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Siv Staubo

Regulation and Corporate Board Composition

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  Does mandatory gender balance work? Changing organizational form to avoid board upheaval
  Authors: Øyvind Bøhren and Siv Staubo

- Article 2:
  Female directors and board independence: Evidence from boards with mandatory gender balance
  Authors: Øyvind Bøhren and Siv Staubo

- Article 3:
  Determinants of board independence in a free contracting environment
  Authors: Siv Staubo

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Regulation and Corporate Board Composition

Siv Staubo

A dissertation submitted to BI Norwegian Business School
for the degree of PhD

PhD specialisation: Financial Economics

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Siv Staubo
Regulation and Corporate Board Composition

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1. Introduction

This thesis consists of three essays investigating the effects of regulations on board composition. Two regulations affecting the selection of board members have been put into effect during the last decade:

Regulation 1: The Gender Balance Law (GBL). In 2003, the Norwegian government passed a law requiring at least 40% of each gender in the board of directors of ASA firms.

Regulation 2: The Independence Code (IC). In 2006, boards of listed ASA firms were recommended by a corporate governance code from the Oslo Stock Exchange to appoint at least 50% independent directors to their boards.

The GBL is unique to Norway. Although ‘women on boards’ is a hot topic in countries across the world, Norway is the first country to establish a 40% gender quota by law. Firms that do not comply with the law will be liquidated.

The IC is a recommendation, following the principle of comply-or-explain. This recommendation is one of the codes in ‘The Norwegian code of practice for Corporate Governance’. Similar codes exist in most countries across the world. An independent director is neither a member of the firm’s management team nor family-related to members of the management team. A more detailed definition of independent directors is given in the second essay.

This thesis is in the field of corporate governance. The corporate governance structure involves laws, rules, and regulations on the distribution of rights and responsibilities among the different stakeholders in the firm. Due to several financial crises in the late 1990s and early 2000s, there has been an increased interest in the regulation of corporate governance. In particular, the composition of the corporate board has achieved extensive attention.

The first essay in the thesis investigates stockholders’ reactions to the GBL.

The second essay mainly addresses a supposedly unintended consequence of the GBL. Furthermore, this essay explores the link between the GBL and the IC.

Finally, using a sample of firms that are neither exposed to the GBL nor the IC, the third essay explores which firms will benefit and which firms will suffer if they had to comply with one of these regulations/recommendations or both.

The motivation for writing three essays on the regulation of board composition is that such regulations come with both costs and benefits. Therefore, regulation might be costly to some firms and beneficial to others. This possibility is analyzed in detail in the three essays. If we assume that stockholders are able to compose an optimal board for their firm, restrictions to board composition might result in non-optimal boards for some firms. This happens if a

regulation makes it costly for stockholders to compose a board with the same qualities as the board had before the firm was exposed to the regulation.

To better understand why the GBL and the IC might have both costs and benefits, we explain the background of the two regulations.

The GBL, was proposed by a politician who believed that more value for stockholders can be created by increasing diversity in top management and on corporate boards. Other politicians argue that it makes a fairer society when firms include more women in their board room. For example, Prime Minister David Cameron recently stated that: “There is clear evidence that ending Britain’s male-dominated business culture would improve performance, and that Britain’s economic recovery is being held back by a lack of women in the boardroom” (The Guardian 2012).

The IC was first proposed in the United States, and later included in the Sarbane-Oxeley Act (SOX). Prior to SOX, boards in United States, as well as in most other countries, were dominated by insiders who were members of the management team. During the last decade, most countries have developed corporate governance codes that recommend stockholders to appoint a majority of independent directors. Following several financial scandals, policy makers suggested that enhancing the boards’ monitoring role would help prevent further scandals. Independent directors are assumed to be better at monitoring management than dependent directors. To illustrate, the European Commission’s Recommendation from October 6, 2006 states the following: ‘The role of independent non-executive directors features prominently in corporate governance codes. The presence of independent representatives on the board, capable of challenging the decisions of management, is widely considered a means of protecting the interests of stockholders and, where appropriate, other stakeholders.’

We believe that the corporate governance rationale for these opinions need to be further investigated. As far as we can judge, existing research provides no robust support for these opinions. That is, there is neither convincing theory nor convincing empirical evidence showing that more board independence unconditionally improves firm value. The reason is simply that more board independence has both benefits and costs and that the costs may outweigh the benefits. Moreover, this relationship between costs and benefits may vary from firm to firm.

1.1 Does mandatory gender balance work? Changing organizational form to avoid board upheaval

In the first essay, we study stockholders' reactions to the gender balance law (GBL). We find that, after the GBL ruled that the firm will be liquidated unless at least 40% of each gender is present on the board, half the firms exited to an organizational form that is not exposed to the law. In Norway, as in many other countries, there are two organizational forms for limited liability firms. All firms operating in the most advanced organizational form (ASA) had to change their boards by 2008. The only way to avoid the GBL was to exit to a less advanced organizational form (AS), where gender diversity in the boardroom is not regulated. It is reasonable to infer that the new regulation is costly to many firms, since the stockholders of half the firms decided to exit the exposed organizational form.

