MANDATED DIVORCE Company Boards, 'Independence' and Performance

Why has the recent performance of many large liquid Australian stocks been so dire, asks **Peter Swan**

The performance of many large Australian stocks has left something to be desired in recent years. BHP Billiton has continued to expand its iron ore output in the face of an enormous decline in the world price and has contributed to the deterioration in Australia's terms of trade. BHP's jointly-owned venture, Samarco in Brazil, doubled its output for each halving of the iron ore price until its tailings dam burst under the pressure with disastrous consequences including the deaths of 19 people. BHP's large board currently consists of the CEO plus nine independent directors.

ANZ has been charged by the Australian Securities and Investments Commission (ASIC) with alleged rate-rigging and its partially-owned Malaysian subsidiary AmBank has been queried over questionable trades amounting to billions of dollars concerning the sovereign wealth fund 1MDB and the corruption scandal involving the Malaysian Prime Minister. ANZ's board is made up of the CEO plus seven independent directors.

In 2009 the Woolworths board launched their now aborted Masters Hardware brand in competition with Bunnings and recently announced nearly a billion dollars in losses and capital impairment of over $3 billion in assets on its Masters brand. Many pundits at the time predicted its demise and others sold down their Woolworths holdings in anticipation of sizeable losses following the disastrous board decision. The Woolworths board currently consists of the CEO and Company Secretary plus six independent directors. Woolworths also has a management board consisting of eight executives.

Disasters like these among the elite of Australia's companies raise the issue as to whether the boards of these companies are really in control or whether boards have become so ineffective in recent years that control has been ceded to management at the expense of shareholder interests.

Why have shareholders been disenfranchised?

The 'mandated divorce' referred to in the main title is between directors whose interests are fully aligned with shareholders—large and small—and company boards. The disenfranchisement of Australian shareholders was

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instigated in 2002 by a very improbable source—namely the Australian Securities Exchange (ASX) whose business it is to promote the interests of shareholders since only shareholders trade shares and without shareholders there would be no ASX. It did so by taking the unprecedented step of abrogating its responsibility to set governance standards for companies listed on the ASX. It delegated this responsibility to the ASX Corporate Governance Council (CGC) made up of a variety of external organisations such as the Australian Institute of Company Directors (AICD), which is a lobby group devoted to promoting the interests of directors, and a number of other professional organisations representing the interests of external groups such as superannuation funds, 'big business' (the Business Council) and the legal profession.

The ASX CGC, which was charged in 2002 with establishing governance rules for all Australian listed companies, specifies in the latest (2014) edition of its *Corporate Governance Principles and Recommendations* that not only must a majority of the board be made up of 'independent' directors but also a factor relevant to assessing the independence of a director is whether or not the director is 'a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity'.[1] A shareholding is deemed 'substantial' when it exceeds 5% of the total number of votes attached to voting shares in the entity.

In the original document that came into effect in 2003 and that stood until a recent slight watering down, the ASX CGC was far more definitive in declaring that a substantial shareholder cannot be 'independent' and thus began the mechanism of removing directors from boards simply because of their substantial share ownership that effectively aligned their interests with smaller shareholders.[2] This policy contradicted the pious declaration that companies must 'respect the rights of shareholders and facilitate the effective exercise of those rights' (p.11) and that 'an independent director is independent of management . . . (p.19)'. Since 'independent directors' 'exercise . . . their unfettered and independent judgement' (p.19), substantial share ownership must sufficiently distort this judgement in favour of shareholders to warrant their exclusion as 'non-independent' directors.

Prior to 2003 there were no mandated board requirements although most boards, especially larger boards, included one or more 'independent' directors who were neither executives, former executives, nor consultants and were thus technically independent of management. Many companies also successfully combined the dual roles of CEO and chair in violation of the recommendations of the newly established ASX CGC.

From 2003 onwards the ASX CGC has preferred a class of 'independent' directors so-called because they had no significant shareholding in the company and no association with management (and thus no company specific information base). In short, the ASX CGC requirements favoured an anodyne professional class of director at the expense of directors with significant shareholdings and directors formerly associated with management. A problem with delegating corporate governance standards to outside organisations is that many representatives and members of these organisations may themselves be aspiring directors with neither significant shareholdings nor firm or even industry-specific knowledge or background. It comes as no surprise that the ASX CGC recommendations would potentially benefit such aspiring directors at the expense of significant shareholders and knowledgeable former CEOs.

