

**CORPORATE BOARD:
ROLE, DUTIES & COMPOSITION**

**СОВЕТ ДИРЕКТОРОВ: РОЛЬ,
ОБЯЗАННОСТИ И СОСТАВ**

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EDITORIAL

Dear readers!

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

Amina Hamdouni examines the effect of ownership structure and board structure on performance in VC-backed firms. Using 106 French VC-backed firms, the methodology is to estimate four equations. A regression analysis is then used to study the impact of ownership structure and board structure on performance and also to analyze whether ownership structure (ownership concentration, director ownership, venture capital ownership and employee ownership) and board variables (size, outside directors, COE-chairman duality, proportion of VC directors, proportion of employee directors and board meeting frequency) are significant determinants of VC-backed firm performance.

Wiem El Manaa, Wafa Khlif, Coral Ingley, Lotfi Karoui used a sample of 76 family businesses in Tunisia to investigate the impact of the family firm dynamic on the composition of their boards of directors. They argue that whether or not a transition in ownership is planned, firms have different governance needs and characteristics depending on the generational phase. The empirical results show that board composition is positively influenced by both generational evolution and succession planning. Their study provides evidence of an increase in the appointment of outside directors to boards of family firms from the third generation of ownership. Such result implies that it is important to consider the generational phase and succession process of the family firm in order to better understand its governance system.

On Kit Tam, Monica Guo-Sze Tan, Helen Wei Hu compared the key governance characteristics of Chinese PLCs that were found to have contravened regulatory compliance requirements (i.e., “non-compliance” PLCs) to those that were not (i.e., “compliance” PLCs). Based on a comparison between 53 pairs of compliance- and non-compliance-PLCs over the period from 2001 to 2006, results show that there are significant differences between the two. They found that ownership concentration is higher in compliance firms that also compensate their directors and executives at higher levels. Furthermore, the results suggest that sound governance practices benefit firms socially and financially, and an effective internal monitoring mechanism can further differentiate good companies from bad companies such that the good companies perform better.

Mariateresa Torchia, Andrea Calabrò, Morten Huse, Marina Brogi offered an empirical test of the critical mass arguments in the discussion of women on corporate boards. The literature in the women on corporate board debate concludes that there must be at least three women on a board before the women really make a difference. These arguments are frequently used in the public debate about the understanding the impact of women on corporate boards, but they have never really been empirically tested on a large sample. In this paper they use a sample of 317 Norwegian firms. Their dependent variable is board strategic involvement. The findings support the critical mass arguments. This study offers useful insights to policy-makers interested in defining legislative measures mandating the presence of women directors in corporate boards by showing that “at least three women” may be particularly beneficial in terms of contribution to board strategic tasks.

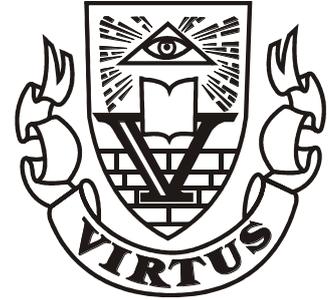
Patrick R. Dailey mentioned that when separating the Chairman role from the CEO, the “soft stuff” is often the “hard stuff”. This corporate terrain is covered with interpersonal trap doors that boards must be alert to perceive and skilled in stepping around. Pivotal Questionsis offered as a preventive against interpersonal dysfunctions which pop up during the initial role separation and the ensuring time period when roles are played out by all the constituencies - the Chairman, the CEO, the presiding director, board members and corporate officers.

Brian G M Main discusses the degree to which codes of corporate governance and the guidelines that develop around them tend to shift the locus of control away from the board of directors. He argued that even in principles-based codes of governance such outcomes are an unavoidable consequence and that policy makers should weigh such consequences carefully before promulgating codes and guidelines. The case of the treatment of footprints (incentive plan performance averaging periods) by the UK's Association of British Insurers (ABI) is analysed to illustrate the problem.

CORPORATE BOARD: ROLE, DUTIES AND COMPOSITION

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OWNERSHIP, BOARD STRUCTURE, AND CORPORATE PERFORMANCE: EVIDENCE OF FRENCH VC-BACKED FIRMS

*Amina Hamdouni**

Abstract

The purpose of this paper is to examine the effect of ownership structure and board structure on performance in VC-backed firms. Using 106 French VC-backed firms, our methodology in this paper is to estimate four equations. A regression analysis is then used to study the impact of ownership structure and board structure on performance and also to analyze whether ownership structure (ownership concentration, director ownership, venture capital ownership and employee ownership) and board variables (size, outside directors, COE-chairman duality, proportion of VC directors, proportion of employee directors and board meeting frequency) are significant determinants of VC-backed firm performance. Results indicate a strong positive relation between ownership concentration and performance and between director ownership and performance measured by ROE. And strong negative relation between ownership concentration and performance and between director ownership and performance measured by ROA. No strong relation was found between venture-capital ownership, employee ownership and firm performance.

Results show also a strong negative relation between board size and performance measured by ROE and positive relation between board size and performance measured by ROA, Tobin's Q and MVA. The proportion of independent outside directors on the board was positively associated with ROE and negatively associated with ROA. The presence of a dual leadership structure is negatively associated with ROE and positively associated with ROA. No strong relation was found between the proportion of venture-capital in board, the presence of employee in board, or board meeting frequency and firm performance.

Keywords: ownership structure, board structure, firm performance, agency theory, venture capital

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1. Introduction

Recent empirical research has found that the effect of venture capital (VC) on the success of Start-up firms is considerable. Venture capitalists (VCs) are specialized intermediaries that direct capital to firms and professional services to companies that might otherwise be excluded from the corporate debt market and other sources of private finance. Venture capital firms concentrate in industries with a great deal of uncertainty, where information gaps among entrepreneurs and venture capitalist are commonplace. Most of prior research use "agency theory" framework to study the relationship between VCs (principal) and entrepreneurs (agent). According to agency theory, the governance arrangements of VC-backed firms tend to allocate greater control to investors.

Agency theory provides a basis for firm governance through the use of internal and external mechanisms. But, the characteristics of VC-backed firms make external monitoring less likely. External governance mechanisms (such as the product market, the market for corporate control, the presence of concentrated shareholdings by persons or institutions, the labor market for managers, and the capital market) are not an important consideration to enhance corporate governance in the VC-backed firms because these firms are not listed firms. VCs institute better internal governance mechanisms that substitute for the external

governance mechanisms for corporate control. As such, alternative monitoring mechanisms, including board of directors and ownership structure, must be in place to discourage deviant managerial behavior. The role of ownership structure and board structure in monitoring management and so improving firm performance has been largely investigated in empirical corporate governance literature.

The nature of the relationship between ownership and financial performance is a first key issue for governance. Berle and Means (1932), Jensen and Meckling (1976) and others support the existence of a linear or monotonic relationship between ownership and performance. Morck et al. (1989), McConnell and Servaes (1990) and others support a non-linear or non-monotonic relationship between them. Most of this research has been carried out for non VC-backed firms. Only a few of the studies have considered the context of innovative firms financed by VC. There exist corporate governance differences, between VC-backed firms and non VC-backed firms and it's important to study the relationship between ownership and firm performance.

The board of directors is a second key issue for corporation governance, and the efficiency of board has much due to its characteristics. Several studies have examined relation between board structure and firm performance, and have procured some consistent conclusions. But these studies not provide results in context of French VC-backed firms. Prior studies explore the involvement of venture capitalists on boards by making comparison between companies backed by venture capital and those not backed by venture capital and not analyze impact of VC's involvement in board structure on performance.

This paper continues the above line of research by investigating the impact of VC's involvement in corporate governance on performance in French context and examines whether the contribution of venture capital managers to corporate governance through the board of directors and ownership structure have an impact on performance. This study seeks to study the impact of ownership structure and board structure on performance as measured by ROE, ROA, Tobin's Q and VMA in French VC-backed firms. We work on a sample of 106 French VC-backed IPOs firms and for the period January 2000 to March 2009.

The contribution of this paper is three-fold. First, the paper contributes to an emerging body of literature on governance in VC-backed firms. While there is a large body of literature examining corporate governance practices in established firms, there have been relatively few studies addressing the nature of corporate governance mechanisms in VC-backed firms characterized by moral hazard problems. Second, this study contributes to the body of literature examining the French context. In French and more generally in Europe, the VC industry remains small and focuses primarily on financing buyouts rather than on early and expansion-stage financing. Comparing to American VCs, European VCs are less "hands-on" and have less control rights.

Finally, we use four performance measures. Most of prior research results on impact of corporate mechanisms on performance are contradictory due to measure of performance. To solve this problem, we vary performance measure by using ROE, ROA, Tobin's Q and MVA.

The results show a strong positive relation between ownership concentration and performance, and manager and director ownership and performance measured by ROE and negative relation between ownership concentration and performance and manager and director ownership performance measured by ROA. For board structure mechanism, the results are contradictory when we change performance measures. We find when we use ROE, board size and the presence of a dual leadership structure have negative effects on performance and the proportion of independent outside directors on the board was positively associated with performance. When we use ROA, board size and the presence of a dual leadership structure have positive effects on performance and the proportion of independent outside directors on the board was negatively associated with performance. When we use Tobin's Q and MVA, board size has positive effect on performance and no strong relation was found between the proportion of independent outside directors and performance and between the presence of a dual leadership structure and performance. For all performance measure, no strong relation was found between the proportion of venture-capital in board, the presence of employee in board, or board meeting frequency and firm performance.

The remainder of this paper is structured as follows. Section 2 briefly examines the literature to investigate the ownership-performance relationship and the board-performance relationship and presents

the research hypotheses. Section 3 details the research methodology and data while Section 4 describes the results of empirical testing. Finally, Section 5 provides the conclusions of the paper.

2. Relationship between corporate ownership, board structure and a firm's performance: Theory and hypothesis

VC provides finance for a limited period of time to the founding or early growth of new companies that do not yet have access to the public securities markets or to institutional lenders" (Gupta and Sapienza, 1992). VC differs from in that there is much more involvement of providers of funds than is the case with other forms of lending such as bank. They use their high level of expertise to perform monitoring and to actively manage the companies they finance. They staged financing in several rounds and they usually have extensive control rights. Due to characteristics of firms that they finance, VCs avoid agency, adverse selection, moral hazard and hold-up problems when contracts are incomplete and investment proceeds in stages. Agency theory describes these problems and provides setting to study relationship between VCs and entrepreneur.

Agency theory is based on the idea that there is separation of ownership (principal) and management (agent), and this leads to costs associated with resolving conflict between the owners and the agents (Berle and Means, 1932; Jensen and Meckling, 1976). Agency theory assumes that agency problems can be resolved with appropriately designed contracts by specifying the rights belonging to agents and principals. Given the problems in mitigating agency problems through the use of contracts, various governance mechanisms can address the agency problems. Thus, agency theory provides a basis for firm governance through the use of internal and external mechanisms. The governance mechanisms are designed to protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment (Davis et al., 1997). Two important governance mechanisms used for this purpose are board of directors and ownership structure. Charreaux and Pitol-Belins (1985 and 1990) noted that in the French context, the role of the board of directors evolves with the property structure and disciplinary function assumed by the board becomes secondary in the domestic or controlled firms. In the context of VC-backed firms, VCs institute better internal governance mechanisms (board of directors and ownership structure) that substitute for the external market for corporate control. VCs, in addition to providing capital, are active in monitoring management and providing value-added services to their portfolio companies by involvement in the corporate governance.

The literature on board and ownership structures, as internal governance mechanisms, is mainly focused on issues such as block holder ownership, manager and director ownership, VCs ownership, employees ownership, board size, inside versus outside directors, separation of CEO and Chair positions (CEO duality), proportion of venture-capital in board, number of board meetings, with an aim to improve performance.

2.1. Ownership concentration and performance

Berle and Means (1932) are among the first to consider the relationship between a firm's ownership structure and its performance. They assert that as the diffuseness of ownership increases, shareholders become powerless to control professional managers.

In this context, the presence of shareholders holding a high proportion of the firm's capital becomes a favorable element to control by the shareholders (Jensen, 1993; Bethel and Liebeskind, 1993; Bethel and al., 1998). Concentrated ownership may improve performance by increasing monitoring and alleviating the free-rider problem in takeovers (Shleifer and Vishny, 1986). In a firm characterized by dispersed ownership, an only shareholder is not incited to exercise a control, because it will be alone to support the cost of the investment whereas all shareholders will benefit from this monitoring.

Mork, Shleifer and Vishny (1988) found a significant relation between firm value and ownership concentration. The results of the empiric studies led on the ownership concentration influence positively firm performance (Shleifer and Vishny, 1990; Bethel and Liebeskind, 1993). These findings have recently been questioned by Agrawal and Knober (1996). They find no evidence for the relationship between firm value and managerial stockholdings, and concluded that managerial stockholding are optimally chosen over the long run.

However, the relation between ownership concentration and performance is different according to the national systems of firm governance (Depret and Hamdouch, 2005). The positive influence is only demonstrated in US countries characterized by external control.

H1: A positive relation exists between ownership concentration and firm performance.

2.2. Manager and director ownership and performance

Directors' ownership provides directors better incentives to monitor management's actions and to act in the interests of outside shareholders. This implies a benefit to shareholders from directors' ownership. Directors' ownership constitutes an excellent incentive to manage firm in accordance with the interests of the shareholders (Berle and Means, 1932; Jensen and Meckling, 1976; Cole and Mehran, 1998). More share capital detained by directors is important, more the conflicts of interests between shareholders and directors are substantial (Mtianos and Paquerot, 1999). When directors have more discretion, the moral hazard problem becomes more substantial, and thus the benefit from providing incentives to directors increases.

H2: Increasing on director ownership improves performance.

2.3. VC ownership and performance

VC invests in firm that presents a strong potential to create value. Venture capital usually refers to the provision of funds for young, entrepreneurial businesses. Venture capital has emerged as the most common form of financing for high-technology start-ups. This form of financing differs from standard bank finance in three major dimensions. VCs use their high level of expertise to perform monitoring and to actively manage the companies they finance. (Smith, 1996; Bathala and al., 1994; Mtianos and Paquerot, 1999).

Prior research finds positive relation between the value of the firm and the percentage of the shares detained by the institutional (McConnell and Servaes, 1990; Kochhar and David, 1996; Carelton and al., 1998; Han and Suk, 1998; Woidtke, 2002; Thomsen and al., 2006).

Meggison and Weiss (1991) find that on average VCs detain 36.6% of the capital before the IPO. Barry and al. (1990), using a sample of 433 firms find on average VCs detain 34.3% of the capital and Gompers (1996) find on average VCs detain 35,7% of the capital.

H3: Increasing on VC ownership improves performance.

2.4. Employee ownership and performance

Employee ownership remains a viable and rewarding strategy to share equity and profits with employees. Employee ownership represents a powerful tool for managers to align company and employee incentives, improve company-wide performance, and show appreciation to employees.

In the literature, employee stock schemes (ESO) have been propounded as an alternative to individual incentive programs.

H4: Increasing on employee ownership improves performance.

2.5. Board size and firm performance

Jensen (1993) and Lipton and Lorsch (1992) suggested that large boards could be less effective than small boards because large boards encourages the domination and the widening of the entrepreneur's discretionary power. Large boards make hard and cost communication, coordination, and decision making than in small boards.

Large boards are reputed to be little reactive and relatively inefficient in their working. Their faculty to exercise a more active surveillance of the leaders finds lessened himself then of it. In the same way, Ginglinger (2002) considers that large boards "increase potential conflicts, costs and to the final, slows down the decision making". When boards are small, they are less likely to function effectively and are easier for the CEO to control. The boards of directors of VC-backed firms are typically small in size (Jensen 1993) consequence to higher levels of board involvement of CVs in corporate governance.

H5: Board size is negatively related to performance.

2.6. The proportion of independent outside directors

Board members are called inside directors if they are members of the management or outside directors if they have no direct role in the company itself. Thus, decisions of the insiders are aligned with those of the managers. On the contrary, outside directors are recruited for service on the board to provide valuable advice and counsel. They may not be executives of competitors or sit on competitors' boards. Their decisions will be aligned with shareholder's interests. Outside directors are also called independent directors because they are not under the influence of the chief executive of the corporation and should have a positive influence on controlling members of the management (Alexander and Paquerot, 2000). Outside directors have mission to monitor management and assist in strategic planning within the firm.

The numerous empiric works argued that the presence of outside directors may enhance the effectiveness of the board of directors in monitoring managers, and improving firm value. In other words, the presence of directors who are not employees of the firm should exercise a better control and should reduce agency costs. More independent board structures contribute to better monitoring of management and decision-making that follows shareholder interests.

Besides, Hochberg (2004) finds that VCs influence the composition of the board of directors to assure an active control. The number of outside directors should be even more important in the VC-backed firms. The outside directors are primarily the VC directors. Jensen (1993) finds that the board of the VC-backed firm was previously noted to have a low insider membership.

H6: The proportion of outside directors in the board is positively related to performance.

2.7. CEO-Chairman duality

For Jensen (1993), CEO-Chairman duality contributes to speculation and inefficacy and damages the shareholder's interest. The interior control system will be inefficacy. Separating the titles of chairman and CEO will reduce agency costs and improve firm performance. Godard and Schatt (2000) found that the performance of the company with independent leadership from managers was better than that of the company with dual leadership structure.

H7: Two-duty conditions is negatively related to firm performance

2.8. The proportion of VC directors

In addition to small board size, low insider representation, and CEO-Chairman duality, we study the proportion of VCs directors. Higher involvement of VCs in corporate governance means that VCs would be active board members. VCs are directly selected by investors (their limited partners) to represent the investors' interest. Furthermore, a large proportion of VCs directors are contingent upon the success of the businesses in which they invest (Sahlman, 1990).

H8: The proportion of VCs directors in the board is positively related to performance.

2.9. Board meeting frequency

Effectiveness of a board depends on frequency of the board meetings. In board meetings, board members discuss the various issues facing a firm. Board meetings are an important resource in improving the effectiveness of the board. Increase in board meetings is considered to represent the intensity of board activity (Vafeas, 1999). Lipton and Lorsch (1992) suggest that boards that meet frequently are more likely to perform their duties diligently to protect shareholders interests.

H9: Board meetings are positively associated with firm performance.

3. Data, variables and regression equation

3.1. Data

The sample covers the period January 2000- March 2009. The initial sample consists of all French IPOs on the First, Second and New Markets on the period from January 2000 to December 2004 and all IPOs on Alternext and Euronext on the period from January 2005 to March 2009. The data in this study are collected from the IPO prospectuses and annual reports of VC-backed firm.

The VC-backed firms are identified from the data provided in prospectuses. IPO prospectuses and annual reports were obtained from archives of the French Stock exchange Corporation. The exam of ownership structure allows us to identify VC-backed firms. The guide of the VC companies and the guide of French Private Equity Association (AFIC) permit to identify VC.

The selection criteria are as following: First, non VC-backed firms are excluded if the exam of ownership structure not identifies one or more than VC. Second, we eliminate firms without complete information concerning the variables described in the methodology. The final sample consists of 106 French VC-backed firms.

Details of board size, outside directors, board composition, COE-Chairman duality, ownership structure, and firm characteristics (size, age ...) were hand collected from the prospectus.

3.2. Variables

3.2.1. Performance measures

The indicators of the performance are distinguished according to two criteria: nature of the performance (financial or economic) on the one hand, and situation in the time of the measure (ex post or ex ante) on the other hand. We use return on equity (ROE), and return on assets (ROA) like several previous studies (Boubakri and al. (2005), Jahmani and Ansari (2006)...). We use also Tobin's Q and Value Market Added.

