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ON-GOING BOARD REFORMS: ONE SIZE FITS ALL AND REGULATORY CAPTURE

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Proponents of board reforms assume that corporate structures and director-specific provisions matter. This paper argues that reformers have set minimum standards, but failed to take into account various trade-offs and regulatory capture effects. It is thus suggested that the flexibility of existing provisions be increased and that this new approach be used to improve shareholder protection against board failures in general and failures of institutional investor boards in particular.

I. INTRODUCTION

Among the various factors contributing to a firm's success, board powers, structure, composition, and procedures are likely to weigh less than, say, the adequacy of the firm's business model or the qualities of its top executives (see also Bertrand and Schoar, 2003). It thus comes as no great surprise that shareholders, consultants, politicians, and academics alike had long paid only rather limited attention to such mundane corporate governance issues—much to the delight of executives in both widely held and controlled firms.

Interest in boards has, however, been significantly augmented in past decades (Millstein and MacAvoy, 2003). Increase in US takeover activity during the 1980s and emerging globalization were instrumental in bringing corporate governance back from obscurity. The takeover bubble reminded market participants about significant conflicts of interests between managers and shareholders, while increasing competition made it difficult to neglect any factor that could contribute to firm performance. Boards eventually moved to corporate centre stage, owing to exponential growth in managerial compensation throughout the 1990s, followed by

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economic downturn and corporate scandals at the turn of the century.

Directors were, indeed, ideal culprits. They were the ones who had approved often extraordinarily large compensation packages without much of an inquiry about their justification or true costs. They also failed to detect the financial manipulation and asset diversions that caused, or at least contributed to the downfall of major firms. Once hindsight made it clear that many executives were given the wrong incentives and that boards were not adequately monitoring them, directors were an easy target for political entrepreneurs—and welcome scapegoats for other possible culprits, such as greedy investment bankers or exuberant investors.

Board reform proposals, which had already started to flourish in the late 1990s, multiplied following the Enron, WorldCom, and Parmalat cohort of scandals. Law-makers in the EU, the USA, and elsewhere took the view that weak boards were a distinct feature of companies engaging in fraud and had to be reformed so as to play effectively their first-line-of-defence role against corporate malpractice (European Commission, 2004). Agencies and courts did not want to be left behind, especially in the USA (see Veasey, 2004). Thus, both the Securities and Exchange Commission (SEC) and the Delaware judiciary are currently pondering whether to take steps to give shareholders more of a say in board elections or to reinforce directors' fiduciary duties. At the same time, almost countless self-regulatory 'codes' and governance 'indices' were being enacted by bodies of all kinds—some acting on behalf of governments or established interest groups, other simply implementing advertising efforts by consultants eager to sell their corporate governance services.

It follows that board reform proposals reflect quite diverging agendas, which casts doubts on their effectiveness or efficiency. In particular, it cannot be denied that law-makers sometimes pass mere 'me-too' reforms, whereas self-regulatory codes enacted by interest groups often resemble damage limitation exercises. Moreover, even 'honest' proposals may prove inefficient because of failures to take into consideration the board's multiple functions: crisis management, regulatory compliance, management monitoring, strategy setting, and mediation of conflicts of interests. Finally, proposals that seem justified or rather harmless today could end up having costly 'petrification' effects (Buxbaum and Hopt, 1988). Indeed, reformers generally battle past scandals rather than future market failures, their main purpose being the short-term rebuilding of investor confidence or the soothing of voter anger prior to the next election.

On the other hand, regulatory intervention may be a prerequisite for boards to adopt quality-enhancing governance changes. This is likely to be the case not only when it comes to reducing directors' private benefits (Bebchuk, 2003), but also for mere departures from the existing equilibrium. For example, directors often fear that the undertaking of governance changes in the absence of regulatory support will send the wrong signal to investors, i.e. be interpreted as due to yet to be disclosed problems.

To be sure, market forces often prove sufficient to generate needed changes. For example, many listed firms started to address board deficiencies well before reforms were adopted (see, for example, Sonnenfeld, 2002). But overall board change can be slow, even under combined market and regulatory pressure. Hence, scandals and recent reforms are said still to have limited impact on US managers' established practice of ignoring shareholder wishes on key governance questions.[2]

It thus cannot simply be stated that regulatory intervention has no positive net present value. Section II, therefore, provides an overview of board reforms, while section III assesses their scope. Efficiency and regulatory capture issues are discussed in section IV. Section V concludes with some policy recommendations.