In mitigation, the 'if not, why not' principle—which requires firms to justify in their annual reports or website any and all departures from the recommended governance requirements—gave companies that could withstand media and proxy advisor pressure the ability to opt out of what was a peculiar manifesto giving no reasons for its distaste for incentivised (or 'non-independent' substantial shareholders) and informed directors ('non-independent' former CEOs and the like). Subsequently, the Australian Prudential Regulatory Authority (APRA) has required all banking, financial and insurance firms subject to regulation to adopt the CGC rules holus-bolus as a matter of law, not by choice and without any 'if not, why not' escape clause. Many proxy advisers have since taken the same approach as APRA.

Come 12 years later by 2014, the principle of eliminating directors whose interests are aligned with shareholders has been qualified due to adverse publicity arising from my earlier research.[3] It is now stated that directors with substantial shareholdings may help to align interests with that of other security holders and are therefore 'not discouraged' and that a security holder with a substantial stake is merely seen as having a 'different interest to security holders with smaller stakes'. However, the CGC still opines that substantial shareholders cannot 'bring an independent judgement to bear on issues before the board'.[4]

While the apparently anti-capitalist and anti-shareholder stance of the ASX CGC over the period 2003-2014 appears to have done considerable harm to the governance of Australian companies, it has benefited researchers in that it has acted as a natural experiment in which 'non-independent' incentivised directors (with substantial shareholdings) and 'non-independent' informed directors (with significant industry or firm-specific knowledge) have been replaced by 'independent' outside directors with typically negligible 'skin in the game' and no specific firm or perhaps even industry background.

The peculiar recommendations of the ASX CGC have enabled me to test my hypothesis based on a theoretical model I have developed that informed institutional traders—observing the actions of boards and executives—are the only really effective monitors of both board directors and the CEO as their trading actions, performed on the ASX market itself, drive stock price towards its fundamental value. This fundamental value is largely dependent on how well the CEO and executive team perform and whether or not directors are effective in their oversight and advisory roles. Informed traders who operate primarily in large, liquid stocks drive the stock price up when they see (or anticipate) good managerial actions and drive it down when they see poor decision-making—Woolworths' Masters $3 billion outlay is a case in point. If these traders can successfully forecast future returns due to their informational advantage then we say that the stock price is 'informative'. I capture 'informativeness' empirically by institutional 'swing trades' that change direction frequently to predict stock price changes, and elsewhere show that such trades are profitable even after transaction costs.[5]

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Who really cares for the interests of shareholders?

So what makes for a successful board? Such a board works with rather than against external market monitoring performed by institutional traders.

Can boards make use of the information contained in stock trades and thus in stock price movements, or 'stock price informativeness', to better run a company due to this external monitoring? Yes, they most certainly can and do.

To understand how one must grasp the composition of an average Australian ASX board over our sample period made up of around 45% 'independent' part-time outside directors with no significant share ownership and no association with company management, 20% executive directors who are full-time employees, 13% 'informed' outside directors with typically previous experience as an executive or CEO and who are thus very knowledgeable about the company, and 10% outside directors who either have substantial shareholdings or are associated with such a shareholder and who may thus be considered 'incentivised'. Of course, due to dictates of the ASX CGC, 'independent' directors now dominate at the expense particularly of informed directors (former CEOs and the like) and incentivised directors (substantial shareholders) deemed 'non-independent' by the CGC.

Skin-in-the-game is not enough

The responsiveness to market returns is higher the higher is the director's own share ownership. The group with the highest shareholding is the incentivised directors followed by the CEO and other executives, informed directors and, finally, the regulatory-favoured 'independent' directors with negligible holdings.

Hence a company wishing to harness the power of stock price informativeness will have a board consisting of a high proportion of incentivised directors and CEO/executives with substantial shareholdings, knowing that they will be rewarded for good governance and punished for bad.

In order to add internal firm-specific knowledge the company will also wish to ensure that it has a sizeable representation of informed directors such as the former CEO to provide sufficient firm-specific knowledge, especially if the stock is fairly illiquid or rarely trades and thus is not likely to contain a great deal of information.

