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SEVEN MYTHS OF CORPORATE GOVERNANCE

INTRODUCTION

Corporate governance has become a popular topic of discussion among the business community, the media, regulators, legislators, and the general public. This has particularly been the case since the scandals of 2001-2002 (Enron, WorldCom, Tyco, etc.) and the financial crisis of 2008-2009 (Bear Stearns, Lehman, AIG, etc.) exposed self-interested and in some cases fraudulent behavior that precipitated the collapse of prominent U.S. corporations. Subsequently, much of the discussion has focused on how to improve governance systems broadly. In the process, certain myths have developed that continue to be accepted, despite a lack of robust supporting evidence.

MYTH #1: THE STRUCTURE OF THE BOARD = THE QUALITY OF THE BOARD

The most commonly accepted myth in corporate governance is that the structure of the board always tells you something about the quality of the board. To this end, governance experts often evaluate a board by placing considerable emphasis on its prominent observable attributes. These include features such as whether it has an independent chairman, a lead director, the number of outside directors, the independence of its directors, the independence of its committees, size, diversity, the number of “busy” directors, and whether the board is interlocked.¹ However, these attributes have been rigorously studied by researchers and, for the most part, have been shown to have little bearing on governance quality (see **Exhibit 1**).² Instead, board quality likely depends on attributes that are less well examined, including the qualification and engagement of

¹ A “busy” director is one who serves on multiple boards (typically three or more) at the same time. An interlocked board is one in which senior executives sit reciprocally on each other’s boards.

² One exception is “busy” directors, which are consistently shown to have worse stock price and operating performance and to award above-average CEO compensation packages. For a detailed review, see: David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New York, NY: FT Press, 2011).

Professor David F. Larcker and Brian Tayan prepared this material as the basis for discussion. Larcker and Tayan are co-authors of the book [Corporate Governance Matters](#). The Corporate Governance Research Program is a research center within the Stanford Graduate School of Business. For more information, visit: <http://www.gsb.stanford.edu/cgrp/>.

individual directors, boardroom dynamics, and the processes by which the board fulfills its duties.

MYTH #2: CEOs ARE SYSTEMATICALLY OVERPAID

Another common misconception is that the CEOs of publicly traded U.S. corporations are systematically overpaid. For example, Bebchuk and Fried have written that, “Flawed compensation arrangements have not been limited to a small number of ‘bad apples’; they have been widespread, persistent, and systemic.”³ Similarly, Macey has posited that, “Executive compensation is too high in the U.S. because the process by which executive compensation is determined has been corrupted by acquiescent, pandering, and otherwise ‘captured’ boards of directors.”⁴

While it is true that certain individual executives in the U.S. receive compensation that is unmerited based on the size and performance of their company, the compensation awarded to the average CEO is much more modest than these authors suggest. Based on data from the 4,000 largest publicly traded companies, the average (median) CEO received total compensation of \$1.6 million in fiscal year 2008. This figure includes salary, bonus, the fair value of equity-related grants, and other benefits and income.⁵ This does not seem like an unconscionable level of compensation for an around-the-clock job with tremendous responsibility (see **Exhibit 2**).

The average CEO among the largest 100 corporations received total compensation of \$11.4 million. These executives managed companies with a median market capitalization of \$35.6 billion. It is much more difficult to evaluate whether compensation packages of this size are appropriate. The companies involved are very large, and their management is no easy task. Part of the assessment should take into account how much pay-for-performance is embedded in the arrangement. (That is, these figures are not all fixed salary. A considerable portion represents “at risk” compensation in the form of equity-related grants whose ultimate worth will depend on the value delivered.) This requires a case-by-case evaluation.

MYTH #3: THERE IS NO “PAY FOR PERFORMANCE” IN CEO COMPENSATION

“Pay for performance” is the notion that the amount of compensation awarded to an executive should be related to the value of the services rendered during a specified period. Some critics contend that there is a disconnect between these two and that pay for performance does not exist in the U.S.⁶ While there are examples of unreasonable compensation, it is not true that the typical CEO is not paid to perform. On average, CEOs hold a personal equity stake in the companies they manage with a median value of \$4.6 million. This includes the fair value of stock directly held and equity grants, such as stock options and restricted stock. A one percent change in the company’s share price translates into a roughly \$54,000 change in the underlying

³ Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2006).

⁴ Jonathan Macey, “Holding CEOs Accountable,” *The Wall Street Journal*, December 9, 2008.

⁵ Calculations by the authors based on data from Equilar, Inc., for the fiscal years ending June 2008 to May 2009.

⁶ Say-on-pay regulation, in which shareholders are given an advisory vote on the executive compensation package, is intended to correct this problem. See Myth #5 below.

value of these holdings. If the CEO doubles the stock price, he or she stands to realize \$5.2 million in appreciated value.⁷ These are significant sums of money that provide incentive to create, and not destroy, shareholder wealth over the long-term (see **Exhibit 3**).

