

BOARD RESPONSIBILITIES AND CREATING VALUE

Introduction

1. There has been a lot of debate and some legislation on the structure and composition of corporate boards.
2. But have the changes mandated, or widely adopted, increased the value of the corporation measured by stock price or by net income?
3. Today I will focus on one specific aspect of board composition – the independent chairman – since this is a major difference between UK and US corporate structure, and try to ascertain whether this aspect makes a difference in terms of corporate value.

I. UK Situation

Let's begin by reviewing the UK situation:

A. Independent Chairman

1. 95% of FTSE 350 have a chairman who is separate and independent from the CEO: the chairman runs the board, while the CEO runs the business.
2. These chairmen are typically retired CEOs from other companies: they do not move from CEO and chairman in the same company.

3. Independent chairman gets paid substantially more than non-executive directors, and devotes several days per month to the company (in addition to board days).

B. Other Aspects of UK Board Structure

1. 83% of FTSE 100 have a Senior Independent Director
 - a. The senior independent director should be identified in annual report.
 - b. Senior independent director leads the annual evaluation of the independent chair.
 - c. Senior independent director available to shareholders or other stakeholders if they cannot reach the Chairman or want another point of access.

C. Independence of Board

1. Almost all FTSE 350 companies meet the Combined Code recommendation that the majority of the board be comprised of non-executive directors. The board majority is typically comprised of two-thirds non-executive directors and one-third executive directors. Within the non-executive director proportion, approximately 80% of UK companies meet the Code's independence criteria.
2. In 80% of FTSE 100 companies, at least half of the board (other than the chair) are "non-executive" and meet the independence criteria.

3. The chair may be “executive” in the sense that he or she helps the CEO in some executive functions, but the chair is otherwise “independent” of the company.

II. US Situation

(look at S&P 500 through 2004 study by Spencer Stuart)

A. Chairman separate from CEO

1. 370 had combined chair and CEO.
2. Only 37 had separate chairman who is not former CEO.
3. 93 had separate chair who was previously CEO.

Note: during 2003-2004, 12 companies reversed the trend by merging Chairman and CEO – mainly by adding Chairman title to CEO. These seem to be relatively new CEOs who gradually assumed more responsibility (Source ISS).

B. Lead Senior Independent Director

1. 84% of S&P companies had lead director (up sharply from 36% in 2003).
2. About $\frac{3}{4}$ of these companies have permanent independent senior director; $\frac{1}{4}$ rotate position.
3. Senior independent director often gets an extra stipend of \$25,000 or \$50,000 per year, and spends some time outside of board meetings talking to the CEO.

C. Independence of Board

1. Almost all publicly held companies listed in US now have majority of independent directors.
2. Exception – majority controlled subs that are listed.

III. Empirical Evidence

- A. Since we have companies in the U.S. with and without independent chairs, economic significance has been measured by several studies over the last decade, summarized by Yale Law professor Roberta Romano, 18 Yale J. of Regulation (2001): There is no significant difference between those corporations with an independent chair and these without an independent chair in terms of stock price or accounting income. But there are a minority of studies that go the other way (e.g. Yermack).
- B. A more recent study by ISS shows that stock price is not affected by a company's announcement that it will separate the Chairman and CEO position (though other studies purport to show higher P/B ratios or ROA for separate Chairman and CEO in particular industries).
- C. Also empirical studies on independent chairs of mutual fund boards. Again hard to see clear differences in fund performance between those funds with independent chairs and those without independent chairs. Some of the worst scandals in funds with independent chairs (e.g., Putnam).
- D. The best empirical study on the UK code was done by Professor Jay Dahya in 2005. He concludes: "We find companies splitting the combined CEO and COB position to conform to the Code's

requirement did not exhibit any absolute or relative improvement in performance to various peer-group benchmarks.”

- E. One study of the Chairman vs. CEO functions in Swiss companies (Schmid and Zimmermann) concluded: “We find no evidence of a systematic and significant difference in firm value between firms with combined and firms with separated firms.”
- F. One more empirical finding that seems to hold in U.S. and Europe as well as Japan: If you are going to have a different person be Chairman and CEO, don't have the Chairman be the prior CEO. The prior CEO acts as an inhibitor to change and shareholder returns tend to decline.

IV. Logical Arguments

Despite lack of empirical evidence, we sometimes hear that “best practice” requires an independent board chair. Let me review the logical arguments for an independent chair (as in UK system), with emphasis on whether those same arguments would hold for an independent lead director (as in the US system).

- A. Logical Arguments For
 - 1. Can provide wisdom and guidance to CEO:
 - yes for both independent chair and independent lead
 - 2. Can act as liaison with shareholders and other stockholders:
 - yes for both independent chair and independent lead
 - 3. External and internal stakeholders may be less intimidated by someone other than the CEO:

yes for both independent chair and independent lead

4. Plays a major role in shaping board agenda:

yes for both independent chair and independent lead, though in both cases the CEO still suggests agenda items and independent may add or subtract.

5. Leads executive sessions in which neither the CEO and nor anyone from management are present.

Yes for both the independent chair and independent lead.

6. Leads the Board meetings – this is the big difference:

Independent chair – yes

Independent lead – no

B. Logical Counter-Arguments Against

1. Having split roles may divide decision-making and make it more difficult to develop a coherent strategy.

- a. This counter-argument seems to have relatively little weight now that we have moved from “imperial” CEOs to “collaborative” CEOs, as CEO will need to consult on overall company strategy with the board regardless of whether he or she is both Chairman & CEO, and regardless of whether the company has an independent chair or an independent lead director.

2. Some good CEOs will not take the job if not Chairman

- a. Still true in some US cases, though less so.

- b. These people all accept independent lead, but some want to be Chair and CEO so will not accept independent chair
- 3. Maybe more important that rest of board is independent than if you have independent chair or independent lead. No clear evidence for or against this counter-argument.

Conclusions

1. Seems that independent chair in UK and Independent lead in US play useful functions (though may not need both in UK)
2. Unclear if UK independent chair is superior to US independent lead – this may be form over function.
3. Or it may depend on nature of company where there is a need for an external facing chair and a CEO to run the business (e.g. Comsat had to deal with Congress); or where there is a relatively new CEO with little global experience so a seasoned independent chair is needed (at least for a few years).
4. Most important functions to enhancing company value: helping set the agenda, leading executive sessions of non-management directors, and liaison with company shareholders in difficult situations.
5. It is critical that these functions be played by an independent and senior board member; less critical whether that person has the title independent chair or independent lead director.