If the stock price is uninformative or fairly illiquid then having directors with significant shareholdings will be ineffective as the market will react only very slowly to the quality of decision-making. This is where knowledgeable informed directors and 'independent' directors will tend to do relatively better.

Fortunately from the perspective of researchers who require 'exogenous' variation, but possibly at a sizeable cost to investors, regulators have intervened to either mandate or promote particular board structures which they deem as *ipso facto* desirable and thus seem not to require any justification or supporting empirical evidence.

Under the US Sarbanes-Oxley Act (2002) independent director control of the audit committee was mandated. In 2003, following pressure from the Securities and Exchange Commission, the major US exchanges required a majority of independent directors on the entire board. However, unlike the ASX CGC, the New York Stock Exchange and NASDAQ did not delegate to outside pressure groups. Hence, unlike Australia, a director in the US who is a substantial shareholder is not automatically deemed to be 'non-independent'.

While the reason for this apparently anti-capitalistic rule to socialise or democratise stock markets is rarely articulated, it has presumably been put in place to supposedly protect small shareholders from 'predation' by large shareholders who might otherwise gain majority control of the board by appointing nominees and expropriate minority shareholders. However, this explanation for rules designed to discourage directors who have the greatest incentive to look after the interests of all shareholders rings hollow. Not only do company laws protect minority shareholders but also minority shareholders actually benefit from the presence of a large blockholder on the board.[6]

The downside for investors is, of course, that it is precisely these departing directors who previously, in protecting themselves against avaricious management, passed on this protection to the 'little guy' while these significant shareholders bore most of the costs of intensive monitoring. The upside for researchers is that we can observe company performance changes as both 'non-independent' incentivised directors (significant shareholders) and informed directors (former CEOs and the like) depart the board as a result of regulatory-induced pressure.

Our dataset consists of the largest 500 ASX-listed companies between 2001 and 2012 for 1,414 distinct firms, approximately 11,965 firm-year observations, and 72,589 director-years. I standardise the measure of the variability in board structure, called the 'standard deviation', over the nearly 12,000 observations in the database. For example, one board proportion may vary by 10% and another by 20% and these variations need to be placed on an equal footing to make valid comparisons. Thus, instead of reporting my actual regression coefficients that can be misleading due to these variations in board composition, I report the standardised effect of each major coefficient. For example, two regression coefficients may appear to be of similar magnitude but their economic significance could vary greatly. I report the economically significant effects.

Empirical findings

Summarising the main results, perhaps the performance measure of most interest is a conventional measure used in practically all corporate governance research known as the 'Tobin's Q ratio', named after the economist James Tobin. This glorified market-to-book ratio represents the total market value of all the company's assets divided by the book value of all assets and is a shorthand measure of the value that a board and company management have contributed over and above the outlay on assets.

It is a useful performance measure as it captures the extent to which over time the board and management add or destroy value to the assets they acquire. A change in this ratio measures the change in share value from adoption of the ASX CGC's policies of discouraging what they deem 'non-independent' directors with firm-specific knowledge and the incentive to maximise the stock price.

The model is estimated by examining the changes in the proportions of the different board types and observing the change in company performance one year following the departure of directors deemed 'non-independent' by the ASX regulator.

'Tainted' former CEOs are major contributors to board performance

Former CEOs and other informed directors who once had an association with the company are seen as 'tainted' by this association as they are no longer deemed to be 'independent', despite their superior knowledge of the firm and its operations. Surprisingly, a lapse of three or more years is sufficient to restore their 'independence' according to the rules of the ASX CGC. A one standard deviation fall in the proportion of informed or 'non-independent' directors, due to the actions of the regulators, reduces Tobin's Q and thus destroys corporate value due to share price falls in the following year by a sizeable 5.9%, or $202 million for a company of average size. Multiplied across the sample of 1,414 firms, this amounts to a sizeable reduction in stock value to the tune of $16.9 billion.

The effect of the policy promoted by the ASX CGC has been arbitrarily to eliminate these directors without any attempt to investigate the merits of that policy based on empirical evidence. It is a policy based on *a priori* beliefs held by the constituent members of the ASX CGC. Moreover, it is a theoretical policy formulated by a body with no responsibility for losses induced by a compliant 'independent' board whose members may have little company or even industry specific knowledge.

