Does BBR render CGR and CGI DOA?

Or, no matter what the evidence, is it all CYA?

BY HOFFER KABACK

ARE CORPORATE GOVERNANCE "indices" valuable ... or meaningless? Do so-called governance "best practices" lead to better corporate performance ... or are they not worth a John Nance Garner bucketful of warm p—? Should directors cut their consciences (and practices) to fit this year's governance fashions ... or should they stand tall and refuse to do so?

The commercial rating services answer these three questions by claiming that their proprietary formulae for weighting governance practices yield a valuable tool for investors. (And, plainly, their substantial customer base votes with its pocketbook on this assertion.)

Very different answers are given in an October 2007 paper by Professors Sanjai Bhagat, Brian Bolton, and Roberta Romano (BBR). Titled "The Promise and Peril of Corporate Governance Indices," it was written for the European Corporate Governance Institute (and can be downloaded at www.ecgi.org/wp).

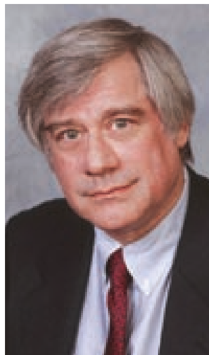
BBR's principal points include:

1. Those who sell governance ratings and evaluation services to investors assert that earlier academic studies demonstrate a causal, statistically significant connection between governance indices and corporate performance.

2. BBR's analysis shows, on the contrary, that there is "no consistent relation between the academic and related commercial governance indices and measures of corporate performance."

3. Regulators should not mandate specific governance practices but should encourage flexibility. In other (my) words: Corporate governance indices (CGI) and corporate governance ratings (CGR) are bunk.

4. The single characteristic of outside board members' stock ownership is a better proxy for good governance than CGI/CGR insofar as such ownership relates to (a) future accounting earnings and (b) firing the CEO after bad performance.



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5. Indices that weight individual governance practices overlook the issue of interaction among practices and that practices may be substitutes (rather than complements).

6. There are differences between relating governance to (a) stock returns and (b) accounting earnings.

7. "Comply or explain" regulatory regimes (as in Canada) create an unhealthy and inappropriate incentive for companies to conform to governance checklist-ism; better would be disclosure without comparisons to a purported standard.

8. Purchasers of CGR services may not themselves even believe that such ratings have predictive or analytical value; they may instead be engaged in CYA activity as fiduciaries.

9. BBR's two key policy conclusions are: a) regulation regarding governance practices should not be "checklist"-oriented but instead disclosure-driven; and b) investors should grasp that CGR and CGI do not and cannot predict stock price movement.

Now to comments and criticism:

• Virtually every BBR citation appears to be to an article from an academic journal. Why such "purity"? There are numerous pieces, written by academics and nonacademics alike but published in nonacademic journals and periodicals, that contribute not insignificantly to governance literature and thinking. But in BBR, governance analysis appears to exist only in strictly formal academic journals — a space not necessarily coextensive with the real world.

• BBR's inferences about directors' stock ownership are, in my view, misguided. Among many other things, BBR fails to consider that directors own a fair amount of stock these days not necessarily because they desire to or because they are convinced that doing so is a superb investment but because the companies on whose boards they sit *require* them to (if they want to be directors); and those companies so compel them because of pressure over the last 15 years from the chefs de cuisine in the "eat your own cooking" governance kitchen. Were all U.S. directors required to wear maroon ties to board meetings, then one could correlate that to corporate performance. BBR's conclusions about directors' stock ownership may reflect that directors at some companies have been compelled to hold more dollar value of stock than have directors at other companies.

• Will BBR render CGR and CGI henceforward "dead on arrival"? For many years now, several commentators (and the Business Roundtable) have criticized the checklist mindset, emphasizing instead that the essence of governance lies in each director's character and ability. To the extent, however, that the CYA mentality remains operative in the institutional investor world, BBR will have the same little effect that these far earlier anti-checklist analyses had.

For, clearly, the purchase of checklist-based CGRs is *itself* an act of checklisting. The CYA-oriented investor buys the CGR and checks the "buy a CGR" box. For such an investor, CGR and CGI will not be DOA; they will endure. ■

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