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Under the spotlight: institutional investors and firm responses to the Council of Institutional Investors' Annual Focus List

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Abstract

This article looks at how a negative third-party quality signal, in the form of external monitoring of firm performance by an investor group, prompts a response from both institutional investors and the firms publicly identified as poor performers. Using a sample of 93 firms placed on the Focus List of the Council of Institutional Investors from 2000 to 2005 and a comparison group of 96 firms in the bottom quartile in stock performance from the S&P500, the authors find that institutional investors respond to this negative third-party signal by reducing their holdings in firms that received this public repudiation. However, this reduction in holdings is moderated by the independence of the board of the targeted firm. This result suggests institutional investors pay particular attention to the governance characteristics of underperforming firms. Lastly, the authors found that targeted firms with more independent boards respond by increasing the intensity of incentives of the CEO, thus signaling their responsiveness to investor concerns.

Key words • certifications • corporate governance • governance mechanisms • shareholder activism • third-party quality signals

One of the most significant problems regarding the separation of ownership and control in the modern corporation is that shareholders cannot directly observe if their capital is being managed competently (Berle and Means, 1932). Investors must rely on boards of directors to effectively oversee and monitor executives on their behalf. Even shareholders with large blocks of holdings, such as institutional investors, may have difficulty assessing how

effective management may be at any particular firm. This information asymmetry between investors and management becomes of particular concern to investors when the firm is underperforming and investors need to be able to distinguish whether the firm is in a position to turn poor performance around or if the firm's performance will continue to spiral downward.

In light of these monitoring and assessment uncertainties, scholars suggest that third-party quality signals, such as information provided by the outcomes of certification contests, may be particularly influential for shareholders and boards of directors within the governance context (Johnson et al., 2005; Wade et al., 2006). For instance, signals regarding CEO quality have been shown to positively correlate with firms' stock price (Malmendier and Tate, 2005; Wade et al., 2006). At the board level, such informational cues have been shown to influence shareholder assessments of firm governance (Johnson et al., 2005). In sum, these studies suggest that investors are sensitive to third-party signals and that such assessments influence investor sentiment about company performance. In light of this influence, third-party signals may evoke responses from focal firms themselves and influence internal governance mechanisms (Almazan et al., 2005; Carleton et al., 1998; Gordon and Pound, 1993). Firm responses can be substantive or symbolic, yet research shows that both can serve as effective signals from the firms to the investor community. Research in this area has examined the response of firms to shareholder activism through board structure and CEO changes (Wu, 2004), as well as through changes in governance processes and policies (Carleton et al., 1998). Such activism has also been shown to prompt firms to make changes in managerial compensation and pay-for-performance sensitivity (Almazan et al., 2005; Hartzell and Starks, 2003), as well as signal increased incentive alignment through the announcement of long-term incentive plans (Westphal and Zajac, 1994).

While numerous studies have recognized that firms may proactively attempt to influence how investors may perceive governance outcomes (e.g. Porac et al., 1999; Westphal and Zajac, 1994, 2001), little research focuses on how companies under the spotlight of third parties may react to and attempt to manage this external scrutiny. Specifically, in organization theory and strategy there is little research about how the stigmatization of negative third-party signals directly influences investor behavior. With the rise of shareholder activism (Bebchuk, 2005; Bebchuk and Fried, 2003; Useem, 1996), the role of institutional investors and third parties in monitoring management becomes particularly germane to understanding how shareholder activism prompts changes in investor behavior and responses by firms under the spotlight of underperformance. We address this issue by examining the interplay between a shareholder group that 'spotlights' underperformers, institutional investors and the firms' internal governance control mechanisms. Specifically, we look at how institutional investors react to firms in their portfolio that are certified as extreme underperformers by third-party expert evaluators. We then examine

how firms with more independent governance structures respond to negative third-party signals of quality by issuing their own signals in order to distinguish themselves from other underperformers and assure institutional investors of the viability of their investments.

