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Judge Business School

**SHOULD THE USA FOLLOW THE UK'S LEAD AND SPLIT THE DUAL CEO/CHAIRPERSON's ROLE?**

## INTRODUCTION

Whether a company and its stakeholders benefit from splitting CEO and chairperson is a question that has gained momentum following the recent financial crisis, coming back to the forefront of corporate governance debates. Promoters of the split view it as a way of further ensuring the independence of company boards. Listed UK firms shifted to a split between the two roles following the Cadbury Code recommendation in 1999. The discussion as to whether the same should be occurring in the USA is currently being debated. This paper will be looking at the current split in the USA, and how this has been changing over recent years.

In order to address the question as to what position the USA ought to take going forward one first needs to look at why boards exist and what role they are expected to play. This and the specific role of the chairperson will be presented in section II. Section III. introduces some arguments for and against a split, while section IV. looks at the academic research on the topic. An analysis of the problem will be presented in section V. Our conclusion that the SEC ought to tighten their requirements, along the lines of the UK model, will finally be presented in section VI.

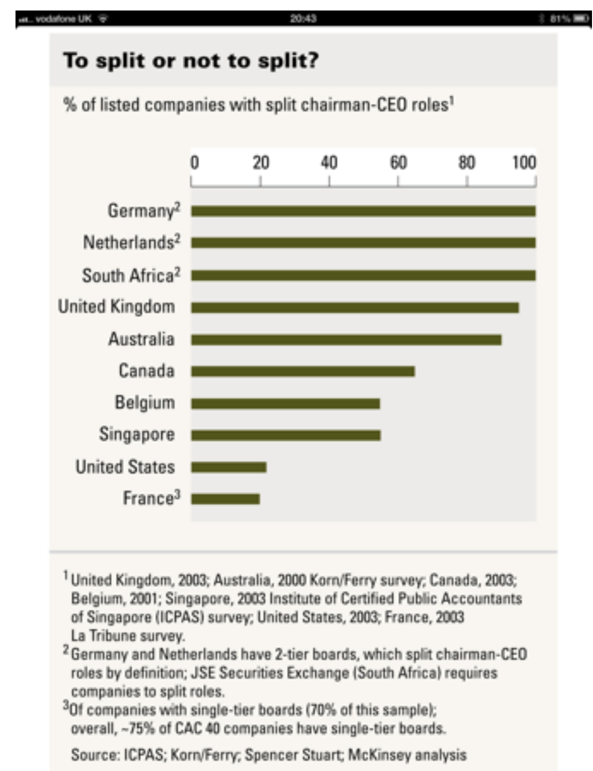
## I. THE UK VERSUS THE US MODEL

As mentioned above the UK shifted to a split between the CEO and Chairperson following the Cadbury Code recommendation in 1999, as a result 95% of the FTSE 100[1] companies have got separate individuals performing the roles. This has neither been made mandatory nor been strongly recommended in the USA, with the current SEC recommendations only going as far as requiring companies

[1] GMI (March 2013)
[2] S. Davies (May 2011)

to clearly identify board leadership models and reasons for holding it.[2] Even though there is no legal requirement to split the roles a clear voluntary trend has developed in the USA to do so. The graph below shows what the split in the USA was in 2003 versus other countries. In 2004 73.4% of S&P 500 companies had a combined CEO/Chairman role, in May 2012 the same was only true for 57.2% of companies.[3]

Furthermore it is not only the proportion of separate CEO's from chairpersons that has been on the rise, but also the number of chairman roles that are being filled by independent chairpersons. In 2004 only 6.4% of S&P 500 companies declared having an independent chairperson, this number has increased to 20% in May 2012 (GMI 2013).




*Source: C.M Daily & D.R. Dalton*

A majority of US firms that have a combined CEO/Chairperson role have instead opted to introduce a 'lead director' on their boards. Their role being to head sessions of independent directors, help advise the CEO/Chairperson when it comes to selecting a board committee and setting board meeting agendas.[4]

An additional difference between the UK and the US model is the length of time during which the Chairperson resides. In the USA this tends to be three to four

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[2] S. Davies (May 2011)
[3] GMI (March 2013)
[4] Thuy-Nga (2010)

years, while a Chairperson remains in their position for on average ten years in the UK, allowing for a deeper knowledge and understanding of the firm.

II. THE ROLE OF THE BOARD AND THE ROLE OF THE CHAIRPERSON

The legal responsibilities of a board of directors may vary depending on the structure of the organization and the country under which they operate. What does not vary is its main intended purpose and what brought about its existence, namely to govern the corporation in the interest of all stakeholders by facilitating:

"effective, entrepreneurial and prudent management that can deliver the long-term success of the company"

*Source: FRC, The UK Corporate Governance Code (June 2010)*[5]

Such a definition not only implies that the board of directors play a role in overseeing business operations, but also play a critical part in monitoring management in order to deliver corporate success.

