not appear to be the solution to failings in the governance of public companies. Institutional monitoring, whether through voting, engagement or intervention, has been widely suggested as a supplemental form of governance to address the drawbacks of the Anglo-American corporate governance system (Diamond, 1984; Agrawal and Knoeber, 1996; Maug, 1998). Empirical evidence suggests, that in the US at least, institutional investors engage in low levels or limited monitoring activities (Black, 1998; Gillan and Starks (2001)). This may be due to inconclusive evidence relating to the link between institutional monitoring and performance but also the size and raw monetary value of institution’s stake, firm specific factors and other legal and market factors including free riding conflicts of interest, and market perception (Coffee, 1991; Pound, 1993; Kahn and Winton, 1998; Edkins and Bush, 2002; Myners, 2004; Yaron, 2005; Black, 1998). Specifically, skill

levels and experience have been highlighted as both barriers to engaging in monitoring activity and resulting impact (Coffee, 1991, Myners, 2004; Lipton and Rosenblum (1991)

While it has been suggested that pension funds may be the optimal monitors due to their legal structure, freedom from conflicts of interest, investment horizon and investment stake size, investment functions are often delegated to intermediaries such as investment managers (Coffee, 1991; Del Guercio and Hawkins, 1999). As such, pension funds may effectively disconnect their activism and therefore are not likely to monitor or publicise their activism efforts (Del Guercio and Hawkins, 1999). For example, Yaron (2005) suggests that the vehicle chosen for investing pension assets can often have a direct impact on access to the proxy and engagement options. Where investments are pooled, pension schemes do not have direct access to the proxy nor do they have rights as shareholders in the funds. Typically, all rights are exercised at the discretion of the manager. Unless the pension fund has specifically mandated, external managers may not monitor and rely on boilerplate clauses within investment agreement for justification thereby disenfranchising the pension fund from a significant shareholder right.

In this article, the main research questions of the



study are as follows:

- Do Irish occupational pension funds and external fund managers employ institutional monitoring strategies in relation to the companies in which they have invested?
- Are there significant differences in attitudes between Irish occupational pension funds and external fund managers across key themes relating to shareholder activism by occupational pension funds?

The second research question is operationalised by examining whether attitudes to board reform, information flow to shareholders, anti-takeover measures, corporate social responsibility, barriers to shareholder activism and mandatory voting by pension funds varies between the two groups in order to identify whether potential agency problems may exist in relation to delegation and representation. To answer these questions, questionnaire-based research augmented with statistical analysis was undertaken.

In the following sections, we review different approaches, foci and activities related to institutional monitoring, outline the methodology used, present the main findings and conclusions as well as suggest avenues for further research.

## Institutional Monitoring

Recently there has been a blurring in the distinction between “monitoring” and other related terms such as “intervention”, “active investing”, “shareholder activism” and “relationship investing”. Stapledon (1996) defines monitoring as “any form of involvement, direct or indirect, at firm level or industry-wide, by institutions in corporate governance.” This implies that monitoring may (a) include direct action by an institution or through an intermediary and (b) be targeted at companies and/or industries.

Maug defines monitoring more broadly as:

“...a comprehensive label for all value-enhancing activities; it comprises intervention in a company's affairs as well as information acquisition (e.g., in order to identify a potential target of intervention) and is used synonymously with “intervention” and “shareholder activism”.”

Similarly Yaron has defined “shareholder activism” or “active investing” as including both the practices of voting proxies and corporate engagement collectively. Yaron bases this on the definition of Gordon and Pound (1993) who define “active investing” as:

“...comprised of investment strategies in which the investor takes actions involving the target corporation, other than simply buying or selling securities, that are designed to increase the returns generated by this investment. Such actions typically involve exerting significant influence over corporate policy or control over the corporate entity in the hope

of elevating the value of the firm. An active investing strategy is thus one in which the returns derived from a given investment are endogenous – subject to influence by the individual investor after the investment is made.”

“Relationship investing”, a specific form of monitoring, is defined by Hawley and Williams (1996) as:

“monitoring in which an owner or groups of owners hold a significant block of equity in a particular firm, thereby establishing a long-term position and by virtue of their ownership block can exert leverage on management.”

In order to enhance institutional voice, Black (1992) advocates that institutions reduce their portfolio size so that they hold between 5 and 10% of the stock in a particular company but no more than this. Black believes that this would facilitate greater communication and stronger influence without the threat of a single dominant shareholder.

Roe (1993) suggests that a structure of multiple intermediaries:

“...can deter opportunism by monitoring one another, impel action in a way that a single blockholder might not, and facilitate power-sharing, not domination.”

These definitions are consistent with Section 2509.94-2 of Title 29, Chapter 25 of the US Code of Federal Regulations which finds such monitoring activity, including the coordination of activity with other shareholders, appropriate for fiduciaries of pension plans.

## Focus of Institutional Monitoring

The focus of institutional monitoring historically has been on three main activities – (i) protecting the market for corporate control, (ii) improving information flow, and (iii) reforming the board.

Institutional investors have attempted to protect the market for corporate control by limiting defensive tactics being introduced by portfolio companies. These tactics include poison pills, management control of agenda setting, director election, and all phases of proxy processes. Although campaigns have successfully reduced the impact of anti-takeover mechanisms (Gordon and Pound, 1991), common reform issues raised by shareholder activists include increasing confidential voting, curtailing the ability of the board to call off an election on a particular matter if it thinks it may lose, and reducing the impact of staggered elections (Romano, 2000; Gordon and Pound, 1991).

Non-executive directors inevitably cannot know as much about the firm as management. Most importantly, non-executive directors do not devote their entire professional efforts to a single company and therefore are not enmeshed in the day-to-day information flow of the company. This is compounded by management's control of the information that does

reach the board. The result can be a board knowing too little, too late and, even if is willing and able to act to confront a growing problem or crisis, it is often unable to do so. This is obviously compounded in the case of shareholders who are even further removed from the information than non executive directors. In broad terms, some institutions have focussed on improving the quality and frequency of management-shareholder exchanges. Some commentators have called for the establishment of formal shareholder advisory committees representing the largest shareholders, typically institutional investors (Essen, 2000).

Historically, most corporate governance debates revolve around the board of directors and specifically the role of outside independent directors as a means for addressing the agency problem by acting as monitors of executive management (Gilson and Kraakman, 1991). Institutional investors have sought direct influence on the board of directors including the leadership, selection, structure, composition, compensation and operation of the board (Turnbull, 2000).

### **Institutional Monitoring Activities**

Institutional monitoring activities can be broadly divided into three types: voting, engagement and intervention.

#### Voting

Principle E.3 of the Combined Code states that institutional shareholders have a responsibility to make considered use of their votes. The right to vote, which is attached to voting shares, is a basic prerogative of share ownership. Depending on availability, voting can take place at the meeting, by proxy, postal vote and increasingly by electronic voting. Some institutional investors may have a policy of trying to vote on all issues, which may be raised at an investee's annual general meeting ("agm").

A number of representative bodies have indicated the importance attached to institutional investors exercising their right to vote in an informed manner and providing greater transparency and access to information and participation, electronically or otherwise. The OECD places specific emphasis on the role of institutional investors. The general approach taken by the Principles is that the decision to exercise voting rights in an informed manner is related to both the costs and benefits of voting, so in many instances it is the incentive to vote which needs to be improved, in part through policy initiatives. The Principles do not oblige institutional investors acting in a fiduciary capacity to vote their shares, but they do call on them to disclose their voting policies. When these policies include active use of ownership rights, the Principles also recommend that institutional investors disclose how they implement these policies, including the resources they set aside for this purpose.

As discussed earlier, US tax-approved pension funds are mandated to vote their share under the

Employee Retirement Income Security Act. This has attracted some controversy as it has been argued that it dilutes the value of the votes cast voluntarily and with thought by those investment managers, and by implication pension funds, who do see an economic value in stewardship. For example, shareholders who might not ordinarily vote may vote in favour of management, without due consideration, as a matter of compliance rather than considered and informed voting. Primary research undertaken for this thesis suggested that neither pension funds nor investment managers would support mandatory voting by Irish pension funds.

Institutional investors generally try and resolve any contentious issues with management prior to AGMs. However if this fails, institutional investors may abstain or vote against a resolution. In these instances, the company may be notified in advance.

A number of reasons are regularly cited for why pension funds should vote their shares. The NAPF summarises these reasons as follows: the fiduciary duty to vote; it provides signals to management of support or lack of support on major issues; it demonstrates that funds are exercising their shareholder responsibilities; it can help lower the cost of capital of companies which have a good governance regime; and it may forestall government attempts to make it compulsory. For example, Grundfest advocates that multiple monitors use "Just Vote No" campaigns directed against directors, as a whole and individually. While Grundfest acknowledges that these campaigns achieve only minority support, he argues that they are effective as public flags that something is wrong, and can be important first steps toward correcting perceived problems, usually by putting pressure on the board. Reasons cited for not voting include costs, misinterpreted signals by management as a no confidence vote on issues of lesser importance, lack of evidence that voting adds value, and accountability for voting agents.

The cumbersome and outdated nature of paper-based systems, lack of auditability or adequate confirmatory procedures, and communication problems between interested parties are just some of the issues and barriers to institutional voting identified by NAPF. The International Corporate Governance Network found that most institutional investors had great difficulties in exercising overseas proxies due to timing problems, insufficient information, language problems, blocking or depositing of shares, and voting procedures or methods. Lynn (2005) also notes that external managers may not vote shares due to the conclusion that the cost of voting the proxy outweighs any potential benefit to the client, that in the investment manager's judgement, the matter to be voted is neither material nor relevant to shareholders and the issuer of securities; or the value or amount of the securities to be voted is insignificant or undeterminable.

#### Engagement

"Engagement" can be defined as the range of

discussions and meetings that shareholders have with companies to raise issues including strategy, board structure, performance, quality of management and other corporate governance issues (Edkins and Bush, 2002; ABI, 1991, Stapledon, 1996). Where institutional investors are concerned about specific investments or strategies, they will often arrange formal or informal meetings to discuss these issues. Alternatively, institutional investors may choose to present their views on corporate governance directly to investee companies or publish them without consultation with companies. It is common for companies to meet with their largest or most influential institutional investors on a one-to-one or group basis during the course of a year; the frequency of these meetings may be increased where the situation requires high supervision and control Shidvasani and Zenner (2004). This information may be fed back to the board in the planning process particularly where there are collective commonalities.