To examine this process, we employ the annual Focus List of underperforming companies, which is compiled by the Council for Institutional Investors (CII). From its founding in 1985, the CII has attempted to give voice to institutional investors by targeting poorly performing firms and highlighting their governance practices and underperformance. In 1991, the CII began to publish a Focus List of companies that it was targeting for change. From 1991 to 1993, the methodology for selecting the companies for the Focus List was a combination of corporate governance issues and financial underperformance. Since 1994, by which time the CII annual Focus List was garnering a great deal of media and investor attention, the Council selected its Focus List based purely on poor returns to shareholders, thereby adopting a more defensible objective approach to selecting firms for inclusion on their Focus List. In effect, the Focus List represents a legitimate, negative certification by a reputable third party, the Council for Institutional Investors. Our results suggest that a firm's inclusion on the Focus List prompts institutional investors to reduce their holdings in those companies placed under the spotlight for their underperformance, but that institutional investors are less likely to divest their holdings in companies with boards that are more independent. Further, companies on the Focus List that have relatively more independent boards are more likely to respond with a positive signal to investors by further strengthening the alignment of managerial and shareholder interests through managerial pay structures.

Theory and hypotheses

Corporate governance becomes important when there is information asymmetry between agents and principals such that agents possess more information than principals do and the interests of agents and principals have the potential to diverge (Alchian and Demsetz, 1972). Agency theory asserts that when ownership and control are separated, managers (agents) are self-serving and often fail to act in the best interests of the shareholders (principals) (Coase, 1937; Fama and Jensen, 1983; Jensen and Meckling, 1976). Agency costs are incurred when managers possess information that is unavailable to shareholders and they consequently engage in shirking behaviors (Eisenhardt, 1989). However, as more information becomes available to shareholders, agency costs may be reduced. Shareholders may acquire information directly from the company or from external monitoring by third parties (e.g. Johnson et al., 2005). The information is often in the form of signals that can be used to demonstrate the quality of products or services

and/or to allay shareholder fears of mismanagement (e.g. Sanders and Boivie, 2004; Westphal and Zajac, 1994).

The influence of quality signals is covered in two distinct literatures. First, signaling theory is focused on how firms send signals of quality, such as through warranties, to reduce customer uncertainty over the quality of the firm or its products. In essence, the signaling literature focuses on the dyadic relationship between a party sending a signal to inform a second party (Spence, 1977). Second, the reputation literature examines how third-party signals, such as certifications, reduce uncertainty regarding a focal firm's quality (Pollock and Gulati, 2007; Rao, 1994). Both literatures address the issue of reducing uncertainty surrounding assessments of a firm, albeit through different mechanisms. We begin with a look at how a signal generated by an external third-party observer, in this case the CII Focus List, may affect the behavior of other external parties, in this case, institutional investors in the firm. We then examine how firms respond to external identification as poor performers with corresponding signals of their own quality through corporate governance reforms.

Negative third-party signals

The reputation literature suggests that, in contexts where assessing the overall quality or capabilities of an actor is difficult, third-party signals play an important role in influencing quality evaluations (e.g. Rao, 1994; Rindova et al., 2005). Such signals often take the form of certification contests, defined as a 'competition in which actors in a given domain are ranked based upon performance criteria that are accepted by key stakeholders as being credible and legitimate' (Wade et al., 2006: 644). Through such endorsements or repudiations, certification contests allow observers to distill myriad data points into one ranking, and make evaluations of a firm's relative quality (Elsbach and Kramer, 1996; Fombrun and Shanley, 1990).

Prior studies have posited that certifications are an important means by which the uncertainty regarding a firm's quality is reduced (Booth and Smith, 1986; Megginson and Weiss, 1991; Rao, 1994; Wade et al., 2006). This may be the case even when the certification does not portray any new information as to how the firm performed per se, but rather how others have interpreted the firm's earlier performance relative to its peers (Graffin and Ward, forthcoming). Third-party evaluations may thus increase salience of the firm's performance as well as provide information as to how others view the acceptability of this performance. Such certifications can influence how investors and the public view these firms (Johnson et al., 2005) as well as the valuation of initial public offerings (Booth and Smith, 1986; Megginson and Weiss, 1991) and acquisitions (Puranam et al., 2006). Certification contests thus become a source of cognitive validity and social standing in and of themselves (Rao, 1994) and the reputation of the certifier provides

legitimacy to the certification (Booth and Smith, 1986; Megginson and Weiss, 1991). With few exceptions (e.g. Johnson et al., 2005), research has almost exclusively focused on certification contests that are positive in nature, where winning the contest provides a positive reputational signal. However, we examine a case where the certification contest is a negative signal about the firm. As such, we expect that being singled out for a negative certification would have the opposite effect of delegitimizing the organization and reducing its reputation for quality, potentially leading to stigmatization of the firm (Wiesenfeld et al., 2008).