MYTH #4: COMPANIES ARE PREPARED FOR A CEO SUCCESSION

Another myth in corporate governance is that boards of directors are prepared to replace the CEO in the event of a transition. Unfortunately, the evidence suggests that this is not the case. At many companies, succession planning appears to be compliance-based rather than operational (i.e., the company has a list of potential candidates but could not name a permanent successor if called to do so immediately). According to survey data, 39 percent of companies report having zero “ready now” internal candidates to fill the CEO role. One reason for this lack of preparedness seems to be insufficient attention on the part of the board. On average, boards spend only 2 hours per year discussing succession (see **Exhibit 4**).⁸ This might explain why so many companies resort to “emergency” (or interim) appointments and begin the permanent selection process only after a resignation has occurred.

MYTH #5: REGULATION IMPROVES CORPORATE GOVERNANCE

In the last ten years, two major pieces of legislation have been enacted in the United States relating to governance. The first is the Sarbanes-Oxley Act of 2002. The second is the Dodd-Frank Act of 2010. Despite the increased “federalization” of corporate governance, there is little evidence that legislative mandates improve corporate outcomes. For example, ten years after the passage of Sarbanes-Oxley, experts are still debating whether the regulation is cost effective.⁹ Similarly, the Dodd-Frank Act imposes governance changes on companies that were previously at the discretion of the board and its shareholders. Two of its key provisions include proxy access and say-on-pay.¹⁰

- **Proxy access.** Companies must allow shareholders (or groups of shareholders) that maintain at least a 3 percent ownership position for three or more years to nominate up the 25 percent of the board on the annual proxy. This is also referred to as “shareholder democracy.”
- **Say-on-Pay.** Companies are required to grant shareholders a nonbinding, advisory vote on whether they approve of the executive compensation program. Say-on-pay votes must take place no less frequently than every three years.

⁷ Calculations by the authors based on data from Equilar, Inc., for the fiscal years ending June 2008 to May 2009.

⁸ Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford, “2010 Survey on CEO Succession Planning,” Jun. 2010. Available at: <http://www.gsb.stanford.edu/cgrp/topics/succession/surveys.html>.

⁹ Romano (2005) finds that many of the restrictions of SOX do little to improve audit quality. She recommends that they be optional and not required for listed companies. See Roberta Romano, “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,” *Yale Law Review* (2005).

¹⁰ Other governance related provisions include the requirement that companies develop clawback policies and enhance their disclosure. Companies must now disclose metrics on internal pay equity (the ratio of median employee compensation to CEO total compensation), whether they allow executives to hedge equity holdings, and if the company does not have an independent chairman why it allows one person to hold both positions

There is no evidence that these provisions improve corporate outcomes. In fact, some research findings suggest that Dodd-Frank is more likely to destroy than enhance shareholder value.¹¹

MYTH #6: VOTING RECOMMENDATIONS ARE BASED ON RIGOROUS RESEARCH

Another widely accepted myth of corporate governance is that proxy advisory firms are experts and that their recommendations increase shareholder value. Many institutional investors consult the recommendation of a third-party advisory firm before deciding how to vote the annual proxy. The evidence suggests that the recommendations of these firms are influential: an unfavorable recommendation from Institutional Shareholder Services (the largest advisory firm) can reduce shareholder support by 14 to 21 percent, depending on the matter of the proposal.¹² However, robust evidence does not exist that the recommendations of advisory firms are correct. They have not been shown to increase shareholder value, correlate with improved operating performance, or predict negative events such as financial restatements, bankruptcies, or class-action lawsuits.¹³ In the absence of such evidence, their recommendations should be treated as opinion rather than expertise.

MYTH #7: BEST PRACTICES ARE THE SOLUTION

Finally, the most destructive myth in corporate governance is the notion that best practices exist which, if uniformly followed, lead to better oversight and performance. This is simply not the case. Despite the best efforts of regulatory, commercial, and academic experts, no one has yet identified standards that are consistently associated with improved corporate outcomes. This includes the recommendations of blue-ribbon panels, corporate governance ratings, and governance indices.¹⁴

It should not be surprising that uniform best practices do not exist in governance. Corporations are organizational systems. Their success is predicated on their external setting, the interactions of their constituents, and the processes by which the corporate strategy is planned and executed (see **Exhibit 5**). It is hard to imagine that the complexity of such an undertaking can be reduced

¹¹ Larcker, Ormazabal, and Taylor observe a negative shareholder reaction among companies in the U.S. that are likely to be affected. See David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, “The Market Reaction to Corporate Governance Regulation,” *Journal of Financial Economics* (forthcoming).

¹² Jennifer E. Bethel and Stuart L. Gillan, “The Impact of Institutional and Regulatory Environment on Shareholder Voting,” *Financial Management* (2002).