The OECD (2003) has called on countries to lift unnecessary regulatory barriers to a continuing dialogue between investors and companies. At the same time, recognising that such close relations can degenerate into abuses, particularly in situations where there are inherent conflicts of interest, the OECD recommends that general disclosure of information to the market should remain the practice. Any additional information released by a company to institutional investors should be aimed at helping them understand the background to such published information.

In addition, institutional investors may participate in and support representative bodies to set and promote specific corporate government policies as well as monitor companies (Stapledon, 2006). These representative bodies actively publish guidelines, research, and reports on specific items but also lobby stakeholders to adhere to these guidelines. Institutional investors can also use public lobbying directly by either commenting on the circumstance of a particular company, which is rare, or publishing their intention to vote or abstain from voting on a particular issue. This may involve shareholder proposals, media campaigns or in extreme cases, litigation (Yaron, 2005).

### Intervention

The UK Institutional Shareholders' Committee ("ISC") recommends that institutional investors intervene where necessary. Although commonly referenced, "intervention" is rarely defined. For the purposes of this paper it is submitted that intervention is a specific activity or set of activities developed and implemented to change or improve a company's knowledge, attitudes, behaviour or awareness. Furthermore, it is submitted that intervention differs from engagement in intent and sensitivity. Intervention is typically more proactive in relation to change than engagement and involves amongst other things conducting very detailed research into a company and the reasons for its poor performance, putting proposals

for change to the management of the company, and often co-ordinating other shareholders (Edkins and Bush, 2001). Proposals may relate to board changes, financial goals of selling unfocused businesses and unprofitable assets, restricting capital expenditure, increasing payouts, and changing capital structure (Becht, Franks, Mayer and Rossi, 2008). Proposals may be later withdrawn subsequent to negotiation (Chidambaran and Woidtke, 1999). In some instances it may involve the sharing of price-sensitive data or more active involvement by the institutional investor in the company's affairs.

Intervention may also involve targeting a broader range of underperforming companies for placement on a published focus list. Target companies are typically identified through establishing a focus list of companies that underperform a main index or may have a poor comparative corporate governance rating. This is often followed by enquiries and suggestions by the investor. Where enquiries are not responded to or suggestions not taken into account, the institutional investors may escalate their response and seek to change directors or exit the firm. As such, intervention may be collaborative, confrontational or a mixture of the two (Becht, Franks, Mayer and Rossi, 2008).

As intervention can be very costly, the OECD (2003) recommends that the authorities allow or even encourage institutions (and other shareholders) to co-operate and co-ordinate their actions provided that such co-operation is not aimed at manipulating the market or obtaining control of the company without going through accepted takeover procedures. Furthermore, where intervention involves the administrators of a pension fund nominating a trustee, employee, adviser or other candidate to the board of a company, the pension fund and the nominee may be exposed to additional liabilities and restrictions under common law or company, takeover or market abuse regulation should the trustee be held to be *de facto* or shadow director.

### **The Optimal Institutional Monitor**

Coffee (1991) has suggested that the optimal monitor meet at least three criteria: (1) the institution should be reasonably free from conflicts of interest so that its evaluation of corporate management will not be biased by the opportunity to earn fees or income not equally available to shareholders; (2) its stake should be large enough to justify the expenditure of significant monitoring costs; and (3) its preferred investment horizon should be sufficiently long so that it has an interest in improved corporate governance, even when no immediate value-maximising transaction is in the offing. Based on these three criteria, Coffee has suggested that the pension fund is relatively superior as a monitor than other institutional investors. Despite Coffee's relative optimism, empirical evidence to support the proposition that activism by public pension funds leads to performance improvements is limited (English, Smythe and McNeil (2004); Del Guercio and

Hawkins (1999)) although there is evidence to link shareholder activism with improvements in corporate governance structures in target firms (Karpoff, 2001).

### The Irish Pension Funds Industry

Irish pension funds are relatively free from conflicts of interest. They have no other opportunities to earn fees or income from the investee company. They cannot make takeover bids. They do not face shareholder redemptions nor are they engaged in active competition for investors' funds. Furthermore, the institutional form is conducive to Irish occupational pension funds acting as monitors. Legally, trustees must not subordinate the interests of the members and beneficiaries of their pension funds to unrelated objectives or put themselves in a position where their own interest and their duty as trustees conflict. As the trustees of Irish pension funds are often the senior executives of the sponsor company and the Irish market is relatively small, the assumption of freedom from conflicts of interest may not apply to the same degree as the US where the pension fund has a better opportunity to avoid such conflicts. Even in the US, where public pension funds are mandated to exercise their voting rights, pension funds have been known to have experienced this tension (Kolman, 1985). Unlike the US, voting is not mandatory and there is no requirement for Irish occupational pension funds to exercise their rights as shareholders.

As a whole, Irish pension funds have a very significant monetary stake in Irish companies and capital markets and should therefore care about the performance of those companies in which they have invested. For the year ending 31 December 2007, pension fund assets under management amounted to €86.6bn compared with €87.73bn at 31 December 2006; equities accounted for 66.3% of assets under management with Irish equity content of 8.2% (€7.1bn) (IAPF, 2008). Based on these statistics, Irish pension funds owned c. 7.6% of the total Irish equity market at the end of 2007 (IAPF, 2008). However, although Irish pension funds have a significant stake as a whole in Irish equities, there is no evidence that discrete individual pension funds have significant shareholdings in Irish companies. In fact, a basic survey of the Annual Reports of 59 Irish public limited companies undertaken for this study provided no evidence that Irish occupational pension funds directly held significant shareholdings or large blockholdings in those companies.<sup>1</sup>

Irish occupational pension funds are the dominant form of long-term savings in Ireland. Pension fund stock turnover rates are typically lower than other institutions and so have a relatively longer investment horizon. The majority of Irish pension funds invest in long-term illiquid stocks including property, forestry, fixed interest, international equities, and fixed interest and index-linked stocks (IAIM, 2007; IAPF, 2008).

This evidence suggests that Irish occupational

pension funds display the characteristics of suitable monitors. Although the area of institutional monitoring is widely debated internationally, there is little existing Irish data on pension fund and investment manager monitoring activity and their perceptions to key corporate governance themes.

### Research Methodology

In this paper, we examine the prevalence of institutional monitoring strategies by pension funds and external fund managers in relation to the companies in which they have invested. Furthermore, we test whether there are significant differences in attitudes between the two groups across key themes relating to shareholder activism by occupational pension funds. Specifically, we examine whether attitudes to the board reform, information flow to shareholders, anti-takeover measures, corporate social responsibility, barriers to shareholder activism and mandatory voting by pension funds varies between the two groups in order to identify whether potential agency problems may exist in relation to delegation and representation.

The purpose of this study is to present preliminary evidence on (i) the prevalence of institutional monitoring strategies by occupational pension funds („pension funds“) and external fund managers in relation to the companies in which they have invested, and (ii) attitudes between the two groups across key themes relating to shareholder activism by occupational pension funds. Such evidence will permit the formulation of hypotheses on these issues for investigation in future research. To address the research questions, it was necessary to conduct questionnaire based research to collect data and ascertain the views of a sample of the two target groups.

The Irish pension funds industry was examined as data from such sources is reasonably accessible and as a result of European regulation, operates under a similar regime to other European countries and in particular the UK. Furthermore, the study argues that the findings have wider relevance because the Irish pension funds industry is not only relatively large in size in comparison to other European countries but also invests more heavily in equities than other European countries (with the exception of the UK) and therefore should have a greater interest in any risk-mitigating activities including monitoring (Mercer Investment Consulting, 2008).

Due to the size and geographical location of the intended sample, and following consultation with the Irish Association of Pension Funds as to how best obtain responses from those employed in the Irish pension funds industry for the research project, it was decided to use a questionnaire-based research methodology to ascertain directly the views of those to be surveyed and therefore appropriately address the research questions of the paper.

A questionnaire was designed consisting of 21

questions to elicit the respondent's views on their voting policies, engagement strategies with investee companies, their intervention strategies with investee companies and the institution's general attitudes to shareholder activism. The questionnaire was developed following extensive consultation with colleagues and staff at the authors, neighbouring and affiliated Universities as well as the Irish Association of Pension Funds and the Irish Association for Investment Managers. Discussions on the questionnaire focused on its content and whether it would adequately address the research questions of the paper. Prior relevant research was also examined to inform the content and focus of the questions contained in the questionnaire, and where appropriate, suggest potential questions for inclusion. The questionnaire was tested in advance of distribution to the sample population. This testing involved circulating the questionnaire to the Irish Association of Pension Funds and the Irish Association for Investment Managers and asking for comments or methods by which the questionnaire could be enhanced. The final questionnaire used in this investigation was approved by both the Irish Association of Pension Funds and the Irish Association for Investment Managers.

Questions included in the questionnaire were largely driven by prior research and by the key research questions this paper aims to address. 19 of the 21 questions included in the questionnaire were closed questions, while 2 were open questions which asked the respondents to provide details on their role within the institution and the type of institution they worked for. Nevertheless, in questions where it was appropriate to provide respondents with the means of providing information unique to their own institution not covered in the available responses to the questionnaire, an open ended „other“ option was offered. This appears in 4 of the 21 questions included in the questionnaire. One of the questions contained in the questionnaire asks respondents on whether they believed it was appropriate for pension funds to play a role in the corporate governance of investee companies. In instances where the respondents gave a „no“ answer, they were given the opportunity of explaining why they believed this to be the case. This study would argue that closed questions are more appropriate to facilitate the empirical analysis that will be presented later in the paper. While it could be claimed that open ended questions on the main themes addressed in this study may provide more insight into the various issues explored, offering respondents open ended questions may also lead to greater subjectivity in the responses or indeed may be misunderstood by the respondents when answering and thus may undermine the validity of the conclusions drawn from such findings.