The performance measure (Y_i) adopted in this paper shall be as follows:

- (1) Return on Equity (ROE) measures the rate of return on the ownership of the common stock owners. To calculate ROE, the net income after tax is divided by shareholder equity.
- (2) Return on investment (ROA) is the ratio of money gained or lost on an investment relative to the amount of money invested. To calculate ROA, the net income is divided by the total assets.
- (3) Tobin's Q is calculated by dividing the market value of a company by the replacement value of the book equity. Tobin's Q is estimated as (equity market value + liabilities Book value) divided by total assets book value.
- (4) Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors. $MVA = \text{market value} - \text{invested capital}$.

3.2.2. Independent variable

Ownership concentration (OC): We measure ownership concentration by the cumulative percentage of voting rights owned by the first five shareholders (Like works of Mtanios and Paquerots, 1999 and Demsetz and Villalonga, 2001).

Director ownership (DO): We measure director ownership by the percentage of equity owned by the director.

VC ownership (VCO): We measure VC ownership by the percentage of equity owned by VCs.

Employee ownership (EO): We measure employee ownership by the percentage of equity owned by employees.

Board size (BS): We measure board size of directors by the number of directors sitting on the board at the shareholders' annual meeting. It is the number of whole directors.

The proportion of outside directors (POD): It is calculated as the number of outside directors divided by the total number of directors.

The proportion of VC directors (PVC): It is calculated as the number of VC directors divided by the total number of directors.

The proportion of employee in board (PE): It is calculated as the number of employee in the board divided by the total number of directors.

Dummy variable of two-duty conditions (DUAL): A dummy variable that takes on 1 if the CEO is also the chairman of the board and 0 otherwise.

Board meeting frequency (MF): It is measured by the number of meetings per year.

3.2.3. Control variable

Firm Age (AGE): Quantitative variable measured by the difference between date of IPO and date of creation of the firm.

Firm size (SIZE): quantitative variable measured by the logarithm of Book value of total assets.

Debt ratio (DEBT): quantitative variable measured by financial debt divided by total of assets. This measure is also used by Agrawal and Knoeber (1996), Fernandez and Arrondo (2005) and Kochhar and David (1996).

Industry segment (SECTOR): qualitative variable indicating the industry segment of firm. It takes on 1 if segment is IT and 0 otherwise.

3.3. Statistic method and equation

We use descriptive statistics and regression analysis to test the hypotheses which we have suggested above and the statistic tool which we used is Eviews3.

The equations we design are as follows:

$$ROE_i = \alpha_0 + \alpha_1 OC_i + \alpha_2 DO_i + \alpha_3 VCO_i + \alpha_4 EO_i + \alpha_5 BS_i + \alpha_6 POD_i + \alpha_7 PVC_i + \alpha_8 PE_i + \alpha_9 DUAL_i + \alpha_{10} MF_i + \alpha_{11} AGE_i + \alpha_{12} SECTOR_i + \alpha_{13} SIZE_i + \alpha_{14} DEBT_i + \varepsilon_i \quad (1)$$

$$ROA_i = \beta_0 + \beta_1 OC_i + \beta_2 DO_i + \beta_3 VCO_i + \beta_4 EO_i + \beta_5 BS_i + \beta_6 POD_i + \beta_7 PVC_i + \beta_8 PE_i + \beta_9 DUAL_i + \beta_{10} MF_i + \beta_{11} AGE_i + \beta_{12} SECTOR_i + \beta_{13} SIZE_i + \beta_{14} DEBT_i + \varepsilon_i \quad (2)$$

$$Tobin's Q_i = \gamma_0 + \gamma_1 OC_i + \gamma_2 DO_i + \gamma_3 VCO_i + \gamma_4 EO_i + \gamma_5 BS_i + \gamma_6 POD_i + \gamma_7 PVC_i + \gamma_8 PE_i + \gamma_9 DUAL_i + \gamma_{10} MF_i + \gamma_{11} AGE_i + \gamma_{12} SECTOR_i + \gamma_{13} SIZE_i + \gamma_{14} DEBT_i + \varepsilon_i \quad (3)$$

$$MVA_i = \delta_0 + \delta_1 OC_i + \delta_2 DO_i + \delta_3 VCO_i + \delta_4 EO_i + \delta_5 BS_i + \delta_6 POD_i + \delta_7 PVC_i + \delta_8 PE_i + \delta_9 DUAL_i + \delta_{10} MF_i + \delta_{11} AGE_i + \delta_{12} SECTOR_i + \delta_{13} SIZE_i + \delta_{14} DEBT_i + \varepsilon_i \quad (4)$$

α_0 α_{10} : coefficient estimates.

β_0 β_{10} : coefficient estimates.

γ_0 γ_{10} : coefficient estimates.

δ_0 δ_{10} : coefficient estimates.

ε_i : The statistical errors

i : 1.....n

n=106 firms

4. Statistic results

4.1. Descriptive statistics

Table 1. Descriptive statistics of Board Characteristics

	BS	POD	PVC	PE	MF
Mean	6.235849	0.130460	0.137512	0.008176	5.962264
Median	6.000000	0.000000	0.038462	0.000000	5.500000
Maximum	16.000000	0.750000	0.750000	0.250000	14.000000
Minimum	3.000000	0.000000	0.000000	0.000000	1.000000
Standard Deviation	2.436046	0.188806	0.170340	0.042053	2.721780
Sample number	106	106	106	106	106

Table 2. The two-duty condition

	Modality	Ratio
DUAL	1	67,64%
	0	32,35%

Table 1 and table 2 report descriptive statistics for the variables used in the study of the relation between board structure and performance. The mean of board size is 6.23 directors among whom 13% are outsiders (the number of independent director is zero in many company, which means they have no independent system), 13.7% are VCs and 0.8% are employees. We can see also that most firms adopt two-duty governance system. The proportion of the companies which adopt this system is 0.676.

Table 3. Descriptive statistics of ownership structure

	OC	DO	VCO	EO
Mean	0.770945	0.231043	0.320338	0.018679
Median	0.797800	0.148300	0.274150	0.000000
Maximum	1.000000	0.859500	0.866800	0.443000
Minimum	0.126320	0.000000	0.000000	0.000000
Standard Deviation	0.173728	0.228572	0.219736	0.056227
Sample number	106	106	106	106

Table 3 presents basic statistics for ownership structure measures across all firms in the sample. At the average, ownership concentration is 77%. Ownership tends to be highly concentrated. The data also reveal that there is substantial variation across firms in ownership concentration: despite the large average, the minimum value for the 5 largest owner's holding is 12% and the maximum value is 100% percent.

As shown in Table 3 for our data, Director holds in average 23% of capital. VCs hold on average 32% of capital and finally, employee hold only a low percentage of capital (on average in 1.8 %).

Table 4 shows that the average level of debts is 50.03 %. The firm size of our sample (measured by the total log of assets) is on average 4.3. The firm age is on average 11 years. Almost 1/3 of these firms are "new economy" firms.

Table 4. Descriptive statistics of control variables

	Modality		Ratio
SECTOR	1		29,24%
	0		70,75%

	AGE	SIZE	DEBT
Mean	3950.11	4.316733	0.502920
Median	2882.000	4.345312	0.572818
Maximum	24310.00	6.323871	0.910929
Minimum	263.0000	1.763158	0.006323
Standard Deviation	3678.324	0.763212	0.255335
Sample number	106	106	106

4.2. Regression analysis

The correlation matrix computes the correlation coefficients of the columns of a matrix (see table 5). We don't find some kind of correlation between all variables. None of the correlations are high enough to warrant any problem.

Table 5. Correlation Matrix

	OC	DO	VCO	EO	BS	ICA	POD	PE	DUAL	FR	AGE	SECTOR	SIZE	DEBT
OC	1													
DO	-0.274	1												
VCO	0.165	-0.327	1											
EO	0.007	0.091	-0.099	1										
BS	-0.054	-0.179	-0.109	-0.037	1									
POD	-0.132	-0.216	0.108	0.041	0.395	1								
PVC	0.004	-0.125	0.447	0.044	0.225	0.118	1							
PE	0.157	-0.134	-0.003	0.226	0.203	0.014	0.028	1						
DUAL	0.137	0.154	-0.035	-0.041	-0.111	0.064	-0.128	0.064	1					
FR	-0.026	-0.023	0.039	-0.107	0.178	0.119	0.189	-0.119	-0.062	1				
AGE	0.062	-0.054	-0.180	-0.071	-0.047	0.128	-0.203	-0.068	0.135	0.035	1			
SECTOR	0.016	0.134	0.023	0.110	-0.028	0.237	0.123	-0.058	-0.150	-0.136	-0.122	1		
SIZE	-0.003	-0.122	0.016	-0.071	0.231	0.064	-0.006	0.246	0.071	-0.136	-0.144	-0.128	1	
DEBT	0.112	0.040	-0.035	-0.086	-0.106	0.073	-0.126	-0.087	0.160	0.063	0.290	-0.155	0.149	1

To examine the impact of ownership structure, board structures as governance mechanisms on performance, we estimate equations (1) to (4).

The regression results of equation (1) in table 6 where ROE is regressed on all board structure variables and ownership structures with other control variables show that there are five significant regression analyses. Ownership concentration and director ownership are positively correlated with performance. The effects are statistically significant at the 5 percent and the 1 percent level, respectively. Ownership structure and director ownership become a favorable elements to control and align interests to perform performance. They are consistent with the hypothesis 1 and 2 that ownership concentration and director ownership have a positive effect on performance. VC ownership and employee ownership have a negative impact in performance and neither of them is statistically significant for either dependent variable.

Table 6 provides also some evidence for board structure impact on performance. The coefficients of board size variable, CEO-Chairman duality variable, Sector variable and debt ratio are negatively correlated with ROE. The effects are statistically significant at the 5 percent, the 1 percent level, the 1 percent level and the 1 percent level, respectively. So, hypotheses 5 and 7 are supported. This finding for board size is consistent with Jensen (1993) and Lipton and Lorsch (1992). CEO-Chairman duality

contributes to speculation and inefficacy and damages the shareholder's interest consistent with Jensen (1993).

The coefficient of independent director variable is positively correlated with performance. The effect is statistically significant at the 1 percent. Hypothesis 6 is also right and confirms that Outside directors enhance the effectiveness of the board of directors in monitoring managers, and improving firm value (Alexander and Paquerot, 2000; Hochberg, 2004).

The presence of VCs in board and The proportion of employee in board are positively associated with performance but in absent significance. Board meeting frequency is negatively related to performance but not significant. Hence hypothesis 8 and 9 are not supported.

The regression results of equation 2 are completely contrary to those obtained in equation 1 and show that there are five significant correlations. Ownership concentration and director ownership are negatively correlated with performance at 5% level. VC ownership and employee ownership have not a significant impact in performance. Board size variable, CEO-Chairman duality variable, Sector variable and debt ratio are positively correlated with ROA. So, hypotheses 1, 2, 5 and 7 are not validated when we use ROA as performance measure. Correlations are also found between independent director variable at 1% level and between the proportion of employee, the presence of VCs in board and Board meeting frequency and performance, but in absent significance.

Table 6. Regression Analysis of ownership structure, board structure and Firm Performance

	(1) ROE	(2) ROA	(3) Tobin's Q	(4) MVA
OC	1.472904** (2.365956)	-0.718511** (-2.318533)	-0.150243 (-0.092296)	1828.300 (0.267929)
DO	1.368803*** (2.686724)	-0.660422** (-2.604061)	0.276035 (0.207207)	-3609.747 (-0.646397)
VCO	-0.834195 (-1.501773)	0.393775 (1.424073)	1.758082 (1.210411)	7392.821 (1.214193)
EO	-1.354763 (-0.748625)	0.632027 (0.701590)	-1.909592 (-0.403551)	-5099.868 (-0.257099)
BS	-12.33177** (-2.451149)	6.010241** (2.399847)	45.82855*** (3.483669)	140428.3* (2.546475)
POD	28.12750*** (3.106379)	-13.63914*** (-3.025923)	-29.09593 (-1.228888)	-113247.3 (-1.141016)
PVC	2.938509 (0.253694)	-1.294374 (-0.224487)	-18.47914 (-0.610130)	-26003.63 (-0.204813)
PE	4.872201 (0.171218)	-2.319670 (-0.163757)	25.46060 (0.342177)	-90644.54 (-0.290608)
DUAL	-65.19212*** (-2.895153)	31.58345*** (2.817627)	96.03648 (1.631058)	139603.9 (0.565607)
MF	-3.889376 (-1.027730)	1.730233 (0.918441)	-2.586758 (-0.261404)	-28556.22 (-0.688400)
AGE	-0.003085 (-1.060022)	0.001498 (1.033883)	0.002658 (0.349159)	7.622746 (0.238916)
SECTOR	-67.51844*** (-2.789182)	32.46534*** (2.694151)	36.87424 (0.582551)	363793.1 (1.371039)
SIZE	0.131348 (0.009330)	0.053561 (0.007643)	-206.4396*** (-5.608176)	-276714.8* (-1.793267)
DEBT	-83.21682** (-1.996517)	40.19649** (1.937303)	192.4197* (1.765502)	566319.8 (1.239551)
R²	0.226953	0.216222	0.321200	0.124249
adj-R²	0.108022	0.095641	0.216769	-0.010482
F-statistic	1.908282**	1.793168*	3.075725***	0.922198

Annotation: The number in the bracket is standard error

***Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level

The regression results of equation 3 where we use Tobin's Q as dependent measure find only one correlation between board size and performance but board size is positively correlated to performance at 1% level. Firm size is negatively correlated to performance at 1% level. Hence, no one of all hypotheses is supported.

The regression results of equation 4 shows there is no significant correlation between all independent variables and performance with the exception of a positive and significant correlation (at 10%) between board size and performance measured by MVA. Firm size is negatively correlated to performance at 10% level. So, hypothesis 1 is not right. And no of other hypotheses are supported.

5. Conclusion

The possible impact of ownership structure and board structure on corporate performance has been a central question in research on corporate governance. This paper investigates those questions to better understand involvement of VCs in corporate governance and to understand also how internal control mechanism affects firm performance.

We find that the evidence on the nature of the relationship has been decidedly mixed if we change performance measure. We use in this paper ROE, ROA, Tobin's Q and MVA as performance measures. The results of impact ownership structure and board structure on performance of VC-backed firms provide supports for scholars and practitioners. To sum up, VCs mitigate principal-agent problems and improve performance. We show in this paper that there is significant correlation between ownership concentration, director ownership, board size and performance when we use ROE and ROA. We show also that board size has negative coefficient when we use ROE and positive coefficient when we use ROA, Tobin's Q and MVA. The result shows the condition that CEO and chairman is one person is significantly negative related to the ROE, and is significantly positive related to the ROA. The effect of outside directors is examined also, and the result shows that there is significant correlation between the proportion of outside directors and performance measured by ROE and ROI but there is no significant correlation between outside directors and other performance measure. In this paper, there is no statistic significance between the proportion of VC in board, the proportion of employee in the board, board meeting frequency and performance.

This study suggest that VCs is an active investor and play role in corporate governance by creating boards with low number of member and with greater independence. But this study is limited to ownership structure and board structure as governance mechanisms. Other governance mechanisms can be studied in the future to analyze VC involvement in corporate governance and impact of VC involvement on performance.

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BOARD COMPOSITION IN FAMILY-INFLUENCED FIRMS: A DYNAMIC PERSPECTIVE

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Abstract

This paper uses a sample of 76 family businesses in Tunisia to investigate the impact of the family firm dynamic on the composition of their boards of directors. We argue that whether or not a transition in ownership is planned, firms have different governance needs and characteristics depending on the generational phase. The empirical results show that board composition is positively influenced by both generational evolution and succession planning. This study provides evidence of an increase in the appointment of outside directors to boards of family firms from the third generation of ownership. This result implies that it is important to consider the generational phase and succession process of the family firm in order to better understand its governance system.

Keywords: family firms, Board composition, generational evolution, succession process

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Introduction

Family firms have gained increasing attention in the recent literature and research has shown that the majority of firms around the world are directly controlled by their founders or their founders' descendants (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Claessens, Fan, and Lang, 2000). In Tunisia, founding families own and control a significant number of firms. Among 200 leading Tunisian firms, founding family involvement prevails in more than one-third of them.

Generational changes and succession processes are believed to be the most challenging tasks facing family business managers (Morris and al., 1997; Davis and Harveston, 1998). Researchers observe that only a small percentage of family firms survive the transition to the second generation and many intergenerational transitions fail soon after the second generation takes control (Davis and Harveston, 1998; Morris and al., 1997).

However, despite the widespread attention given to the succession and generational issues by family business researchers, little systematic interest has been taken in the impact of these issues on the firm's governance system. Hence, the exit or failure of a significant number of family ventures could be avoided by implementing well-functioning governance mechanisms, such as a formal board of directors (Bammens et al., 2006). These mechanisms help to ensure the business's survival as they enhance the cohesiveness of the controlling family as well as contribute to better corporate performance (Neubauer and Lank, 1998; Schulze et al., 2001).

For each transition in a firm's life cycle, firms need to adapt their governance mechanisms to their requirements (Lynall et al., 2003; Filatotchev et al., 2006). As this transition happens over time, movement through the succession process may also affect forms of corporate governance (Fiegener et al., 2000). In addition, family succession adds valuable business experience and skills to the firm.

Corbetta and Salvato (2004) argue that board composition characteristics should be linked to variables that simultaneously define different family business types and have relevance for determining governance needs.

Following this argument, our study considers succession planning, generational issues and family experience. The purpose of this paper is to examine the relationship between important dynamics in the dimensions of family firms, such as generational changes, succession processes, family experience and board composition. We argue, in agreement with Voordeckers et al.'s (2007) typology, that these dimensions align with formal boards comprising more outside directors.

Governance in Tunisia is moving slowly from a system of stable "insider" relations to a more flexible market-based "outsider" model of shareholder participation and control. Major changes in the commercial code, the bankruptcy code, accounting rules and shareholder structures have already moved the country towards a more open market economy. However, strong families still dominate the ownership of the largest companies.

Following a wave of international corporate scandals, a series of Tunisian government committees and laws (e.g. law 2005-96) led to the creation of a Code¹ of Governance Practice (IACE², 2008) for companies. This code emphasises the importance of family firms and provides a set of principles on which targeted board characteristics can be based.

The remainder of this paper is organized as follows: In the next section, an overview is given of key theoretical developments concerning board composition, namely agency theory and stewardship theory. We then develop our research hypotheses, on which we base our analysis of the impact of generational evolution, succession process and family experience on board composition in family firms. For this analysis we clarify our research method, followed by a discussion of the empirical results. Finally, we present implications for management theory and practice from our findings and indicate research paths for further investigation.

Theoretical background for board composition

"Board composition can be described as the definition of each director's affiliation with the firm" (Finkelstein and Hambrick 1996)³. The importance of board composition is in its perceived role in enhancing the firm's performance. Indeed, a central dimension in board composition is the level of director independence, grounded in agency theory (Johnson, Daily, and Ellstrand 1996). According to this approach, the primary function of boards of directors is to monitor the managers' actions and decisions, in order to protect the interests of owners from managerial opportunism (Fama and Jensen, 1983). Agency theory describes the potential for conflicts of interest arising from the separation of ownership and control in firms. Placing a board of directors with independent nonexecutive directors in a monitoring and oversight role can be an effective means for addressing the problem of conflicting interests and decreasing associated agency costs (Fama and Jensen 1983). Independent/outside directors are expected to be more effective monitors management's self-interest than are dependent directors.

