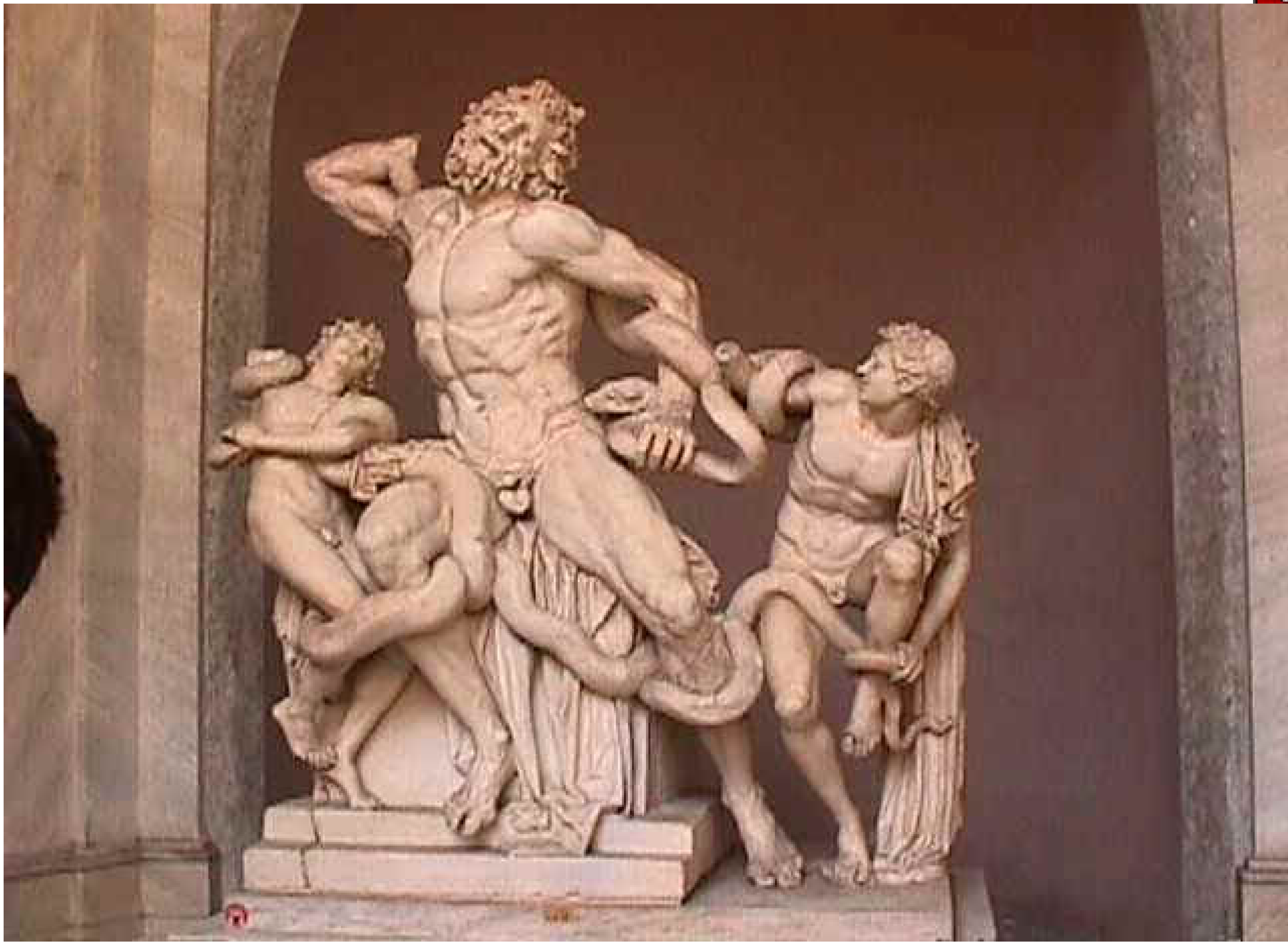
The Laocoön Syndrom

Luigi Zingales
University of Chicago
Booth School of Business

Motivation

- In any governance system it is crucial to aggregate information
  - To help in the decision process
  - To make reputation work
- Information is diffuse (Hayek, 1957)
- How can we best aggregate it
  - to induce better decision making
  - make reputation work
- In particular, how do we ensure that negative news emerge?