With regard to their voting policies, the questionnaire addressed issues such as: identifying if the institution has a formal voting policy and to whom it is supplied; if compliance with the voting policy is monitored and how often such monitoring takes place; whether compliance is required by the institution from

its agents; whether the institution votes directly on issues raised at meetings, and if the institution publishes details on voting issues.

As regards engagement with investee companies, the questionnaire examines if the institutions meet, formally or informally, with the senior management of the investee companies, the frequency of such meetings and the issues addressed at meetings (e.g. strategy, performance, board structure, management quality or other issues).

To examine the respondent institution's intervention strategies, the questionnaire investigates if the institutions, individually or with other shareholders, target or otherwise use intervention strategies in relation to investee companies. Intervention strategies could include: conducting research on poor performance and submitting proposals for change to management, based on this research; targeting investee companies and disclosing the names of the companies with the reasons for targeting to the company and the general public; targeting investee companies and disclosing the names of the companies with the reason for targeting to the company only; co-ordinating activity with other shareholders; exit strategies, or other methods used by the respondent institution.

Finally, to provide insight into the institution's general attitudes to shareholder activism by pension funds, the questionnaire asks for the respondent's views on corporate governance in the Irish publicly listed companies and the role that pension funds can play in such governance. For this latter question, two key areas are examined. First, the perceived impact of pension funds to areas such as corporate board reform, improved information flow to shareholder, anti-takeover measures and corporate social responsibility. Secondly, the perceived importance of these same areas to pension funds. In each case, respondents may cite a „low“, „medium“ or „high“ impact/importance as their answer. In each of areas listed above, the study will investigate the extent to which the respondents perceive the impact of pension funds to be different from the perceived importance to pension funds. In addition, the questionnaire asks for the respondent's views on what they consider to be the major barriers to pension funds engaging on shareholder activism. Respondents are presented with a range of potential barriers, such as such as conflicts of interest, skill levels, market perception and liquidity problems, and are required to rate their responses again in terms of „low“, „medium“ or „high“. Finally, the questionnaire examines if the institutions would support mandatory voting by pension funds in public companies both in general terms and in an Irish context only.

The survey was restricted to members of the Irish Association of Pension Funds (excluding pension fund advisors) and the Irish Association of Investment Managers. The questionnaire was distributed in July 2005 to 313 Member Representatives listed in the 2005 Irish Association of Pension Funds Yearbook and the 13 Member Representatives listed on the Irish

Association of Investment Managers website. Personalised letters accompanied these questionnaires explaining the purpose of the survey and detailing instructions on how to respond. The total population was 316 as 10 of the Irish Association of Investment Managers members were also members of the Irish Association of Pension Funds.

A total of 55 responses (17.4% of the population) were received. However, 12 organisations who initially responded were unable to form part of the final sample used in the study. All 12 of these organisations were occupational pension funds, 3 of which indicated that they could not respond due to lack of resources or for policy reasons. Of the remaining 9, 4 indicated that the questionnaire was irrelevant to them and 5 indicated that it would be more appropriate for completion by an investment manager. Thus, the final sample consists of 43 usable responses (13.6% of the population) were received. Of the 43 responses, 33 respondents (77% of the useable sample) were pension funds or schemes and 10 respondents (23% of the useable sample) were investment managers. While the overall response rate to the questionnaire is low, this comes as no surprise given that notable non-response often occurs when using questionnaires to collect data from large, geographically dispersed populations (Edwards *et al.*, 2002). Given that the purpose of this investigation is to gather and present preliminary evidence on monitoring and corporate governance mechanisms in the Irish pension funds industry for hypothesis generation, it is argued that the final sample obtained is sufficient for this purpose and therefore no follow-up contact was made with the identified population. Table 1 presents a summary of the final sample used in the study.

## Analysis of Results

In this section, descriptive statistics of the response data obtained is first presented. This will then be followed by an assessment of whether there are any statistically significant differences between the two response groups with regard to their responses to the questionnaire. From an initial assessment of the data obtained from those who responded, it was identified that all variables were non-normally distributed. Consequently, non-parametric statistical analysis is appropriate in this regard.

## Respondent Role and Institution Type

The first two questions of the questionnaire asks the respondent to define their role within the institution and to state what type of institution they work for. Table 2 presents the analysis of the final sample for these two questions. As Table 2 shows, there is clearly considerable variation in the small sample surveyed in this study. This variation should provide interesting results in subsequent analysis.

## Voting

As mentioned above, voting is a fundamental right of share ownership and is specifically emphasised by the Combined Code (2003) and the OECD (2004) as important governance mechanisms. Table 3 presents an analysis of the responses provided in relation to the voting policies used by occupational pension funds and investment managers in Ireland. In particular, the survey sought to assess the prevalence of formal voting policies, the disclosure and monitoring of voting policies, and the actual voting at AGMs of investee companies.

As Table 3 shows, there is clearly notable disparity between the findings for both samples with 90.9% of occupational pensions fund sample reporting that they have no formal voting policy compared to all investment managers contacted reporting that they have a formal policy for voting in place. In fact, only one occupational pension fund had a formal voting policy. This one respondent:

- did not supply the voting policy to investee companies nor did it monitor investee compliance with the formal voting policy;
- supplied all agents with a copy of this voting policy and required compliance by agents with the voting policy;
- monitored agent compliance quarterly;
- did not vote directly on any issues raised at investee company AGMs; and
- did not publish details on its own specific use of votes.

As will be shown later in Table 6, 48.5% of pension fund responses regarding mandatory voting were not supportive of mandatory voting by pension funds in public companies even if limited to Irish plcs (51.5%).

**Table 1.** Details of Final Sample

Panel A: Summary of overall sample		
	No.	%
Non-responses	261	82.6
Unusable responses	12	3.8
Usable Responses	43	13.6
Total number of questionnaires issued	<u>316</u>	<u>100</u>
Panel B: Analysis of final sample by sub group		
<i>Occupational Pension Funds:</i>		
	No.	%
Non-responses	258	85.1
Unusable responses	12	4.0
Usable Responses	33	10.9
Total number of questionnaires issued	<u>303</u>	<u>100</u>
<i>Investment Managers:</i>		
	No.	%
Non-responses	3	23.1
Unusable responses	-	0
Usable Responses	10	76.9
Total number of questionnaires issued	<u>13</u>	<u>100</u>

All data was collected by questionnaire which was posted in July 2005. All potential respondents were identified from the Irish Association of Pension Funds 2005 Yearbook and the Irish Association for Investment Managers membership for 2005 as defined on their website at [www.iaim.ie](http://www.iaim.ie).

**Table 2.** Descriptive Statistics: Analysis of Sample by Respondent Role and Organisation Type

Panel A: Respondent Role		
	No.	%
<i>Occupational Pension Funds:</i>		
Pension fund trustee	8	24.2
Pension trust secretary	5	15.2
Director	5	15.2
Management	3	9.1
Analyst	2	6.1
Human Resources Manager	2	6.1
CEO	2	6.1
Pension fund accountant	1	3.0
Client manager	1	3.0
Chair of pension fund	1	3.0
Administration controller	1	3.0
Financial controller	1	3.0
Not disclosed	1	3.0
	<u>33</u>	<u>100</u>
<i>Investment Managers:</i>		
	No.	%
Senior corporate governance management	3	30.0
CEO	2	20.0
Head of equity strategy	1	10.0
Head of legal department	1	10.0
Portfolio implementation	1	10.0
N/A	2	20.0
	<u>10</u>	<u>100</u>
Panel B: Institution Type		
	No.	%
<i>Occupational Pension Funds:</i>		
Pension fund	21	63.7
Broker	2	6.1
Defined pension fund	2	6.1
Public sector body	2	6.1
Private hospital	1	3.0
Financial securer	1	3.0
Insurance company	1	3.0
Wholly owned subsidiary	1	3.0
Privately owned bank	1	3.0
Wholesale distribution company	1	3.0
	<u>33</u>	<u>100</u>
<i>Investment Managers:</i>		
	No.	%
Fund manager	3	30.0
Investment manager	3	30.0
Asset manager	1	10.0
Mutimanager	1	10.0
Corporate Governance manager	1	10.0
Insurance	1	10.0
	<u>10</u>	<u>100</u>

All Investment Managers surveyed had formal voting policies and 50% of the sample supplied their investee companies with this voting policy. However, only 40% of the investment managers contacted monitor compliance with voting policies. Nevertheless, this remains notably higher than that reported for the occupational pension funds sampled where very little evidence of voting policy or voting policy compliance monitoring was found to exist. One of the investment managers surveyed (10%) indicated that monitoring in fact took place more often than every 3 months. In addition, one investment manager (10%) supplied their voting policy to other agents and required compliance with this voting policy by the agents. Compliance was monitored monthly in this instance. The remainder did not supply their voting policy or indicated that it was not applicable. This is most likely because agents such as custodians or proxy voting services are expected to strictly act on their instructions.

One investment manager (10%) indicated that he/she voted on none of the issues raised at investee company AGMs. Of the remainder, five (50%) voted on all issues and four (40%) on selected issues. Three respondents published details on their own specific use of votes. One of the respondents clarified that these votes were published in the UK only and in aggregate form. It is argued that not making voting policies public detracts from the impact such policies might have on corporate governance. In particular, it seems somewhat illogical to judge a company against expectations of which they are unaware or to have a voting policy and not to vote at general meetings, in fact that is the case. As can be seen in Table 7, 60% of investment managers surveyed were not supportive of mandatory voting by pension funds in plcs even if limited to Irish plcs.