Incentivised directors are beneficial only when stock price is informative

Turning now to the presence of incentivised directors (or 'non-independent' substantial shareholders) they seem to be particularly effective on the audit committee as they have a strong incentive to reduce costs. A one standard deviation reduction in this ratio as these 'non-independent' directors depart lowers Tobin's Q by a still sizeable 1.8%.

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In the absence of an informative stock price—that is, information contained in stock trades and thus in stock price movements—greater CEO stock ownership giving higher CEO pay-for-performance sensitivity does not improve company performance. However, a one standard deviation increase in stock price informativeness for a given CEO's pay-for-performance sensitivity improves Tobin's Q by a significant 2%. This finding indicates that managerial incentives are only effective if the stock price is informative of the manager's actions.

Company performance improves greatly in the stockholdings of 'non-independent' incentivised and informed directors and in the shareholdings of executives but this improvement is entirely dependent on there being considerable information in the stock price.

I also find that a one standard deviation increase in the proportion of 'independent' directors diminishes the company's accounting returns by a substantial 11.3% when the stock price is informative. Thus the greater presence of 'independent' directors on the board can have a disastrous impact on the firm's accounting performance.

I have nothing against genuinely independent directors. According to the world's most successful investor, Warren Buffett, board independence is a crucial factor in providing good corporate governance. Note his words: 'True independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare.'[7]

Unsurprisingly, Buffett is diametrically opposed to the ASX CGC's determination to eliminate significant shareholders from the board: 'The place to look for [true independence] is among high-grade people whose interests are in line with those of rank-and-file shareholders—and are in line in a very big way.'[8] Share ownership by Buffett's directors ranges from a minimum of $4 million to hundreds of millions of dollars, all paid for by themselves at market prices.

Incentivised directors provide better advice on takeovers

I also investigate the role that board composition plays for the 667 firms in my sample that made takeover offers. There is a sizeable 3.3% reduction in stock returns for a one standard deviation reduction in the proportion of 'non-independent' incentivised directors on the audit committee. Incentivised directors provide good advice during takeovers with this advice being more effective as more information is incorporated into the stock price.

CEOs have good reason to love 'independent' directors

Who monitors the pay of the CEO? The pay of Australian CEOs is seen to be excessive by some, which led in 2011 to the introduction of the 'Two Strikes rule' whereby an entire board can face re-election if shareholders disagree with executive salaries and bonuses. However, regulatory intervention seems responsible for much of the increase. I find that a one standard deviation reduction in the presence of 'non-independent' incentivised executive directors raises CEO pay by a massive 42% while 'independent' directors do not appear to monitor CEO pay at all.

Finally, I find that the greater the presence of incentivised directors on the audit committee the higher is the dividend and payout ratio. In February 2016, BHP Billiton announced a 74% dividend cut to its fully franked dividend. Given, as noted earlier, that its large board of ten has only one 'non-independent' director, this cut should not have come as a great surprise.

Conclusions

In conclusion, my research shows that one reason the performance of many large Australian companies with informative stock prices in the recent decade has been so lacklustre is because they have dispensed with most of their former 'non-independent' informed and incentivised directors, as well as many of their executive directors and dual role CEO-chairs.

There is practically no area of company performance that has not deteriorated in response to these regulatory-induced departures. Losses are more severe the more informative is the stock price and hence they tend to affect larger, more liquid stocks such as Woolworths and BHP Billiton more severely. This is not so much a problem for small companies experiencing thin trading on the ASX. Such companies are under less pressure from the media and proxy advisors and hence are less likely to adopt wealth-destroying ASX CGC recommendations in the first place.

Informed and incentivised directors have been replaced by 'independent' directors with negligible skin in the game and very little direct knowledge or experience of the firm on their appointment. By the very nature of the 'independence' criterion, they lack firm-specific knowledge and background on their appointment, with their career prospects appearing to be too dependent on retaining the goodwill of the CEO. Unlike fellow executive directors, these directors do not monitor the CEOs pay or recognise when greater effort on the CEO's part requires higher compensation.