The agency problem seems less important in family firms because property rights are largely restricted to internal decision agents. However, Morck and Yeung (2003) report real divergences in principals' and agents' goals within family firms. Along with other recent studies of the family factor in relation to agency theory (e.g. Dyer 2003; Morck and Yeung, 2003; Schulze et al., 2003; Steier 2003; Gómez-Mejía et al., 2001; Schulze et al. 2001), they identify specific agency problems pertaining to family firms. These studies highlight differences in agency relationships between family and non family firms. Corbetta and

¹ In collaboration with the CIPE (Centre for International Private Enterprise).

² Institut Arabe des Chefs d'Entreprise: the leading CEO's association (mostly owners).

³ In Voordeckers and al. (2007).

Salvato (2004a) have also investigated agency problems by type of family firm and have found considerable variety in their adoption of outside boards of directors for better monitoring and control.

Ghoshal and Moran (1996) emphasised the effects of existing good social relationships between owners and managers. These relationships are important in family firms where some of the board members, as well as managers and owners, belong to the same family. The close social relations among family members may allow the firm to build informal, relational governance mechanisms.

To better understand this context, Huse (2005) recommends a multiple-theories approach. As well as agency theory, stewardship theory has also been used to explain the composition of the board of directors (Corbetta and Salvato, 2004). According to this perspective, the role of the board is to “look after” the management by providing services and offering advices. Managers are here characterized by high degrees of commitment toward the owners as there is a significant overlap between their values and those of the firm. Hence, stewardship theory proposes that board structure should be characterized mainly by insiders or by affiliated outsiders who are linked to organization or to each other by family and social ties (Sundaramurthy and Lewis, 2003).

Board-management social ties are said to foster trust, helping executives to engage less in impression management and to seek greater input from other directors (Westphal, 1999). Likewise, directors may offer more open feedback, confident that executives will consider their views.

Stewardship theory advances a framework of situational and psychological factors leading to a better understanding of the principle/agent relationship (Davis et al., 1997; Lee and O'Neill, 2003). This theory defines situations in which managers behave as stewards and gain higher utility from pro-organizational, collectivistic behaviour than from individualistic, self-serving behaviour as presumed by agency theory. This attitude is particularly significant in family businesses where prevalent kinship ties between individuals can allow governance mechanisms, such as boards, to serve different functions and roles (Lane et al., 2006). As Lee and O'Neill (2003: 212) stress: “what works well to control or motivate an opportunistic manager may not work well to control or motivate a steward”. While agency theory suggests formal control by boards and reliance on punishments to control managerial behaviour, stewardship theory suggests social control as an effective constraint on management.

Ward and Handy (1988) present a typology of board composition which may include several board roles. Finkelstein and Hambrick (1996) differentiate between inside directors, outside directors, affiliated directors and family directors. Pearce and Zahra (1992) discuss the importance of two groups of outside directors, namely affiliated and non-affiliated external directors.

According to Whisler (1988) and Bammens et al., (2006), the knowledge input of boards of directors can be very valuable during life-cycle changes, leadership and generational succession and for transferring family experience in family firms.

In the next section, research hypotheses based on the typologies presented by Finkelstein and Hambrick (1996) and Pearce and Zahra (1992) are developed concerning the influence of family business dynamics on the adoption of three defined categories of board composition: family board, inside board and outside board.

Development of hypotheses

Organizational dynamics emerge within several aspects of family firms. Among these we focus on the leadership succession process, generational issues and transfer of family experience.

Generational evolution and board composition

Zahra and Pearce (1989) assert that board composition is contingent upon the phase in a company's life cycle. This generation evolution can lead to significant goal divergence during each transition phase. While founders are concerned about entrusting “their” business, the younger generations are more likely to focus on the economic viability of the existing business (Kohl and White, 2001). Lievens (2006)

shows 3 stages in this particular life cycle: the “owner centered” stage, the “sibling partnership”⁴ stage and “cousin consortium”⁵ stage. In the first generation of family firms, the relationships among family members are supposedly sound and stable. Lievens (2006) explains that in the course of the controlling owner stage in which the family firm is the property of principal shareholder, the board of directors often comprises family members sharing the same values and perspectives. The patrimonial interests coincide with those of principal shareholder. Therefore, the protection of those interests does not preoccupy the board at this stage. However, when firms move into the sibling partnership or the cousin consortium stages, the potential for conflicts can arise between members of different generations and adequate governance structures are essential for the mediation of such sources of conflict.

A number of researchers have demonstrated that the level of conflict among relatives involved in the family firm increases over the generations (Davis and Harveston 1999, 2001; Ensley and Pearson 2005). This is due to the fact that the likelihood of diverging opinions concerning the firm increases as different generations and family branches become involved (Dyer 1994; Ward and Aronoff, 1994). The presence of additional family members in these organizations seems only to intensify the eruption of conflict (Davis and Harveston, 2001). According to agency theory, the increase in the level of conflict over the generations can be linked to the need for control by a formal board of directors. More specifically, the generational phase can be linked to the likelihood of having outside directors within the board. The outsiders may play a vital role as arbitrator in the case of conflicts between family members.

Based on this reasoning, our first hypothesis is stated as follows:

*Hypothesis 1: Generational evolution influences the probability of having an outside board*⁶.

Succession process and board composition

The leadership succession process in family business has received much research attention because this type of business frequently stumbles in the area of succession planning (Zahra and Sharma, 2004; De Pontet and al., 2007). As mentioned by Lussier and Sonfield (2004, p. 49): “the primary issues here involve the difficulties founders have in “letting go” and passing on the reins of control and authority, the lack of preparation for leadership which next-generation family members often inherit, and thus the need for, and importance of, succession planning”.

The succession process in a family firm is often accompanied by a power struggle (Barnes and Hershon 1994). The inclusion of outsiders on the board may help to guide this process and prevent irreparable family rifts and company stagnation. Outside directors may fulfil the role of arbitrator within the board and provide a forum for discussion and conflict resolution (Whisler 1988). Based on these arguments, we expect that the succession process leads family firms to adopt outside directors.

We therefore postulate the following hypothesis:

Hypothesis 2: The generational transition influences the probability of having an outside board.

Family business experience and Board composition

The concept of family experience refers to the tacit organizational knowledge that families develop over time (Astrachan et al., 2002). Family succession can add valuable business experience and skills to the firm.

Miller and Le Breton-Miller (2006) indicate that families do well at passing on tacit organizational knowledge from one generation to the next. The older generation is usually very willing to share its knowledge with the next generation of family managers and to discuss their own mistakes with them. Furthermore, each generation adds valuable business experience and skills to the family (Corbetta and Salvato 2004; Klein et al., 2005).

As indicated by Huse (1990), boards can enhance the expertise of the management team. However, as noted by Bammens et al., (2006), the need for board advice can be expected to decrease as the level of family experience and tacit knowledge of the business increases over the generations. Concomitantly, as the level of organizational knowledge increases (Astrachan et al., 2002; Miller and Le Breton-Miller 2006), the need for complementary advice held by inside directors should decrease. We therefore propose the following:

Hypothesis 3: Family business experience influences the probability of having an outside board.

⁴ Much more a « family clan » cycle.

⁵ Translating the « family dynasty » influence.

⁶ Referring to Voordeckers and al. (2007) concept of « board comprising external directors ».

Research method

Sample and data collection

As definitions of family businesses are various and ambiguities persist (Chua, et al., 1999), we provide an operational definition for the research objective. Firms included in this study were required to meet two selection criteria: (1) at least 50 percent of the ownership is controlled by the family and (2) at least two family members exhibit kinship ties or occupy management roles. These criteria produced a population of 168 industrial family firms, selected from a set of 270 public limited companies⁷ included in the database of the Tunisian Agency for the Promotion of Industry⁸. A survey questionnaire was sent to all 168 CEOs. As Zahra (2005, p.30) points out, “the company’s CEO is usually the most informed person concerning the company’s entrepreneurial and strategic operations” and hence our selection of the CEO as the key informant in our survey. From this sample 76 usable responses were obtained from family firms operating in various sectors of industry, resulting in a net response rate of 45 percent.

The total sample characteristics is presented in Table 1. On average, responding firms are 30 years old. Most of the firms (76%) are small and medium sized. Young firms dominate the sample (<50 years)⁹. More than 20 percent are managed by the first generation of family owners, 71 percent by the second generation, and 9 percent by the third generation. In all of the firms, the CEO is also a member of the board. The sample is strongly dominated by family firms in which family ownership is high. More than half (55%) of the firms have 90 percent family ownership. Concerning this dependent variable, 50 percent of the firms have a family board, 38.2 percent have an inside board and 11.8 percent have an outside board.

Table 1. Descriptive statistics of the sample

	N=76	Percentage
<i>Size</i>		
Micro (<10 employees)	-	-
Small (10-50 employees)	23	30.3
Medium (51-250 employees)	35	46
Large > 250 employees	18	23.7
<i>Age</i>		
< 50 years	74	97.4
≥ 50 years	2	2.6
<i>Generation</i>		
First generation	15	19.7
Second generation	54	71
Third generation	7	9.3
<i>Affiliation Classification of Directors</i>		
Family Boards	38	50
Inside Boards	29	38.2
Outside Boards	9	11.8

Dependent variable: Board composition

We used the board classification adopted by Voordeckers et al. (2007) who proposed a complete classification, including different categories of director affiliation other than the traditional inside-outside board distinction. More specifically, they differentiate between (1) family boards composed entirely of family members, (2) inside boards with at least one director who is not a member of the family but who has a direct or indirect affiliation with the company, such as top management or affiliated directors and

⁷ Or limited liability companies, in Tunisia “sociétés anonymes”: with the legal obligation to have a Board of directors with at least three directors.

⁸ The wider and most complete industrial database in Tunisia.

⁹ Anderson and Reeb (2004) classify family firms as follows: Young family firms are those with a firm age of less than 50 years and old family firms are those with a firm age of more than 50 years.

(3) outside boards with at least one outside director. An outside director is defined as a nonexecutive who is not a family member, a nonfamily manager, or an affiliated director such as an attorney or accountant.

Independent variables: family business dynamic

Generational evolution

To determine the generation in charge of the company, the survey included a question in which respondents had to indicate the generation currently having decision power in the firm. We recoded this variable in three categories: first generation; second generation; third and subsequent generations.

Generational transition

This variable is measured by a dummy variable, coded “1” if the generational transition was planned and “0” otherwise.

Family business experience

Three items measure the experience dimension: (1) the generation of the family owning the company, (2) the generation of the family managing the company and (3) the generation active on the governance board. The alpha coefficient for this three-item scale is very high at 0.897.

Control variables

Two control variables were inserted into the econometric model: firm size (logarithm of the number of permanent employees) and firm age (logarithm of firm age measured in years). These control variables were used to capture company effects on the relationships depicted in the study’s hypotheses.

Method

The objective of the econometrical model is to analyze the multivariate relationship between a mixed set of metric and categorical covariates and a polytomous dependent variable. Thus, we need a procedure that can predict the estimate of the probability that the event will or will not occur. For metric dependent variables, multivariate regression can be used. However, as we have polytomous dependent variables and metric variables, logistic regression is more appropriate. Logistic regression differs from multiple regressions in that it predicts directly the probability of an event occurring. This statistical technique consequently enables the identification, among interacting factors, of most significant variables explaining board composition in family-influenced firms. The data is analyzed with SPSS16.

Results and discussion

The relationship between board composition and the family dynamic was examined using a multinomial logistic regression analysis with the board composition as a categorical variable, having three alternatives: (1) a family board¹⁰, (2) an inside board, and (3) an outside board.

Table 2 shows the results for the estimate of the multinomial logistic regression. The positive (negative) coefficients indicate positive (negative) relations between the independent variables and board composition.

Table 2. Multinomial logistic regression analyses for family business ^a

Independent variables	Dependent variable	
	(1) In (P _{fam} / P _{out})	(2) In (P _{int} / P _{out})
<i>Intercept</i>	1.667 (1.315)	1.833 (0.712)
Generation		
1 st Generation	1.602 (4.706)***	0.145 (0.159)*
2 nd Generation	0.807 (0.916)*	1.477 (2.279)**
Generational transition	3.445	3.206

¹⁰ For the Multinomial Logistic Regression procedure, we selected outside board as reference category.

	(4.331)***	(4.607)*
Experience	-3.064 (2.385)	-1.451 (1.012)
LN (Firm size)	- 0.591 (2.200)	-0.194 (0.215)
LN (Firm age)	-0.834	-2.582
	(0.418)**	(3.716)*
Chi square	45.219 ***	
N	76	

a -Third generation is the suppressed comparison categories. Wald statistics between parentheses.

* - p<10%;

** - p<5%;

*** - p<1%.

Results from statistical analysis of the data support H1. As expected, each generational evolution increases the probability of having outsiders on the board. Accordingly, we find a significant coefficient for the first generation (controlling owner). This stage of the firm's life cycle is characterized by strong family power resulting from the domination of family members holding the company's key leadership position. The resulting lack of goal conflict and risk differential between owners and managers reduces agency problems (Fama and Jensen, 1983). First-generation family firms have no need for control by an outside board. The surprising result is that the coefficient for the second generation is significantly positive in regressions (1) and (2). Family firms in the second generation are also less likely to adopt an outside board. Schulze, Lubatkin, and Dino (2003) point out that agency dynamics during the sibling partnership stage - found mostly in the second generation - are more problematic than in the stages of controlling owner (first generation) or cousin consortium (third generation and higher). However, from our result, we conclude that family firms adopt an outside board only when they have moved into the third generation (cousin consortium) stage. This result implies that first and second generations of family leadership are unceasingly influenced by the original business objectives and methods of the firm's founders. "Generational shadow"¹¹ and "legacy centrality"¹², as described in the literature (Sonfield and Lussier, 2004), remain in force beyond the first and second generations of a family firm. Indeed, the succession by the second generation is not equivalent to the formal leaving of the firm by the founder. Normally the founder's influence and authority remain influential and help to address subsequent sources of conflict among successive generations. Consequently, the founder's influence extends also to the choice of board members in second-generation family firms. In addition, third-generation CEOs of family firms seem to appreciate the presence of outside board members. They appear to recognize the added value outside directors can deliver as advisors or arbitrators.

The results support also H2. Thus, the generational transition influences the probability of adopting an outside board. Planning for succession is an opportune time also to consider the firm's objectives when the family anticipates the evolution and takes the time to address issues around the relationships within the firm and the family. During the transition period, the founder develops a better acceptance of the "retirement" stage and at the same time provides an opportunity for outsiders (family outsiders not necessary firm ones), to help arbitrate the potential conflicts between siblings. Subsequent generation successors are often better educated than the first generation owner manager. Indeed an increase in the firm's knowledge base contributed by later, more highly educated generations also increases the perception among the family members of the added value of outside directors. Moreover, family firms in the third generation seem to be less focused on family objectives and are more aware of the need for, and more likely to accept, external advice and counsel.

The coefficients in regressions (1) and (2) show the expected negative sign but the result does not show statistical significance. Family experience does not appear to influence board composition (H3 is thus rejected). This result seems to indicate that the board's role is not really that of an advisory mechanism in family firms, suggesting that there is no need for a particular board composition based on this characteristic.

¹¹ "In a multi-generation family firm a generational shadow, shed by the founder, may be cast over the organization and the critical processes within it".(Sonfield and al., 2004)

¹² « a family firm founder's "legacy centrality" will influence the strategic behavior of succeeding generations' family member managers, with both positive and negative impact » (Sonfield and Lussier, 2004).

For the control variables, the results show a significant effect of firm age on board composition. Older family firms are more likely to adopt outside boards. This result for firm age corroborates the findings for the first hypothesis relating to the family firm life cycle, while firm size has no influence on board composition.

Conclusion

The purpose of this study was to scrutinize the relationship between board composition and important dimensions of a family firm's dynamics, such as generational changes, leadership succession planning, family experience. General analysis of the two regressions in the multinomial logit model reveals that two comparisons show significant results. The comparison between outside boards and family boards seems to yield a more important result than the comparison between inside and outside boards for these firms. The results also show that reasons for appointing inside managers to the board of directors differ from reasons for appointing outside directors. This result indicates a third "family board" category where, in the case of family firms, the traditional "inside-outside" board categories are not relevant.

Succession planning and generational evolution are found to be significant determinants of board composition. Nevertheless, an expected relationship between formalised, outside boards and generational changes, especially with the move from first to second generation family leadership, shows a result opposite to that expected. The value added by outside directors is seen when family firms move into the third generation (cousin consortium stage) and usually not before. However, we might surmise that the introduction of outside board members is more likely to occur when the founder disappears (by illness or death). The patriarch's presence is strong in Tunisian culture and the disappearance of this leader figure can facilitate the "opening up" of the board to the appointment of outsiders.

We can thus describe the evolutionary process of board composition in family firms as follows. At the first stage in a firm's life cycle, the composition of the board comprises a majority of family members led by the founder. At the second stage, and if succession is planned, outsiders who are affiliated to and considered part of the large or extended family are introduced to the board. It is only from the third generation on, that the board will include outside members who are independent from the family

In general, the dynamics of the family firm are significant determinants of the composition of the board. , Our findings support the argument by Lynall et al., (2003) that board characteristics are an expression of the family firm's life cycle stage and also contributes to the literature that focuses on behavioural perspectives of corporate governance (Forbes and Milliken 1999, Huse 2005, Bammens and al., 2006).

Our study has some limitations that should be acknowledged and addressed in future research. First, we have discussed only a limited number of variables relating to the dynamics in family firms, deriving from these implications for board composition. Future research should incorporate other factors specific to family firms in empirical models to build a clearer understanding board effectiveness in this context. We propose, for example, including variables relating to family power and influence on firms (Corbetta and Salvato, 2004).

Second, subsequent studies can enlarge the theoretical foundations of agency and stewardship theory. Future research can gain further insights from the theoretical investigation of boards based on other theoretical perspectives such as resource dependence theory. According to this perspective (Pfeffer and Salancik, 1978), an organization benefits from the access to resources critical to company success that outside board members provide (Pfeffer and Salancik, 1978; Zahra and Pearce 1989; Borch and Huse, 1993). While an integrative conceptual model including resource dependence theory is outside the scope of this empirical paper, this theoretical perspective represents a fruitful basis for future research.

Third, this study does not address several related board topics. In governance research, further analysis should focus on the relationship between family firm dynamics and the frequency of board meetings (Vafeas, 1999), board processes (Huse, 2005) and board diversity (Carter et al., 2003). The context of board processes requires a panel data sample for analysis. Such a data sample would also questions of causality between variables to be better addressed.

Finally, this study is limited to an investigation of family firms in the country context of Tunisia. Family firm dynamics may vary considerably in other country settings and cross-country comparisons may build a richer model of board composition at varying stages of firm and generational evolution.

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GOVERNANCE AND PERFORMANCE IN COMPLIANCE VERSUS NON-COMPLIANCE CHINESE LISTED COMPANIES

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Abstract

Cases of corporate scandals and the misconduct of publicly listed companies (PLCs) are growing amid rapid economic development in China. Systematic research on governance factors affecting these corporate misdeeds and their consequences is however scant. This study compares the key governance characteristics of Chinese PLCs that were found to have contravened regulatory compliance requirements (i.e., “non-compliance” PLCs) to those that were not (i.e., “compliance” PLCs). Based on a comparison between 53 pairs of compliance- and non-compliance-PLCs over the period from 2001 to 2006, our results show that there are significant differences between the two. We found that ownership concentration is higher in compliance firms that also compensate their directors and executives at higher levels. Furthermore, the results suggest that sound governance practices benefit firms socially and financially, and an effective internal monitoring mechanism can further differentiate good companies from bad companies such that the good companies perform better.