### **Engagement with Investee Companies**

Table 4 presents the survey results for the analysis of engagement activity of institutions with investee companies. Panel A presents those for the occupational pension funds. Engagement would seem to be the most evident monitoring activity by Pension Funds. 27.3% of respondents (9 pension funds) met with the senior executives of investee companies. Of these respondents:

- 12.1% (4 pension funds) held these meetings every three to six months with a further 15.1% (5 pension funds) holding meetings every 12 months or more.
- 24.2% (8 pension funds) categorised these meetings as formal;
- All pension funds who met with senior executives of the investee companies discussed performance and strategy at meetings, while 3 (9.1%) discussed board structure, 6 (18.2%) discussed management quality and 2 (6%) discussed other issues such as future corporate structure, investment strategy and specific stock selection.<sup>2</sup>

The level of engagement in the above findings is surprising given the low number of voting policies. However, no assessment of the quality of these engagements can be made. Equally the type of engagement is not cited. As the majority of those surveyed (8 out of 9 respondents) indicated that these meetings were formal in nature, it is likely that the strategic impact of the engagements is low. The engagement might have been a semi-anonymous conference call, presentation or other similar event. No indication is given that corporate governance regulation or compliance was discussed and in fact there is some evidence to suggest that respondents may have confused engagement with investee companies and investment managers.

Panel B of Table 4 presents the findings for investment managers. The results indicate that all investment managers surveyed meet with senior executives of investee companies. 4 investment managers (40%) held these meetings every 12 months and a further 2 (20%) every six months. The remainder indicated more periodic timeframes. Eight of the ten respondents (80%) categorised the meetings as formal; the remainder indicated informal. All respondents stated that the main topics of these meetings were strategy and performance. 70% (7 respondents) indicated that board structure was discussed and 50% (5 respondents) indicated that management quality and other topics such as remuneration policy and practice, succession planning and corporate social responsibility were discussed.

Again, while engagement levels were high, no assessment of the quality of these engagements can be made for the reasons given earlier. Only one respondent (10%) indicated that corporate governance regulation or compliance was discussed. It is submitted that institutional investors would have greater impact in informal meetings and that addressing specific corporate governance compliance issues in this way may result in greater compliance.



**Table 3: Descriptive Statistics: Analysis of Voting Policies used by Sample Institutions**

Panel A: Occupational Pension Funds (number of respondents = 33). Note that 'N/R' refers to 'Non-Response'.						
Question:	Yes %	No %	N/R %			
Does your institution have a formal voting policy?	3.0	90.9	6.1			
<i>If 'Yes' then:</i>						
Does your institution supply all investee companies with this formal voting policy?	0.0	9.1	90.9			
Does your institution systematically monitor investee compliance with the policy?	0.0	6.1	93.9			
Does your institution supply all agents with this voting policy?	0.0	3.0	97.0			
<i>If 'Yes' then:</i>						
Does your institution require compliance by agents with this voting policy?	0.0	3.0	97.0			
Does your institution monitor compliance with your formal voting policy?	0.0	3.0	97.0			
Does your institution publish details on its own specific use of votes?	0.0	3.0	97.0			
	3 mths %	6mths %	12 mths %	12+ mths %	Other %	N/R %
If your institution systematically monitors investee compliance with your formal voting policy, how regular does such monitoring occur?	0.0	0.0	0.0	0.0	0.0	100.0
If your institution monitors agent compliance with your formal voting policy, how regular does such monitoring occur?	3.0	0.0	0.0	0.0	0.0	97.0
	All Issues %		Selected Issues %	None at all %	N/R %	
Does your institution vote directly on issues raised at investee company AGMs?	0.0		0.0	0.0	100.0	
Panel B: Investment Managers (number of respondents = 10). Note that 'N/R' refers to 'Non-Response'.						
Question:	Yes %	No %	N/R %			
Does your institution have a formal voting policy?	100.0	0.0	0.0			
<i>If 'Yes' then:</i>						
Does your institution supply all investee companies with this formal voting policy?	50.0	50.0	0.0			
Does your institution systematically monitor investee compliance with the policy?	40.0	50.0	0.0			
Does your institution supply all agents with this voting policy?	10.0	0.0	90.0			
<i>If 'Yes' then:</i>						
Does your institution require compliance by agents with this voting policy?	0.0	0.0	100.0			
Does your institution monitor compliance with your formal voting policy?	10.0	0.0	90.0			
Does your institution publish details on its own specific use of votes?	30.0	60.0	10.0			
	3 mths %	6mths %	12 mths %	12+ mths %	Other %	N/R %
If your institution systematically monitors investee compliance with your formal voting policy, how regular does such monitoring occur?	10.0	0.0	30.0	0.0	0.0	60.0
If your institution monitors agent compliance with your formal voting policy, how regular does such monitoring occur?	0.0	0.0	0.0	0.0	10.0	90.0
	All Issues %		Selected Issues %	None at all %	N/R %	
Does your institution vote directly on issues raised at investee company AGMs?	50.0		40.0	10.0	0.0	

**Table 4: Descriptive Statistics: Analysis of Engagement Activity of Institutions with Investee Companies**

Panel A: Occupational Pension Funds (number of respondents = 33). Note that 'N/R' refers to 'Non-Response'.						
Question:	Yes %	No %	N/R %			
Does your institution meet with the senior executives of investee companies?	27.3	66.7	6.0			
Are strategy issues discussed at these meetings?	27.3	0.0	72.7			
Are performance issues discussed at these meetings?	27.3	0.0	72.7			
Are board structure issues discussed at these meetings?	9.1	18.2	72.7			
Are management quality issues discussed at these meetings?	18.2	9.1	72.7			
Are other issues discussed at these meetings?	6.0	21.3	72.7			
	3 mths %	6mths %	12 mths %	12+ mths %	Other %	N/R %
If your institution meets with senior executives, how regular are these meetings?	3.0	9.1	9.1	3.0	3.0	72.7
	Formal %		Informal %	N/R %		
Would your institution categorise these meetings as formal or informal?	24.2		3.0	72.7		
Panel B: Investment Managers (number of respondents = 10). Note that 'N/R' refers to 'Non-Response'.						
Question:	Yes %	No %	N/R %			
Does your institution meet with the senior executives of investee companies?	100.0	0.0	0.0			
Are strategy issues discussed at these meetings?	100.0	0.0	0.0			
Are performance issues discussed at these meetings?	100.0	0.0	0.0			
Are board structure issues discussed at these meetings?	70.0	30.0	0.0			
Are management quality issues discussed at these meetings?	50.0	50.0	0.0			
Are other issues discussed at these meetings?	50.0	10.0	40.0			
	3 mths %	6mths %	12 mths %	12+ mths %	Other %	N/R %
If your institution meets with senior executives, how regular are these meetings?	0.0	20.0	40.0	0.0	40.0	0.0
	Formal %		Informal %	N/R %		
Would your institution categorise these meetings as formal or informal?	80.0		20.0	0.0		

### **Intervention Strategies and Investee Companies**

Panel A of Table 5 presents the responses of those occupational pension funds surveyed regarding their intervention strategies. None of the Pension Funds surveyed made use of intervention strategies with investee companies. This is not surprising given the lack of evidence of significant individual shareholdings by Pensions Funds in Irish listed plcs. Intervention, as a strategy, relies heavily on the influence of the shareholder, primarily based on the size of their stake in the company being targeted. Furthermore, intervention is costly compared to other monitoring activities and therefore may not be cost-efficient where the shareholding is no significant.

Panel B of Table 5 presents the findings for the investment managers surveyed. 4 (40%) of investment managers indicated use of intervention strategies with investee companies. Half of those surveyed indicated that they used co-ordinating activity with other shareholders including discussing issues about the company (including problems and potential solutions) and discussing and exchanging views on a resolution to be voted on at a meeting. A lesser number (40%) held discussions or meetings about voting at a specific or proposed meeting of a company or disclosed individual voting intentions on a resolution (10%). No respondent indicated that they had recommended that another institution vote in a particular way. 2 respondents (20%) indicated that they conducted research on poor performance and submitted proposals for change to management based on that research. Further, 2 respondents (20%) indicated that they targeted investee companies but only disclosed the names of the companies with the reasons for targeting to the company.

From the evidence presented, it is submitted that more aggressive intervention strategies such as targeting, public or otherwise, are not widespread in Ireland. This may result from fear of market or public perception or simply it is perceived to be unnecessary given the size of the market. No assessment of the regularity of such interventions can be made and therefore it may be that these intervention strategies are used in very rare occasions.

### **General Attitudes to Shareholder Activism**

A key section of the questionnaire examines the respondent's general attitudes to shareholder activism by pension funds. Table 6 presents those findings pertaining to the occupational pension funds. Panel A presents general attitudes while Panel B presents specific views regarding the respondent's beliefs on the impact of pension funds in corporate governance and the importance to pension funds of corporate governance. Finally, Panel C of Table 6 summarises the respondent's views on barriers to shareholder activism.

In Table 6, despite the low level of monitoring activity found in the pension funds industry, the overwhelming majority of pension funds surveyed believed that there is a positive link between corporate governance and corporate performance (93.9%) and that it is appropriate for pension funds to play a role in the corporate governance of investee companies (69.7%). The majority of pension fund respondents (87.9%) perceived the quality of corporate governance compliance in Irish public companies as "medium". 3% perceived the quality of compliance as "high" and the remainder (9.1%) as "low", suggesting that while respondents are satisfied with the compliance levels, there are areas where compliance could be improved.

As regards Panels B and C of Table 6, while around 40% of the pension fund respondents surveyed regarded such questions as non-applicable, it may be useful to summarise such responses in terms of those that expressed a view on the link between pension funds and corporate governance and their perceived barriers to shareholder activism. To do so, those who returned a view of „Low“ in the questions cited in Panels B and C in Table 6 are assigned a value of 1; those whose responded with „Medium“ are assigned a value of 2, and those who responded with „High“ are assigned a value of 3. The total values for each question are then computed based on the values above returned from the respondents. This score provides an indication of the respondent's overall importance attached to each of the areas examined. Finally, to provide a simple heuristic of the importance of each area analysed, as determined by the sample responses, the total scores for all questions are ranked, with the highest score being ranked 1, the next highest score being ranked 2 and so on. The results from this analysis are presented in Table 7.

“Improving information flow”, together with “director independence” were rated by the pension funds surveyed as the area perceived as the issues most likely to impact upon pension funds, while “Improving information flow” was again found to be the issue most likely to be important to pension funds. This may reflect concerns by Pension Funds on the quality of information provided or the regularity of information provided.