II. OVERVIEW OF BOARD REFORMS

On-going board reforms can be divided into three broad categories. The first comprises proposals aiming at reducing board discretion by reinforcing the powers of shareholders and auditors. A second category of reforms aims at improving board

[2] See, for example, Millstein (2004).

independence by dealing with board structure, composition, and procedure. Finally, director incentives are targeted through director compensation and liability provisions.

(i) Constraining Board Discretion

Proposals aiming at reinforcing shareholder powers diverge somewhat on opposite sides of the Atlantic, reflecting differences in the ownership structures of listed US and European firms. The former are generally widely held, while the latter are often dominated by large shareholders (La Porta *et al.*, 1999; Barca and Becht, 2001; Cheffins, 2001). As a result, board elections are typically in the hands of the firms' executives in the USA, whereas in Europe controlling block holders have a history of reinforcing their grip over the board by minimizing the corporate affairs involvement of small shareholders.

Thus, the main US regulatory debate is about giving shareholders more of a say in director elections. Shareholders that are dissatisfied with board nominees currently have two equally unattractive options. One is to mount a costly and uncertain campaign for rival proxies. The other is to withhold their vote, a tactic that signals opposition but is not binding for the board.

Against this background, the SEC has proposed a new rule, permitting shareholders holding more than 5 per cent of voting rights to nominate candidates for election as directors, provided that at least one of the nominees proposed by the board in the previous election received more than 35 per cent 'withhold' votes.[3] However, this or any related proposals have yet to be adopted, owing to strong opposition led by the Business Roundtable, an association comprising more than 150 chief executive officers (CEOs) from the largest US corporations. Despite, or possibly because of this stalemate, the Delaware judiciary has taken it upon itself to find a solution. Adopting a rather unusual approach, Delaware judges are discussing ways to increase shareholders' powers to vote out unwanted directors with representatives of institutional investors.[4]

In Europe, by contrast, the focus is on giving the general meeting the right to vote on remuneration policies and stock option plans—a subject that is more a matter of academic than law-maker interest in the USA.[5] The UK Combined Code has recently been amended to allow investors in listed companies an advisory vote on executive pay plans, a practice that is said to have proven quite effective in forcing companies to take into account institutional investor opinion. The European Commission is similarly recommending that member states let shareholders of listed companies vote on director remuneration policies as well as on schemes under which directors are remunerated in shares or share options, or on the basis of share movement.[6] There is more divergence when it comes to individual executive pay. For example, strong union and political pressure was needed to bring German listed companies to merely disclose individual executive compensation figures—a standard practice in the UK.

Board powers are also constrained by reforms aiming at increasing the compliance role of auditors, not least because recent scandals have revealed various instances of audit complacency. The USA has taken the lead by requiring auditors to attest the adequacy of internal controls over financial data (Section 404, Sarbanes–Oxley Act—SOX). This requirement reduces board discretion by forcing directors to comply with auditor instructions unless they are prepared to inform investors that they have not dealt with material weaknesses identified by auditors. In Europe, the European Commission is proposing the adoption of a Directive to reinforce auditor independence, in particular by limiting the board's ability to participate in audit execution and restricting auditor dismissal to 'proper grounds' cases only.[7]

[3] See Securities Exchange Act Release 48,626, 81 SEC Docket 770 (2003).

[4] See Tucker (2004).

[5] The SEC, for example, is more interested in getting firms to disclose executive compensation packages in a user-friendly form than in getting shareholders to vote on them.

[6] See Commission Recommendation on Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies [2004] O.J. L 385/55.

[7] See Proposal for a Directive on Statutory Audit of Annual Accounts and Consolidated Accounts COM(2004) 177 final (March 2004), available at europa.eu.int

(ii) Reinforcing Board Independence

On-going reforms also aim at pressuring firms listed in major jurisdictions to improve board independence, be it from the firm's executives, controlling shareholders, or other parties whose influence may prove costly. Boards should have a majority of independent directors and set up nominating, compensation, and audit committees comprising only, or at least a majority of independent directors. Moreover, the separation of CEO and board chairperson is either encouraged by providing new default provisions (as is the case in France) or by recommending that CEOs should not act as chairpersons. Alternatively, independent directors are expected to convene without the CEO or other executives being present, the meeting being chaired by a lead director.

It has not escaped reformers' attention that focusing on directorial independence means little without proper definition. First movers have adopted rather general definitions. For example, the revised New York Stock Exchange (NYSE) *Listed Company Manual* defines independent directors as those having 'no material relationship' with the listed company, whereas the UK's Combined Code refers to the non-existence of 'relationship or circumstances that are likely to affect or appear to affect the director's judgment'.[8] However, it was felt that the flexibility of these definitions could threaten their effectiveness. Reformers thus supplemented them by specific examples of non-independence, such as the existence of a relationship with a major supplier or customer (NYSE *Listed Company Manual*) or the representation of a significant shareholder (UK Combined Code).