Keywords: corporate governance, regulatory compliance, ownership structure, compensation, China

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Introduction

Many of the world’s corporate failures and misconduct in recent times have been associated with corporate misbehavior, highlighting the need for having good corporate governance frameworks and practices. Though countries are in a race to develop sound corporate governance systems, the regulatory enforcement of governance compliance in many developing nations remains ineffective (Berglöf and Claessens, 2006). China is no exception. With sustained rapid economic growth in China, reports of corporate scandals and misconduct, particularly at the top levels, have also become widespread in recent years. Some of these scandals involved top leaders of the country’s largest business enterprises, including its major state-owned banks (Tam, 2008). Systematic research on the factors driving this corporate misconduct and its consequences, however, is scant.

Is corporate misconduct common in China? What are the governance factors that affect corporations’ misconduct and how does misconduct affect shareholder value? To address these questions, our study investigates the key corporate characteristics and performance outcomes of China’s publicly listed companies (PLCs) that were found to have contravened regulatory compliance versus companies that were not. It examines whether PLCs with misconduct exhibit any significant differences in governance practices and performance as compared to their complying counterparts.

Collecting the cases of non-compliance that were identified and penalized by the Chinese stock market watchdog, the China Securities Regulatory Commission (CSRC), over the period from 2002 to 2006, we found 53 companies engaged in misconduct. After using a random sampling technique to find 53 matched pairs of compliance firms, and after collecting the firms' prior compliance or non-compliance data from 2001, the final sample consisted of 106 companies with a total of 636 firm-year observations. The findings from this study show that ownership concentration is higher in compliance firms, indicating that large shareholders have greater incentives and efficiency in monitoring firms' behavior (Shleifer and Vishny, 1997). The results also show that executives and directors receive higher compensation than their peers in non-compliance firms do, suggesting that attractive compensation packages could deter corporate shirking behaviors. Apart from better governance practices, compliance firms outperform their non-compliance counterparts, which suggests that compliance is not simply a "tick-the-box" exercise; it brings social and financial benefits to firms.

The remainder of this study is organized as follows. We discuss the background of China's corporate sector and legal environment in Section 2. Section 3 reviews the literature and formulates our theoretical hypotheses. Section 4 describes the research design, sample selection and variable measurements. Results and discussions are provided in Section 5, and Section 6 concludes the paper.

China's corporate sector and legal framework

Two Chinese stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), were established in 1990 and 1991, respectively, in conjunction with the country's economic reforms. As a part of "corporatization", many state-owned enterprises (SOEs) were selected and filed for initial public offering on the basis of provincial and local government quotas rather than on their financial soundness. However, a large number of these companies did not perform well after going public, and they did not engage in proper governance practices. For instance, a study by Schipani and Liu (2002) showed that some companies did not even convene regular meetings of the board of directors. Moreover, the major corporate scandals such as those involving Yin Guang Xia Co Ltd, Zhengzhou Baiwen Co Ltd, and Lantian Co Ltd, which were uncovered in 2000, have further raised the growing concerns over the efficiency of the governance mechanisms of Chinese companies. In response, the CSRC has released two major corporate governance regulations to strengthen the corporate sector and improve investor confidence. The two key governance regulations are (1) "*The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies*" (CSRC, 2001, released on 16 August 2001) and (2) "*The Code of Corporate Governance for Listed Companies in China*" (CSRC, 2002, released on 7 January 2002), which put greater emphasis on internal control mechanisms and on independent nonexecutive directors.

In the Chinese context, a concentrated ownership structure is the key characteristic of PLCs, with the state often being the largest shareholder, holding more than 45 percent of the total shares on average in a listed company (Dong and Gao, 2002). Studies of the ownership structures of Chinese companies have found mixed results. Some research shows that concentrated ownership is detrimental to firm performance (Hu et al., 2010; Xu and Wang, 1997), which can be attributed to the different objectives and goals among the controlling shareholders and other shareholders (Laffont and Tirole, 1991; Turnbull, 2005), managers' opportunistic behavior (Ma, 2000; Wei, 2000), and ineffective external control mechanisms (Lee and Hahn, 2001; Qian, 1995). Others compare state ownership with legal person ownership and private ownership, suggesting that different types of ownerships may exert different impacts on firm performance (Chen et al., 2009; Wang, 2005).

Given the country's weak legal system and inactive external control mechanisms, the effectiveness of internal governance mechanisms becomes more vital in Chinese firms (Hu et al., 2010). Subsequently, we develop a model that focuses on how ownership structure under strong state intervention may influence governance compliance and thereby affect firm performance for Chinese PLCs. Figure 1 depicts the model of the relationships among the variables examined in this paper.

The model builds upon the regulatory framework and the current developments of the corporate sector and corporate governance in China. Ownership structure is a product of state interventions and market development in the Chinese corporate sector. This paper shows that differences in ownership structures can affect the behavior of agents through variations in compensation schemes and the fulfillment of corporate goals and social objectives, thereby resulting in different levels of corporate governance

compliance behaviors and firm performance. The following section explores the literature framework that supports the formation of this model.

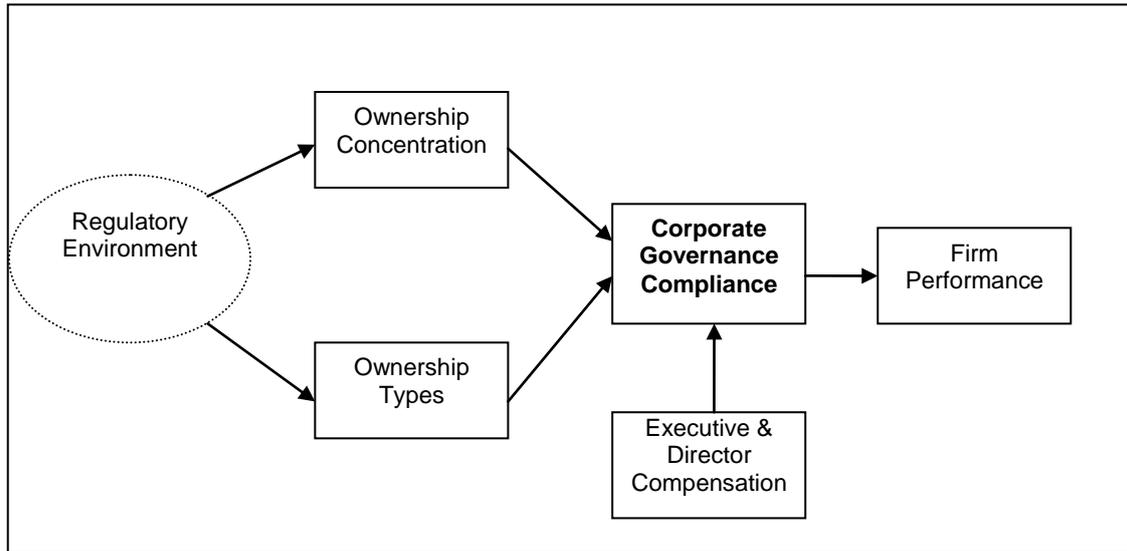


Figure 1. This framework depicts the relationships among ownership structure, corporate governance compliance, board and executive compensation and firm performance

Literature review and hypotheses development

Ownership concentration and corporate governance compliance

Ownership structure is clearly one of the most important governance mechanisms (Connelly et al., 2010; La Porta et al., 1999). With the separation of ownership and control in Anglo-American companies, agency theory suggests that a low level of monitoring could result in a higher level of agency costs (Jensen and Meckling, 1976). Thus, without a strong monitor, managers have ample room to engage in shirking behaviors that potentially hurt shareholders' welfare. By contrast, the presence of large shareholders can overcome the 'free rider' problem of dispersed ownership and therefore diminish the agency problem. With a higher ownership concentration, there is more incentive for the largest shareholder to perform the monitoring (Shleifer and Vishny, 1997). The ownership structure can therefore be an important determinant of the level of monitoring and the quality of corporate governance compliance within a firm. For example, Anderson and Reeb (2003) show that a high level of ownership concentration results in the more effective monitoring of firm managers by the largest shareholder, which in return is better aligned with the interests of the other shareholders. Therefore, we argue that a higher ownership concentration can reduce the incidences of corporate misconduct. Hypothesis 1 is formulated as follows:

Hypothesis 1: Compliance firms have higher ownership concentrations than non-compliance firms.

Ownership types and corporate governance compliance

Apart from ownership concentration, the type of large shareholder who holds the most control of a PLC also affects the quality of corporate governance compliance. In China, neither family ownership nor institutional investors have a significant presence yet; rather, it is the State that plays a predominant role. In a Chinese listed company, shares are either owned directly by the State at various levels, by Legal Persons (i.e., SOEs) that are majority owned by the State, or by private enterprises and individual shareholders. However, empirical findings on the performance implications of these different types of ownerships are mixed. By means of a study of over 500 companies listed on the Chinese stock exchanges during the period of 1993 to 1995, Xu and Wang (1997) find that corporate performance is negatively related to the proportion of a company's shares that are owned by the state, but holdings by legal persons are positively related to firm performance. This can be explained by the conflicts of interest between the government and the shareholders, which is a source of inefficiency (Laffont and Tirole, 1991). Also,

when legal persons' equity holdings in the firm are high and their objectives are to maximize the firm's value, the goal is the same as that of outsider shareholders (Morck et al., 1988). Empirically, this viewpoint is also supported by Qi *et al.* (2000), Hovey, Li and Naughton (2003) and Chiou and Lin (2005), who showed that there was a positive correlation between legal person shares and firm performance.

In contrast, some researchers argue that state ownership may not be less efficient than private ownership (Kay and Thompson, 1986; Kole and Mulherin, 1997). Chen (1998) finds that firm performance is positively related to state ownership rather than to legal person ownership. Likewise, Che and Qian (1998) argue that local government state ownership can signal a commitment mechanism to the market and offers necessary support to enterprises. A study by Tian (2001), which finds a U-shaped pattern between state ownership and firm performance, stresses that the government offers both 'grabbing' and 'helping' hands. Sun *et al.* (2002) also suggest that partial state ownership has a positive impact on firm performance. In fact, a U-shaped pattern between government ownership and firm performance indicates that a certain level of state ownership is to be encouraged, but not in excess. Perotti (2004) concludes that in transitional economies where proper control mechanisms are not well established, a residual degree of state ownership might be necessary. A hypothesis on the possible link between different types of shareholders and corporate governance compliance in China is therefore formulated as follows:

Hypothesis 2: Corporate governance compliance varies according to ownership type.

Compensation and corporate governance compliance

Executive compensation serves as an important mechanism in aligning the interests of directors and managers with those of their shareholders. A competitive compensation package can also lead to good management and better firm performance (Buchholtz et al., 1998; Stanwick and Stanwick, 2001). With China's booming economy, large Chinese firms and foreign-invested companies in the country are starting to offer attractive compensation packages to attract and retain good talent. We argue that directors and executives in firms with competitive compensation packages will be more inclined to engage in better governance compliance than their counterparts for three reasons. First, it is well accepted that a manager's compensation is related to the value and scarcity of the skill set that the manager brings to the firm. Therefore, capable and competent managers are more likely to negotiate a better compensation package for themselves and are more inclined to comply with best practices, standards, and governance regulations. Second, the market for managers in China is becoming increasingly competitive and might be sufficient to differentiate good from bad talent as well as good from bad firms. Third, poor compensation structure may also increase managers' shirking behaviors, leading to greater possibilities of misconduct. Therefore, the compensation of managers and directors is higher in compliance firms than their non-compliance counterparts. Hypothesis 3 is developed as follows:

Hypothesis 3: Director and executive compensation is higher in compliance firms than it is in non-compliance firms.

Corporate governance compliance and firm performance

From the 1997 Asian Financial Crisis to the recent 2008 Global Financial Crisis, poor corporate governance has been one of the key reasons for many corporate collapses (Claessens et al., 1999; Kirkpatrick, 2009). On the one hand, many studies report that good corporate governance could provide improvement when a company is underperforming due to poor management (Lipton and Lorsch, 1992), lead to a better-performing board (IBR, 2000), or result in less incidences of corporate misconduct (Chen et al., 2006). On the other hand, Dalton et al. (1998) show that the relationships between corporate governance and firm performance can be inconclusive. This is partly due to the complexity in defining corporate governance, which results in a difficulty in identifying variables to measure it precisely. This study attempts to avoid the ambiguity of what constitutes corporate governance by examining the relationship between the compliance of the regulatory framework and firm performance. Firms that are found to be non-compliance are determined by the existing legal framework and governance requirements. We adopt a holistic view that corporate governance is the complete strategic and operational system put in place as a monitoring mechanism to safeguard the interests of shareholders. Therefore, we propose that firms that are non-compliant in terms of corporate governance requirements show worse performance. Hypothesis 4 is formulated as follows:

Hypothesis 4: Compliance firms perform better than non-compliance firms.

Methodology

Sampling and data collection

The data are composed of all non-compliance Chinese listed companies that were identified and penalized by the CSRC between 2002 and 2006. After exclusion of the missing data, a final sample of 53 PLCs was found to be non-compliance. A control group is constructed by selecting PLCs paired with each non-compliance company based on their relevant sector (according to the CSRC's sector code) and firm size. As a result, a group of 53 compliance PLCs are collected. Because the non-compliance cases occurred between 2002 and 2006, prior data on ownership structure, board structure and the firm performance of these firms were collected to cater for a potential lag effect. Therefore, three years of data are collected from the firms' annual reports from 2001 to 2003. In total, 106 PLCs consisting of non-compliance and compliance companies and 636 firm-year observations are used for this study.

Variables

A *non-compliance* dummy variable is used to differentiate between non-compliance (coded one) and compliance (coded zero) firms, which is consistent with the prior research (e.g., Chen et al., 2006). Details of different categories of non-compliance and their respective monetary fines are also collected for testing. The variables of ownership structure are composed of ownership concentration and ownership type. *Ownership concentration* is measured by the percentage of the shares owned by the largest shareholder in a firm and often has great influence over firms' corporate behaviors (Chen et al., 2006). *Ownership type* is defined by the type of shares owned by the largest shareholder. According to the CSRC classification, there are three major groups of ownership types: state-owned shares, legal person shares, and state legal person shares. Collected from firms' annual reports, the *compensation* variable is measured by (1) the total compensation of the board members, (2) the average compensation of a director, and (3) the average compensation of an executive. Lastly, *firm performance* variables are measured by return on assets (ROA) and earnings per share (EPS), which are frequently used as a primary measure of a firm's profitability and share performance (May et al., 1975; Stickney and Weil, 1994).

Results and discussion

Table 1 shows the descriptive statistics for the variables. The average amount of fines imposed on each non-compliance firm is approximately RMB 626,245. This amount has increased significantly over the years. The amount of fines imposed on an average individual offender across all non-compliance firms is approximately RMB 62,688, which may be considered to be relatively low in comparison to the penalty that is imposed in the Western world. Ownership concentration is estimated at 40% of all outstanding shares in an average firm in the sample, while the aggregate amount of the top ten shareholders is about 60%. Average board size in the sample firms is 9.58, while board independence is close to the standard one-third ratio of independent directors on an average board, which is also the minimum requirement on board independence set by the CSRC (CSRC, 2001). Firm performance is low on average, with ROA of -0.06 and EPS of -0.06. The total compensation amount received by board members is approximately RMB 98,394, with the average compensation level of an executive (i.e., RMB 35,557) being higher than that of a director (i.e., RMB 29,241).

Table 1. Descriptive statistics of variables

Variables	Mean	Median	Std. Deviation	Min.	25 th Percentile	75 th Percentile	Max.	<i>n</i>
Compliance ¹	.50	.50	.50	0.00	-	-	1.00	106
No of Offenders ²	3.98	0.00	5.60	0.00	0.00	9.00	24.00	53
Fine Type ³	3.04	3.00	1.19	1.00	2.00	4.00	5.00	53
Total Fine (RMB)	626244.67	560000.00	541732.21	0.00	100000.00	905000.00	191096.70	53
Fine Per Person ⁴	62688.28	63333.33	54243.89	0.00	1071.43	97777.78	191667.00	53
Executive Fine ⁵	112830.19	30000.00	181207.25	0.00	0.00	175000.00	880000.00	53
Insider Fine ⁶	297924.53	190000.00	336431.26	0.00	0.00	465000.00	127000.00	53
Insider Fine/Total Fine	.36	.38	.30	0.00	0.00	.56	1.00	53
Largest Shareholder Type ⁷	1.93	2.00	.83	1.00	-	-	3.00	106
Second Largest Shareholder Type ⁸	2.16	2.00	1.24	1.00	-	-	5.00	106
Largest Shareholding ⁹	40.13	38.00	15.46	12.06	27.60	52.34	75.82	106
Second Largest Shareholding ¹⁰	10.41	8.91	8.45	0.01	2.75	17.30	29.58	106
Top 10 Shareholding ¹¹	60.08	60.94	11.39	25.49	52.94	68.47	89.20	106
EPS	-.05	.01	.57	-1.82	-.29	.17	2.36	102
ROA	-.06	-.01	.15	-.55	-.10	.03	.15	104
Board Size	9.58	9.00	1.88	5.00	8.33	10.33	16	106
Independent Directors per Board (%)	0.29	0.30	0.07	0.00	0.26	0.32	0.60	106
Total Board Compensation	98394.46	70931.04	83413.73	8081.00	44986.33	123090.65	408411.00	104
Average Director Compensation	29241.76	25242.42	23047.56	0.00	12000.00	38615.38	116522.00	103
Average Executive Compensation	35557.24	27923.08	29000.10	4968.00	17939.46	41538.46	139829.00	103

¹ Dummy variable; 1 indicates non-compliance, otherwise 0. ² Number of offenders involved in each non-compliance case. ³ Dummy variable; refer to Table 3 for types of non-compliance. ⁴ The amount of fine imposed on each offender in a non-compliance case. ⁵ The total amount of fine imposed on executive members in a non-compliance case. ⁶ The total amount of fine imposed on firm insiders in a non-compliance case. ⁷ Dummy variable; 1 indicates state, 2 indicates state-legal-person, otherwise 0. ⁸ Dummy variable; 1 indicates state, 2 indicates state-legal-person, otherwise 0. ⁹ Shares owned by the largest shareholder. ¹⁰ Shares owned by the second largest shareholder. ¹¹ Shares owned by the top 10 largest shareholders. These variables are used in the subsequent tables.

Table 2 shows that the number of cases of non-compliance has been indeed on the rise over the years. The number peaked in 2004 and gradually decreased in 2005 and 2006. This decrease might be due to the increasing efforts and emphasis on developing and enforcing corporate governance standards and good corporate reputations to attract investments in the private market by the government.