We also show that the costs are firm-specific. Exit is more common when the firm is non-listed, successful, small, young, has powerful owners, no dominating family owner, and few female directors. It is important to notice that listed firms have to delist if they change organizational form. That is, all listed firms have to operate in the most advanced organizational form. Consequently, if the benefits of being listed are greater than the costs of changing the board, the GBL is still costly even though the firm does not exit. Correspondingly, certain unexposed firms may hesitate to become exposed because the expected benefits of operating in the most advanced organizational form are lower than the cost of changing the board.

Overall, we find that mandatory gender balance may produce firms with either inefficient boards or inefficient organizational forms.

1.2 Female directors and board independence: Evidence from boards with mandatory gender balance

The second essay explores whether gender quotas have other effects on the composition of corporate boards than the implied upward shift in gender diversity. We analyze the impact on board independence of the GBL that requires at least 40 percent of a firm's directors to be of each gender. We find that the average fraction of independent directors grows by 20 percentage points after the passage of the law. This upwards shift occurs because 84 percent of the female directors are independent, while only 50 percent of the men are.

This large increase in board independence may be costly to some firms because the demand for monitoring by independent directors is firm-specific. That is, optimal board independence requires a trade-off between monitoring by independent directors and advice by dependent directors. This conflict between monitoring and advice suggests that board quality will suffer if forced gender balance pushes the board's independence level above its optimal level.

We find that demand for an independent board is lowest in small, young, profitable, non-listed firms with few female directors and powerful stockholders. Such firms need monitoring by independent directors the least and advice by dependent directors the most. These firms are hit hardest by excessive board independence, which may be an unintended side effect of mandatory gender balance.

One may wonder whether increased board independence is driven not by the GBL, but rather by the IC, which was introduced in the middle of our sample period. This code is soft law based on the principle of comply-or-explain, recommending that half the firm's directors be independent. However, the code applies to the listed (public) firms, but not to the non-listed (private). Hence, whereas the GBL imposes the same indirect restriction on board independence regardless of listing status, the IC restricts board independence only in listed firms. We exploit this difference to separate the effects on independence stemming from the two regulations. Roughly, half the firms in the population are listed and implicitly exposed to both the GBL and the code. The other half consists of non-listed firms and is exposed only to the GBL. Therefore, the smaller the difference in growth of board independence between listed and non-listed firms, the higher the likelihood that the regulatory effect on independence is due to the GBL rather than the IC.

Our evidence shows that the impact does not come from the IC, but rather from the GBL. The GBL produces the same upward shift in board independence regardless of the firm's listing status. That is, because the entire pool of female director talent has so few dependent candidates, one cannot select both many women and many dependent women simultaneously. Therefore, choosing a female director very often means having to choose an independent director, even though that was not the intention.

1.3 Determinants of board independence in a free contracting environment

The essay is the first to explore the demand for monitoring and advice on the board by the owners of firms that are not required by regulation to appoint independent directors. The sample of firms in this study is regulated neither by the GBL nor by the IC. Our focus is on the potential conflict between monitoring and advice and on the idea that the relative value of these two board functions varies across firms.

We explore the board's monitoring role not just relative to the CEO, but also relative to potential conflicts between large and small stockholders. The first of these two monitoring functions is the only focus in the existing literature. This function of the board is to reduce the principal-agent problem that arises when managers exploit their control rights at the stockholders' expense. This situation is called the first agency problem in the literature, and directors who are independent of management are supposed to be better at reducing this problem.

The board's second monitoring function is to oversee the conflict between majority and minority stockholders, which has been called the second agency problem. Directors who are independent of influential stockholders are supposed to be better at protecting the rights of minority stockholders. As far as we are aware, we are the first to study the second monitoring function in a board independence setting.

Our evidence shows that well established, small, and profitable firms with concentrated ownership need advice from dependent directors more than monitoring of their management by independent directors. The analysis shows similar results when we investigate the demand for board independence driven by potential conflicts between large and small stockholders. Unlike earlier research, we find that female directors are just as likely to be advisors as monitors when the firm operates in a free contracting environment regarding gender balance and independence. Our results support the idea that optimal board independence is firm-specific.