These specific examples have been a source of concern, especially in firms with concentrated shareholdings or co-determined boards. As a result, the European Commission had to water down its Recommendation on non-executive directors.[9] While independence is still defined as being free from any business, family, or other relationship that creates a conflict of interest such as to jeopardize independent judgement, examples of non-independence have been relegated to an 'additional guidance' annex. At the same time, however, Delaware courts seem to be signalling that directors will have to fulfil increasingly demanding criteria to be considered independent in votes involving controlling shareholder interests.[10]

Reformers are also aware that independence is not only a question of structure and composition, but also of procedures. Thus, both the NYSE *Listed Company Manual* and the European Commission's Recommendation on non-executive directors emphasize the need for the board to carry out regular evaluations of its own performance.

(iii) Director Incentives

Reformers are not only addressing board independence, but also board competence. In particular, audit committee members of firms listed on the NYSE are required to be financially literate, while at least one of them shall have accounting or related financial management expertise. More generally, the European Commission is recommending that boards be composed of members who, as a whole, have the required diversity of knowledge, judgement, and expertise to complete their task properly.[11]

Reformers expected the more stringent director independence and competence requirements to have implications for compensation, as they were likely to increase reputation and liability risks. Hence, the European Commission has recommended that listed firms disclose director compensation data, which should include information about the variable and non-variable remuneration, as well as information about non-cash and retirement benefits.

Time will tell whether board reforms will significantly change director liability risks. Current Delaware Court of Chancery opinions seem less board friendly than they used to be, as exemplified by the Court of Chancery's ruling that directors with

[8] §303A(2) NYSE *Listed Company Manual* and §A.3.1 UK Combined Code.

[9] See Commission Recommendation on the Role of Non-Executive or Supervisory Directors and on the Committees of the (Supervisory) Board [2005] O.J. L 52/51.

[10] See *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Delaware Chancery Court 2003) (board inquiry into possible insider trading); Emerging Communications Shareholders Litigation, 2004 Delaware Chancery Court, LEXIS 70 (approval of going private transaction).

[11] See Commission Recommendation, fn. 9.

specialized knowledge or expertise are held to higher standards than other directors.[12] Similarly, Germany's *Bundesgerichtshof* has recently set a precedent by holding that supervisory board members could individually be sued over false announcements.[13] However, it would be premature to extrapolate from recent judicial activism or scandal-related record US settlements that a new trend has been set.[14]

III. SCOPE OF REFORM: REGULATORY TIMIDITY OR HYPOCRISY?

On-going board reforms generally target listed firms. There are, however, significant gaps and spillovers. On the one hand, institutional investors, such as mutual and pension funds, are generally left outside the scope of corporate governance codes.[15] On the other hand, board reforms have a *de facto* impact on non-listed firms, regardless of their size and ownership structure.

The question thus arises as to whether board reforms are under-inclusive or over-inclusive. We address the first question in the section devoted to regulatory capture issues. The second question can be dealt with in two steps: (i) is there a one-size-fits-all issue? (ii) if so, are reforms imposed upon firms that cannot afford them?

(i) One Size Fits All?

Although the reforms described in section II were originally designed for large, widely held Anglo-Saxon firms, they are having or can be expected to have an impact on firms around the world, regardless of their size and ownership structure.[16]

Continental European reluctance to follow the UK and US lead started to soften owing to EU firms increasingly tapping US capital markets, and practically disappeared once it became clear that corporate scandals were not confined to North America.[17] For their part, firms listed in industrialized Asian countries or in developing and transition countries are increasingly forced to show compliance with some kind of corporate governance principles if they want to avoid the costs associated with scoring badly on global corporate governance tables.[18]

Similar dilemmas are faced by non-listed publicly held firms, as well as by privately held firms. For example, lenders increasingly take into account governance issues when determining a firm's credit rating (see Grunert *et al*., 2005). A comparable approach seems to be adopted by venture capitalists selecting possible investment opportunities and insurance companies having to price directors and officers (D&O) liability premiums.