Why Is So Difficult to Bear Bad News?

1. We are reporting to our judges
    - CEO is afraid to share bad info with the Board (Adams and Ferreira, 2005).
2. Blame the messenger
    - We dislike teachers who criticize our kids
3. Concentrated costs diffuse benefits
    – Speak against an internal appointment
    – Who has the information does not want to reveal it because news affects value of his/own human capital
4. Loyalty vs. honesty
    – Whistle blowers
5. Social pressure
    – Criticism is seen as antagonistic
    – Dissenters are ostracized

Mechanisms to solve this problem:

1) Financial markets
   - A profit reason to spread bad news.
2) Market for news – the media
3) Entrenchment
   - Watson story
4) A market for Laocoons
   - External auditors reporting to the auditing committee composed of independent board members

Why reputation is not enough?

- Consider external auditors
- Does it pay to blow the whistle?
- Before 2002 auditors who overlooked a fraud were not penalized (Dyck et al, 2008).
- After 2002 yes, why?
- Because SOX forced transferred the right to appoint the auditors to the audit committee formed of independent directors

The Myth of Independent Directors

- Why should they behave any differently?
- If they value their reputation more than their position, they should not accept the nomination.
- If they do accept it, why should they not compromise (at least within limits)?

What Is The Solution?

- Directors not appointed by management
- It is not a guaranty of success, but a hope.
- If directors act in the interest of who appoint them, an alternative source of appointment might change their incentives.
- Does it?
- It is still too early to say

The Italian Experience

- Legge Draghi (1998) introduces the presence of a statutory auditors appointed by “minority” shareholders
- Privatized companies also have a few borad seats reserved for directors appointed by “minority” shareholders
- Legge sul risparmio (2005) extends this to all listed companies

Amministratori eletti dalle minoranze

	None	Minoranze istituzionali	Altre minoranze	Totale
Societa' non privatizzate	12	2	1	15
	80.00%	13.33%	6.67%	
Societa' privatizzate		7	12	19
		36.84%	63.16%	
Total	12	9	13	34
	35.29%	26.47%	38.24%	

Sindaci eletti dalle minoranze

None	Minoranze istituzionali	Altre minoranze	Totale
42	8	18	68
61.76%	11.76%	26.47%	

Problems – 1

- Who is a minority shareholder?
  - Risk that this position kidnapped by minority shareholders with a different agenda
  - Risk is particularly intense when international institutional investors do not vote because they are not aware of this concept.
- Limit who can propose the slate of directors

Problems – 2

- Risk of Balakanization of boards like little inefficient parliaments.
- Unlike parliaments, corporate boards' primary function is not to redistribute resources but to create them.
- Unlike parliaments, corporate boards have to
  - compete in the marketplace
  - live under the constant monitoring of the stock market,
- The problem in the opposite: social pressure to conform that can lead to what Jarvis (1972) define as groupthink.

Problems 3: Excessive short – termism

- Making directors more accountable to shareholders make them more short-termist
- I do not know of any empirical support for this view.
- Primary reason for a short-term bias is precisely the lack of accountability for corporate boards.
- The role of the board is not to blindly follow stock prices, but to create value for shareholders, exploiting the informational advantage they have.
- In other words, a board that is legitimated can more easily resist the stock market pressure than a board that is not.

Problem 4: Information

- Directors depend on managers for information
- Very risky to create a tension between directors and executives
- Solution is not to ignore it and give all the power to managers

Conclusions

- We need to create the incentives for people to report bad information.
- Besides the stock market, the best way is to create positive career incentives for people who report bad news.
- The most important of such position is the one “minority directors”
- It is not perfect, but it beats the alternatives