Table 2. Frequency table of non-compliance offences between the years 2002-2006

Year of Offence	Frequency	Percent	Cumulative Percent	<i>N</i>
2002	9	17.0	17.0	53
2003	3	5.6	22.6	
2004	22	41.6	64.2	
2005	12	22.6	86.8	
2006	7	13.2	100.0	
Total	53	100.00		

Table 3. Frequency and ANOVA table of types of non-compliance offence

Types of Non-Compliance				Total		Total
	Frequency	Percent	Cumulative Percent	Amount of Fine (RMB)	Total Number of Offenders	Amount of Fine per Offender
Fail to publish annual report on time	6	11.3	11.3	83,333	0.00	0.00
Fail to disclose significant information	15	28.3	39.6	397,478	5.53	49,030
Fabricate significant information	6	11.3	50.9	436,715	9.50	57,772
Fabricate and fail to disclose significant information	23	43.4	94.3	502,326	11.74	88,703
Fail to publish annual report on time and disclose significant information	3	5.7	100.0	378,990	4.00	66,746
Total	53	100.0		626,245	7.96	62,688
<i>N</i>		53		53	53	53
F-value		n/a		8.330	4.561	13.593
<i>P</i>		n/a		0.000	0.003	0.000

In Table 3, most cases of non-compliance are associated with failures to disclose significant information and/or fabrication of financial information in annual reports. Offences associated with the fabrication of significant information not surprisingly attract higher fines. For instance, members of the Chinese Institute of Certified Public Accountants found that listed companies overstated profits or assets by RMB 220 billion based on their audit of the 2001 annual reports. Therefore, the quality of accounting information and financial statements in Chinese companies is problematic. This implies that China still has a long way to go to achieve quality financial reporting to promote integrity and a healthy disclosure culture. To enhance the corporate reputation and increase investor confidence, this is an essential area where appropriate frameworks and practices should be put in place. It would therefore be desirable for Chinese companies to adopt the transparency and disclosure guidelines contained in the OECD Guidelines on Corporate Governance of State-owned Enterprises so that efficient internal and external audit procedures and functions can be established to provide timely material information according to high-quality internationally recognized standards (OECD, 2005).

Table 4 shows that Legal Person firms have the lowest ownership concentration overall, with an average value of 32%. This supports the notion that the investor class of Legal Persons, like many institutional investors, is less likely than other types of investors to retain control of their firms due to the nature of their investments (Xu and Wang, 1997). Furthermore, the high level of ownership concentration among firms with the state as the dominant shareholder implies that strong government influence may be in place to mitigate the absence of many market structures and instruments needed for the effective functioning of modern corporate governance practices. In Table 5, the ownership concentration by all types of the largest shareholders, namely Legal Person, State, and State Legal Person, is higher in compliance firms. This supports the argument that large shareholders have greater incentives to monitor their firms through concentrated ownership structure (Shleifer and Vishny, 1997). Therefore, the finding supports Hypothesis 1 that compliance firms have a higher ownership concentration than non-compliance firms.

In Table 6, we also find significant differences that distinctively differentiate compliance and non-compliance firms in terms of their ownership structures, which supports Hypothesis 2. First, in nearly half of the non-compliance companies, the Legal Person is the largest shareholder. This shows that the ambiguity inherent in the status of legal person shareholders contributes further to the complexity of the multilevel agency problem. The absence in China of a clearly defined ownership policy that sets out the overall objectives of state ownership has not helped the legal person shareholder in exercising its ownership rights over the companies it invests in. Furthermore, with the rapid corporate restructuring of SOEs in China, more stringent monitoring might have indeed been facilitated by a higher degree of state interest, thereby resulting in better corporate governance behaviors. This result is consistent with the findings by many researchers that, in transitional economies, a residual degree of state ownership might be necessary if proper control mechanisms are not well established (Perotti, 2004).

Table 4. ANOVA results for the level of shareholding according to largest shareholder types

	Shareholder Types	Mean	F	p	n
Largest shareholding	Legal Person	32.03	10.752	0.000	106
	State	46.39			
	State Legal Person	43.68			
Second largest shareholding	Legal Person	12.60	2.868	0.061	106
	State	7.93			
	State Legal Person	10.25			
Top 10 Shareholding	Legal Person	55.92	4.762	0.011	106
	State	61.80			
	State Legal Person	63.40			

Table 5. ANOVA results for the level of ownership concentration to largest shareholder types between compliance and non-compliance companies

Largest Shareholder Types	Companies	Largest Shareholding	Top 10 Largest Shareholding
Legal Person	Compliance	36.16	54.82
	Non-Compliance	29.81	56.51
State	Compliance	47.54	63.24
	Non-Compliance	44.38	59.28
State Legal Person	Compliance	45.34	66.77
	Non-Compliance	41.68	59.34
<i>F</i> -value		4.837	4.031
<i>P</i>		0.001	0.002
<i>N</i>		106	104

Table 6. Cross-tabulation for largest shareholder type between compliance and non-compliance companies

	Shareholder Types			Total	χ^2	<i>N</i>
	Legal Person	State	State Legal Person			
Compliance	26.4	39.6	34.0	100.0	6.327	0.042
Non-Compliance	49.1	22.6	28.3	100.0		

Table 7 shows a model where the shareholding of the largest shareholder (ownership concentration) is regressed against the total amount of fines, the number of offenders in each non-compliance case and the amount of fines per person. The results suggest that higher ownership concentration has a negative impact on the amount of fines imposed on non-compliance firms and the number of offenders involved in a non-compliance case. Differences are also detected in the amount of fines between types of offences, with the misrepresentation of information attracting the higher fine, as shown in Table 3. Ownership structure has clearly affected the types of non-compliance behaviors that result for various levels of fines. This implies that the level of monitoring could play a role in non-compliance behaviors, although this paper has yet to find conclusive results due to the limited number of observations of non-compliance cases in the dataset.

The results in Table 8 show that higher compensation is found in compliance firms, and that these firms also perform better than non-compliance firms. For instance, a manager in a compliance firm has an annual compensation of RMB 46,700 as compared to RMB 32,047 for their counterparts in non-compliance firms. This difference in compensation is statistically significant, supporting Hypothesis 3. This also supports the notion that a strong relationship is present between compensation and corporate governance compliance. In addition, good governance practices are associated with better firm performance, as shown in Table 8, which indicates that both ROA and EPS are substantially higher in compliance firms than they are in non-compliance firms. Therefore, Hypothesis 4 is supported, which also rejects the view held by many that corporate governance is merely a compliance exercise. Indeed, it is important to ensure that good compensation schemes foster the long-term interest of the company and create incentives for attracting and keeping qualified professionals (OECD, 2005). Furthermore, the results obtained from Table 8 also suggest that the market for executives and directors in China may be efficient enough to differentiate the quality of managerial talent.

Table 7. Regression models on ownership concentration and the level of monetary fine

	Total Amount of Fine	Number of Offenders Involved in the Non-Compliance	Total Fine Per Offenders
Constant	-	-	-
	(5.019)	(5.138)	(5.474)
Largest Shareholding	-0.271**	-0.249***	-0.324**
	(-2.013)	(-2.620)	(-2.444)
Adjusted R ¹	0.055	0.053	0.081
F Value	4.051	6.866	5.971

¹ upper value shows standardized coefficient, lower value shows t-value, *, **, *** significant at 10%, 5%, 1% levels.

Table 8. This table shows the ANOVA results for various performance and compensation proxies between compliance and non-compliance firms

Companies	ROA	EPS	Total Board Compensation	Average Director Compensation	Average Executive Compensation
Compliance	-0.013	0.120	130,170	39,722	46,700
Non-Compliance	-0.158	-0.519	83,871	26,957	32,047
F-value	9,174	13.356	5.521	3.988	4.419
P	0.003	0.000	0.021	0.048	0.038
N	106	104	106	106	106

Conclusion

China has been rapidly developing its economy and legal systems to support the development of its corporate sector. To promote good business practices and protect shareholder interests, corporate governance has become an important tool for the development of modern corporations in China. Our study has shown a rising number of cases of corporate governance non-compliance while the government is promoting the development of effective corporate governance frameworks and practices in the country. The results suggest that ownership is still concentrated across all ownership types in China. Based on the corporate governance non-compliance cases between 2002 to 2006, this paper finds that the most pressing non-compliance behavior is related to issues of information disclosure and reporting among Chinese listed firms. In fact, half of the non-compliance firms are controlled and owned largely by legal person shareholders, which indicates a higher risk of agency costs in such organizations. This study also affirms that good corporate governance practices enable firms to not only closely align the interests of managers with those of shareholders but also to help firms achieve better performance. Therefore, corporate governance compliance is more than just a "tick-the-box" exercise; it brings social and financial benefits to firms as well.

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CRITICAL MASS THEORY AND WOMEN DIRECTORS' CONTRIBUTION TO BOARD STRATEGIC TASKS

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Abstract

In this article we offer an empirical test of the critical mass arguments in the discussion of women on corporate boards. The literature in the women on corporate board debate concludes that there must be at least three women on a board before the women really make a difference. These arguments are frequently used in the public debate about the understanding the impact of women on corporate boards, but they have never really been empirically tested on a large sample. In this paper we use a sample of 317 Norwegian firms. Our dependent variable is board strategic involvement. The findings support the critical mass arguments. This study offers useful insights to policy-makers interested in defining legislative measures mandating the presence of women directors in corporate boards by showing that “at least three women” may be particularly beneficial in terms of contribution to board strategic tasks.

Keywords: corporate governance, critical mass, women directors, board strategic tasks

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1. Introduction

The issue of women in corporate boards has internationally gained considerable interest in practice as well as in the corporate governance literature. Many authors argued that women directors on corporate boards offer many contributions (Bilimoria, 1995; Bilimoria and Huse, 1997) such as new ideas, more communication and transformation in the management style (Rosener, 1990; Milliken and Martins, 1996; Daily, Certo and Dalton, 1999), and lead to an increase of firm performance (Erhardt, Werbel and Schrader, 2003; Farrell and Hersch, 2005).

Several studies identify significant ethical and economic reasons for the appointment of more women in the corporate boardrooms. The “normative case” for more women and minorities suggests that it is unethical for groups of people to be denied access to societal power solely as a result of individual traits, unrelated to ability, such as their gender, race, religion (Keasey, Thompson and Wright, 1997; Carver, 2002). Other researchers make a “business case” for more women on corporate boards. The main argument is that women represent a diversity that is needed in the boardrooms (Milliken and Martin, 1996; Huse and Solberg, 2006). Another argument is about the use of knowledge. If a segment of society talent is systematically excluded from board directorships not because of competence, but due to gender, this leads to suboptimal company boards (Burke, 1999; Cassell, 2000; Carver, 2002).

Previous studies (Huse, 2005; Nielsen and Huse, 2010; Singh, Vinnicombe and Terjesen, 2007) show that there are two sets of benefits deriving from board diversity: one relating to the boardroom; the other to the company. Diversity should lead to more effective boardroom behaviour, a better understanding of the marketplace and the workforce and better decision-making. Corporate performance, instead, is impacted

by board diversity in terms of enhancing the reputation of the company, bringing legitimacy, attracting funds from ethical investors and inspiring women at lower management tiers in the organization.

However, we still need to improve our understanding of how women directors behave in boards as workgroups, and how their behaviour is different when they are alone among a large group of male directors, or in a more qualified minority. The article contributes to the existing debate using the critical mass perspective to analyse the contribution of women directors to board strategic tasks.

According to previous studies on group dynamics we consider boards as workgroups performing many tasks (Bettenhausen, 1991; Forbes and Milliken, 1999; Huse, 2005). Moreover, we develop a model relating board member characteristics to board strategic tasks (Zahra and Pearce, 1989; Forbes and Milliken, 1999; Huse, 2005) and test the validity of the critical mass arguments examining the impact of “at-least-three” women directors on board strategic tasks.

Previous studies have introduced the theoretical implications of the critical mass perspective in corporate governance settings (Kanter, 1977a; 1977b; 1987; Greed, 2000; Lortie-Lussier and Rinfret, 2002; Erkut et al., 2008; Childs and Krook, 2008). This article adds to existing research by proposing and testing an operational application of critical mass in the corporate board. Hence, testing the validity of the critical mass perspective on women directors (Erkut et al., 2008), advances studies of corporate boards. Our test was conducted on a sample of 317 Norwegian firms. A Norwegian sample is a necessity and, at the same time, a great opportunity. A necessity, because Norway offers researchers a considerable number of companies in which women are a qualified minority, also because it was the first mover in the introduction of a quota laws mandating a minimum 40% representation of women on the boards of publicly tradable companies. In addition to contributing to the long-lasting academic debate on women of boards (over 400 articles recently reviewed by Terjesen et al., 2009) insights, "lessons", from Norway may be of great interest for policy-makers and practitioners from other countries which more recently introduced quota laws (such as Spain) are in the process of passing quota laws (such as France and Italy) or are considering them (such as the UK).

The article is organized as follows: in the next section we discuss the main arguments in the critical mass perspectives, highlighting its importance and challenges for the debate on women on corporate boards, and present our research model and hypothesis. Methods (sample, data and variable operationalization) are presented in section three. Results and conclusions follow in sections four and five.

2. Critical mass perspective and women directors

There are numerous arguments supporting the need for more women on corporate boards. Some focus on ethical issues (Keasey et al., 1997; Carver, 2002) while others highlight the economic rationale (Burke, 1999; Cassell, 2000; Carver, 2002; Huse, 2005; Singh et al., 2007). While there is a general consensus in favour of more women on boards in theory, in practice, the number of women on corporate boards around the world is still extremely limited (Bilimoria and Piderit, 1994; Conyon and Mallin, 1997; Singh, Vinnicombe and Johnson, 2001; Thomas, 2001; Daily and Dalton, 2003; Singh and Vinnicombe, 2004; European Commission, 2010).

Studies on women directors raise the following questions: how many women are there? Are they able to express their capabilities, personalities, feelings, and behaviours? How many women must be introduced in the board to make a difference? One, two, three or more? And which are the effects of different women minorities in the boardroom? When do women directors behave effectively acting as a qualified minority? These and other questions still remain unanswered. We argue that the critical mass theory (Kanter, 1977a; 1977b; 1987; Greed, 2000; Lortie-Lussier and Rinfret, 2002; Childs and Krook, 2008; Erkut et. al., 2008) may improve our understanding of the contribution of women to corporate boards.

Starting from group dynamics theories and explaining minority and majority influences on decision-making in groups, we look at women on board of directors as a minority subgroup within a larger group. For decades scholars have studied the effects of majority and minority influence in small groups, beginning with Asch, experiments on conformity to majority influence (Asch, 1951; 1955). Studies on the influence of a majority within a group show that it exerts more influence than minorities (Kalven and Zeisel, 1966; Tanford and Penrod, 1984). Minorities are viewed negatively, sometimes with downright derision (Nemeth and Wachtler, 1983; Maass and Clark, 1984). Majorities, instead, have more impact and

exert more influence, due to their greater numbers (Moscovici, 1980). Some authors, from a different angle, studied the effects of minorities on a majority (Nemeth and Wachtler, 1974; Moscovici, 1980; Mugny, 1982) and show that a minority can in any case influence a majority. Latané (1981) argues that the amount of influence produced by either a majority or a minority will be the multiplicative function of strength, immediacy, and number of its members. Therefore subgroup size seems to have great importance.

The critical mass perspective or theory (Kanter, 1977a; 1977b; 1987; Greed, 2000; Lortie-Lussier and Rinfret, 2002; Erkut et al., 2008; Childs and Krook, 2008) falls within this second strand of literature. It derives from nuclear physics and its application to social science can be traced to Granovetter's analysis of collective behaviour (Granovetter, 1978). Applied to social science, its main contribution is to suggest that the nature of group interactions depends upon minority group size. In particular, shifting the size of a minority group also changes the impact on the larger group, moreover, that impact becomes more pronounced when the size of the minority group reaches a certain threshold, or a critical mass. In particular when a certain threshold is reached the degree of a subgroup's influence grows. Because, as suggested by the theory, there is a qualitative change in the nature of group interactions, as the minority starts to assert itself and thereby transforms the institution's culture, norms and values (Norris and Lovenduski, 2001).

Kanter analysed experiences of women who form small minorities in corporate spheres. She observed that the relative numbers of socially and culturally different people in a group are critical in shaping interaction dynamics in group life (Kanter, 1977a; 1977b). In theorising these interactions she identified four types of groups with different majority-minority ratios: (1) uniform, with no significant minority; (2) skewed, with a minority of perhaps up to 15.0%; (3) tilted, with perhaps a 15.0 – 40.0% minority; and (4) balanced, perhaps with a minority of more than 40.0% (Kanter, 1977a; 1977b). With higher relative numbers, minority members are potentially allies, can form a coalition and can affect the culture of the group. Stemming from these considerations, other scholars deduced the concept of "critical mass" (Oliver, Marwell and Teixeira, 1985; Greed, 2000; Lortie-Lussier and Rinfret, 2002; Childs and Krook, 2008).

Over the last twenty years, the critical mass perspective or theory has gained wide currency among politicians, the media and international organizations as a justification for measures to bring more women into political offices (Grey, 2006). Moreover, several scholars have applied Kanter's work to the legislative and political setting. Saint-Germain (1989), for example, found that significant gender differences in the introduction of traditional women's interest measures were evident once the percentage of women reached approximately 15.0%. Thomas (1991; 1994) presented evidence that gender differences in the prioritizing of legislation involving women, children, and families were least marked in States with low percentages of women, and most evident in States with high percentages of women. Grey (2002) found that women in politics were more actively involved in debates regarding feminist issues as they approached a critical mass of 15.0%.

Despite the evident appeal of critical mass theory and its widespread application to legislative and political research, there are few studies that draw upon the critical mass theory to explain the contribution of women on corporate boards (Erkut et al., 2008). These studies apply the theory and analyse cases without testing the validity of its use in the corporate governance domain. Also a recent study on women on corporate boards (Terjesen et al., 2009) points to the critical mass perspective as a rapidly-growing research framework in the analysis on women and board related issues. Especially, they identify three perspectives and dimensions in the study of women on corporate boards (Terjesen et al., 2009). The critical mass is identified in the impact perspective and the analysis with this approach is at various levels (micro, meso, macro). Referring to boards of directors the analysis is at a meso-level (Terjesen et al., 2009). This recent contribution addresses better the actual need of understanding this issue and its related dynamics.

Some immediate reflections follow: which is the critical mass? What number is likely to constitute a critical mass of women directors? While critical mass theory predicts that at a certain threshold the degree of the minority group's influence grows, the theory does not suggest what number is likely to constitute a critical mass. In order to understand how many women directors constitute a critical mass we focus our attention on the studies of Asch (1951; 1955). Asch shows that when an individual is faced with the opinion of three unanimous people, he/she is likely to conform to the unanimous "majority" opinion.

Moreover the effectiveness of the group pressure markedly increases when a group size is three (Asch, 1955). Asch concluded that a minority size of three is sufficient for the full impact of the group to be felt. Accordingly also other studies suggest that three people constitute a critical mass that can be very influential in a group setting (Tanford and Penrod, 1984; Bond, 2005; Nemeth, 1986). Moreover, previous studies on women on corporate boards (Erkut et al., 2008) suggested that the presence of three or more women can create a critical mass which enables women to substantially influence the content and process of board discussions. Therefore, according to these studies critical mass is reached when there are “at-least-three” women directors, and our objective is to test three as the threshold for the impact of women directors on board strategic tasks. We focus on board tasks because we are interested in analysing the contribution of board members. Assuming that board tasks mediate the relationship between board member characteristics and firm level outcome (Zahra and Pearce, 1989; Forbes and Milliken, 1999; Nielsen, 2009), we postulate that boards including “at-least-three-women” are different from those with less than three women in terms of involvement in strategy and we therefore test the effect of critical mass (at least three women directors) on board strategic tasks.