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Appendix 1: Characteristics of non-listed firms and listed firms

	Non-listed firms		Listed firms	
Variable	Mean	Median	Mean	Median
Board characteristics				
Board independence - A1	0.48	0.00	0.92	1.00
Board independence - A2	0.57	0.67	0.93	1.00
Board size	3.80	3.00	6.20	6.00
Female directors	0.15	0.00	0.21	0.20
BoD tenure	3.47	3.00	1.62	1.37
Ownership characteristics				
Outside concentration	0.21	0.20	0.16	0.10
Inside ownership	78.30	93.00	0.12	0.00
CEO ownership	37.30	33.33	0.10	8.33
Largest owner	45.79	49.00	26.61	22.64
Family ownership	82.98	99.95	20.53	14.20
Family characteristics				
Family control	0.82	1.00	0.08	0.00
Family chair	0.43	0.00	0.12	0.00
Family CEO	0.45	0.00	0.08	0.00
Family board	0.45	0.00	0.07	0.00
General firm characteristics				
Performance	8.48	3.42	5.59	5.02
Leverage	0.74	0.76	0.49	0.52
Growth	1.26	1.03	1.15	1.08
Information costs	8.58	5.09	7.35	4.96
Firm age	12.28	9.00	34.61	18.00
Firm size	28.06	8.20	885.84	85.58
CEO tenure	6.12	5.00	5.09	4.00
CEO age	46.64	46.00	47.12	47.00
N	178,721	178,721	3,427	3,427

This table shows the mean and median values of the variables used to measure board, ownership, family, and general firm characteristics. Table 1 defines the variables. The sample is Norwegian non-listed and listed firms, from 2000–2011, where revenue ≥ 2 million NOK, board size ≥ 3, and the largest owner holds < 90% of the equity. Performance is censored at 2% and 98% and leverage is censored at 99%.

Appendix 2: Properties of the instrumental variable (IV)

Panel A: CEO ownership classified by CEO age

Variable	All	Young CEO	Old CEO	Difference	p-value
CEO ownership	37.30	36.16	38.49	-2.33	(0.000)

Panel B: Board and firm characteristics classified by CEO age

Variable	All	Young CEO	Old CEO	Difference	p-value
Board independence-A1	0.48	0.48	0.48	0.00	(1.000)
Board independence-A2	0.57	0.58	0.56	0.02	(0.000)
Performance	8.48	8.62	8.27	0.35	(0.000)
Leverage	0.74	0.76	0.71	0.05	(0.000)
Female directors	0.15	0.15	0.16	-0.01	(0.000)
Firm size	16.18	16.13	16.28	-0.15	(0.000)

This table shows board and firm characteristics for young and old CEOs. A young CEO is a CEO that is younger than 47 years (the average age of CEOs in our sample), an old CEO is a CEO that is 47 years or older. Panel A shows the ownership of young and old CEOs, the difference is shown in the fifth column, and the p-value is stated in the sixth column. Panel B shows board and firm characteristics for young and old CEOs, the differences are shown in the fifth column and the p-values are stated in parentheses in the sixth column. Table 1 defines the variables. The sample is Norwegian non-listed firms from 2000–2011 where revenue ≥ 2 million NOK, board size ≥ 3, and the largest owner holds < 90% of the equity. Performance is censored at 2% and 98%, and leverage is censored at 99%.

5. Summary

The findings in this thesis show that regulation, such as the gender balance law and the board independence code, results in unintended effects which may matter for the firm’s behavior. In the first essay, we find that stockholders of half the firms that suddenly become exposed to the gender balance law (GBL) choose the only alternative to changing the board that is to exit into an organizational form where the GBL does not apply.

The second essay finds that the GBL causes a large increase in board independence. Involuntary increase in board independence is a potential problem because there is a trade-off between the board’s monitoring role and advice role. More independent directors are assumed to strengthen the board’s monitoring role, while more dependent directors are better advisors. Finally, we find that recommending a majority of independent directors in every firm by the independence code (IC) may hurt firms that are better off with a lower level of board independence.

This thesis addresses economic consequences of new regulation of board composition. Our results show that profitable, young, and small firms are hurt the most by these regulations. That is, the cost of changing the board, either by increasing the fraction of female directors or by increasing the fraction of independent directors, is particularly costly for such firms.

Recent political signals indicate that the exit option we analyze may soon disappear. In particular, gender balance in corporate boards may be made mandatory not just for ASA firms, but also for some AS firms . If that happens, Norway will not just be special for being the first and only country to mandate a massive, rapid shift in the composition of corporate boards and to punish non-compliers with liquidation. The regulators may also decide to eliminate the option firms currently have to mitigate the costs of regulatory shocks by transforming into organizational forms that are not exposed to the law. Every other country considering gender balance regulation seems to favor the comply-or-explain system or considerably milder sanctions than liquidation. Such regulatory regimes would leave the gender balance choice to the firm’s discretion and hence allow for firm heterogeneity in board design. Our findings suggest that, compared to this more flexible alternative, the mandatory approach, and particularly one without exit options, is a costly way to regulate gender balance on corporate boards.

Although the gender balance law is mandatory, the corporate governance code is not mandatory, but follows the principle of comply-or-explain. Nevertheless, there is a widespread view among policy makers that boards with at least half the directors being independent ensure good governance. Therefore, it is often argued that stockholders should ensure that their firm follows the code. Our evidence suggests that some firms are better off with a lower level of board independence. Hence, one-size-fits-all regulation is costly and should not be complied with by all firms.

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