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# The effect of corporate governance on CEO luck: Evidence from the Institutional Shareholder Services (ISS) <sup>☆</sup>



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## ARTICLE INFO

### Article history:

Received 21 February 2013

Accepted 6 June 2013

Available online 13 June 2013

### JEL classification:

G30

G34

G32

G39

### Keywords:

Corporate governance

Option backdating

Lucky CEOs

Institutional Shareholder Services

Agency theory

Agency conflict

## ABSTRACT

CEOs are “lucky” when they receive stock option grants on days when the stock price is the lowest in the month of the grant, implying opportunistic timing. Extending the work of [Bebchuk et al. \(2010\)](#), we explore the effect of overall corporate governance quality on CEO luck. Provided by the Institutional Shareholder Services (ISS), our comprehensive governance metrics are much broader than those used in prior studies, encompassing more diverse aspects of corporate governance, such as audit, state laws, boards, ownership, and director education. We show that an improvement in governance quality by one standard deviation diminishes CEO luck by 14.77–21.06%. The governance standards recommended by ISS appear to be effective in deterring the opportunistic timing of option grants.

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## 1. Introduction

“Lucky” CEOs are given stock option grants on days when the stock price is the lowest in the month of the grant, implying opportunistic timing ([Bebchuk et al., 2010](#), BGP hereafter). If CEO luck were

<sup>☆</sup> Part of this research was conducted while the second author served as Visiting Associate Professor of Finance at Mahidol University, and The National Institute of Development Administration (NIDA) in Bangkok, Thailand.

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random, it should not be correlated with governance mechanisms. However, BGP find that CEO luck is in fact associated with three variables related to greater influence of the CEO (no majority of independent directors on the board, no independent compensation committee with an outside blockholder, and long CEO tenure). We extend BGP's study by investigating a much broader set of corporate governance mechanisms. While BGP focuses on board-related governance variables, our governance metrics encompass many more aspects of corporate governance, including audit issues, board structure and composition, other charter and bylaw provisions, director education, executive and director compensation, director and officer ownership, progressive practices, and state laws. Our governance measures are constructed based on the governance standards provided by the Institutional Shareholder Services (ISS), one of the most well-known and successful shareholder advisory groups that provide recommendations to institutional investors. Given the comprehensive nature of our governance metrics, we seek to understand how the "overall" quality of corporate governance affects the opportunistic timing of option grants.

Our results show that more effective governance does indeed deter opportunistic timing. In particular, an improvement in governance quality by one standard deviation diminishes CEO luck by 14.77–21.06%. In addition to the board of directors, we find that other governance categories such as audit issues and ownership structure also help prevent opportunistic timing. There has been a fierce debate on whether or not the governance standards recommended by ISS are appropriate. We contribute to this debate by demonstrating that the ISS governance standards are effective in preventing the opportunistic timing of option grants.

## 2. Sample construction and data description

### 2.1. Sample construction

BGP's sample is available on Professor Bebchuk's website. We merge their sample with our governance database provided by ISS. We eliminate firms whose financial characteristics are not available on COMPUSTAT. The final sample consists of 2800 firm-year observations from 2001 to 2004.<sup>1</sup>

### 2.2. Corporate governance metrics

To gauge corporate governance quality, we employ year-end data on governance standards provided by the Institutional Shareholder Services (ISS). The scope of the governance data is very broad, encompassing fifty-one governance standards in eight categories as defined by ISS. The eight categories include audit issues, board structure and composition, other charter and bylaw provisions, director education, executive and director compensation, director and officer ownership, progressive practices, and laws of the state of incorporation related to takeover defenses.<sup>2</sup>

We employ two metrics to gauge the aggregate quality of corporate governance. First, similar to Brown and Caylor (2006) and Chung et al. (2010), we construct an index for each firm by assigning one point for each governance standard that is satisfied. We label this index "Gov-score". We ascertain whether a specific governance standard is met using the minimum standard provided in the *ISS Corporate Governance: Best Practices User Guide and Glossary* (2003). Second, we employ the metric computed by ISS to measure governance quality. We refer to this metric as "ISS-score". Although constructed based on the same governance standards, ISS-score is different from Gov-score because ISS-score allows interaction terms that occur in combination with others. For instance, ISS assigns more weight to a firm whose board consists of a majority of independent directors and whose key board panels (audit, nominating, and composition) are all composed of independent directors, than it assigns to each of those standards individually.

<sup>1</sup> We finish the sample in 2004 because after 2004, ISS both added some governance factors and dropped others, making it challenging to construct a consistent index.

<sup>2</sup> The complete list of the fifty-one governance standards and their eight categories can be found in Jiraporn et al. (2011, 2012, 2013).

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