**Table 5.** Descriptive Statistics: Analysis of Intervention Strategies used by Sample Institutions

Panel A: Occupational Pension Funds (number of respondents = 33). Note that „N/R” refers to „Non-Response”.			
<b>Question:</b>	Yes %	No %	N/R %
Does your institution use intervention strategies with investee companies?	0.0	93.9	0.0
<i>Which of the following intervention strategies has your institution used?</i>			
Conducting research on poor performance and submitting proposals for change to management based on this research	0.0	0.0	100.0
Targeting investee companies and disclosing the names of the companies with the reasons for targeting to the company and the general public	0.0	0.0	100.0
Targeting investee companies and disclosing only the names of the companies with reason for targeting to the company only	0.0	0.0	100.0
Co-ordinating activity with other shareholders	0.0	0.0	100.0
- Holding discussions or meetings about voting at a specific or proposed meeting of a company	0.0	0.0	100.0
- Discussing issues about the company, including problems and potential solutions	0.0	0.0	100.0
- Discussing and exchanging views on a resolution to be voted on at a meeting	0.0	0.0	100.0
- Disclosing individual voting intentions on a resolution	0.0	0.0	100.0
- Recommending that another institution votes in a particular way	0.0	0.0	100.0
Exit strategies	0.0	0.0	100.0
Other strategies	0.0	0.0	100.0
Panel B: Investment Managers (number of respondents = 10). Note that „N/R” refers to „Non-Response”.			
<b>Question:</b>	Yes %	No %	N/R %
Does your institution use intervention strategies with investee companies?	40.0	60.0	0.0
<i>Which of the following intervention strategies has your institution used?</i>			
Conducting research on poor performance and submitting proposals for change to management based on this research	20.0	0.0	80.0
Targeting investee companies and disclosing the names of the companies with the reasons for targeting to the company and the general public	0.0	20.0	80.0
Targeting investee companies and disclosing only the names of the companies with reason for targeting to the company only	20.0	10.0	70.0
Co-ordinating activity with other shareholders	50.0	0.0	50.0
- Holding discussions or meetings about voting at a specific or proposed meeting of a company	40.0	0.0	60.0
- Discussing issues about the company, including problems and potential solutions	50.0	0.0	50.0
- Discussing and exchanging views on a resolution to be voted on at a meeting	50.0	0.0	50.0
- Disclosing individual voting intentions on a resolution	10.0	30.0	60.0
- Recommending that another institution votes in a particular way	0.0	40.0	60.0
Exit strategies	30.0	10.0	60.0
Other strategies	10.0	0.0	90.0

**Table 6.** Descriptive Statistics: Pension Funds: Analysis of Attitudes to Shareholder Activism

Panel A: General Attitudes. Note that „N/R“ refers to „Non-Response“.

Number of respondents = 33

**Question:**

	Low %	Medium %	High%
How do you perceive the quality of corporate governance in Irish plcs?	3.0	87.9	9.1
	Yes %	No %	N/A %
Do you believe that there is a positive link between corporate governance and corporate performance?	93.9	6.1	0.0
Do you believe your institution would support mandatory voting by pension funds in public companies?	45.5	48.5	6.1
Do you believe your institution would support mandatory voting by pension funds in Irish public companies only?	39.4	51.5	9.1

Panel B: Pension Fund Impact &amp; The Importance of Pension Funds. Note that „N/R“ refers to „Non-Response“.

**Question:**

	Yes %	No %	N/R %
Do you believe that it is appropriate for pension funds to play a role in the corporate governance of investee companies?	69.7	24.2	6.1

*If 'Yes', then indicate your assessment of the impact of pension funds to:*

	Low %	Med %	High%	N/R %
- Board reform	9.1	27.3	24.2	39.4
o CEO-Chairman separation	21.2	21.2	27.3	30.3
o Director selection	9.1	48.5	12.1	30.3
o Director independence	6.1	30.3	33.3	30.3
o Personal accountability of directors	9.1	36.4	24.2	30.3
o Remuneration	18.2	33.3	15.2	33.3
- Improving information flow to shareholders	6.1	30.3	33.3	30.3
- Anti-takeover measures	21.2	30.3	18.2	30.3
- Corporate Social Responsibility	12.1	36.4	18.2	33.3
- Other	3.0	3.0	3.0	91.0

*If 'Yes', then indicate your assessment of the importance to pension funds of:*

	Low %	Med %	High%	N/A %
o Board reform	9.1	18.2	30.3	42.4
o CEO-Chairman separation	18.2	18.2	30.3	33.3
o Director selection	12.1	24.2	30.3	33.3
o Director independence	6.1	21.2	39.4	33.3
o Personal accountability of directors	6.1	30.3	30.3	33.3
o Remuneration	18.2	33.3	15.2	33.3
- Improving information flow to shareholders	9.1	12.1	45.5	33.3
- Anti-takeover measures	24.2	24.2	15.2	36.4
- Corporate Social Responsibility	9.1	36.4	18.2	36.4
- Other	3.0	3.0	6.1	93.9

Panel C: Barriers to Shareholder Activism. Note that „N/R“ refers to „Non-Response“.

**Question:**

	Low %	Med %	High%	N/R %
What do you consider to be the major barriers to pension funds acting as shareholder activists? Rate the following based on impact:				
- Liquidity	30.3	15.2	18.2	36.4
- Thin equity	18.2	33.3	24.2	24.2
- Benefit time horizon	27.3	27.3	9.1	36.4
- Competition	24.2	30.3	3.0	42.4
- Free riders	30.3	33.3	6.1	30.3
- Conflicts of interest	18.2	15.2	39.4	27.3
- Political retaliation	24.2	36.4	15.2	24.2
- Market perception	24.2	21.2	30.3	24.2
- Public perception	33.3	15.2	24.2	33.3
- Financial constraints	27.3	15.2	24.2	33.3
- Skill levels	3.0	24.2	45.5	27.3
- Management manipulation of agenda	15.2	45.5	15.2	24.2
- Voting process	21.2	42.4	6.1	30.3
- Insider dealing provisions	24.2	27.3	15.2	33.3
- Control aggregation provisions	24.2	24.2	9.1	42.4
- Other company law	21.2	24.2	6.1	48.5
- Other legal reasons	30.3	33.3	6.1	30.3
- Other	0.0	0.0	21.2	78.8

**Table 7.** Descriptive Statistics: Ranking of selected focus areas: Occupational Pension Funds Industry

Presented below is a summary of responses provided by respondents in the Irish occupational pension funds industry as regards the significance they place on the impact of pension funds on selected focus areas (the „Impact Ranking”), the importance of selected focus areas to pension funds (the „Importance Ranking”) as well as the importance they place on barriers to shareholder activism (the „Barrier Ranking”).

The below statistics are computed as follows: For each question pertaining to the Impact Ranking, the Importance Ranking and the Barrier Ranking, a response of „Low”, „Medium” and „High” is available. Responses are coded 1, 2 and 3 for Low, Medium and High, Respectively. The total score for each selected focus area is then calculated and the final scores ranked, with the highest score ranking „1”, the next highest score ranking „2”, and so on.

Panel A: The impact of pension funds to selected focus areas and the importance of selected focus areas to pension funds

	Total Score	Impact Ranking	Total Score	Importance Ranking
Board reform	45	7	45	6
CEO-Chairman separation	48	4	48	5
Director selection	47	5	50	4
Director independence	55	1	55	2
Personal accountability of directors	51	3	52	3
Remuneration	43	9	43	8
Improving information flow to shareholders	55	1	56	1
Anti-takeover measures	45	7	39	9
Corporate Social Responsibility	46	6	45	6
Other	6	10	5	10

Panel B: The Importance of Barriers to Shareholder Activism

	Total Score	Barrier Ranking
Skill levels	62	1
Conflicts of interest	55	2
Benefit time horizon	52	3
Market perception	52	3
Management manipulation of agenda	50	5
Public perception	48	6
Political retaliation	47	7
Financial constraints	43	8
Voting process	41	9
Insider dealing provisions	41	9
Liquidity	38	11
Thin equity	38	11
Competition	36	13
Control aggregation provisions	33	14
Free riders	31	15
Other company law	29	16
Other legal reasons	14	17
Other	0	18

The Pension Funds surveyed have clear concerns regarding “director independence” which is rated significantly higher than all other board reform focus areas measured both in terms of importance and impact. In addition, it is interesting to observe that those in surveyed in the occupational pension funds industry view personal accountability of directors” and “director selection” as key issues within board reform. “CEO-Chairman separation” and “Remuneration” were rated relatively lower, possibly reflecting relative importance, apathy, or that it is not an issue of concern in Ireland.

Panel B of Table 7 shows the relative ranking of perceived barriers to pension funds acting as shareholder activists. Owing to the sizeable number of

potential barriers suggested in the questionnaire, the rankings have been sorted in descending order. Until recently, trustees in Ireland were not required to undertake any training and it is likely that this is a major contributing factor to these results.<sup>2</sup> Unsurprisingly, “Skill levels” were perceived as by far the greatest barrier. Although no research is available on the matter, it is likely that the situation in relation to trustee expertise in Ireland is somewhat similar to that found by Myners (2001) in the UK in that many trustees are not especially expert in investment and do not receive substantial training to perform their role as trustee.

The high rating of “Conflicts of interest” should be examined in the context of the relatively high

ratings of perception measures (market perception”, “public perception” and “political retaliation”). Ireland is both a relatively small country and market for products and services. It is not unreasonable to believe that Pension Funds or their employer-sponsors would have or would like to have significant relationships with many Irish plcs. Furthermore, these findings may indicate a fear of reprisals for such action directly or indirectly.

“Benefit time horizons” was rated as joint third in terms of perceived barriers to shareholder activism. This may represent the Pension Funds’ apprehension of the risk-return ratio on shareholder activism but may also reflect a perceived impact on liquidity and the ability to exit. Furthermore, given the trends in the market towards passive management, it may merely reflect a division in the market in relation to asset composition.

Due to the size of the Irish market, a number of large individual stockholders exist in major Irish plcs. Their perceived influence over those companies receives widespread media attention in Ireland. This may explain the high rating of “managerial manipulation of agenda” as a perceived barrier.

