Reputation Penalties for Poor Monitoring of Executive Pay: Evidence from Option Backdating

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Research Question and Motivation

Are outside directors held accountable for

poor monitoring of executive pay?

- Poor monitoring will <u>generally</u> result in labor market penalties.
- Bebchuk and Fried (2004) – directors are unlikely to bear reputation costs for poor oversight of <u>executive pay</u>.
  - Most pay practices can be justified ex post on economic grounds and can be "camouflaged."

  => Do not generate "outrage costs" – the only significant constraint on CEO Pay.
- We examine the reputation penalties (votes withheld and director turnover) to directors of firms involved in option backdating (BD) scandal of 2006 – 2007.

BD – A Powerful Setting

- Backdating: practice of retroactively selecting a past date when the stock price was particularly low as the option grant date
- Unlike other controversial compensation practices, hard to justify on economic grounds.
  - Significant drop in stock price of firms upon revelation of BD.
- Opportunity to observe a previously camouflaged pay practice.
- Empirical evidence:
  - # of firms likely to have engaged in BD far exceeds # eventually investigated
  - director interlocks may have contributed to the spread of BD
  - BD more likely when directors & CEO receive options around the same time

=> spark further “outrage.”

Sample Selection and Data

- Initial sample of 271 firms that announced internal reviews, SEC inquiries, Department of Justice subpoenas related to BD.
  - Glass, Lewis & Co. Yellow Card Trend Alert Report (June 14, 2007).
  - Complement with hand-collected data from 10-K filings.
- Final sample of approximately 180 firms.
  - Main sources of attrition:
    - Internal investigation concluded that no BD took place (30 firms).
    - Unable to measure reputation penalties because of mergers completed shortly after BD announcement date (25 firms; in 21 of these cases merger announced prior to revelation of BD).
    - Missing data for control variables (30 firms).
- Data sources: Boardex, Voting Analytics and the usual suspects.

Overview of Empirical Analyses

- Penalties at BD firms
  - Votes withheld from directors up for election.
    - A measure of damage to reputational capital.
    - Shareholders have increasingly been using votes withheld to reflect their assessment of directors' performance and boards have been responding to high votes withheld.
    - Del Guercio, Seery & Woidtke (2008); Cai, Garner & Walkling (2009); Ertimur, Ferri and Muslu (2010); Fischer, Gramlich, Miller and White (2009).
  - Subsequent director turnover.
- Reputation penalties at non-BD firms
  - Votes withheld, loss/gain of seats

Are More Votes Withheld from Directors at BD Firms?

	Coefficient	
Intercept	0.0375	
Director BD Firm	0.0516	***
New Director	-0.0078	***
Female Director	-0.0027	
Director Age > 65	-0.0001	
Tenure	0.0007	***
Number of Other Directorships	0.0004	
% of Outside Directors	0.0072	
Board Size	-0.0013	*
Total CEO Compensation	0.0004	
Industry Adjusted ROA	-0.0375	*
Abnormal Returns	0.0048	
Non-BD Related Litigation	0.0230	
Non-BD Related Restatement	-0.0058	
Non-BD Related RiskMetrics Wh. Rec.	0.1801	***
% of Institutional Holdings	0.0489	***
Blockholder	0.0038	
Ln(Assets)	0.0001	

Table 2 Panel A Model (1)

- N = 7,582

  Adjusted R^2 = 41.40%
- VW from directors at BD firms roughly twice as high as VW from directors at non-BD firms – Average VW in sample ~5%.

Does Voting Dissent at BD Firms Reflect Directors' Responsibilities & Decision Rights?

Excerpts from Table 2 Panel A Model (4)

	Coefficient	
CC Director BD Firm – On CC During BD Period	0.0976	***
CC Director BD Firm – Not on CC During BD Period	0.0626	***
CC Director BD Firm – Not on Board During BD Period	0.0484	***
AC Director BD Firm – On CC During BD Period	0.0985	***
AC Director BD Firm – Not on CC During BD Period	0.0255	***
AC Director BD Firm – Not on Board During BD Period	0.0187	***
Other Director BD Firm – On CC During BD Period	0.1032	***
Other Director BD Firm – Not on CC During BD Period	0.0201	**
Other Director BD Firm – Not on Board During BD Period	0.0334	***

- A "pecking order" of penalties:
  - Directors on CC during the BD period (~10%)
  - Current CC members (~5-6%)
  - All other BD Directors (~2-3%)

Does Voting Dissent Reflect the Severity of BD?