It follows that board reforms have *de facto* one-size-fits-all consequences, which raises efficiency issues. In spite of globalization, there are still significant financial system, ownership structure, and legal or cultural differences between jurisdictions (Allen and Gale, 2000). Experiences in developing or transition jurisdictions are a case in point about the potential inefficiency of legal transplants (Black *et al*., 2000; Pistor *et al*., 2002). Moreover, even assuming that the alleged costs of SOX-like reforms are exaggerated or balanced by investor-confidence benefits (Li *et al*., 2004), it seems at least plausible that submitting smaller firms to governance principles designed for larger firms will prove inefficient.

To be sure, corporate governance regulation and codes often take into account that some rules can be disproportionate or less relevant for smaller firms. For example, the UK's Combined Code explicitly exempts listed companies that are not among the 350 largest from some of its provisions (Preamble,

[12] *Emerging Communications Shareholders Litigation*, 2004 Delaware Court of Chancery LEXIS 70.

[13] *In re Infomatec AG*, BGH II ZR 217/03, 218/03 and 402/02 of 19 July 2004 (English summary available at germanlawjournal.com).

[14] See also Black *et al*. (2005).

[15] For example, the UK Combined Code devotes a section to institutional investor behaviour, but does not deal with their boards' structure, composition, or procedure.

[16] See Cheffins (2000), Hopt and Leyens (2004), and Stork (2004).

[17] See also Birchall and Tait (2004), citing PwC Research data: compared to 2003, class actions against non-US firms almost doubled in 2004.

[18] Tables such as those by Governance Metrics International are given prominent investor attention: see Roberts (2004*a*), emphasizing the low scores obtained by Japanese and Hong-Kong listed companies.

No. 6). Somewhat similarly, the NYSE *Listed Company Manual* permits family-controlled companies not to comply with some of its rules, provided they disclose that choice (Section 303A). In addition, owing to the generalization of the 'comply or explain' regulatory approach, listed firms may ignore most rules in most jurisdictions, provided they disclose the particular circumstances justifying their doing so.

However, it would be naïve to believe that firms can easily avoid compliance. Corporate governance provisions, whether enacted by law-makers or part of self-regulatory codes, have standardization effects. First, the default nature of governance codes does not mean that they are not sticky. Investor expectations can make non-compliance by listed firms costly, even when compliance would have no specific advantages (see Sunstein, 2002; Korobkin, 2003).

Second, financial analysts can be expected to frown on publicly held firms that force them to engage in specific governance assessments. More generally, lending officers are likely to find it more risky to deal with firms of any size that do not follow what is considered 'good practice', especially given the importance assigned to borrower corporate governance under the revised capital-adequacy framework (Basel II).

In short, there is a one-size-fits-all issue. It is thus justified to ascertain whether some firms are likely to be subject to disproportionate costs by examining the magnitude of the changes induced by board reforms.

(ii) Minimum Standards, Not 'Best Practices'

Corporate governance reformers often claim that they are providing 'best practice' or 'good governance' provisions. However, it is more accurate to refer to reformers' output as representative of 'average practice' or 'minimum standards'.

Admittedly, on-going board reforms are likely to have some impact even for the 'best' listed firms. For example, board reforms have certainly contributed to boards in Europe and the USA increasingly meeting without the CEO being present.[19] Similarly, recent claims about difficulties in recruiting non-executive directors and increases in their remuneration are likely to be at least partly related to board reforms.[20]

Generally speaking, however, reforms tend to follow rather than cause change in the boardroom. Hence, recent board reforms do not seem to have had a significant impact. For example, according to a recent multi-jurisdiction survey, directors of EU firms doubt that new corporate governance codes are making a noticeable difference.[21] Or, to take another example, while board reforms may have contributed to increased refusal rates and compensation levels, they do not seem to have significantly affected the supply of candidate directors or their remuneration.[22]

Conversely, many observable board changes are due to market forces rather than regulatory reforms. There is evidence that economic shocks are the main cause of US board structure adjustments, not regulatory reforms (Denis and Sarin, 1999). Similarly, the fact that European boards have recently proved more likely than their US counterparts to fire the CEO must be related to either competitive pressures or controlling shareholder activism.[23] Or, to take another example, the number of outsiders on Japanese boards is expected to increase following the profitability-driven dismantling of cross-shareholdings.[24] Reformers, themselves, seem to

[19] See Raghavan (2005), citing a Spencer Stuart study according to which S&P 500 CEOs nowadays serve on 0.9 outside boards on average, compared to two in 1997; Ascarelli (2004*a*), citing a Korn/Ferry survey.