“Financial constraints” was rated mid-table by Pension Funds. This may reflect the relatively low level of current monitoring activity, the small number of plcs listed on the Irish Stock Exchange or the low number of significant holdings by occupational pension funds. As the number of investments that could be monitored may be perceived as extremely low, the associated cost of monitoring may be perceived as insignificant.

The remaining factors were not considered by respondents as significant barriers to shareholder activism. A number of possible explanations may exist:

- liquidity and thin equity may not be considered barriers due to the structural and long term nature of most pension funds.
- most Irish occupational pension funds do not compete per se, their investment managers or agents do. This may account for the relatively low ranking of “competition”.
- the general lack of concern towards legal barriers may be attributable to a low

assessment of risk, skill levels or general ignorance of the law.

It should be noted that the voting process was not explicitly included as a potential barrier despite commentators such as Myners (2001) citing this as a potential barrier to shareholder activism and specifically voting.

Table 8 presents the summary statistics for the investment manager’s attitudes to shareholder activism. In line with Pension Fund responses, those from Investment Managers suggest a widely held perception that there is a positive link between corporate governance and corporate performance (90%) and that it is appropriate for pension funds to play a role in the corporate governance of investee companies (100%).

Similarly, all Investment Managers responding perceived the quality of corporate governance compliance in Irish public companies as “medium” reinforcing the proposition that there are areas where compliance could be improved.

Table 9 summarises investment manager ratings of the importance to pension funds and impact of pension funds on specific focus areas as well as the perceived importance of certain barriers to shareholder activism. Table 9 highlights that even in small samples such as that reported in this investigation, there are notable differences with regard to investment manager’s perceptions of the importance of “Anti-takeover measures”, “Improving information flow to shareholders” and “Remuneration” to pension funds, when compared against the rankings for the impact of pension funds to each of these particular areas. Panel B of Table also shows that investment managers regard that “Skill levels”, “Financial constraints” and “Public perception” to be the main barriers to shareholder activism.

Overall, these findings suggest that the priorities of Pension Fund Trustees and Investment Managers may be different and in some instances Investment Managers may not adequately reflect the concerns of the Pension Funds which they represent. Whether this reflects a significant agency problem or rather a natural difference due to institutional form requires further research however it may suggest the need for greater clearer instructions and a higher degree of agent monitoring by Pension Funds.

**Table 8.** Descriptive Statistics: Investment Managers: Analysis of Attitudes to Shareholder Activism

Panel A: General Attitudes. Note that „N/R“ refers to „Non-Response“.				
Number of respondents = 10				
<b>Question:</b>				
How do you perceive the quality of corporate governance in Irish plcs?	Low %	Medium %	High%	
	0.0	100.0	0.0	
	Yes %	No %	N/R %	
Do you believe that there is a positive link between corporate governance and corporate performance?	90.0	10.0	0.0	
Do you believe your institution would support mandatory voting by pension funds in public companies?	30.0	60.0	10.0	
Do you believe your institution would support mandatory voting by pension funds in Irish public companies only?	30.0	60.0	10.0	
Panel B: Pension Fund Impact & The Importance of Pension Funds. Note that „N/R“ refers to „Non-Response“.				
<b>Question:</b>				
Do you believe that it is appropriate for pension funds to play a role in the corporate governance of investee companies?	Yes %	No %	N/R %	
	100.0	0.0	0.0	
<i>If 'Yes', then indicate your assessment of the impact of pension funds to:</i>				
	Low %	Med %	High%	N/A %
- Board reform	0.0	30.0	40.0	30.0
o CEO-Chairman separation	0.0	50.0	40.0	10.0
o Director selection	20.0	30.0	40.0	10.0
o Director independence	10.0	30.0	50.0	10.0
o Personal accountability of directors	10.0	20.0	60.0	10.0
o Remuneration	0.0	50.0	30.0	20.0
- Improving information flow to shareholders	10.0	30.0	50.0	10.0
- Anti-takeover measures	0.0	30.0	60.0	10.0
- Corporate Social Responsibility	10.0	60.0	20.0	10.0
- Other	10.0	10.0	10.0	70.0
<i>If 'Yes', then indicate your assessment of the importance to pension funds of:</i>				
	Low %	Med %	High%	N/A %
o Board reform	10.0	30.0	40.0	20.0
o CEO-Chairman separation	10.0	20.0	60.0	10.0
o Director selection	20.0	20.0	50.0	10.0
o Director independence	10.0	10.0	70.0	10.0
o Personal accountability of directors	20.0	0.0	70.0	10.0
o Remuneration	10.0	40.0	30.0	20.0
- Improving information flow to shareholders	10.0	50.0	30.0	10.0
- Anti-takeover measures	10.0	30.0	50.0	10.0
- Corporate Social Responsibility	10.0	50.0	30.0	10.0
- Other	10.0	10.0	10.0	70.0
Panel C: Barriers to Shareholder Activism. Note that „N/R“ refers to „Non-Response“.				
<b>Question:</b>				
What do you consider to be the major barriers to pension funds acting as shareholder activists? Rate the following based on impact:	Low %	Med %	High%	N/R %
- Liquidity	40.0	10.0	10.0	40.0
- Thin equity	10.0	40.0	0.0	50.0
- Benefit time horizon	20.0	10.0	20.0	50.0
- Competition	40.0	10.0	0.0	50.0
- Free riders	30.0	10.0	0.0	60.0
- Conflicts of interest	10.0	40.0	0.0	50.0
- Political retaliation	20.0	10.0	10.0	60.0
- Market perception	20.0	0.0	20.0	60.0
- Public perception	20.0	0.0	30.0	50.0
- Financial constraints	10.0	0.0	40.0	50.0
- Skill levels	10.0	10.0	40.0	40.0
- Management manipulation of agenda	10.0	30.0	40.0	60.0
- Voting process	30.0	10.0	10.0	50.0
- Insider dealing provisions	40.0	10.0	50.0	50.0
- Control aggregation provisions	30.0	10.0	40.0	60.0
- Other company law	20.0	10.0	0.0	70.0
- Other legal reasons	20.0	10.0	30.0	70.0
- Other	0.0	0.0	10.0	90.0

**Table 9.** Descriptive Statistics: Ranking of selected focus areas: Investment Managers

Presented below is a summary of responses provided by investment managers as regards the significance they place on the impact of pension funds on selected focus areas (the „Impact Ranking”), the importance of selected focus areas to pension funds (the „Importance Ranking”) as well as the importance they place on barriers to shareholder activism (the „Barrier Ranking”).

The below statistics are computed as follows: For each question pertaining to the Impact Ranking, the Importance Ranking and the Barrier Ranking, a response of „Low”, „Medium” and „High” is available. Responses are coded 1, 2 and 3 for Low, Medium and High, Respectively. The total score for each selected focus area is then calculated and the final scores ranked, with the highest score ranking „1”, the next highest score ranking „2”, and so on.

Panel A: The impact of pension funds to selected focus areas and the importance of selected focus areas to pension funds

	Total Score	Impact Ranking	Total Score	Importance Ranking
Board reform	18	9	19	8
CEO-Chairman separation	22	3	23	2
Director selection	20	6	21	5
Director independence	22	3	24	1
Personal accountability of directors	23	2	23	2
Remuneration	19	7	18	9
Improving information flow to shareholders	22	3	20	6
Anti-takeover measures	24	1	22	4
Corporate Social Responsibility	19	7	20	6
Other	6	10	6	10

Panel B: The Importance of Barriers to Shareholder Activism

	Total Score	Barrier Ranking
Skill levels	15	1
Financial constraints	13	2
Public perception	11	3
Benefit time horizon	10	4
Conflicts of interest	9	5
Liquidity	9	5
Thin equity	9	5
Voting process	8	8
Market perception	8	8
Management manipulation of agenda	7	10
Political retaliation	7	10
Insider dealing provisions	6	12
Competition	6	12
Control aggregation provisions	5	14
Free riders	5	14
Other company law	4	16
Other legal reasons	4	16
Other	0	18

**Table 10.** General Attitudes Towards Shareholder Activism: Comparison of Rankings

Presented below is a comparison of the rankings for the „Impact Ranking”, „Importance Ranking” and the „Barrier Ranking”, as defined in Tables 7 and 9. All total scores pertaining to each rank and an explanation of how they calculated can be found in Tables 7 and 9.

Panel A: Comparison of Impact Ranking

	Impact Ranking Pension Funds	Impact Ranking Investment Managers
Board reform	7	9
CEO-Chairman separation	4	3
Director selection	5	6
Director independence	1	3
Personal accountability of directors	3	2
Remuneration	9	7
Improving information flow to shareholders	1	3
Anti-takeover measures	7	1
Corporate Social Responsibility	6	7
Other	10	10



Panel B: Comparison of Importance Ranking

	Importance Ranking Pension Funds	Importance Ranking Investment Managers
Board reform	6	8
CEO-Chairman separation	5	2
Director selection	4	5
Director independence	2	1
Personal accountability of directors	3	2
Remuneration	8	9
Improving information flow to shareholders	1	6
Anti-takeover measures	9	4
Corporate Social Responsibility	6	6
Other	10	10

Panel C: Comparison of Barrier Ranking

	Barrier Ranking Pension Funds	Barrier Ranking Investment Managers
Skill levels	1	1
Conflicts of interest	2	5
Benefit time horizon	3	4
Market perception	3	8
Management manipulation of agenda	5	10
Public perception	6	3
Political retaliation	7	10
Financial constraints	8	2
Voting process	9	8
Insider dealing provisions	9	12
Liquidity	11	5
Thin equity	11	5
Competition	13	12
Control aggregation provisions	14	14
Free riders	15	14
Other company law	16	16
Other legal reasons	17	16
Other	18	18

As Panel C of Table 10 shows, there are also similarities in the barrier rankings attached to the various barriers to shareholder activism between the two groups surveyed. There is general agreement on skill levels as the most significant barrier. Again, this is not surprising for reasons mentioned earlier but also given that expertise and knowledge is one of the central justifications for delegation to investment managers. The high barrier ranking of “Financial constraints” according to pension funds is consistent with this proposition in that the use of investment management services is justified on cost-efficiency grounds. In addition, the responses also clearly indicate differences in relation to perception ratings between the two different respondent types. This is particularly the case for variables such as “Market perception” and “Management manipulation of agenda”, which are ranked much higher in the pension funds surveyed, when compared to the investment managers surveyed. The lower ranking of “Management manipulation of agenda” by Investment Managers may be attributed to the greater influence of investment managers or by greater emphasis on passive management. In contrast, “Financial constraints”, “Liquidity” and “Thin Equity” are ranked much higher by investment managers relative to pension funds. This may be explained by a higher degree of knowledge and sophistication of Investment Managers.