2.1 Critical mass of women directors and board strategic tasks

Many studies on boards of directors have identified different sets of board tasks (Zahra and Pearce, 1989; Stiles and Taylor, 2001). Board tasks are usually grouped into strategic tasks, service tasks and control tasks (Zahra and Pearce, 1989; Stiles and Taylor, 2001; Huse, 2007).

The article focuses on strategic tasks in relation to women directors for many reasons. Board strategic tasks are better suited to our analysis because they i) require considerable interactions among directors on future scenarios, ii) necessitate great director attention to the various elements of the strategic process, the board’s strategic involvement covers corporate mission development, strategy conception and formulation, and strategy implementation (Zahra and Pearce, 1989), iii) are widely recognised as one of the major tasks of the board (Andrews 1981; Baysinger and Hoskisson, 1990; Zahra and Pearce, 1989; Finkelstein and Hambrick, 1996; McNulty and Pettigrew, 1999; Golden and Zajac, 2001; Huse, 2007) and iv) entail a complex and multidimensional concept (Ravasi and Zattoni, 2006) defined by scholars in several ways (Zahra and Pearce, 1989; Stiles and Taylor, 2001; Ruigrok, Peck and Tacheva, 2007; Schmidt and Bauer, 2006).

We examine the impact of the critical mass of women directors on board involvement in strategic tasks which require board members to be involved in the initiation and implementation phases of the strategic process (Zahra and Pearce, 1989; Huse, 2005). Following this reasoning we argue that board strategic tasks are the most representative tasks for testing the validity of the critical mass theory in board of directors, because effectiveness of both minority groups and the boards as teams are based on interactions and behavioural-related aspects. We investigate this relation, because the literature on management teams suggests that groups composed by demographically dissimilar members have the potential to generate original approaches to intellectual and decision-making tasks (McGrath, 1984; Williams and O’Reilly, 1998). Moreover, minorities (such as women directors) can stimulate other board members to consider a wider range of potential solutions (Nemeth, 1986). For example, when the majority of group members share a particular background, influence exerted by a director with a different background can lead board members to change or expand the criteria used to evaluate strategic alternatives (Hitt and Tyler, 1991). This pattern of results may suggest that minority directors (as women) may contribute to board decision-making by providing unique perspectives on strategic issues and by prompting divergent thinking among majority directors (Westphal and Milton, 2000). Therefore, according to this perspective achieving a critical number of women directors is desirable not only because it influences the nature of group interactions but also because it increases the diversity of viewpoints within a group (Chaney, 2006). For this reasoning, we formulate the following hypothesis:

There is a positive relationship between a critical mass of women directors (at least three women) and the involvement of boards in strategic tasks.

3. Methods

3.1 Data collection and sample

This study is based on a unique survey conducted among Norwegian companies during the winter 2005/2006 and the first half of 2006. Data were gathered from a questionnaire sent out to 2954 firms grouped in several sets with different characteristics: firms listed on the Oslo Stock Exchange; unlisted publicly limited firms; private joint stock companies with more than 100 employees; private joint stock companies with between 50 to 100 employees and a total turnover of more than 5 million NOK; smaller private joint stock companies with less than 50 employees and total turnover exceeding 50 million NOK. The survey used a questionnaire of 265 questions to the CEOs, 235 to the chairperson and 215 to the other board members.

The Norwegian database was used for many different reasons. First, it provides more observations compared with similar studies based on the survey method. Second, in studies on women directors there are no significant surveys which try to focus on board dynamics and board member characteristics. Moreover, the construction of this database allows us to better understand what happens inside the board of directors by analyzing aspects related to board tasks. Finally, Norway has the highest ratio of women directors in Europe and it is interesting to analyze Norwegian data because in 2003 the Norwegian government issued a legislative proposal aimed at achieving an overall target of 40% female representation on the boards. The law became effective in 2005 and offered two years for transition time. The deadline was January 2008. Our analysis does not take the full effect of the law because we analyze data from 2005/2006 but it may be the basis for future comparative investigations. The targeted women ratio in the Norwegian companies was met in 2008.

We tested our hypotheses on a sample using CEOs responses, which showed an overall response rate of 33.0%. We selected firm in which women directors don't represent a minority. We built a "women ratio" (number of women directors/total number of board members) and excluded the boards with a women ratio higher than 49.0%. 317 firms are included in the final sample. Thus our sample included firms with a board size ranging from 6 to 12 board members.

The responding firms have, on average, 437 employees (median, 135). The firm age is on average 55.6 (median, 41). 39% of the firms are in the high-tech industry. Board size on average is 7.12 and the average of women directors is 1.5. 26.0% of firms have 0 women directors in their boards, 28.0% have 1 woman, 27.0% have two women directors and, finally, 19% of the firms have "at least three women directors", considering that the maximum number of women directors in a board is 5. CEO tenure is on average 6.82 and board chair tenure is on average 4.77. 5.0% of CEOs are women, and 7.0% of board chairs are women. Each year there are on average 6 board meetings and each meeting is, on average, just under 4 hours long.

3.2 Measures

Data related to dependent, independent and control variables were collected through the questionnaire survey.

Dependent variable – The dependent variable (board strategic tasks) was measured by several items on a seven points Likert-type scale (7 = fully agree, 1 = fully disagree). The CEOs were asked to value the involvement of the board in: a) making proposals on long-term strategies and main goals; b) deciding on long-term strategies and main goals; d) implementing decisions on long-term strategies and main goals into action; e) controlling the follow up of decisions on long-term strategies and main goals into action. The output variable board, strategic tasks, was built as a mean of the four items. The Cronbach's alpha coefficient equals 0.89.

Independent variables – *Critical mass (at least three women directors)* is the independent variable. Critical mass is a dummy variable assuming value 1 when in boards there are at least three women directors, 0 otherwise.

Control variables - We control for firm and context features, which are: firm size and industrial sector. *Firm size* is measured by the number of employees on 31st December 2004. In order to meet the normal

distribution requirement a log-linear transformation was used. *Industrial sector* is a dummy variable coded 1 when the firm is a high-tech firm, 0 otherwise. We also control for board composition features, i.e. board size, CEO tenure, CEO gender, length of board meetings and knowledge and competence of directors. *Board size* indicates the number of board directors with voting rights. In the sample construction we discarded small boards considering only relatively-large boards, ranging from 6 to 12 members. *CEO tenure* is equal to the number of years the CEO has served on the board. *CEO gender* is measured by a dummy variable coded 1 when the CEO is a man, 0 otherwise. *Length of board meetings* reflects the general duration of information exchange in board meetings. It was measured as the duration in hours of an ordinary board meeting transformed into its natural logarithmic function. Finally, director's *knowledge and competence* was measured by six items on a seven points Likert-type scale (7 = fully agree, 1 = fully disagree). The CEOs were asked to value the board members: a) Knowledge of the firm's main operations; b) Knowledge of the firm's critical technology and key competence; c) Knowledge of the firm's weak sides and its products and services; d) Knowledge of the development regarding the firm's customers, markets, products and services; e) Knowledge of the firm's suppliers and customer negotiation power; f) Knowledge of threats from entrants and new products and services. The output variable *knowledge and competences* was built as a mean of the six items. The Cronbach's alpha coefficient equals 0.87.

3.3 Analysis

We tested the hypothesized effect of the critical mass of women directors on board strategic tasks using multiple linear least-square regression analyses.

4. Results

The Pearson's product-moment correlation coefficients of all variables are reported in Table 1. The correlation matrix shows that there is no significant correlation among variables.

Table 1. Correlation matrix (317 firms)

	Mean	S.D.	1	2	3	4	5	6	7	8	9
1. Firm size (number of employees)	437.25	891.42	-								
2. Industrial sector (high-tech)	.39	.48	.06	-							
3. Board size (number board members)	7.12	1.22	.34**	.04	-						
4. CEO tenure (years)	6.82	5.95	.01	.01	.03	-					
5. CEO gender (male)	.95	.23	.05	.03	-.04	.07	-				
5. Length board meetings (hours)	3.95	1.88	.18**	.02	.09	.09	.01	-			
7. Knowledge and competence	5.04	.96	.03	-.01	-.07	-.06	.03	.03	-		
8. At least three women (Critical mass)	.19	.39	.15**	.06	.39**	-.03	-.02	.07	-.05	-	
9. Board strategic tasks	5.13	1.40	.21**	.08	.18**	.15**	.01	.26**	.18**	.15**	-

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

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

Results of the hypothesis testing are presented in Table 2.

Table 2. Regression analyses (317 firms). Dependent variable Board Strategic Tasks

	Model I		Model II	
	B	Std. Error	B	Std. Error
Firm size (ln employees)	.10 [†]	.08	.11 [†]	.06
Industrial sector (high-tech)	.10*	.13	.17	.17
Board size (number of board members)	.15*	.07	.07	.08
CEO tenure (years)	.20 [†]	.11	.21 [†]	.12
CEO gender (male)	-.20	.37	-.05	.38
Length board meetings (hours)	.92**	.30	.87**	.30
Knowledge and competence	.09	.08	.08	.09
At least three women (Critical mass)			.74***	.21
Adj R2	.12		.19	
F	5.28***		6.69*	

Unstandardized coefficients are displayed. The levels of significance are: [†]< 0.1; *<0.05; **<0.01; ***<0.001

Two models are presented. Model I regressed the board strategic tasks on the control variables, the adjusted R² is 0.12. Model II regressed the board strategic tasks on the control variables and the independent variable (critical mass of women directors), the adjusted R² is 0.19.

Hypothesis 1 is supported, suggesting that there is a positive relationship between the critical mass of women directors (“at least three women”) and board strategic tasks (.74; p<.0001).

We made also some residual analyses where the dichotomous number of three women was replaced with one or two women. These analyses did not show any significant relationships between the women variable and board strategic tasks.

5. Conclusions and future investigations

The article builds on critical mass theory and provides empirical test that women directors significantly increase boards’ strategic tasks involvement only when there is a minimum number of three women.

This result suggests that, when in the boardroom there is just one woman her “isolated presence” means that she may only to a limited extend perform and contribute through her work and behaviour to the strategic tasks. Just one woman on a board may be a token risking stereotyped actions by the dominant group, and she may adapt to the existing boardroom behaviour (Kanter, 1977; Crocker and McGraw, 1984; Cohen and Swin, 1995). Similarly, when there are two women in the board they do not have an impact on board strategic tasks, because they are not enough to eliminate the evidences of tokenism (Kramer et al., 2006; Erkut et al., 2008).

The article contributes to the existing debate by proposing and testing an operational application of the critical mass perspective in relation to corporate boards. Hence, testing the validity of the critical mass perspective on women directors advances corporate boards studies. Moreover the critical mass test has been made on Norwegian firms giving potential relevance to the result. Indeed, Norway offers researchers a playground or a research laboratory in which women are a qualified minority, also because it was the first mover in the introduction of a quota law mandating a minimum 40% representation of women on the boards of listed companies. Lessons from Norway may be of great interest for policy-makers and practitioners from other countries that are considering the possibility of introducing a similar law.

The article offers some insights for future research. First, this paper analyse the impact that a certain number of women has on board strategic tasks. Future studies may take into account differences in women directors' backgrounds, skills and personalities with respect to their male counterparts. It could be interesting to test the validity of the critical mass theory in a model which also considers other differences in addition to gender (Nielsen and Huse, 2010). It could also be useful to take the critical mass theory beyond surface level diversity by exploring how the critical mass of women directors on board affects board dynamics.

Moreover, considering that Norway represents the first mover in the mandatory introduction of a certain percentage of women directors in the board, a cross-country analysis of the different political and institutional contexts in other countries that have introduced quota laws (Spain) or are discussing bills (Italy and France) could be another interesting research direction.

Finally, the critical mass test has been made on the board strategic tasks. Future research may take into account whether the critical mass influence the value creation of the firm. In this sense it could be of great interest analyse how women impact on the value creation, considering also the mediating and moderating role of board processes and dynamics as well as on corporate innovative behaviour.

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PIVOTAL QUESTIONS IN SEPARATING THE CHAIRMAN FROM THE CHIEF EXECUTIVE ROLE

Patrick R. Dailey

Abstract

Separation of the Non-Executive Chairman role from the Chief Executive role continues to gain global acceptance. Prescriptions for separating these roles are most entirely focused on policy and structural matters. Little attention has been focused upon the interpersonal dynamics which determine the initial acceptance of the separation and its ongoing success.

Pivotal Questions focuses upon a Board's interpersonal dynamics crucial to the role separation. Pivotal Questions supplies guided questions that are the catalysis to dialogue that if not considered, might derail the intended success of the separation.

Keywords: Non-executive Chairman of the Board, Board dynamics, Board evaluation, Separation of the Chairman from the CEO role, Board governance, Role of the Chairman of the Board

Introduction

Sitting atop every public corporation is a structurally flat, largely non-hierarchical organization staffed with part-timers. These current and former titans of command and control organizations come together, perhaps, for a half dozen regular meetings annually in the high stakes application of participative management to govern public corporations as their company's Board of Directors.

The effectiveness of every board is guided by statutory regulations, best practice advice, and the interpersonal dynamics amongst board members. There is increasing attention upon policy manifestos, structural design, and regulatory solutions to corporate governance ills. Yet the impact of interpersonal dynamics, the so called "soft side factors", upon board effectiveness continues to be neglected. Too often, exceptional board leaders flounder a bit in board processes due to a lack of competence with the interpersonal elements that are intended to foster exceptional board synergy, that *magic* that every board member wants to feel and be a part of.

The growing *global* momentum for separating the Chairman from the Chief Executive role fits the above commentary nicely - lots of focus on policy and structure; little focus on the interpersonal dynamics involved in negotiating, implementing and living with the split.

Pivotal Questions provides Boards and their advisors a pragmatic agenda to consider the dynamics of the split and then better implement the separation of the Chairman role from the Chief Executive role. The approach is pragmatic. The belief is that candid discussion by the Board of those pivotal issues impacting the role separation can prevent dysfunction and deliver an outcome that is acceptable to all the constituencies - each board member, the Chairman, the Chief Executive, Presiding Director, and key senior management.

***Pivotal Questions* assists Boards explore crucial issues affecting the split.**

Pivotal questions is a menu of candid, direct and sometimes uncomfortable questions that dig in to those crucial issues that often derail the separation of the Chairman role from the Chief Executive role. Good intentions and some courage will lead you, the board leader, to choose those pivotal questions that your board wishes to explore. The process is constructive discussion. The payoff is board synergy that just may deliver that *magic* that boards strive for.

The left column of the table categorizes the various roles a Chairman plays in business oversight and governance. The right column provides the menu of pivotal questions. Pivotal questions have been vetted by Board Chairs, members, and professionals. By design, there are no formulaic prescriptions about correct vs. incorrect choices for the split. Choose those topics and questions that are material to the success of your board.

Chairman Roles and Responsibilities	Pivotal Questions
<p>Stress-test Strategy</p> <p>The Chairman takes the lead in facilitating Board debate and arriving at consensus decisions regarding strategic proposals presented by management. The Chairman adds additional value by bringing sector relevant experiences, strong strategic planning skills, and a rolodex of outside contacts with bankers, investors, and competitors.</p>	<p>Fresh Thinking</p> <p><i>Will new ideas flourish with your Chairman? Will your Chairman be a catalyst for taking the Board and management beyond “familiar” thinking and traditional ambitions to “fresh” thinking about the vision, realities, and opportunities for the business? Or, will new and divergent ideas be deftly shelved or bludgeoned with not-invented-on-my-watch instincts and controls?</i></p> <p>Future Focus</p> <p><i>Can your Chairman guide the company into the future? Do care, intellect, experience and persuasiveness blend together into a formidable board leadership capability? Or, does the appointment essentially boil down to the appointment of an honorary figure head respected for substantial contributions in the company’s past?</i></p> <p>Breadth and Range</p> <p><i>Will your Chairman stress-test strategic proposals? Is your Chairman thoroughly informed, professionally up-to-date, and conversant about sector best practices, customers, competitive innovation, threats, and the Board’s duty of care obligations? Or, do discussions rarely go beyond discussion of financial matters and stock price implications?</i></p> <p>Deal Guidance</p> <p><i>Does your Chair have the “juice” to access the best advisors and attract “most favored” terms and conditions? Do your Chairman’s external relationships provide the company with the “first look” or the “last look” on deals? Do doors open? Or, will your Chairman largely be an insider with limited external “pull” who relies on others for deal acceleration?</i></p>
<p>Monitor Risk and Business Performance</p> <p>While the full Board is accountable for monitoring the company’s operational and financial performance, its long term viability of the business, and timely, transparent, and full disclosure to shareholders, the Chairman often takes the “point” in the Board’s fulfillment of its risk</p>	<p>Risk Appetite</p> <p><i>Does the Chair’s risk appetite align with the CEO’s? Where will there be friction? Does the Board agree with the balance point the Chairman will guide the company to follow between high risk pursuits versus risk avoidance inclinations?</i></p> <p>Availability</p> <p><i>Will your Chairman be reachable and available? Is your Chairman prepared to invest upwards of 500 hours per year or more to Board business? Can your Chairman devote even more time as major events materialize - acquisitions, disposals, key</i></p>

<p>management responsibility for shareholders. With Dodd-Frank legislation, these accountabilities become more significant.</p>	<p>hires, major capital commitments? Or, will your Chairman's availability be more of an "on call" commitment?</p> <p>Solo Act</p> <p><i>Is it clearly understood among board members that risk and performance monitoring is not the sole responsibility of the Chairman? Will board members tend to relinquish or neglect their individual monitoring of risk and performance and come to rely upon the Chairman as the solo "watch dog"?</i></p> <p>Respected Advice</p> <p><i>Will the business advice offered by the Chair to management be respected? Can your Chair "make the case" for changes and adjustments to protect the fiscal quarter or take advantage of emerging competitive opportunity? Or, is your Chairman's advice largely historical and general?</i></p> <p>External Credibility</p> <p><i>Can your Chair tap external networks for intelligence and influence these networks? Does your Chairman have substantial visibility and credibility outside your company to make things happen with customers, regulators, and competitors? Are your Chairman's external networks well-developed, diverse, and productive? Or, is your Chair's influence and credibility limited and/or in decline?</i></p> <p>Access to Information</p> <p><i>Will the communications channels between the Chair and internal company contacts be clear and wide open? Will there be open access and full disclosure to your Chairman by company contacts designated to provide information used by the Chairman in his/her periodic monitoring of operational and financial information? When would "need to know" restrictions ever be imposed?</i></p>
<p>Oversee Governance Policy and Practice</p> <p>Best practice places the Chairman as a key champion of good governance policy and practices. The Chair is expected to possess well-developed corporate governance experience plus broad-based understanding of current statutory requirements issued by the SEC, IRS and other regulatory bodies. Best practice also suggests that the Chairman takes initiative for Board member selection and assimilation.</p>	<p>Board Relationships</p> <p><i>Will Board members perceive they are colleagues of the Chairman or essentially, subordinates? Will the Chairman foster collegial Board relations – both inside and outside the Board room? Or, will the Chairman bully members, throttle robust questioning and discussion, and muscle his/her decisions through to final voting?</i></p> <p>Board Purpose</p> <p><i>Will the Board function largely as a ceremonial body or a proactive, advisory force? Will your Chairman steer the attention and contribution of your Board away from a body that is largely content to review and approve management actions toward a body that challenges, provokes, shapes, and guides the management team?</i></p>