The tragedy is that almost universally regulators have come to believe that companies are better run by boards made up of 'independent' non-executive directors who provide governance and set strategy while tasks are carried out by executives. These beliefs have been formed *a priori* without any attempt at validation by objective research. It is bad enough that these beliefs have devolved from a Council appointed by the ASX which itself supposedly has the interests of investors at heart, but now the Australian government is attempting to impose 'independent' directors on reluctant 'industry' superannuation funds without even being clear what the 'independence' should be from.[9]

Even more disturbingly, the recent report of the 'Capability Review' into ASIC has recommended that ASIC have a full-time non-executive board with a governance role responsible for strategy, accountability and delivery, and all executives reporting to it.[10] This is to meet their belief that 'a dual governance and executive line management role inherently undermines accountability', as they perceive with the current executive-chair structure. But commissioners with no executive role to hire and fire—and with little effective power or knowledge of the problems of implementation—are even less likely to adequately fulfil their responsibilities than are the 'independent' directors who notionally run most large Australian companies.

I strongly urge the dismantling of the ASX Corporate Governance Council. Many of its affiliated members are conflicted because they are from an aspiring class of professional 'independent' directors identified with the 'big end of town'. Shareholders should have the right to elect directors who act in the interests of all shareholders in a free and unfettered manner. Shareholder rights in a free society rank with freedom of speech. Will ASIC as the cop on the beat itself be effectively dismembered before it can act decisively against the 'big end of town' represented by the ASX Corporate Governance Council?

Endnotes

1 See Box 2.3, 'Principle 2: Structure of the Board to Add Value', ASX Corporate Governance Council (CGC), *Corporate Governance Principles and Recommendations*, 3rd edition (Sydney: ASX CGC, 2014), p. 16, http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

2 See Box 2.1: Assessing the independence of directors. 'An independent director is a non-executive director (that is, is not a member of management) and: 1. is not a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company.' ASX Corporate Governance Council (CGC), *Corporate Governance Principles and Recommendations* (Sydney: ASX CGC, March 2003), http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364
The ASX CGC recommendation to exclude significant shareholder directors as being 'non-independent' was adopted from the Investment and Financial Services Association (IFSA) Blue Book recommendations put out (of all people) by the private superannuation and life assurance funds.

3 This research is discussed in an earlier article I authored on independent directors, published in 2014. See Peter Swan, 'The ASX Governance Council and "Independent" Boards', *Law and Financial Markets Review* 8: 3 (September 2014), 196-198.

4 'To describe a director as "independent" carries with it a particular connotation that the director is not allied with the interests of management, a substantial security holder or other relevant stakeholder and can and will bring an independent judgement to bear on issues before the board'. ASX Corporate Governance Council (CGC), *Corporate Governance Principles and Recommendations*, 3rd edition (Sydney: ASX CGC, 2014), p. 16, http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

5 David R. Gallagher, Peter A. Gardner, and Peter L. Swan, 'Governance through Trading: Institutional Swing Trades and Subsequent Firm Performance', *Journal of Finance and Quantitative Analysis* 48 (2013), 427-458.

6 Ronald C. Anderson and David M. Reeb, 'Founding-Family Ownership, Corporate Diversification, and Firm Leverage', *Journal of Law and Economics* 46 (2003), 653-684.

7 Warren Buffett's Annual Letter on the Selection of Corporate Directors: Berkshire Hathaway, *2003 Annual Report*, pp. 9-10.

8 As above.

9 Presumably, the purpose of the legislation is to dilute the role of employers and especially unions on the boards of 'industry' funds even though they appear to perform better than 'retail' funds. A more justifiable reform would require all directors to place their own 'nest eggs' in the funds they manage. See 'Exposure Draft: Superannuation Legislation Amendment (Governance) Bill 2015', http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Reforms%20to%20Superannuation%20Governance/Key%20Documents/PDF/150625-Draft-Legislation-Super-Legislation-Amendment-Bill-2015.ashx

10 Page 6 of *Fit for the Future: A Capability Review of the Australian Securities and Investments Commission*, A Report to Government (December 2015), http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2016/Fit%20for%20the%20future/Downloads/PDF/ASIC-Capability-Review-Final-Report.ashx