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SPECIAL FEATURE

What Good Governance Means for Stock Prices

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Aside from preventing outright theft, does corporate good governance matter? How do you measure good governance, anyway?

For years, economists at Harvard University's Olin Center for Law, Economics and Business have attempted to measure the impact of law on what actually occurs in the business community.

Two currently published papers make it clear that even for economists using sophisticated methodology, it is difficult to measure the effectiveness of SEC regulation on corporate governance.

The driving metric of the Olin papers is corporate democracy as defined by the extent of shareholder control. The greater the power of shareholders, and the less entrenched by defensive measures the board, the greater is the amount of "corporate democracy," a term the authors equate with good governance.

Governance disconnect

In "Learning and the Disappearing Association Between Governance and Returns," an effort is made to explain a seemingly high correlation between good governance and abnormally high stock trading returns during the 1990s, while no such correlation exists during the 2000s.

The paper contends that, during the 1990s, the stock market had yet to fully appreciate the economic advantage of well-governed firms and, surprised by their superior economic performance, jumped the market value of their shares.

But by the 2000s, more companies had adopted good governance methods — perhaps because of SEC pressure and regulation or because the marketplace had become more efficient ascribing a higher initial market price to well-governed companies — and so analysts and investors were no longer surprised.

Regulatory effects

What is the effect of SEC regulation in these results?

During the 1990s, "or at least since 1995, there were no legal developments that changed the significance of governance provisions in place and could by themselves produce abnormal returns."

Finding no SEC action of significance (and only minor activity in the Delaware courts that would bear on good governance), the paper concludes that increased regulation was not related to superior stock market return for well-governed companies.

In the 2000s, a decade fraught with public awareness and high levels of SEC activity, companies scoring well on good governance criteria did not enjoy abnormal stock market returns. By then, the benefit of good governance was already priced into stocks.

The paper excludes a variety of other independent factors that might give rise to this result. The lack of correlation between good governance and rising stock prices was not caused by fundamental change in the business climate, nor by independent swings in the stock market as a whole, nor by the types of

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businesses whose shares were being traded.

Abnormal trading profit is different from profitability of the enterprise itself. "[W]hile the governance indices can be expected at some point to cease to be correlated with abnormal trading profits, as their relevance for firm value and performance becomes incorporated into market prices, the correlation of these indices with firm value and performance can be expected to persist."

The 2000s were marked by massive corporate scandals, Sarbanes-Oxley, activist shareholders, an inflamed press, activist Congress, and emboldened institutional shareholders more willing to challenge governance status quo.

Thus, while good governance did translate into profits during that decade, there was no correlation between good governance and abnormal trading profits driven by unexpected company performance.

One might conclude that without SEC activity in the 1990s, well-governed companies enjoyed increases in market value, while in a decade of intense SEC regulation, well-governed companies did not enjoy a market advantage. This paper exposes the fallacy that SEC regulation helped create a better-informed market and erased earlier, anomalous pricing behavior.

Proxy access

A second Olin paper, "Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge," poses a more specific question about the value of SEC regulation of governance.

Since proxy access is mandated by the Dodd-Frank Act and SEC rules implementing it, what was the economic effect of the SEC suspending its implementation rules in the face of a legal challenge from the Business Roundtable?

Prior studies indicated that proposals to increase shareholder access to the proxy mechanism reduced financial returns for an entire United States stock portfolio relative to nondomestic portfolios, and for U.S. financial firms, theoretically more sensitive to shareholder proxy access, relative to nonfinancial firms.

In August 2010, the SEC had proposed a rule to become effective last fall mandating a certain level of shareholder access to the process of electing directors: 3-percent shareholders with a position held for at least three years were given the right to nominate directors and have them included in the company proxy solicitation.

Shareholders were also given the right to propose bylaw amendments providing for even more liberal shareholder nominating rights.

But Oct. 4, 2010, the Business Roundtable in the D.C. Circuit Court of Appeals challenged the new rule as arbitrary, capricious, beyond the SEC's authority and causing a reduction in overall shareholder wealth.

In response, the SEC suspended the applicability of its rules on Oct. 4, taking them off the table for the 2011 proxy season.

What was the immediate result of this "repeal" of shareholder proxy access?

The value of firms most vulnerable to shareholder proxy access dropped in a statistically significant manner. Firms most affected by proxy access — those with largest institutional ownership over three years — lost the most value.

"These results suggest that financial markets placed a positive value on shareholder access, as implemented in the SEC's August 2010 Rule."

The researchers looked for significant, long-term stockholdings by activist investors and found that companies with such investors had value declines significantly larger than those companies "insulated" from the rule. The more activist the institutional ownership, and the greater percentage owned by such shareholders, the greater the relative drop in share value.

The authors note that the drop in value was greatest for companies with activist hedge fund shareholders compared to companies with index fund shareholders, who are traditionally more passive.

Additionally, companies with greater director entrenchment and less shareholder democracy suffered a greater drop in value compared to their well-governed peers.

Apparently, the existence of a staggered board did not lead to a higher drop in market value. Rather, the single most significant trigger, a value loss almost five times greater, was large ownership stake by historically activist institutions.

The drop in shareholder value was less for companies incorporated in Delaware. In anticipation of federal legislation, Delaware enacted a statute in 2009 that would permit some shareholder role in director nominations. Theoretically, since those companies already enjoyed some of the financial benefit inherent in shareholder proxy access, the delay in SEC regulation had less negative impact on market price.

Why the difference in result between prior studies and the current paper?

Researchers claim the triggering events used in prior studies were of questionable importance and predictable in advance, while the SEC rule suspension was not, and therefore, a better test.

Since the litigation challenge on the SEC's rule is based in part upon it being "arbitrary and capricious," the authors believe their paper will buttress the SEC's position in litigation by demonstrating the positive market value of proxy access.

Those who think seating activist shareholder-designated directors will make "good directors" less likely to want to serve, or that activist directors will pursue short-term or skewed agendas, or that shareholders should let the professionals do the work of governance, might conclude that both of these Harvard papers were studying the wrong thing. After all, who knows what the results would be if the focus were wholly on return on investment?

The application of economic analysis does at least one thing. It pushes some of the policy debate from the academic and philosophical into the reality of hard numbers.

Perhaps as part of its ongoing organizational reforms, the SEC ought to open an office of "mark me to market." NEIH