[20] Smith (2004), citing a Korn/Ferry survey according to which 2004 refusal rates are 31 per cent for Germany (11 per cent in 2003); 51 per cent in UK (46 per cent in 2003); and 52 per cent in France (38 per cent in 2003); Roberts (2004*b*), citing Compliance Week data for the USA; Overell (2004), citing Independent Remuneration Solutions data for the UK; and 'Höhere Entschädigungen für Schweizer Verwaltungsräte', *Neue Zürcher Zeitung*, No. 222, 23 September 2004, p. 21, citing Swiss data.

[21] See Ascarelli (2004*b*), citing a Corporate Board Member Europe survey of 319 senior executives and board members in 14 European jurisdictions.

[22] See 'A Chink in the Boardroom Door', *The Economist*, 18 December 2004, p. 119 (citing a Hewitt survey of 170 large US firms according to which the median retainer for board members rose from $35,000 in 2003 to $40,000 in 2004); and Wighton (2004).

[23] See Skapinker (2004), citing Booz Allen Hamilton data for 2003, with 8.1 per cent of fired CEOs for Germany, 6.5 per cent for the UK, and 4.5 per cent for the USA.

[24] See Sapsford and Fackler (2005).

be content leaving critical issues unaddressed until generally accepted 'minimum standards' emerge. For example, board collective decision-making, compensation structure, institutional investor governance or individual shareholder monitoring are topics that have yet to be seriously tackled.

Regulatory timidity is not limited to local board reformers, who may be inclined to show higher deference to the wishes of the dominant interest group (Rajan and Zingales, 2003; Hertig and Kraakman, 2004). For example, both the SEC and the EU have demonstrated reluctance to deal with boards of institutional investors, even though they play a major governance role. More generally, EU harmonization proposals do not significantly differ from what has already been achieved in major member states.

There are three possible explanations for 'best practices' being no more than 'minimum' standards. One is that board reformers are aware of the described 'one-size-fits-all' issues and prefer to be considered somewhat ineffective than embark on inefficient innovation. Another is that minimum standards are not as 'minimum' as they appear. Still another explanation is that the reform process has been plagued by regulatory capture. As the next section shows, there is truth in all of the above, and the combination results in board reforms being both inefficient and insufficient.

IV. EFFICIENCY AND REGULATORY CAPTURE ISSUES

The adoption of minimum standards should minimize one-size-fits-all inefficiencies. After all, jurisdictions around the word are facilitating transactions by adopting corporate forms that are largely similar (Kraakman *et al.*, 2004). However, this presupposes the taking into account of multiple trade-offs. Thus, increasing shareholder control over the board could create new avenues for opportunistic behaviour by either controlling or minority shareholders. Similarly, reinforcing the board's monitoring duties could hamper its ability to fulfil its strategy function.

In other words, encompassing minimum-standards reforms requires the careful and objective balance of multiple factors. Recent board reforms, however, have been either hastily adopted in the wake of scandals or driven by institutional investor pressure. This section thus examines whether time constraints or regulatory capture have resulted in inefficient or inadequate reforms.

(i) Trade-offs

There is evidence that reformers failed to take trade-offs into account adequately. Good examples are provided by an overview of the impact of new provisions on the functions of the board, the role of gatekeepers, and the design of compensation packages.

Functions of the board

Boards have multiple functions, the most important being the setting of the firm's strategy, the approval of major corporate actions, the monitoring of ongoing firm activities, and the management of crises and conflicts of interests. The relative importance of these functions varies depending upon, among other things, firm size, shareholder structure, and firm-specific governance decisions (see Nadler, 2004).

Reformers have focused on the monitoring and conflicts-of-interests functions for two reasons. First, scandals have revealed glaring examples of non-compliance with accounting and disclosure requirements. Second, many boards have not given related-party transactions (which include managerial compensation agreements) the attention they deserve, thus facilitating asset diversion by managers or controlling shareholders.

As a result, director independence is at the core of any board reform. Director-independence issues, however, have not been dealt with from an 'independence of mind' perspective.[25] Reformers chose, rather, to adopt a combined structure and relationship approach. As indicated in section II, independence provisions generally call for the board to be composed of a majority of directors with no personal, financial, or other links with the firm or its managers and controlling shareholders.

[25] Board self-evaluation rules being the exception that confirms the rule; see section II(ii). Compare Morck (2004) (discussing director subservience to CEOs and structural factors that may reduce behavioural disposition to obey legitimate authority).

One issue with 'no relationship' directors is that they may have deficient knowledge about the firm's business. This does not necessarily make them unable to manage conflicts of interests. Theoretical work and 'laboratorial' experiments indicate that boards with a majority of trustworthy but uninformed 'watchdogs' may mitigate conflicts of interests (Gillette *et al*., 2003). On the other hand, theory also shows that having a majority of independent directors could, when insiders have significantly more information than outsiders, reduce the information available to the board at large (Harris and Raviv, 2004).