¹³ Larcker, McCall, and Ormazabal (2011) find a negative relation between the recommendations of Institutional Shareholder Services with regard to stock option exchanges and corporate outcomes. See David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, “Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services,” Stanford Rock Center for Corporate Governance at Stanford University working paper No. 100 (Apr. 15, 2011). Available at: <http://ssrn.com/abstract=1811130>.

¹⁴ For a review of the recommendations of the Cadbury Commission (1992) and the Higgs Report (2003), see Carol Padgett and Amama Shabbir, *The UK Code of Corporate Governance: Link between Compliance and Firm Performance*, ICMA Centre, University of Reading, discussion papers in finance (2005); for a review of commercial governance ratings, see: Robert Daines, Ian D. Gow, and David F. Larcker, “Rating the Ratings: How Good Are Commercial Governance Ratings?” *Journal of Financial Economics* (2010); and for a review of governance indices, see: John E. Core, Wayne R. Guay, and Tjomme O. Rusticus, “Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors’ Expectations,” *Journal of Finance* (2006); and Shane A. Johnson, Theodore C. Moorman, and Sorin Sorescu, “A Reexamination of Corporate Governance and Equity Prices,” *Review of Financial Studies* (2009).

to a checklist that is no more difficult to follow than the recipe in a cookbook. Rather than focus on check-the-box solutions, governance can only be improved when corporate practitioners and their constituents give the matter the careful consideration it deserves.

WHY THIS MATTERS

1. Governance choices affect managerial behavior and the performance of the firm. When companies get these choices wrong or make incorrect selections based on “myths” about corporate governance, the welfare of shareholders and stakeholders is harmed.
2. Decisions regarding the structure and processes of a governance system should be based on concrete evidence, not the educated guesses of self-styled experts. To this end, a comprehensive and rigorous body of research exists that examines many of these important questions. We believe that this research should be consulted and carefully considered when governance decisions are being made.

Exhibit 1
The Structure of the Board of Directors (Selected Attributes)

Structural Attribute of the Board	Findings from Research
Independent chairman	No evidence
Independent directors	No evidence
Lead independent director	Modest evidence
Board size	Mixed evidence
Diversity / female directors	Mixed evidence
“Busy” boards	Negative impact
Boards “appointed by” the CEO	Negative impact

Source: Adapted from David F. Larcker and Brian Tayan, *Corporate Governance Matters*.

Exhibit 2
Median Total Compensation Paid to CEOs in the U.S.

	Total Annual Compensation	Market Value of Company
Top 100	\$11,357,478	\$36,577,000,000
101 to 500	\$6,546,988	\$6,928,000,000
501 to 1,000	\$4,100,877	\$2,057,000,000
1,001 to 2,000	\$2,129,101	\$639,000,000
2,001 to 3,000	\$1,152,533	\$175,000,000
3,001 to 4,000	\$613,596	\$35,000,000
1 to 4,000	\$1,588,389	\$332,000,000

Note: Total compensation includes salary, annual bonus, other bonus, expected value of stock options, performance plans, restricted stock grants, pensions, benefits, and perquisites. In calculating stock option fair value, remaining terms are reduced by 30 percent to adjust for potential early exercise or termination. Market value is the value of common shares outstanding at fiscal year end.

Source: Calculations by the authors. Based on Equilar compensation data, fiscal years ending June 2008 to May 2009.

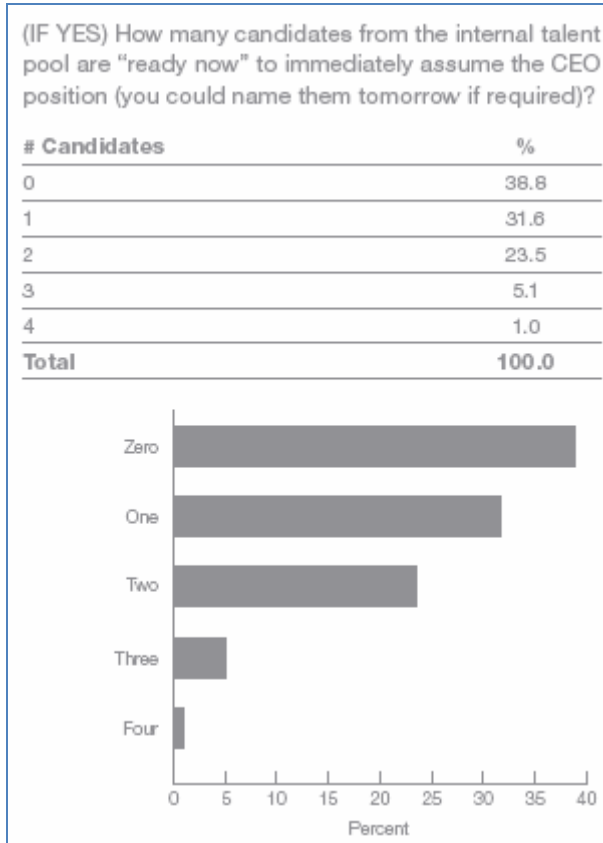
Exhibit 3
Median Pay-for-Performance: Relation between CEO Wealth and Stock Price