Excerpts from Table 2 Panel B Models (1) and (2)

	Effect of Restatement Amount	Effect of BD Related RiskMetrics Wh. Rec.
	Coefficient	Coefficient
Director BD Firm – Severity High	0.0959 ***	0.2711 ***
Director BD Firm – Severity Low	0.0279 ***	0.0217 ***

- Severity measures:
  - Magnitude of the restatement – higher the larger of # of options backdated (correlated w/ length of BD period) and the more in-the-money the options are (potential hidden profit to executives).
  - BD related RiskMetrics withhold recommendation – recommend shareholders withhold votes "from CC members who oversaw the questionable options grant practices or from current CC members who fail to respond to the issues proactively…on a case-by-case basis…"
- VW from BD directors > VW from non-BD directors regardless of the severity of backdating, but VW from BD directors significantly higher when severity is high.

Does Voting Dissent Merely Reflect RiskMetrics Recs?

Excerpts from Table 2 Panel B Models (2) and (3)

	Effect of BD Related RiskMetrics Wh. Rec.		Effect of BD Related RiskMetrics Wh. Rec. & BD Period CC Membership	
	Coefficient		Coefficient	
Director BD Firm – BD Related RiskMetrics Wh. Rec.	0.2711	***		
Director BD Firm – No BD Related RiskMetrics Wh. Rec.	0.0217	***		
Director BD Firm – On CC During BD Period & BD Related RM Wh. Rec.			0.3073	***
Director BD Firm – Not on CC During BD Period & BD Related RM Wh. Rec.			0.1540	***
Director BD Firm – On CC During BD Period & No BD Related RM Wh. Rec.			0.0300	***
Director BD Firm – Not on CC During BD Period & No BD Related RM Wh. Rec.			0.0176	***
Non-BD Related RM Wh. Rec.	0.1806	***	0.1823	***

- Effect of BD-related RiskMetrics Wh. Rec. on VW is greater than effect of non-BD related RiskMetrics Wh. Rec.
- Effect of BD-related RiskMetrics Wh. Rec. greater when director is on CC during BD Period.

Director Turnover – Main Results

- Do directors of BD firms experience higher turnover? Yes.
  - Predicted probability of turnover for
    - directors at BD firms = 17.5%
    - directors at non-BD firms = 14.4%
- Does director turnover at BD firms reflect directors' responsibility and decision rights? Yes.
  - CC members at BD firms are more likely to lose their seat than CC members at non-BD firms and AC members at BD firms.
  - Predicted probability of turnover for
    - CC directors at BD firms = 17.3%
    - CC directors at non-BD firms = 12.7%
    - AC directors at BD firms = 11.3%
  - There is no differential turnover effect for directors who sat on CC during BD period.

Does Director Turnover at BD Firms Reflect the Severity of BD and Firm Performance?

Excerpts from Table 4 Panel B Models (1) – (3)

	Coefficient	Coefficient	Coefficient
CC Director BD Firm	0.3964***		
CC Director BD Firm – High Restatement		0.6499***	
CC Director BD Firm – Low Restatement		0.1790	
CC Director BD Firm – High Performance			0.1450
CC Director BD Firm – Low Performance			0.9790***

- The abnormal turnover of CC members at BD firms is driven by most severe cases of BD and by BD firms with low performance.
- Predicted probability of turnover for CC members
  - at high restatement BD firms = 29.4 %, at low performance BD firms = 28.1%
  - at low restatement BD firms = 15.4% , at high performance BD firms = 14.5%
  - at non-BD firms = 12.8%.

Reputation Consequences for BD Directors at Other Firms

- Do BD firm directors receive higher votes withheld when up for election at non-BD firms? No.
  - Few statistically significant effects, but no economically significant effects.
  - No cases where RiskMetrics recommended withholding votes from a director because of his/her association with a BD firm.
- Do BD firm directors experience a (net) decrease in the number of other directorships they hold? No.

Conclusion

- Involvement in BD resulted in significant reputation penalties for CC directors in terms of votes withheld and turnover at BD firms.
  - Shareholders penalized all directors sitting on the CC during the BD period, regardless of their current committee positions.
  - Boards focused the replacement decisions on current CC members.
- No evidence that BD directors suffered reputation penalties at other non-BD firms.

=> are reputation penalties sufficient to have an ex ante effect on directors' incentives to monitor CEO pay.