Given that the study is presenting the views of two different groups on the same issues, it will also be of interest to determine whether there are any statistically significant differences between the two groups with regard to their responses yielded in their questionnaire responses. Using basic statistical analysis, it was identified that the data extracted from the respondents was non-normally distributed. Consequently, non-parametric statistical analysis is employed to examine for statistically significant differences between the two groups for which data has been collected. To examine for differences between the continuous and ordinal variables collected between the two groups, a Mann-Whitney U Test is conducted. To test for statistically significant differences between the discrete variables collected between the two industries, a Chi-Square Test is conducted.

Table 11 presents the results from the application of the Mann-Whitney U test to the sample data. It shows that the only statistically significant differences between the two groups is with respect to their general attitudes towards shareholder activism. More specifically, findings show that there is a statistically significant difference in perception between investment managers and pension funds in relation to the impact of pension funds on anti-takeover measures

and the importance of these measures to pension funds. In relation to this item, investment managers perceive the impact to and importance of pension funds to be significantly higher than pension funds themselves. Ireland is not noted for the presence of takeover defence structures in listed plcs, mainly due to the heavy regulation of takeovers. This may explain the difference in attitudes between the two groups.

Furthermore, there were statistically significant differences between the two groups in relation to insider dealing as a barrier to shareholder activism. Pension Funds perceive insider dealing to be a greater barrier to activism than investment managers. This may relate to lack of skill levels and/or fear of a complex but high profile offence with significant penalties. At the time of the survey, a high profile insider dealing case was being heard in the Irish courts and this may have had an impact on responses. Investment Managers are more likely to be more aware of the degree to which pension funds are insulated from insider dealing and the rarity of insider dealing offences.

Table 12 presents the results from the application of the Chi-Square test to the sample data. This test cannot be performed if there is no data from one of the samples under comparison. Given that there was notable non-response from those surveyed from the Irish occupational pension funds industry, a considerable number of Chi-Square tests cannot be performed. These are presented as „N/A“ in Table 12. Table 12 reports that there are number of statistically significant differences between the sample groups surveyed. Since all investment managers surveyed have a formal voting policy in place and meet with the senior executives of their investee companies, this has given rise to a statistically significant difference between the two sample groups with respect to these variables. Table 12 also reports a statistically significant difference in the variable “Are other issues discussed at these meetings with senior executives of investee companies?”. From those surveyed in the pension funds industry, issues such as specific stock selection and future investment strategy are discussed in such meetings, while investment managers meeting with senior executives of investee companies discuss other issues such as remuneration policies, succession planning, corporate social responsibility, corporate governance regulation, capital structure, dividend policy and return on capital to shareholders. Finally, Table 12 also reports that a greater proportion of investment managers, compared to those surveyed in the pension funds industry, believe that it is appropriate for pension funds to play a role in the corporate governance of investee companies.

**Table 11.** Analysis of Significant Differences in Responses Between Sample Groups: Continuous Variables

This table presents the summary statistics of an examination for evidence of statistically significant differences between the two sample groups surveyed. To test for statistically significant differences in the continuous variables between the two groups, a Mann-Whitney U Test is employed. The Mann-Whitney Z statistic is presented for each variable together with its probability value (p-value), indicating the statistical significance of the difference in the responses between the two groups.

Note that in cases where there are no responses from sample groups, the Mann Whitney U test cannot be performed. In such cases, „N/A” will entered below.

Topic and Related Questions	Z	p-value
<b>Voting Policies</b>		
If your institution systematically monitors investee compliance with your formal voting policy, how regular does such monitoring occur?	-1.000	0.317
If your institution monitors agent compliance with your formal voting policy, how regular does such monitoring occur?	N/A	N/A
Does your institution vote directly on issues raised at investee company AGMs?	N/A	N/A
<b>Engagement Activity with Institutions of Investee Companies</b>		
If your institution meets with senior executives, how regular are these meetings?	-1.365	0.172
<b>General Attitudes to Shareholder Activism</b>		
How do you perceive the quality of corporate governance in Irish plcs?	-0.571	0.568
<i>The impact of pension funds to:</i>		
Board reform	-1.006	0.315
CEO-Chairman separation	-1.033	0.302
Director selection	-0.787	0.431
Director independence	-0.280	0.780
Personal accountability of directors	-1.379	0.168
Remuneration	-1.448	0.148
Improving information flow to shareholders	-0.280	0.780
Anti-takeover measures	-2.358	0.018**
Corporate Social Responsibility	-0.049	0.961
Other	0.000	1.000
<i>The importance of pension funds to:</i>		
Board reform	0.029	0.977
CEO-Chairman separation	-1.143	0.253
Director selection	-0.284	0.777
Director independence	-0.824	0.410
Personal accountability of directors	-1.070	0.284
Remuneration	-0.995	0.320
Improving information flow to shareholders	-1.430	0.153
Anti-takeover measures	-1.825	0.068*
Corporate Social Responsibility	-0.306	0.760
Other	-0.609	0.543
<i>Perceived barriers to shareholder activism:</i>		
Liquidity	-0.685	0.493
Thin Equity	-0.174	0.862
Benefit time horizon	-0.178	0.859
Competition	-1.511	0.131
Free riders	-1.192	0.233
Conflict of interest	-1.426	0.154
Political retaliation	-0.375	0.708
Market perception	-0.135	0.892
Public perception	-0.603	0.546
Financial constraints	-1.450	0.147
Skills level	-0.031	0.976
Management manipulation of agenda	-0.731	0.465
Voting process	-0.737	0.461
Insider dealing provisions	-1.788	0.074*
Control aggregation provisions	-1.246	0.213
Other company law	-0.877	0.380
Other legal reasons	-0.200	0.841
Other	-0.125	0.484

\*\*\* Statistically significant at the 1% level

\*\* Statistically significant at the 5% level

\* Statistically significant at the 10% level

**Table 12.** Analysis of Significant Differences in Responses Between Sample Groups: Discrete Variables

This table presents the summary statistics of an examination for evidence of statistically significant differences between the two sample groups surveyed. To test for statistically significant differences in the dichotomous variables between the two groups (where, in most cases, an answer of „Yes“ from the respondent equals 1, and „No“ equals 0), a Chi-Square Test is employed. The Chi-Square statistic ( $\chi^2$ ) is presented for each variable together with its probability value (p-value), indicating the statistical significance of the difference in the responses between the two groups.

Note that in cases where there are no responses from sample groups, the Chi-Square test cannot be performed. In such cases, „N/A“ will entered below.

Topic and Related Questions	$\chi^2$	p-value
<b>Voting Policies</b>		
Does your institution have a formal voting policy?	36.10	0.000***
Does your institution supply all investee companies with this formal voting policy?	N/A	N/A
Does your institution systematically monitor investee compliance with the policy?	N/A	N/A
Does your institution supply all agents with this voting policy?	N/A	N/A
Does your institution require compliance by agents with this voting policy?	N/A	N/A
Does your institution monitor compliance with your formal voting policy?	N/A	N/A
Does your institution publish details on its own specific use of votes?	N/A	N/A
<b>Engagement Activity with Institutions of Investee Companies</b>		
Does your institution meet with the senior executives of investee companies?	15.30	0.000***
Would your institution categorise these meetings as formal (1) or informal (0)?	0.28	0.596
Are strategy issues discussed at these meetings?	N/A	N/A
Are performance issues discussed at these meetings?	N/A	N/A
Are board structure issues discussed at these meetings?	2.55	0.110
Are management quality issues discussed at these meetings?	0.54	0.463
Are other issues discussed at these meetings?	5.40	0.020**
<b>Intervention Strategies</b>		
Does your institution use intervention strategies with investee companies?	N/A	N/A
Do you conduct research on poor performance and submitting proposals for change to management based on this research?	N/A	N/A
Do you target investee companies and disclose the names of the companies with the reasons for targeting to the company and the general public?	N/A	N/A
Do you target investee companies and disclose only the names of the companies with reason for targeting to the company only?	N/A	N/A
Do you Co-ordinate activity with other shareholders?	N/A	N/A
Do you hold discussions or meetings about voting at a specific or proposed meeting of a company?	N/A	N/A
Do you discuss issues about the company, including problems and potential solutions?	N/A	N/A
Do you discuss and exchange views on a resolution to be voted on at a meeting?	N/A	N/A
Do you disclose individual voting intentions on a resolution?	N/A	N/A
Do you recommend that another institution votes in a particular way?	N/A	N/A
Do you have exit strategies?	N/A	N/A
Do you have other strategies?	N/A	N/A
Do you believe your institution would support mandatory voting by pension funds in public companies?		
<b>General Attitudes to Shareholder Activism</b>		
Do you believe that there is a positive link between corporate governance and corporate performance?	0.18	0.668
Do you believe that it is appropriate for pension funds to play a role in the corporate governance of investee companies?	3.21	0.073*
Do you believe your institution would support mandatory voting by pension funds in public companies?	0.64	0.424
Do you believe your institution would support mandatory voting by pension funds in Irish public companies only?	0.29	0.593

\*\*\* Statistically significant at the 1% level

\*\* Statistically significant at the 5% level

\* Statistically significant at the 10% level

## Conclusions

The research questions of this study were twofold; the first asks if Irish occupational pension funds and external fund managers employ institutional monitoring strategies in relation to investee companies. The preliminary evidence presented in this article suggests that Irish occupational pension funds display the characteristics of suitable monitors but are not optimal candidates for the role. On the one hand, their

institutional form, their aggregate size, general portfolio composition and investment strategies would suggest that they are suitable candidates for monitors. Furthermore, the findings suggest that they and their agents, the investment managers, believe that they have a role to play in the corporate governance of the companies in which they invest. They share common concerns over specific corporate governance issues and perceive that they can have an impact on resolving these issues. On the other hand, few, if any, Irish

occupational pension funds have significant shareholdings in Irish listed plcs. Despite the guidance by the Combined Code and the OECD, current monitoring activity by Irish occupational pension funds is at a very low level and what little exists seems limited to formal periodic meetings with executive management of investee companies. Furthermore, there is evidence to suggest that they may not have the experience or expertise to be active monitors. On the other hand, Investment Managers, would seem to undertake a significant level of monitoring activity.