This information-reduction risk increases with the broadening of the scope of regulatory definitions of independence. The requirement that a majority of directors can neither be suppliers or customers of the firms, nor work for related companies is likely to result in improving boards' ability to deal with conflicts of interests. But such boards are also likely to be worse at making strategic decisions for lack of industry- or firm-specific knowledge. This functional deficiency will be reinforced if, as indicated by survey data, board independence reduces cooperative interaction between managers and directors (Westphal, 1998). Indeed, it seems that the most productive boards are those where insiders and outsiders cooperate instead of working against each other (Langevoort, 2001).

To be sure, the relationship between board independence and firm performance remains unclear (compare Klein, 1998; Bhagat and Black, 1999, 2002). One main issue is the existence of an endogenous relation between board composition and firm performance. It has been shown that board independence is a function of negotiations between the CEO and directors, the result of which varies with CEO quality, which in turn affects performance (Hermalin and Weisbach, 1998). Interestingly, such bargaining is not limited to listed firms (see, for example, Arthur, 2001), but also takes place in firms backed by venture capitalists (Baker and Gompers, 2003).

There are strong reasons to believe that negotiations between the CEO and directors reflect a demand for board members that can act as outside advisors rather than a willingness to guarantee the participation of 'no-relationship' directors (see also Callahan *et al*., 2003). In the USA, for example, outside directors with political expertise were more common in the pre-deregulation days than thereafter (Helland and Sykuta, 2004). Or, to take another example, bankers that sit on US boards play an advisory rather than monitoring role—unless the firm is in financial distress (Booth and Deli, 1999; Byrd and Mizruchi, 2005). Similar observations can be made outside the USA, as well as in pre-board-reform times, for example in Japan at the beginning of the twentieth century (see Miwa and Ramseier, 2002).

Negotiations about the participation of advisors are also likely to improve managerial willingness to be transparent with the board. Logic has it that executives will prefer informing a board that plays an important advisory role, than one focusing on monitoring and compliance issues (Adams and Ferreira, 2003; see also Ribstein, 2002). This phenomenon is, unsurprisingly, confirmed by recent empirical data on UK firms (Lasfer, 2004).

In other words, it should be efficient to have outsiders on the board who can fulfil an important advisory function. On the other hand, it would be wrong to argue that outsiders should only play a strategic role, for the very same reasons that speak against giving excessive importance to outside directors' monitoring and conflicts-of-interests roles.

In sum, there is a need for 'independent' outside directors. There is also empirical evidence that board reforms may contribute to increase board autonomy (Goyal and Park, 2002; Dahya and McConell, 2005). What remains unclear, however, is the kind and degree of independence that is needed. For example, even as basic a rule as the requirement that a majority of directors must be independent may result in the emergence of an aggressive minority, which could lead to a 'tyranny of the executives' (Eliaz *et al*., 2004).

It follows that board reformers should refrain from adopting overly detailed rules. Minimum independence standards should be as general as possible and detailed lists of what is or is not an independent director should be avoided. This would facilitate board change and, possibly, judicial review, without costly unintended consequences.

Role of gatekeepers
Recent board reforms aim at reinforcing the powers and independence of auditors by reducing board discretion and setting up independent audit committees with expertise in financial matters. As indicated in section II, auditors will thus play an increased compliance role and management's ability to dismiss auditors will be restricted.

There is a demand for combined gatekeeper activities by auditors and audit committees (see, for example, Deli and Gillan, 2000). Moreover, audit committee financial sophistication can be an important factor in constraining earnings management (see Xie *et al*. (2003), using US data). Note, however, that earnings management could persist if ownership is concentrated and the labour market not very liquid (see Park and Shin (2004), using Canadian data).

Gatekeeper reforms also have their costs. They may force the board to be less entrepreneurial to avoid costly disclosure of non-compliance with regulatory standards because of excessively risk-averse auditors. More importantly, they contribute to further increase the monitoring function of the board by putting auditing issues at the forefront.

Here again, the issue is one of trade-offs (see also Kraakman, 2004). It cannot be denied that some audit committees have not performed adequately. It is also true that past US limitations on auditor liability risk had resulted in auditors becoming more complacent and less likely to discover or deter asset diversion or financial misrepresentations (see also Coffee, 2002).