	Total CEO Wealth	Change in Wealth 1% Δ Stock Price	Change in Wealth 100% Δ Stock Price	Market Value of Company
Top 100	\$41,416,000	\$592,000	\$58,600,000	\$36,577,000,000
101 to 500	\$20,703,000	\$279,000	\$26,900,000	\$6,928,000,000
501 to 1,000	\$12,240,500	\$155,000	\$14,900,000	\$2,057,000,000
1,001 to 2,000	\$7,531,000	\$88,000	\$8,500,000	\$639,000,000
2,001 to 3,000	\$3,312,500	\$38,000	\$3,600,000	\$175,000,000
3,001 to 4,000	\$720,000	\$8,000	\$784,000	\$35,000,000
1 to 4,000	\$4,628,000	\$54,100	\$5,200,000	\$332,000,000

Note: Calculations exclude personal wealth outside company stock. Stock options are valued using the Black–Scholes pricing model, with remaining option term reduced by 30 percent to compensate for potential early exercise or termination and volatility based on actual results from the previous year.

Source: Calculations by the authors. Based on Equilar compensation data, fiscal years ending June 2008 to May 2009.

Exhibit 4 CEO Succession: Survey Data (2010)

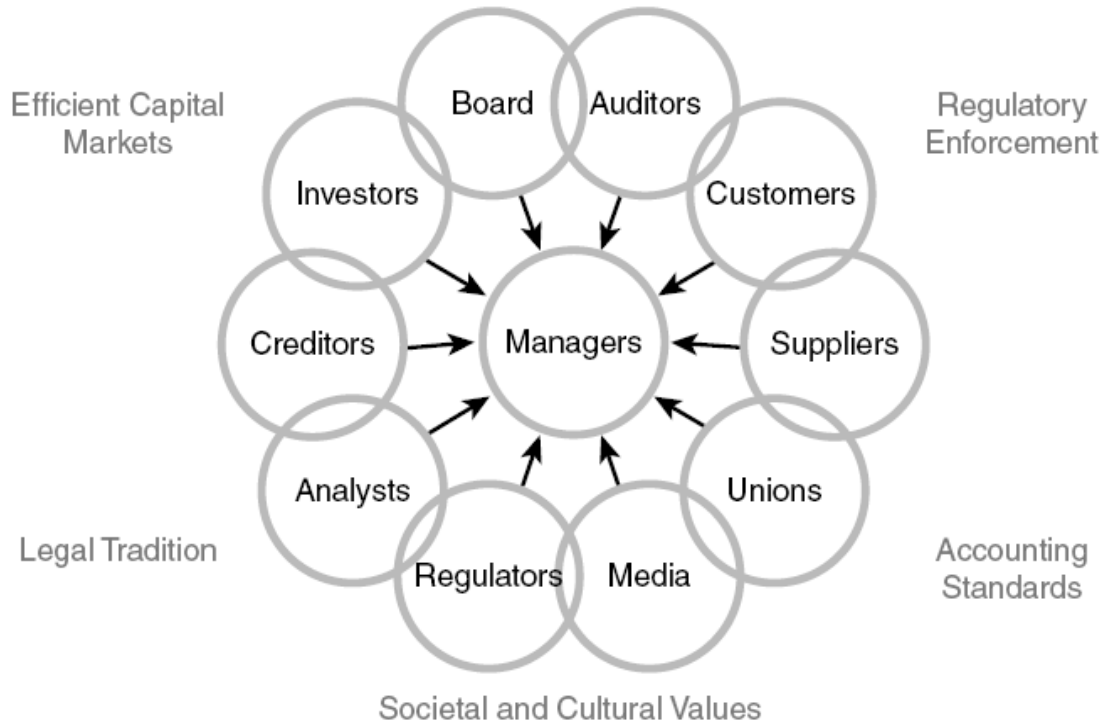


(IF YES) If you had to choose a CEO successor within the next 12 months, how viable are internal candidates for the CEO position? (A viable CEO candidate is an individual the board could confidently promote).

Descriptive	%
Extremely viable	14.4
Very viable	22.5
Moderately viable	30.6
Slightly viable	22.5
Not at all viable	10.0
Total	100.0

Source: Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, “2010 Survey on CEO Succession Planning,” Jun. 2010.

Exhibit 5 Determinant and Participants in Corporate Governance



Source: David Larcker and Brian Tayan, *Corporate Governance Matters*.