	<p>Reputation Management</p> <p><i>Are there detectable concerns from Board members that their reputations might be tarnished by the Chair’s words or deeds? Are there concerns that laissez faire attention to ethical and governance matters may allow surprises to pop up and divert Board focus, jeopardize the enterprise, or create undo Director liability? Or, is there consistent belief that the Chairman will act to protect, if not enhance, personal reputations.</i></p> <p>Personal Values</p> <p><i>Will the Chair’s personal values play positively with stakeholders? Does the Board perceive the presence of a clear moral compass which will impact behavior and decisions within the Board and throughout the company? Are there any practices or beliefs that will need to be “dialed down” or curtailed? Or, are the Chairman’s values largely personal and private and within the company’s code of conduct policy? Might the Board need to be vigilant about values and ethical interpretations which may be applied differently for certain individuals by the Chair or CEO?</i></p> <p>Practical Independence</p> <p><i>Will the CEO forever be in the pocket of the Chairman? Will there be practical independence in thinking and decision-making between the two individuals? Will the CEO have the courage to disagree? Will the CEO need to be encouraged to disagree and challenge the Chairman? Will the relationship between the Chairman and the incoming CEO likely mature into a respectful partnership? In contrast, what is the risk that a problematic rivalry might emerge?</i></p> <p>Role Distinction</p> <p><i>Has the operating space between the Chair and presiding director been worked out? Are duties and accountabilities clear? Has the Board determined if the presiding director’s role is rotational assignment among independent directors versus continuous service by one member? Has the Board inquired about the interest of the presiding director becoming Chair in the future?</i></p>
<p>Manage Board Communications</p> <p>Contemporary Boards are expected to provide increased monitoring and vigilance over business strategy, risk, talent, and operational effectiveness. This contrasts with historic role of Boards of Directors providing advice and, oft times, tacit approval over the plans put forward by management. This new emphasis raises the bar for Chairman to set the tone</p>	<p>Turf Issues</p> <p><i>Where will hot spots or turf issues likely pop up between the Chair and the CEO? How much control over Board priorities and decision-making prerogatives does the Board detect the Chair and the CEO will <u>independently</u> seek?</i></p> <p>Acceptance by the Inner Circle</p> <p><i>Is the Board’s inner circle prepared to accept increased leadership from the Chairman? Will your Chairman move the Board forward in discussion and consensus decision-making or play largely to the inner circle? Will your Chairman be genuinely approachable to all members of the Board?</i></p>

<p>of Board dynamics, artfully manage relationships, and group decision-making as the shareholders’ fiduciaries.</p>	<p>CEO’s Access</p> <p><i>Does the role split effectively “fence off” the CEO from the Board? Does your CEO trust the Board? Will the incoming CEO have more than just a “show and tell” relationship with the Board? Will phone calls, emails and interaction between any board member and the CEO be channeled through the Chairman? How will the CEO develop informal allies, mentors other than the Chair, and join the inner circle?</i></p> <p>Facilitation Skills</p> <p><i>Can your Chairman work the room? Will the bedrock of your Chairman’s power be his/her questioning techniques which are useful in gathering information and opinion, educating, and leading inquiry? Will these skills deliver well-vetted, well-supported, consensus decisions? Or, will your Chairman be often inclined to dominate business, dictate, or demand Board decisions? Or, simply let discussion drift?</i></p> <p>Constructive Challenge</p> <p><i>Will your Chair challenge individual Board members to step up their contribution? Does the Chairman have the personal courage to constructively challenge Board members to engage and challenge the management team? Likewise, will the Board have the courage to ask the Chairman the tough questions? Or will the threat of damaged relationships, loss of personal credibility, or Board exit cause those tough, necessary questions and challenges to go un-asked or glossed over?</i></p> <p>Withdrawal</p> <p><i>With the Chair’s appointment, will once active and engaged Board members throttle down? Will the appointment of a standalone Chairman cause the rest of the Board to withhold, temper, or rein in their inquiries and challenges to the CEO? How will the Board guard against deferral to the Chair, or subject matter experts and consequently forgo solid board discussion, discovery, and group decision-making?</i></p>
<p>Build Board Competency</p> <p>Board composition and selection criteria change with the changing demands of the business. Board members must continuously add to their professional knowledge base. Boards must operate as effective teams with solid process skills and good rapport - individuals and the team benefit from constructive feedback and at times, candid discussion about adjusting their behavior and improving their contribution. Boards need</p>	<p>Board Competency</p> <p><i>Will your Chairman shape a strong, contemporary board? Will your Chairman continually refresh and strengthen Board competency with new appointments that bring relevant experiences and diverse thinking? Will Boards members whose skills and expertise is no longer core be asked to depart? Or, will Board selection focus on familiar names with traditional backgrounds that deliver stale and predictable continuity?</i></p> <p>Evaluation and Feedback</p> <p><i>Will meaningful evaluation and feedback happen? Will the scope of Board evaluation be conducted only at the full board level or Committee level? Or, will the evaluation process examine the contribution of each Board member, individually? What process will the full Board use to evaluate the Chairman’s contribution?</i></p>

<p>development and the Chair is expected to insure development happens and be an active participant.</p>	<p><i>Do the statements regarding board evaluation included in the proxy reflect the real process utilized or just boiler plate comments?</i></p> <p>Difficult Discussions</p> <p><i>Will your Chairman conduct those “difficult” discussions with fellow board members? Will your Chairman, acting with Board support, initiate one-on-one discussion with independent directors about their Board contribution and take action to remediate problems including asking the director to not stand for re-election? Or, will disappointing Board member style and disengagement be glossed over and neglected by the Chair?</i></p> <p>Education</p> <p><i>Will your Chairman support Board education with budget money? Is this a serious priority not a boondoggle that is likely to draw unflattering comments from shareholders, shareholder advisory groups, media and second guessing from employees?</i></p>
<p>Mentor the CEO. Plan Succession.</p> <p>An explicit role of the Chair is serving as a conduit of formal and informal information from the Board to the Chief Executive - all matters are fair game. Likewise, information from the executive is channeled and vetted by the Chair to the Board. These “dance steps” can be tricky. This dynamic is aided when the relationship between the Chair and the Chief Executive is based upon trust, candor and a certain degree of informality. The Chair is more than an “on call” advisor; the Chair is a coach to the executive.</p> <p>The Chair is also responsible succession - emergency and long term planning. To effectively fulfill this responsibility, the Chair must be an effective talent scout, know the talent pipeline and work to develop and ready the company’s leadership pipeline.</p>	<p>Overcoming the “No Confidence Vote”</p> <p><i>With the split, has the CEO essentially received a “no confidence” vote from the Board? Is the Board prepared to deal with political unrest in the management ranks as a consequence of the split? Might an opposition clique to the CEO emerge within the management ranks? How will the Board deal with management seeking out Board members directly for advice and guidance? How will the split limit the candidate pool for the next time the Board recruits a CEO? What is the risk the Board takes of losing the CEO as a by-product of the split?</i></p> <p>Coaching Skill</p> <p><i>Is your Chair equipped from a psychological and personality standpoint to do coaching? Does he/she have the gravitas that commands respect of those being coached? Would he/she be comfortable in the role of a coach? Does he/she have any coaching skills?</i></p> <p>CEO Evaluation</p> <p><i>Can your Chairman be dispassionate? Will your Chairman be capable of taking an unbiased view of the CEO’s strategic leadership, character, operational effectiveness, and financial results into the CEO’s annual performance review process? Or, if the financial numbers are OK, then so too will be everything else regarding the CEO’s contribution?</i></p> <p>Succession Planning</p> <p><i>Will succession planning be a perfunctory exercise resulting in proxy boiler plate? Or, will time and accountability be invested in real progress? Will your Chairman take a “hands on” role in the succession planning process that will identify emergency back fill as well as oversee a long term process of candidate development, assignment management, and vetting?</i></p>

<p>Guide Shareholder Relations</p> <p>With the passage of Dodd-Frank legislation, a new era of shareholder involvement into the governing policies of public companies has been ushered in. The tenor has moved from passive involvement and limited visibility into Board and corporate operations to active involvement by key shareholders. These shareholders will likely be well informed. They will be powerful. Increased involvement requires more proactive and engaged interaction with shareholders. The Chair sets this direction and may have a growing role with key stakeholders and representing the brand. For many sitting Chairman, this is likely to be unfamiliar and potentially conflicted responsibility with the Chief Executive.</p>	<p>Support from Shareholders</p> <p><i>Do major, long term shareholders believe the Chairman is aligned with their interests?</i> <i>Can your Chairman ask for votes and get them? Can the Chairman successfully lead discussion with shareholders about controversial topics and/or deviations from standard best practices that earn their support?</i></p> <p>Showmanship</p> <p><i>Will your Chairman seek the center stage spotlight? Will his/her showmanship be disruptive? Has the Board coordinated the complementary roles the Chairman vs. CEO may have when engaging and interacting with your largest shareholders?</i></p> <p>Presence</p> <p><i>Does your Chairman show well? Is there an adequate stage presence and public speaking skill to preside over shareholder meetings? Can he/she think on his feet? Can he/she deftly handle questions and comments/rants from the floor?</i></p> <p>Combative Instincts</p> <p><i>Does your Chair tend to seek confrontations? What is the propensity of the Chair to duel with media, regulators, bankers, and/or activists' shareholders? Does the Chairman tend to use power to overwhelm or guile and relationships to listen and win over opponents?</i></p>
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<p>Purely Personal</p> <p>This section is distinct from the roles presented above. This section deals with personal matters and expectations found to be important in the selection and coaching of the Chairman.</p>	<p>Temperament</p> <p><i>Is your Chairman emotionally prepared to step away from his/her CEO role? Can well-honed command and control instincts and skills learned through career long experiences be transitioned to exceptional advisory, monitoring, and influencing skills as Board Chairman? What help does he/she need to transition from daily business management and control in order to step up to stewardship and oversight responsibilities? Will he/she comfortably serve as Chairman of the Board, or will the role essentially be force fit and awkward? Will the Chair (only) role diminish his/her proud legacy?</i></p> <p>Overconfidence</p> <p><i>Is your Chairman so self-confident that he/she may not take other Board members seriously?</i></p> <p>Resources and Remuneration</p> <p><i>Is your Chairman prepared to accept Directors' wages? How will Board and management respond to requests for office services resources and staff support?</i></p> <p>Retirement</p> <p><i>How long is the Chair expected to serve? Is there an unwritten expectation for duration of service that should be discussed? When does the Chairman's term of service end? Is there a mandatory retirement age? Can it be waived? Which Board member(s) will be designated to discuss retirement or resignation with the Chairman?</i></p>
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Summary

When separating the Chairman role from the CEO, the “soft stuff” is often the “hard stuff”. This corporate terrain is covered with interpersonal trap doors that boards must be alert to perceive and skilled in stepping around.

Best practices that guide the structural design of role responsibilities and dictate policy decisions for separating Chairman and the CEO role are rather straightforward. Yet, the vexing issues that render these splits problematic are most often “soft side” issues - mismanaged initial and ongoing interpersonal dynamics that fester behind the scenes and certainly, out of the minutes of board meetings. Most likely, the problems of a split gone sour are not aired in annual Board evaluations. These improperly managed soft side issues limit the synergy, the real magic, of participative board deliberation and decision-making by exceptional executives. Insidious undercurrents of mistrust, the all-too-often political dramas that play out, and dissolving collegiality among exceptional leaders conspire to produce a toxic working atmosphere. Board service is no longer fun. The governance experiment fails. And, the full Board fails in fulfilling its fiduciary responsibilities.

Pivotal Questions is offered as a preventive against interpersonal dysfunctions which pop up during the initial role separation and the ensuing time period when roles are played out by all the constituencies--the Chairman, the CEO, the presiding director, board members and corporate officers. These blunt, direct, and sometimes uncomfortable questions are intended to tap matters that should be explored and resolved on the front end of the split. Simply, successful role separation fosters the necessary **realism** needed from every Chairman. Likewise, successful role separation fosters the necessary **optimism** needed from every Chief Executive.

CORPORATE GOVERNANCE AND THE BOARD'S LOCUS OF CONTROL – THE CASE OF THE ABI'S TREATMENT OF FOOTPRINTS.

Brian G M Main*

Abstract

This paper discusses the degree to which codes of corporate governance and the guidelines that develop around them tend to shift the locus of control away from the board of directors. It is argued that even in principles-based codes of governance such outcomes are an unavoidable consequence and that policy makers should weigh such consequences carefully before promulgating codes and guidelines. The case of the treatment of footprints (incentive plan performance averaging periods) by the UK's Association of British Insurers (ABI) is analysed to illustrate the problem.

Keywords: corporate governance, board process, executive remuneration, remuneration committee

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1. Introduction

By their very nature, externally imposed codes of corporate governance represent an attempt to wrest some control away from the executives and board of a company. This is generally done to protect the interests of the shareholders as a whole or some sub-group of shareholders (e.g., minority shareholders versus majority shareholders). The basic logic is that by imposing structure on governance arrangements an improvement in performance will result (Gompers et al., 2003; Eisner and Schenig, 2005). Although governance arrangements themselves are endogenous (Demsetz and Lehn, 1985; Adams et al., 2008), before-and-after studies of the introduction of codes of corporate governance have found evidence of improvements in performance (Stiles and Taylor, 1993; Weir and Laing, 2000; Conyon et al., 2002; Dedman, 2002; and Dahya et al., 2002; Bebchuk et al., 2009). Aguilera and Cuervo-Cazurra (2004) report that, in the past 15 years or so, over 50 countries have adopted codes of corporate governance.

The positive effects of interventions such as published codes of corporate governance may, however, come at the price of unintentionally restricting the profit making opportunities of the enterprise through the constraints so imposed on the actions of the board. There is scope for refinement. While the widespread 'comply or explain' aspect in many codes aims to minimise such costs, there is no disguising the primary intent as being to guide the practices and procedures of the board to "mitigate hazards directly related to bounded rationality and opportunism" (Williamson 1996, p12) or "to make directors more focused on shareholder interests" (Bebchuk and Fried, 2004, p202) or, simply, to ensure "investors get the managers to give them back their money" (Shleifer and Vishny, 1997, p738). This paper uses the recent UK case of incentive plan performance averaging periods to argue in favour of placing more weight on broad disclosure rather than requiring specific compliance to code.

Codes of governance are generally characterised as adopting one of two main approaches – either a rules-based or a principles-based. In the former, as the label suggests, the intervention tends to be explicit and precise. Companies are left with little doubt as to what they should and should not be doing. The system in the USA, most recently encapsulated in the Sarbanes-Oxley Act 2002, represents this approach. On the other hand, the principles-base approach concerns itself with describing standards of behaviour and expectations about how issues are to be approached. The UK adopts this latter approach with its

essentially self-regulatory system, as summarised in the Financial Reporting Council's *Corporate Governance Code* (2010) (formerly known as the *Combined Code*). However, even a principles-based approach, which appears to permit more scope to the individual board, can be constraining in practice. Companies, in striving for the legitimacy that code conformance brings, find themselves in a mimetic isomorphism of practice (DiMaggio and Powell, 1983; Scott, 1991, 2001), even where such restricted behaviour is not specifically required.

But the situation is not simply a case of being seen to adjust to the locally promulgated code of practice. As Seidl (2007) explains, a corporate governance code offers an observational schema through which the actions of the directors can be viewed. In all systems but particularly those that are principles based and permit a certain flexibility in terms of compliance, there is a need for an evaluation mechanism that facilitates the assessment of the extent of adherence to the code or the gravity of any explained departures from the code.

Steidl (2007) argues that corporate governance codes are generally incomplete in that they lack a mechanism to gauge the sufficiency of the disclosed information, or to evaluate the gravity of any deviations from recommended practice and the extent to which offered explanations mitigate such breaches. This lacuna is frequently filled by means of 'commentaries or guidelines to the code' (Steidl, 2007: 718). In the UK the Association of British Insurers Guidelines on executive remuneration (ABI, 1987, 1993, 1994, 2001, 2007, 2009) has emerged as a key factor in the governance of executive remuneration practice and policy. Alongside these guidelines, in recent years, a commercial evaluation mechanism (IVIS – Institutional Voting Information Service) offers a traffic-light system that evaluates a company's compliance. Thus a company will speak of being 'red-topped' or 'amber topped' if they have attracted a negative or qualified evaluation. Selvaggi and Upton (2008) find that the IVIS system predicts superior company performance. The National Association of Pension Schemes initiated a rival evaluation scheme known as RREV (Research Recommendations Electronic Voting), now run by Risk Metrics.

It is clear, however, that for the UK the ABI defines the dominant observation schema for matters pertaining to top executive remuneration. It is possible to trace out the development of remuneration policy through subsequent vintages of these guidelines. While it is possible to argue about whether the ABI was codifying de facto developments in opinion among institutional investors or actually leading that opinion, the move over the years to a near universal adoption of ABI-conforming executive remuneration arrangements is clear. The current prevalence in UK boardrooms is to award share-based incentive schemes based on relative performance, where there is no payment for below median performance, and where vesting starts at a modest level and rises up to a maximum level of vesting only once 'upper quartile' performance has been achieved. All of this has been shaped through the interpreting framework of the ABI Guidelines.

One example of the poor boardroom practice that governance codes aim to tackle can be found in the backdating of executive share options in corporate USA, whereby executives were presented with share options with issue dates (and hence strike prices) chosen in retrospect and to the advantage of the executive. Thus, a recent low period in the company's share performance would be identified and that date used for the effective date of granting share options – even though the award was truly being made at a later date (Bebchuk et al., 2007). On investigation, the practice was found to be widespread and several prosecutions were mounted (Lomax, 2008).

While concern was expressed that such behaviour might be widespread in countries other than the USA (Mallin, 2007, p. 496), little empirical evidence of such behaviour has come to light. Alerted to the general issue, however, attention in the UK has focused instead on the timing of the performance periods that are now commonly used to determine the extent of vesting of share-based incentive pay for executives. In recent versions of its influential guidelines on executive remuneration, the Association of British Insurers (ABI, 2007, 2009) requested that companies should avoid lengthy averaging periods.

This paper examines the role that such averaging periods play in determining the effective reward earned by executives and highlights how overly narrow interpretation of governance guidelines can deprive boards of valuable flexibility in designing executive reward packages to suit their particular situation. There are several circumstances in which the board may find it highly desirable to utilise a radically different size of footprint (averaging period) than had previously been in use. Consider an externally appointed CEO or new top management team arriving at a company which had recently been

experiencing serious underperformance. Either because of unavoidable legal and administrative delays in getting round to awarding long term incentives or because the market has anticipated an impending turnaround effect by bidding up the share price on the announcement of the new management team, the board may feel it fairer to use a footprint that extends further back than the current share price as a basis against which to judge subsequent performance. On the other hand, to always use a long footprint may not be appropriate. When a scandal or external shock suddenly drives down the price of a hitherto high performing company, the board may prefer to use, for any newly appointed executive, the recent low price of the share as a basis of comparison rather than some past average including the previously overpriced phase.

In fact the length of footprint being used is rarely disclosed and this reveals a lacuna in governance reporting requirements that leaves practice in this area largely hidden from shareholder scrutiny. While the move requested by the ABI would, in some ways, remedy this omission it would do so by imposing an unnecessary and restrictive homogeneity of practice in this important area of corporate governance. It is more information not a homogeneity in boardroom practice that is called for. By presenting evidence based on the experience over a ten year period of a FTSE-100 sample of companies, the paper argues that in imposing restrictions on the actions of the board in this area, codes of governance introduce inefficiencies in decision making while providing an imperfect regulation of behaviour. It would be better to allow for continued freedom of choice by boards and their remuneration committees - conditioned on a new obligation to report such detail to shareholders.