On the other hand, it is not clear why reformers have to deal with audit issues in as much detail as they do. Combining basic principles of auditor independence and care with an adequate level of auditor liability should suffice to solve the problems revealed by recent scandals. There are, of course, difficulties in determining the appropriate liability balance (compare Partnoy, 2001; Hamdani, 2003), but they boil down to setting the amount at which auditor liability should be capped (Coffee, 2004).[26] Any additional regulatory intervention is likely either to result in overly costly reductions in board discretion or to facilitate gatekeeper rent-seeking—an issue that is addressed in the next section.

In sum, as for board independence, reformers have adopted rules that are overly detailed.

Compensation
According to board reformers, firms should have compensation committees composed of independent directors in majority or totality. Various codes also recommend that compensation committees use outside consultants to set appropriate benchmarks on which to judge managerial performance—the idea being to prevent executives from playing the 'let's maximize short-term earning per share' game.

These reforms are likely to force the board to pay more attention to the crucial issue of managerial compensation (Bebchuk and Fried, 2004). However, they also have serious flaws. First, reformers do not take into account that managers are not only motivated by money (see Frey (1997) and, more specifically, Stout (2003)). In particular, top managers are also significantly motivated by challenge and self-esteem considerations (Carter and Lorsch, 2004). The focus on compensation may thus have adverse-selection effects by crowding out those managers who are less compensation oriented.

Moreover, the hiring of compensation advisors is likely to cause inefficient increases in compensation. Consultants will necessarily convey information about remuneration in rival or comparable firms. This will stimulate directors to offer richer than planned compensation packages to avoid 'inferiority' compared to the leading firms. In addition, consultants have an incentive to reinforce this self-esteem-driven behaviour to the extent they also operate as head hunters whose earnings vary depending upon their candidates' remuneration. The likelihood of such an evolution is confirmed by data gathered following the introduction of US mandatory disclosure requirements for executive compensation. The increased transparency triggered a self-enforcing process of reference group compensation (Benz and Stutzer, 2003).

[26] This is a practically manageable albeit politically charged issue. See also Hargreaves (2005), reporting on the current liability capping debate.

Here again, the point is not that reform is not needed. Performance-related incentives for outside directors are non-trivial in the USA, even though compensation remains much lower than for top executives (Yermack, 2004). There is also evidence that in large, widely held firms, highly paid CEOs tend to perform badly (Daines *et al*., 2005)—especially when the board lacks independence (Ryan and Wiggins, 2004).

On the other hand, collusion between executives and directors could be in the interest of shareholders if it reduces compensation by limiting firing risk (Beetsma *et al*., 2000). More importantly, institutional investors play an increasingly significant compensation-monitoring role (Chung *et al*., 2002; Hartzell and Starks, 2003; Ferrarini and Moloney, 2004), which reduces the need for regulatory intervention.

The conclusion is the same as for board functions and gatekeepers: board reformers have adopted overly detailed rules.

Summing up, board reformers have enacted minimum standards that embody detailed rules rather than broad principles. Such regulatory micro-management may have the advantage of reducing legal uncertainty and constraining judicial activism. However, these possible benefits pale in comparison to the costs resulting from the failure properly to take into account trade-offs faced by larger firms and one-size-fits-all effects for smaller firms. This conclusion is reinforced by regulatory capture considerations.

(ii) Regulatory Capture

Law-makers have largely delegated board reforms to self-regulatory bodies. The resulting codes have generally been drafted by representatives of managers or controlling shareholders. Moreover, those reforms that have been adopted by law-makers have been largely influenced by political entrepreneurs (see Romano, 2005).

Consequently, board reforms are not a model of transparency and democracy. This is not to say that investor interests have not been taken into account. On the contrary, institutional investors have exercised a significant influence (see, for example, Wu, 2004). However, the role played by political entrepreneurs and the importance given to self-regulation had two consequences.

First, the interests of the weakest constituency, small investors, are likely to have been ignored. Whenever investor interests have played a role, reforms have been biased in favour of institutional investors. The latter, however, also have an interest in reforms that provide financial or political private benefits to their controllers, or permit their managers to shift the blame for insufficient performance on to boards of operational companies.

Specific examples of inefficient institutional investor influence are not difficult to find. For example, rules on the separation of the functions of CEO and chairman of the board have been adopted following calls by institutional investors, regardless of the fact that their costs may exceed their benefits (see Brickley *et al*., 1997).[27] Similarly, new provisions on executive compensation may have as much to do with institutional investors seeking private benefits as with the setting of an adequate remuneration framework. For example, fund managers may seek the disclosure of compensation data because it helps justify their own salaries and deflects attention from their own performance. Alternatively, fund managers may oppose (efficient) forms of remuneration because they would increase their monitoring costs more than those of their rivals. More importantly, provisions on board independence reflect institutional investors' views of what directors should do (monitoring), which negatively affects the balance among board functions.