The main historical reason for the existence of the modern board of directors goes back to the agency theory and the concept of separating ownership and control.[6] The idea being that the management of the firm (those who possess day-to-day control) may have conflicting interests to the owners of the firm[7]. With owners being so many in numbers, each one individually has little say as to the ongoing business of the organization. If it were possible to overcome problems of conflicting interests between managers and owners through contracts, then the agency problem could be overcome. However, this is not a realistic solution due to the transaction costs that would occur and the complexity when needing to take every possible current and future outcome into

[5] As taken from Learmount (March 2013)
[6] Berle and Means (1933)
[7] Owners here are not limited to shareholders alone.

account and trying to contract for them all[8]. Hence the board of directors was put in place to act as a representative of all owners and to protect and ensure their best interests.

Individual directors have the responsibility to act in the following manner:
(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

(a) the likely consequences of any decision in the long term,
(b) the interest of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.
*Source: UK Companies Act 2006, see footnote 5*

In addition to the responsibilities above the Chairperson's primary role according to the Institute of Directors is to:

"Ensure that the board is effective in its tasks of setting and implementing the company's direction and strategy"[9]

As such, he or she also has the further obligations to:

- Provide leadership to the board;
- take responsibility for the board's composition and development;

[8] Hart (1997)
[9] IOD (2010)

- ensure proper information for the board;
- plan and conduct board meetings effectively;
- get all directors involved in the board's work;
- ensure the board focuses on its key tasks;
- engage the board in assessing and improving its performance and,
- support the chief executive/MD.

As can be seen by looking at the responsibilities of all board members and the further obligations of a chairperson, none of these seem to contradict the possibility of one individual holding both roles. So where do the arguments against holding both positions find their grounding?

## III. ARGUMENTS FOR AND AGAINST A SPLIT OF THE CEO/CHAIRPERSON

Supporters for a split, overwhelmingly academics, regulators and shareholders, find justification in their arguments by focusing on the obligation a board of directors have to monitor management performance. As such they refer back to a classical agency theory problem, namely that a more effective monitoring mechanism leads to enhancing firm performance.[10] By separating the two they go back to delegating the task of decision making to the CEO, while providing the board with decision control.[11]

Those against, mainly represented by corporate leaders, seem to draw their legitimacy from the stewardship theory (also referred to as organization theory [12] ), which argues for having clear and unambiguous authority concentrated in one person.[13]

[10] C. M. Daily and D. R. Dalton (1997)
[11] B.K Boyd (May 1995)
[12] C. M. Daily and D. R. Dalton (1997)
[13] M. Tonello (September 2011)

The table below shows the types of rationale the two conflicting groups may claim:

| **Organization Theory Approach: Joint Board Leadership Structure** | **Agency Theory Approach: Separate Board Leadership Structure** |
|---|---|
| • Strong, unambiguous leadership<br>• Internal efficiencies through unity of command<br>• Eliminates potential for conflict between CEO and board chair<br>• Avoids confusion of having two public spokespersons addressing firm stakeholders | • Avoids CEO entrenchment<br>• Increases board monitoring effectiveness<br>• Enables board chair to function as advisor to the CEO<br>• Establishes independence (autonomy) between the board of directors and corporate management |

*Source: C. M. Daily and D.R. Dalton (1997)*

In their recent annual reports some of the companies that are against the split of their own board have given the following disclosure and arguments for a status quo[14]:

Goldman Sachs: The current structure 'demonstrates clearer accountability to our shareholders' and 'enhances transparency between management and our board'. The disclosure also goes on to state that their CEO/Chairman, Loyd Blankfein, contributes to the company by being a 'a knowledgeable resource for our independent directors.'

Amazon: Argues for the current state by referring to the CEO/Chairman, Jeff Bezos, and his 'role in founding Amazon.com and his significant ownership stake. The board believes that this leadership structure improves the board's ability to focus on key policy and operational issues.'

IV. ACADEMIC RESEARCH ON THE TOPIC OF CEO DUALITY

Unfortunately, this debate cannot be settled by providing unequivocal empirical findings as to the long-term outperformance by one of the two proposed board structures. If there is one thing, which most research seems to support, it is the

[14] GMI (March 2013)

lack of supporting empirical evidence for long-term outperformance by either model.

However, what research has gone on to find is a positive correlation between CEO duality and bankruptcy.[15] Furthermore V. Goyal and C. Park (2002) have also shown that firms with CEO duality do not dismiss poorly performing CEO's at the same rate compared with firms where the roles are separated.