The second research question of this study sought to address whether there are significant differences in attitudes between Irish occupational pension funds and external fund managers across key themes relating to shareholder activism by occupational pension funds? This includes perceived barriers to shareholder activism and focus of activity. The corporate governance literature and specifically literature relating to monitoring by institutional investors cite a variety of factors, discussed previously, that may deter occupational pension funds from acting as monitors of the companies in which they invest. Whereas the literature reviewed would suggest that these factors have universal application, the findings of this study suggest that these factors have selected applicability in the Irish context. The results suggest that trustee skill levels, market and political perception, and financial or resource constraints are ranked higher than other issues in the Irish context. Primary research did not establish legal factors as relatively significant disincentives to shareholder activism by Irish occupational pension funds. This may be attributed to low skill and knowledge levels, which is consistent with the findings of the survey. It is submitted that lack of knowledge relating to monitoring in general and the associated laws and regulations lead to an underestimation of the impact that such legal factors might have on monitoring activity.

In the authors' opinion, the deference to intermediaries is one of the most significant disincentives to Irish occupational pension funds. While the sample studied was small, the findings suggest that a fruitful avenue of research may be the agency relationship between Pension Funds and Investment Managers and the role of structural factors and their impact on institutional activism internationally. Our findings suggest that delegation and deference to intermediaries plays a role in the level of monitoring and active investing by pension funds. Firstly, it is submitted that the low level of monitoring activities by pension funds is explainable through a rational apathy, introduced by delegation, by the Irish occupational pension fund relating to the investment; as one respondent stated – "Why pay for a dog and bark yourself?". Secondly, this study identified some significant differences in the priorities of Irish occupational pension funds and Irish investment managers which suggest investment managers may not be representing the issues of Irish occupational pension funds fully. The impact and importance of these

differences needs to be explored in greater depth. Finally, delegation, even where investment manager voting policies are adopted, may result in disenfranchisement for a variety of reasons including stock lending, share blocking, conflicts of interest and cost.

Although the findings of this study suggest that Irish occupational pension funds are not optimal candidates for monitoring, there is evidence that trustees of occupational pension funds in Ireland need, and indeed may want, to take more responsibility for the role that they have undertaken as trustees. Given the large percentage of the population affected by pension fund governance, it would seem a matter of public policy to address these shortcomings in the current pension fund governance system and the relationship between pension funds and their agents, and specifically investment managers. The striking differences between the activities and perceptions of pension funds and investment managers suggests a need for greater regulatory focus on the delegation of management responsibility and specifically the accountability for rights attached to shares that is not currently addressed adequately by regulation.

It is submitted that whilst it is clear that occupational pension funds have a role to play in the corporate governance compliance of investee companies, that role should, at the very least, extend to fulfilling their existing duties and responsibilities – watching the watchmen.

## References

1. ABI (1991) *The Responsibilities of Institutional Shareholders (A Discussion Paper)*. London: ABI. 1991).
2. Admati, A.R., Pfleiderer, P., and Zechner, J. (1994) Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium" *Journal of Political Economy*, 102, 1097-1130.
3. Agrawal, A and Knoeber, CR (1996) Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders *Journal of Financial and Quantitative Analysis*, vol. 31, No. 3, 377-97.
4. Bauer, R. and Guenster, N. (2003) Good Corporate Governance Pays Off! ESB.
5. Becht, M. and Franks, J. (2006) Shareholder Activism in the UK", presentation at the "Shareholder Activism in the United Kingdom. Paper presented at the Shareholder Activism in the United Kingdom Conference at the London Business School Centre for Corporate Governance, London, February 9th, 2006.
6. Bhagat, S. and Black, B. (1999) The Uncertain Relationship Between Board Composition and Firm Performance, *Business Lawyer*, 54, 921-963.
7. Brickley, J.A., Lease, R.C. and Smith, C.W. (1994) Corporate Voting: Evidence from Charter Amendment Proposals, *Journal of Corporate Finance* 1, 5-31.
8. Charkham, J., (1995) *Keeping Good Company: A Study of Corporate Governance in Five Countries*. Oxford: Oxford University Press.
9. Coffee, J.C., (1991) Liquidity versus Control: The Institutional Investor as Corporate Monitor, *Columbia Law Review*, vol.91, No. 6, 1278-367.

10. The Combined Code (1999). Committee on Corporate Governance: The Combined Code, Gee Publishing, London.
11. Diamond, D.W. (1984) Financial Intermediation and Delegated Monitoring, *Review of Economic Studies* 51, 393-414.
12. Drobetz, W., Schillhofer, A. and Zimmermann, H. (2004) Corporate Governance and Firm Performance: Evidence from Germany, Working Paper, 31-32, University of Basel, Switzerland.
13. Dulewicz, V. and Herbert, P. (2004) Does the Composition and Practice of UK Boards Bear Any Relationship to the Performance of Listed Companies? *Corporate Governance, An International Review*, 12, 263-280.
14. Edkins, M. and Bush, T. (2002) Encouraging Shareholder Activism: A Consultation Paper. London: Hermes Pensions Management.
15. Edwards, P., Roberts, I., Clarke, M., DiGuseppi, C., Pratap, S., Wentz, R. and Kwan, I. (2002) Increasing Response Rates to Postal Questionnaires: Systematic review, *British Medical Journal*, vol. 324, 1183-1192
16. European Federation of Retirement Provision (2006) *Basic Statistics – 2005. Retrieved 18 August 2008 from* <http://www.efrp.org/downloads/basicStatistics/2004%20-2005%20data%20-%202006-11-29.pdf>.
17. Financial Reporting Council, (2003) The Combined Code on Corporate Governance. London: CCH Information.
18. Gilson, R.J. and Kraakman, R. (1991) Reinventing the Outside Director: An Agenda for Institutional Investors, *Stanford Law Review*, 43, 863 – 906.
19. Gompers, P., Ishii, J.L. and Metrick, A. (2003) Corporate Governance and Equity Prices *Quarterly Journal of Economics* 118, 107-155.
20. Gordon, L. and Pound, J. (1991) Governance Matters: An Empirical Study of the Relationship Between Corporate Governance and Corporate Performance Cambridge, MA: Harvard University.
21. Hawley, J.P. and Williams, A.T., (1996) *Corporate Governance in the United States: The Rise of Fiduciary Capitalism*, St. Mary's College of California Background Paper Prepared for the OECD, 31 January 1996, Part I.
22. Irish Association of Investment Managers (2008). *Assets Under Management 2006-2007*. Dublin: Irish Association of Investment Managers.
23. Irish Association of Pension Funds (2008) *Asset Allocation Survey 2007*. Dublin: Irish Association of Pension Funds.
24. Kahn, C. and Winton, A. (1998) Ownership Structure, Speculation and Shareholder Intervention *Journal of Finance* 53, 99-129
25. Kolman, J. (1985) The Proxy Pressure on Pension Managers, *Institutional Investor*, 145-47.
26. Lasfer, M.A. (1996) Taxes and Dividends: The UK Evidence, *Journal of Banking and Finance* 20, 455-472.
27. McKinsey & Co. (2002) *Global Investor Opinion Survey: Key Findings*. London: McKinsey & Co.
28. Maug, E. (1998) Large Shareholders as Monitors: Is There a Trade-Off between Liquidity and Control? *Journal of Finance*, vol. 53, No. 1, 65-98.
29. Mercer (2008), *Asset Allocation Survey and Market Profiles*. London: Mercer.
30. Myners, P. (2001) *Institutional Investment in the United Kingdom: A Review*. London: HM Treasury.
31. Myners, P. (2004) *Review of the Impediments to Voting UK Shares*, Report to the Shareholder Voting Working Group.
32. Organisation for Economic Cooperation and Development (2004) *The OECD Principles of Corporate Governance 2004*. Paris: OECD.
33. Pound, J. (1993) *The Rise of the Political Model of Corporate Governance and Corporate Control*, *New York University Law Review*, vol. 63, no. 5, 1003-71.
34. US Department of Labor, *Interpretative Bulletin Relating to Statements of Investment Policy, Including Proxy Voting Policy or Guidelines*, Code of Federal Regulations, Title 29 Chapter XXV, 2509, 94-2(3), 1994.
35. Yaron, G. (2005) *Acting Like Owners: Proxy Voting, Corporate Engagement And The Fiduciary Responsibilities Of Pension Trustees*, 28 June 2005, <<http://www.share.ca/files/pdfs/Acting%20Like%20Owners.pdf>> accessed 20 September 2005.

## Endnotes

1. This review was based on significant shareholder disclosures in annual reports. It is possible that stocks are held indirectly through pooled funds or agents.
2. The inclusion of stock selection by the respondent may indicate that the respondent confused engagement with investee companies and engagement with their fund manager and lends credence to concerns regarding trustee expertise and knowledge.
3. Section 34 of the Social Welfare and Pensions Act 2005 introduced qualification requirements with respect to trustees of pension schemes, which are detailed in Regulation 4(1) of the Occupational Pension Schemes (Trustee) Regulations, 2005, SI No. 595 of 2005. Trustees must possess, or employ or enter into arrangements with advisers who possess the qualifications and experience relevant to the investment of the scheme resources. Despite this it is submitted that skill levels is likely to be a continuing issue as only one trustee of a scheme need possess the necessary experience to satisfy the requirements of the regulations.