Second, many important issues are ignored by board reformers. As indicated above, board collective decision-making, compensation structure, institutional investor governance, or individual shareholder monitoring are topics that have yet to be seriously tackled. While concerns about inefficient regulatory intervention certainly play a role, interest-group influence is at least as important a cause of regulatory inertia. Managers of operational companies

[27] Note that while the NYSE recommends that CEOs should not chair the board, only one-third of the listed US firms have complied. See Roberts (2004*a*), citing Governance Metrix International data.

oppose compensation-structure regulation, whereas their controlling shareholders are not keen to facilitate minority shareholder decision-making.

The same is true for institutional investors. Their managers and owners have no interest in being the target of board independence requirements or retail investor protection regulation. For example, the US mutual fund industry has strongly opposed the adoption of new SEC rules requiring that the chairman as well as 75 per cent of mutual fund board members be independent. Similarly, European fund managers have expressed concerns about the introduction of comparable requirements by the European Commission (Skypala, 2005).

Institutional investor opposition to regulatory intervention is not unjustified. Thus, whereas submitting closed-end investment companies to board independence requirements could benefit investors (Dell Guercio *et al*., 2003), reforms targeting institutional investors could also be plagued by the trade-offs and heterogeneity issues discussed for operational firms. However, this only means that reformers should avoid enacting overly detailed rules and, in addition, focus on the relevant issues.

There are various ways to identify the latter. One is to assume that institutional investor board deficiencies resemble board deficiencies in operational firms. Consequently, one could simply extend the scope of minimum standards applicable to the latter. Provided such minimum standards are sufficiently general (principles, not detailed rules) one-size-fits-all issues should not prove significant. A complementary approach would be to examine whether those funds that have individuals rather than institutions as investors require specific intervention. Indeed, it is striking that retail investor protection is generally ignored by board reformers. There are, for example, few calls for facilitating collective action procedures, even though it can be argued that US corporate scandals have been facilitated by US reforms aiming at constraining class actions.

Summing up, it cannot be denied that board reforms have suffered from regulatory capture. This is beneficial to the extent that managerial, controlling shareholder or institutional investor involvement prevents inefficient regulatory intervention. On the other hand, it has also barred the adoption of efficient reforms.

V. POLICY IMPLICATIONS

Board reforms had to be undertaken to restore investor confidence, constrain 'bad' boards, and support 'good' boards. However, the resulting provisions have generally been drafted in an excessively detailed way. Such an approach has two major disadvantages. First, while these provisions are drafted for large listed firms in industrialized jurisdictions, regulatory and market forces also impose them upon firms in emerging markets or upon firms that are small and non-listed. To the extent that board reforms go beyond the setting of general principles, they inevitably have costly one-size-fits-all effects. Second, detail regulation magnifies the negative impact of failing to take into account trade-offs. For example, the reformers' focus on board monitoring activities has hampered the board's ability to fulfil its other functions, in particular its strategic functions.

Moreover, interest groups have managed to avoid reforms that could have significantly infringed their private benefits. This situation is not only unsatisfactory by itself, it also has ripple effects for operational firms that are outside the scope of reforms.

It is thus urgent for board reformers to have a hard look at the 'minimum standards' they have enacted or are currently considering, with the objective of further simplifying them. Trade-off and 'one-size-fits-all' issues will be minimized, even for small firms (Freedman, 2003), if principles are the norm and detailed rules the absolute exception.

Board issues that have been ignored until now should also be given more adequate consideration. In particular, board reformers should consider the extension of minimum standards to institutional investors with more determination than they have shown up to now. Here again, to the extent that reformers revert to a principles rather than detailed-rule approach, there should be no reason why what is good for operational firms cannot be good for pension funds, mutual funds, and similar financial intermediaries.

Finally, reformers should complement principles with market-oriented implementation mechanisms. First, they should devise board election and other shareholder decision-making mechanisms that allow for efficient institutional investor intervention (see, for example, the proposals by Bebchuk (2004) and Romano (2001)). Second, reformers should consider facilitating *ex post* judicial review whenever the interests of institutional and individual investors are not aligned, or in situations where institutions are not involved—for example when it comes to pension funds. Such market-oriented mechanisms will not only reinforce board accountability while minimizing one-size-fits-all effects, they are also critical for the switch to a more flexible approach.

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