Boyd[16], on the other hand, has found that CEO duality in high complexity environments do have a positive relationship related to firm performance.

Be it that is remains incredibly difficult to control for all the events that may effect how one measures the effectiveness of the two chairperson models and their boards we would still very much benefit from further research looking into more detail as to what types of companies might benefit from which model and under what market conditions.

## V. ANALYSIS

When looking at the effectiveness of a board there are many variables to look at that can alter the situation, such as the general independence of the board or who chose the board, communication and behavior between board members, the persona of the chairperson etc. Taking this into consideration and the fact that there is no unequivocal empirical findings supporting the long-term outperformance of either chairman model then why should so much emphasis and time be spent on the CEO duality debate?

[15] C. M. Daily and D. R. Dalton (1994)
[16] Boyd 1995

One explanation might be the low general trust towards companies. In order to regain trust companies and regulators must show that they are doing everything in their power to create as much reinforcement of independence and transparency within their board of directors as possible without inflicting too high a cost on themselves. We have already seen that this cost does not come in the form of long-term performance, but neither is their any research showing that cost of transfer of information is any higher providing that the chairman has extensive knowledge of the industry. Nor is there any reason why the CEO cannot remain on the board (some would argue as the only executive board director) and provide substantial expertise to the rest of the team.

Much of the pressure for a separation of the two roles has come from shareholders, who are the only group of stakeholders that have a vote in how the company is run and who are often perceived as the ultimate owners of the company with the most to lose if things go wrong. What has been discussed so far in this paper is an 'internal' form of corporate governance as performed by the board of directors. However, shareholders can also be claimed to have both a right and the duty to govern corporate behavior and performance.

The lack of engagement from this group has played an important part in enhancing the gap between control and ownership. Two reasons have often been provided[17] as explanations for this lack of engagement namely:

a) The limited capability a dispersed group of numerous and small owners possess to exercise their control over day-today issues, and
b) the issue of free-riding. Monitoring a company comes at a cost, but all owners share the benefit created by the monitoring shareholder. As such shareholders have had the tendency to wait for others to do the monitoring.

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[17] Hart (1995)

However these arguments are losing their potency with the rise of the institutional investor. During the period of 1957-2009 institutional investor ownership in the USA as a proportion of the whole market increased from 10% to 70%[18]

We are seeing signs that such investors are increasing their engagements with companies, be it in different ways. The most vocal group of such investors most are hedge fund activists, who view it as their right as owners to engage with companies in order to drive change that will benefit share price performance. Their form of governance engagement focuses mainly on overseeing business operations, but also play a critical part in monitoring management to deliver company success. This is the group that has pushes the hardest for the separation of the role.

However a trend is also clear amongst more traditional institutional investors increasing their engagement with companies. An interesting development driving this increase comes across as not their perceived right to drive through change, but instead their duty to do so.

The lack of trust towards companies by the public has hit the financial sector harder than most. As such the sector has had to take a closer look at itself and attempt to regain trust by better reflecting the values of their unit-holders. In a recent conference on the future of fund management[19] *Helena* Morrissey, CEO of Newton Investment Management, and Keith Skeoch, CEO of Standard Life investments, spoke of the need for fund managers to focus more on their role as custodians and stewards of their unit holders investments. Arguing that the only way to regain trust is through increased transparency. Such increased transparency coming from their own organizations, but also driving towards

[18] Bloomberg
[19] Market Force (13 March 2013)

more transparency in the companies in which they invest. Hence a sense of duty to increase their role as monitors and drive to improve transparency can be claimed to be their basis for seeking the separation of the CEO/Chairperson role.

## VI. CONCLUSIONS

Even though investors are taking an increasing interest in the way that companies are run and playing a more active monitoring role, the board is and must always be perceived as being the primary control mechanism for aligning the sometimes-conflicting interests of shareholders and top management. Research cannot conclusively support company's long-term outperformance as a result of either a board structure involving a combined CEO/Chairperson role nor one where the two are separated. As such the question as to which model is right must find its answer elsewhere.

Given the lack of proven additional costs in separating the two roles, it would make sense to fall back on the need for greater transparency, reinforced independence of the board and a perceived improvement to monitoring held by both owners and regulators of public companies.

That is not to say that we are arguing for the compulsory introduction of a split role, but that the SEC ought to further their requirements. Whereas they are currently asking companies to clearly show their board and management structures and explain their rational for either holding a combined or separated CEO and chairperson role, they should instead recommend companies to have a split role, but leaving it open for specific cases where the company can provide a clear argument as to why this would not benefit stakeholders. Similar to the position held in the UK.

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