The following section presents a brief introduction to the academic literature in the area. This is followed by a section detailing the empirical analysis undertaken and the paper concludes with a discussion of the policy implication of the results.

2. Literature review

The practice of timing option awards came to light owing to a forensic investigation by Lie (2005) of the returns enjoyed by executives on their share options. These were seen to be too good to be true. Earlier identification of such effects by Yermack (1997) had put the outcome down to the timing of information release, whereby variously bad or good news was released respectively before or after the anticipated grant date of executive share options. Lie (2005) shows that the effect had actually strengthened since the Yermack study.

Lomax (2008) explains some of the institutional background to this practice and discusses the SEC reaction. Lie (2005) estimated that as many as 2000 companies may have engaged in these practices and the SEC decided to formally investigate some 200 companies. Recently one CEO received a custodial sentence consequent on these investigations, although the vast majority of cases have settled out of court. But Heron and Lie (2007) argue that despite new SEC regulations requiring the prompt announcement of option grants (hence limiting the scope for 'timing'), the practice persists, albeit in a muted form.

None of these revelations has found any echo in UK boardroom practice. The system of corporate governance in the UK is different from that in the USA. In the USA governance practice in the area of executive pay is largely influenced by legislation (primarily in the form of Securities and Exchange Commission regulations). In the UK, on the other hand, a series of non-governmental committees of investigation such as Cadbury (1992), Greenbury (1995), Hampel (1998) and Higgs (2003) have led to a largely self-regulatory approach summarised under the rubric 'comply or explain'. This is brought together under the Combined Code on Corporate Governance (1998, 2003, and 2006). The only government intervention has been in the form of the Directors' Remuneration Regulations (DTI 2002, 2008) which, as the title suggests, mandate reporting of certain features of directors' pay and also guarantee that at the AGM shareholders shall be allowed an advisory vote on the overall remuneration policy of the company.

But, in the UK, the dominant influence in the field, as the earlier list of reports suggests, has been through institutional pressure. This has resulted in arrangements on directors' reward that are markedly different from those customary in boardrooms in the USA. In the UK, there is a strong emphasis on tying reward to relative performance – in particular, performance relative to that of a peer group of companies or to a pertinent market index. Payments, or vesting, on long term incentives such as executive share options or performance shares are not expected to occur for performance judged to be below median. And, when

vesting does occur, the expectation is that the extent of vesting will commence at a moderate level and increase with improved relative performance (ABI, 2009). In this sense, full vesting would generally not be expected to occur for anything less than upper-quartile performance. The directors are usually afforded only one opportunity to satisfy the performance conditions, as 're-testing' or re-visiting the performance targets at a later date is discouraged.

For over 20 years, the Association of British Insurers (ABI, 1987, 2009) through a series of 'Guidelines' has exerted a dominant influence on the precise administration and design of directors' reward in the UK. Most recently, the ABI has focused on the concept of a 'footprint', as used in the context of a performance share plan or executive share option scheme. This is an arrangement whereby the calculation of the start and the end values of the performance metric on which vesting of an award depends is done so as to average over a period of time, rather than being taken on a single start-day and single end-day. Recent ABI Guidelines have drawn attention to the length of such averaging periods or 'footprints':

"4.9 The calculation of starting and finishing values for TSR should be made by reference to average share prices over a short period of time at the beginning and end of the performance period. **Lengthy averaging periods should be avoided.**" [ABI, 2009, emphasis added]

Footprints, are utilised in order to 'smooth out' random fluctuations or non-company-specific noise affecting the performance measures in question. These performance measures can be free standing or, more usually, gauged against a comparator group or index. Among larger UK companies, the commonest footprint is one of three months in length, although it is also possible to find examples of one month, six months, or 12 months.

Work by Booker and Wright (2006) has demonstrated the significant difference to eventual vesting that a few days can make in the choice of the start date for a performance period, when vesting is contingent upon relative performance metrics. This observation reflects the general finding of Acker and Duck (2007) and Dimitrov and Govindaraj (2007) that the choice of a particular reference day from which to calculate monthly returns or variances can lead to substantial variation in estimates so derived. Acker and Duck (2007) point out that such sampling risk or 'estimation risk' can lead to significant differences in inferences made from market data, such as estimates of the market 'beta' of a firm. In the context of executive pay, the use of an averaging period or footprint can be seen as insuring the director and the company against such reference-day risk.

The assumption underlying the ABI advice discussed above is, clearly, that the executives of a company somehow stand to gain by utilising a longer rather than shorter footprint. This paper sets out to subject this assumption to empirical testing. In so doing, it reveals that there is no consistent advantage to be gained by choosing one length of footprint versus another. There is, therefore, no merit in the ABI guidelines insisting on short footprints. On the other hand, the analysis presented below does reveal a clear advantage to be had on the part of an executive from opportunistically switching the length of the footprint to be deployed at certain critical times. This calls for transparency and the need for board to report their chosen footprint lengths and to explain any changes being introduced.

So, while the statistical evidence presented below suggests that there is no good reason for inhibiting companies from choosing one length of footprint versus another, there seem to be very good reasons for requiring companies to fully disclose the length of footprint deployed in their various performance schemes and to justify any alteration in these lengths. At the moment, the length of the footprint utilised in any performance scheme is not a parameter that demands disclosure.

The next section of the paper introduces the method and data to be used in the estimations undertaken on the impact of the choice of footprint length on subsequent vesting of long-term incentive schemes. Section 4 discusses the results in some detail, and the paper concludes with a summary of results and some policy recommendations.

3. Method

In order to study the impact of choice of footprint length on subsequent vesting levels, daily performance data are assembled for a 10-year period (1998-2007) on 100 companies selected by their membership of

the FTSE100 (in January 2008). For those lacking a 10-year continuous share-price history, as the nearest replacement companies at that date, as judged by market capitalisation (Main et al. 2008). The performance measure used throughout is DataStream's daily 'RI' index of total shareholder return (TSR) – dividend yield plus share price appreciation.

It is necessary to reserve the first year of data for use in calculating initial footprints and the assumed three year vesting period requires the end three years of data to observe the final performance plan come to its completion. This means that for each company on each trading day between 1 January 1999 and 31 December 2004 it was possible to follow a three-year performance period as it starts and subsequently vests. The implications for vesting for each company performance share plan can then be calculated. This is done for each of five sizes of assumed footprint: (i) none (i.e., one day); (ii) one month; (iii) three months; (iv) six months; and (v) 12 months.

The standard performance share plan vesting arrangement focuses on the company's relative TSR as calculated over the three year performance or accrual period (BIS, 2010):

RELATIVE RANK:

No vesting for below median (FTSE100)

Vesting on a sliding scale starting at 25%

Maximum vesting (100%) for upper quartile TSR performance.

Pro-rata vesting for performance between those points.

This scheme is designed to be generally representative (see, for example Kingfisher plc Annual Report and Accounts for 2006/07, p.44). An arithmetic average is used to calculate each company's performance measure (the daily RI index from DataStream) in both the starting and ending footprint. The comparator group for each company is the remaining 99 of the 100 sample companies. In practice, the comparator group of companies is often smaller in number than the FTSE100, frequently being individually tailored to the focal company's area of activity. In order to keep a level of generality to the study, however, it has been assumed that each company uses the same 'FTSE100' comparator group.

For a given length of footprint and a given start date, the outcome under the vesting scheme in question can be calculated for each company by following the focal company and the peer group for the subsequent three years. Over the 6-year period in which performance share schemes can both start and terminate, this results in 1566 observations outcomes for each of the 100 companies under any averaging period.

4. Results

Due to the relative performance nature of the incentive scheme, the average level of vesting across the 100 companies is always 40.25%, and the lower performing half of companies receive zero while the top performing quarter receive 100%, and the remainder – those above-median but below upper-quartile performers - receiving between 30% and 100% of their shares. That expected outlook is unchanged no matter what length of footprint is chosen. From this perspective, then, there is no particular gain to the executive from one length of footprint (1-month, say) versus another (1-year, say).

But each individual company (and hence director) may see their fortunes change depending on the exact size of the averaging period that is used to make the performance calculations over any one three year period. In some circumstances the achieved vesting would be higher, in others it would be lower. Table 1 illustrates this variation by contrasting the experience over the 1566 comparator periods for each of the companies, comparing a 1-day comparison period with a variety of longer averaging periods. It can be seen that some companies do better and some worse. Others, of course, have a performance record that is so poor (or so very good) that changing the reference periods makes little difference.

The scope for change clearly depends on the size of the change of footprint or averaging period. Consistently moving for a 1-day to a 1-month footprint makes very little difference on average – just over 1-percentage point worse off or 1-percentage point better off, at most. On the other hand, moving from a 1-day to a 12-month footprint can result at some companies of as much as 12% fewer shares vesting over the period to as much as an extra 10% in some cases. This is a 22% range and shows that being able to choose the footprint length ex-post could be highly advantageous to the executives concerned. Chart 1

illustrates the scope for change in moving between these two footprints (1-day versus 12-month). Chart 1 reports the impact on the average vesting experienced by each of the 100 companies over all schemes starting on each of the 1566 days under study (from the beginning of January 1999 through the end of December 2004). For each company, the average level of vesting achieved is computed and the difference under the two footprints is reported in Chart 1. Quite clearly, the lengthening the footprint does not always imply improved the vesting outcome at the company in question. For some companies, the 1-year footprint improves the average vesting experience, and for others it is worse.

In an effort to examine the scope available to directors to cynically increase their level of vesting by optimal choice of vesting period, each company is followed over the time period and the average vesting outcome experienced by consistently having a 1-day footprint is compared with the average outcome of being able to choose that footprint length that would yield the highest vesting available. In some cases, clearly, the company's prospects are either so dismal or so outstandingly good that footprint length is of little consequence. But in other situations (as Chart 2 demonstrates) there will be a measurable impact. Chart 2 ranks companies by their 1-day vesting experience and demonstrates the scope for increasing this by varying the footprint length optimally. By definition, a company cannot be worse off under the 'best available' situation. The average improvement is 8.5 percentage points (with a statistical significance of 0.001).

Chart 3 ranks companies by the size of the potential gain in vesting through always being able to choose ex-post the optimal footprint size. For almost all companies there is a potential upside in vesting from shifting the length of footprint at various times. The maximum is 19.5 percentage points and the average is an 8.5 percentage point increase in shares vesting. Of course, in the above simulations of behaviour the choice of footprint length is fully informed by the subsequent full performance history. In reality the choice, if any, would be made without the benefit of most of that information. Nevertheless, the adoption or withdrawal from a 1-year footprint would have the advantage of at least one year of observed company performance history.

5. Conclusion and Discussion

This paper has discussed the need for boards to guard against losing control on their decision making to governance codes and guidelines. It draws on one particular case, that of the ABI's attempt to control the abuse of the selection of reference dates (footprint) over which to calculate the performance of executives for the purpose of vesting of long term incentives. Using daily data on the performance of the FTSE100 companies over a period of some 10 years, it demonstrates that, while there is a potential for abuse, strict adherence to the ABI guideline needlessly robs the board of the ability to tailor the design of its long term executive incentives in an appropriate manner. The expected payout is the same under all footprints. The danger lies in opportunistic changes in the length of the footprint not in any particular length of footprint.

Rather than prescribing a length of footprint, a more efficacious approach would have been to require full disclosure of the footprints used and a full explanation and justification of any changes in these. There are times when a change of footprint may be justified. Say, the announcement of an incoming, externally recruited CEO has boosted what had been a faltering share price, then it might be argued that there was justification to change the footprint from a one-month (say) to a six-month length - particularly as it usually is a month or two after appointment before any performance share awards are actually made. Such arguments should be explicitly made to shareholders and should appear in the Directors' Remuneration Report. To ensure all such changes are transparent, it should be a reporting requirement that the length of all footprints utilised in performance evaluation be clearly reported on an annual basis.

There is, of course, a point to the ABI's guideline. On revisiting any three year period of a company's history, it is easy, with the benefit of hindsight, to see that one particular length of averaging period or 'footprint' would have resulted in higher vesting of options or performance shares than alternatives. Thus, a company that just before the beginning of a performance period had suddenly stumbled and fallen behind others in its peer group would be better off with a short 'footprint', so that subsequent performance was more likely to look comparatively good. For example, a company hitherto operating on a one-year footprint which, having had a stunning recent 12 months (let us say by stealing a march on the competition and being an early adopter of some cost-saving technology), has recently seen performance falter as rivals catch up. To reduce the footprint on the next issue of performance shares would unambiguously (and undeservedly) advantage the incumbent top management team.

To avoid such possibilities, it may seem better to essentially remove any discretion, by encouraging all to use uniformly short averaging periods. But this is to place companies in an iron cage (DiMaggio and Powell, 1983) of isomorphic practice. Better to simply require full disclosure, thereby leaving the board in control of the incentive arrangements for its executive.

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Table 1. Distribution of each of the 100 companies' average vesting experience under various footprint lengths

	N	Range	Minimum	Maximum	Mean
DEL_1_month_mean	100	.03	-.01	.01	.0000
DEL_3_months_mean	100	.06	-.03	.03	.0000
DEL_6_months_mean	100	.12	-.07	.05	.0000
DEL_12_months_mean	100	.22	-.12	.10	.0000

Key:

DEL_1_month_mean = difference in average vesting [1-month footprint – 1-day footprint]
 DEL_3_months_mean = difference in average vesting [3-month footprint – 1-day footprint]
 DEL_6_months_mean = difference in average vesting [6-month footprint – 1-day footprint]
 DEL_12_months_mean = difference in average vesting [1-year footprint – 1-day footprint]

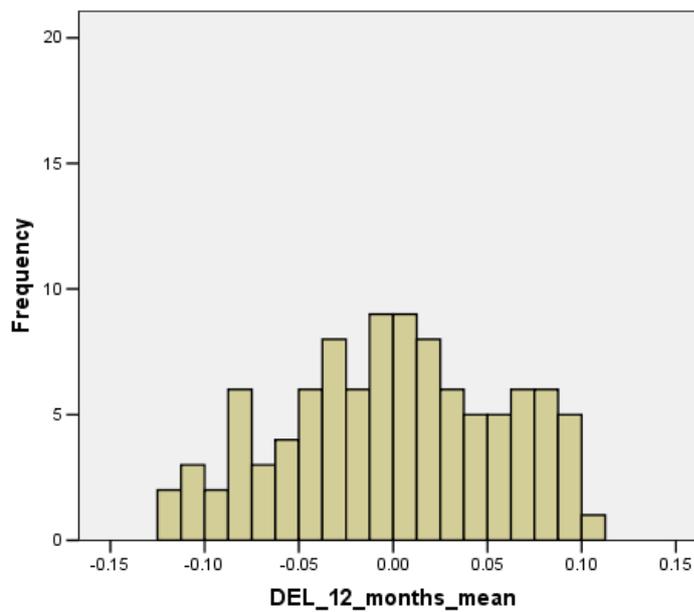


Chart 1. Distribution of change in average vesting in moving to 1-year Footprint from 1-day Footprint (Rank-test vesting).

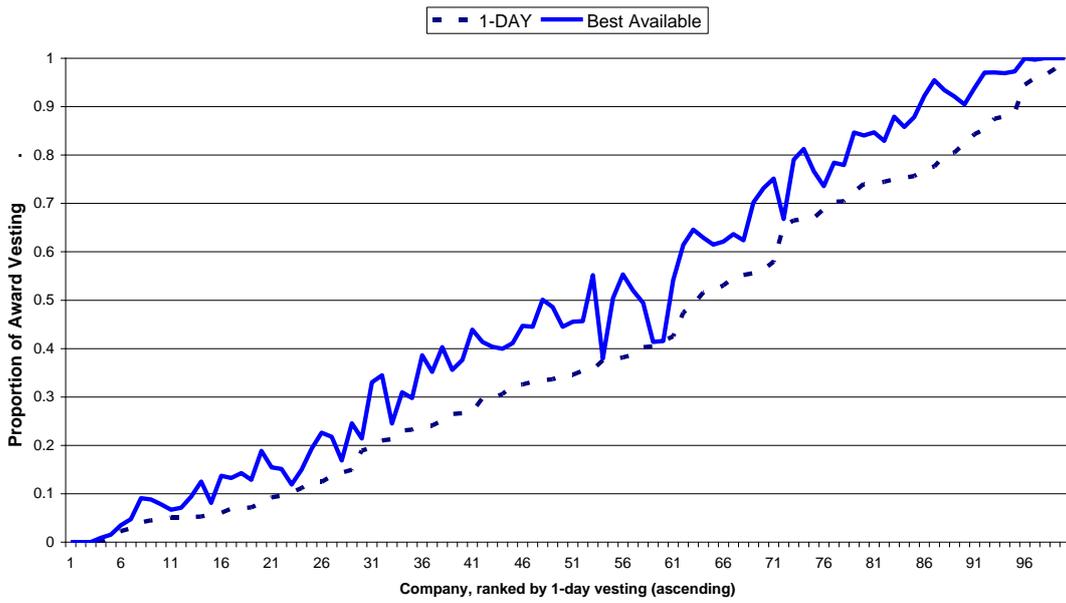


Chart 2. 1-day Footprint versus Best Available (Relative-Rank test)

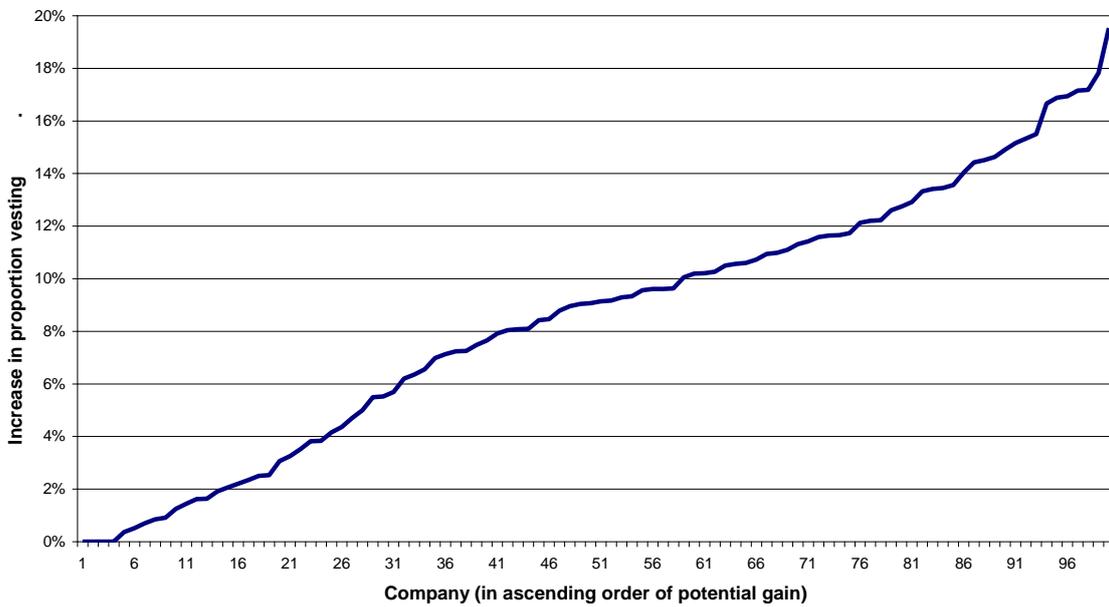


Chart 3. Maximum Potential Gain by Varying Footprint Length

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