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The discretionary effect of CEOs and board chairs on corporate governance structures ☆

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ABSTRACT

In this study we analyze the effect of latent managerial characteristics on corporate governance. We find that CEO and board chair fixed effects explain a significant portion of the variation in board size, board independence, and CEO-chair duality even after controlling for several firm characteristics and firm fixed effects. The effect of CEOs on corporate governance practices is attributable mainly to executives who simultaneously hold the position of CEO and board chair in the same firm. Our results do not show a decline in CEO discretionary influence on corporate governance after the enactment of the Sarbanes–Oxley Act and stock exchange governance regulations.

1. Introduction

> *"In my experience, few directors in modern times have seen their interests as separate from those of the CEO, who effectively appointed them and, presumably, could remove them from future slates of directors submitted to shareholders." — Alan Greenspan at the Stern School of Business, March 26, 2002.*

Despite anecdotal evidence and academic studies on the discretionary power of CEOs in selecting board of director candidates (e.g., Hermalin and Weisbach, 1998; Mace, 1971; Shivdasani and Yermack, 1999), the financial economics and corporate governance literature lack a detailed empirical examination of the influence of CEO effects on a broad range of internal corporate governance structures. Our study addresses this gap by examining for the first time the effect of the variation in non-readily measurable personality traits and managerial styles of CEOs and board chairs, also known as managerial heterogeneity, on corporate governance.

Specifically, in this study we investigate the role of managerial heterogeneity in explaining board size, board independence, and the CEO-chair duality, which have significant influence on financial and strategic corporate decisions. We also examine whether CEO-specific heterogeneity can explain the variation across firms in the strength of shareholder rights, which are represented in this

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study by a modified version of the index created by Gompers et al. (2003). Additionally, we investigate whether the Sarbanes–Oxley Act of 2002 (SOX) along with the NYSE and Nasdaq new governance regulations approved by the Securities and Exchange Commission (SEC) in 2003 has reduced managerial discretion on governance practices in the recent years.

This study contributes to two streams of the recent financial economics and corporate governance literature. First, we complement studies of the effect of managerial characteristics on corporate decisions (e.g., Bertrand and Schoar, 2003; Graham et al., 2012). More specifically, we add an important dimension to the literature on determinants of board structure. Most of the existing finance studies on governance focus on the influence of firm characteristics rather than managerial effects on board structure (e.g., Coles et al., 2008; Link et al., 2009). Second we contribute to studies on the effects of the Sarbanes–Oxley Act (SOX) enacted in 2002 and the new rules approved by the SEC in 2003 on corporate governance and corporate decision making (e.g. Kang et al., 2010; Link et al., 2009). Overall, our study contributes to the ongoing discussion regarding the influence of CEOs on the internal mechanisms of control of their firms. This debate has continued after SOX and is likely to have a significant effect on how new legislative norms and SEC rules will be mandated to address corporate ethical issues.

Our results show that CEO and chairperson characteristics have a significant effect on the variation in board composition (board size and independence) and the decision to join or separate the CEO and board chair positions. The significant effect of CEOs on governance practices appears to be mainly attributable to CEOs who also hold the board chair position. When we analyze fixed effects for CEOs who are not board chairs, the addition of CEO fixed effects to our regressions does not add explanatory power. Powerful CEOs who assume also the role of chair of the board have the ability to significantly influence governance policies. We do not find that Sarbanes–Oxley and stock exchange governance regulations have significantly decreased the effect of CEOs on corporate governance.

Our finding related to the CEO-chair of the board duality is worth of note. While in many countries the separation of the CEO and chair of the board positions is the norm (e.g. Canada, Australia, Britain and much of continental Europe), the majority of U.S. public corporations combine the two positions. Despite pressure from international institutional investors to separate the two jobs, the CEO-chair duality is one of the few significant dimensions of internal corporate governance that SOX and stock exchange governance new regulations have left untouched.[1]

Our findings result from an empirical analysis of the effect of the variation in non-readily measurable personality traits and managerial styles on corporate governance based on the estimation of CEO and chair of the board fixed effects regressions. In assessing the significance of managerial heterogeneity on corporate governance, we control for several firm characteristics that are related to corporate governance. Additionally, we investigate whether new governance regulations implemented in 2002 and 2003 have reduced managerial discretion on governance practices. Finally, we implement a battery of tests to address concerns about a possible endogenous relation between manager-specific characteristics and corporate governance.

Similar to Bertrand and Schoar (2003), we restrict our sample to firms that switch CEOs at least once during the sample period. This sample restriction is required to separate manager fixed effects from firm fixed effects because the effect on corporate practices of a CEO who never changes firm cannot be estimated separately from his firm fixed effect. In this case, there would be perfect correlation between manager fixed effects and firm fixed effects. Moreover, even though it would be statistically possible to extend the analysis to CEOs who manage only one firm for only a portion of the entire sample period, that approach would generate the risk of obtaining spurious results due to unobservable factors that are correlated with manager fixed effects. To avoid this potential risk, we do not extend our sample to those CEO-firm pairs.

Drawing causality between manager-specific heterogeneity and board structure or managerial entrenchment requires careful consideration because the relation between governance structures and CEO heterogeneity might be spurious. For example, changes in board structures and shareholder rights might have been decided previous to the hiring of the new CEO but their implementation coincided with the CEO arrival. In this case, if the model specification adequately captures the effect of all other relevant exogenous variables, we might not find any remaining effect due to managerial heterogeneity. Another possibility is a potentially endogenous relation between managerial characteristics and corporate governance affecting the results of this study due to, for example, reverse causality. It could be argued that managerial heterogeneity does not explain the variation in corporate governance. Instead, firms optimally choose managers who are the best match for their corporate governance structures.

We use firm fixed effects to control for time-invariant, unobserved characteristics that are omitted from our model specification. Moreover, our independent variables control for the possibility that firms with CEO-chair duality are particular types of firms along the dimensions underscored by the firm characteristics proxied by our control variables. We also partially control for reverse causality by lagging the independent variables by one fiscal year. We then address concerns about endogeneity more thoroughly in two additional ways. First, in similar vein to Richardson et al. (2003), we examine changes in governance structures for CEOs and chairs with tenures of at least two years. We essentially focus on those executives who might have an improved ability to influence the governance policy variables due to longer tenure. Second, we adopt the Bertrand and Schoar's (2003) residual regressions and placebo method.

Our second robustness test consists of a parametric analysis based on residual regression to examine the persistence of managerial effects on governance. We regress the executive's average residual in his second firm on his average residual in the first firm. We find a positive and statistically significant relationship between a CEO or chair residual in his last job and his residual in his first job for the majority of our governance variables. We then regress pre-appointment residuals, which assume that each manager in our sample joins his second firm three years before and leaves it on the actual appointment date, on the true average residuals in the first firm. The

[1] “Someone to watch over them”, The Economist, October 15, 2009.