=> Our results provide indirect support for reforms aimed at strengthening other monitoring mechanisms (e.g., say on pay, proxy access)

Contribution

- Literature on the director labor market as an ex post settling up mechanism.
  - Examine whether penalties for poor monitoring in general extend to poor oversight of executive pay, a key governance issue subject to intense scrutiny.
  - Votes withheld as an additional proxy for reputation penalties.
    - Turnover may be forced or voluntary – VW does not suffer from this interpretation problem.
    - Mere focus on turnover may understate reputation consequences.
  - Examine reputation penalties for CC members.
- Literature on shareholder voting.
  - Evidence on sophistication of shareholder votes – take directors' responsibilities and decision rights into account.
  - Evidence that shareholders interpret proxy advisors' recommendations in the context of other information.

BD – Straw Man?

- Conceptually, not obvious that there will be reputation penalties to outside directors.
  - Shareholders may not penalize otherwise valuable directors if they believe that
    - directors primarily serve an advisory role
    - directors' ability to monitor compensation practices is de facto limited (e.g., due to lack of time and expertise, or management control of information flow)
  - Shareholders' power to impose certain penalties (e.g., replace directors) may be limited.

Votes Withheld – Research Design

$$Votes\ Withheld = \alpha_0 + \alpha_1\, Director\ BD\ Firm + \beta\ Control\ Variables + \varepsilon$$

- BD sample: outside directors up for election at the first annual meeting following the BD announcement date (for firms with staggered boards, also include directors up for election at the second meeting date).
- Control sample: outside directors up for election only at non-BD firms at the 2007 annual meeting date.
- Votes Withheld (VW): # of votes withheld/# of votes cast.
- Control Variables: non-BD related withhold recommendation, individual director characteristics, governance structure of the firm, firm performance, institutional ownership, firm size, non-BD related litigation, non-BD related restatement, industry fixed effects.

Does Voting Dissent at BD Firms Reflect Directors' Responsibilities & Decision Rights?

Excerpts from Table 2 Panel A Model (2)

	Coefficient
Director BD Firm – On Board During BD Period	0.0671***
Director BD Firm – Not on Board During BD Period	0.0294***

- Substantial time lag between when BD took place and when it was discovered => not all directors on board at the time of BD announcement were on board during the BD period.
- Do shareholders have "memory" when they cast their votes?
  - VW from BD directors > VW from non-BD directors, but effect more pronounced for BD directors who were on board during BD period.

Does Voting Dissent at BD Firms Reflect Directors' Responsibilities & Decision Rights?

Excerpts from Table 2 Panel A Model (3)

	Coefficient	
CC Director Non-BD Firm	0.0057	***
AC Director Non-BD Firm	0.0052	**
CC Director BD Firm	0.0766	***
AC Director BD Firm	0.0375	***
Other Director BD Firm	0.0374	***

- Does voting penalty depend on directors' current committee membership?
  - BD provides executives with in-the-money rather than at-the-money options, in violation with shareholder-approved stock option plans => may be viewed as monitoring failure of CC.
  - BD under-states compensation expense often requiring a restatement => may be viewed as monitoring failure of AC.
- Results
  - VW from BD directors > VW from other directors at non-BD firms regardless of BD directors' committee membership.
  - VW from CC & AC members at BD firms > VW from their counterparts at non-BD firms.
  - VW from CC members at BD firms > VW from AC members at BD firms.

Director Turnover – Research Design

$$Pr(\textit{Director Turnover}) = \alpha_0 + \alpha_1 \textit{Director BD Firm} + \beta \textit{ Control Variables} + \varepsilon$$

- BD sample: outside directors who were sitting on the boards of BD firms at the most recent annual meeting prior to the revelation of the BD scandal (in most cases, the 2006 meeting).
- Control sample: outside directors that serve only on non-BD firms' boards at the 2006 annual meeting.
- Director Turnover: an indicator variable equal to one if the director turns over by the time of the second annual meeting.
- Control Variables: director gender, age, tenure with the firm, governance structure of the firm, firm performance, size, institutional ownership, events that may lead to/be correlated with board shakeups (e.g., CEO turnover, non-BD related litigation, restatements).

BD – Background

- Almost all employee stock options are granted at-the-money, i.e., exercise price = grant date market price. Why?
  - Accounting treatment: prior to 2005, firms did not have to record compensation expense for options granted at-the-money.
  - Tax treatment: firms required to pay taxes on compensation in excess of $1 million that is not performance based.
- BD is the practice of retroactively selecting a past date when the stock price was particularly low as the option grant date, resulting in a low exercise price & greater option value.
  - Issuing in-the-money options is not illegal per se & may be beneficial in some cases, but violates accounting rules, securities & tax laws if not properly approved, disclosed and accounted for.
  - Evidence of BD as a widespread practice: Lie (2005), first circulated in February 2004. But scandal erupted with story in WSJ in March 2006.