The Council for Institutional Investor's Annual Focus List

As noted, the CII annually generates a Focus List that highlights significantly underperforming firms. In effect, the Focus List represents a legitimate, negative certification by a reputable third party. Institutional investors are the primary audience of the Focus List, and this audience is a highly influential one as institutional shareholdings reached 59.2 percent of the average S&P500 firm in 2003 (Conference Board, 2005). Given the concentration of ownership among institutional investors, they may be an important external governance mechanism that can help to reduce agency costs (Shleifer and Vishny, 1997). Specifically, institutional investor holdings have been demonstrated to be effective in influencing executive compensation and pay-for-performance compensation (Hartzell and Starks, 2003), monitoring anti-takeover amendments (Agrawal and Mandelker, 1992; Brickley et al., 1988; Nelson, 2005), influencing the agenda of shareholder activists (Proffitt and Spicer, 2006) and voting proxies against management (Almazan et al., 2005). Together these studies suggest that institutional investors may be an effective external governance mechanism.

Despite the potential influence of institutional investors on governance, Dharwadkar et al. (2008) propose that individual large institutional investors may not always make good monitors as their portfolio characteristics and need to contain management costs restrict them from effectively monitoring every firm in their portfolios. Hendry et al. (2006) also suggest that most institutional investors regard themselves as traders rather than owners, focusing on portfolio liquidity and profits rather than monitoring firms in their portfolio. Institutional investors are likely not as informed about specific companies in their portfolios as compared to family or other large individual blockholders, who often maintain a long-term concentrated presence in a few firms and who are therefore more likely to closely monitor these firms (Anderson and Reeb, 2003). Indeed, Dharwadkar et al. (2008) contend that institutional investors are limited in their ability to monitor all of the firms in their diverse portfolios¹ and so they restrict themselves to monitoring a relatively small group of problem firms. However, because identifying such firms can require significant resources, institutional investors can enhance their efficiency by

pooling their resources to develop, and subsequently rely on, third-party groups such as the CII to monitor firms on their behalf.

The development of coordinated investor action through the founding of third-party groups such as the CII arose directly from the agency problem evidenced by the widespread adoption of various takeover defenses (Davis and Thompson, 1994). These defenses heighten the concern of shareholders over corporate governance under conditions of poor corporate performance, and in particular, raise shareholder concerns as to whether the firm is misaligned in favor of agent/managers. The CII, which initially represented 19 members, is now comprised of over 140 of the largest investment funds. In 1985, they adopted a 'Shareholders Bill of Rights' to give investors a voice in all 'fundamental decisions which could affect corporate performance and growth' (Davis and Thompson, 1994: 155). Thus, a body such as the CII may be particularly important in overcoming the challenge of disaggregated institutional investors by representing the pooled interests of such institutions that constitute over US\$1 trillion in assets.

Given the influence and signaling ability of the CII, we therefore expect institutional investors to re-examine their holdings of firms highlighted on the Focus List. As the Focus List represents a public repudiation of these listed firms, there may also be a stigma associated with holding Focus List firms, or continuing to hold them following this public repudiation. Stigma is an attribute that is deeply discrediting and that reduces the worth of the organization (Goffman, 1963; Kulik et al., 2008; Wiesenfeld et al., 2008). Associating with stigmatized organizations can lead to delegitimization (Wiesenfeld et al., 2008). In this case, the stigma represented by the Focus List brings each listed firm's underperformance to the attention of institutional investors.

If institutional investors maintain their current level of holdings in these firms, stakeholders may question the competency of these portfolio managers. Indeed, institutional investors are fiduciaries who are charged with competently managing the funds of their clients, and they are under public scrutiny and legal obligation to protect the funds with which they are entrusted. Consequently, in taking a proactive approach to managing these risks, part of the management of their portfolio is to anticipate the reaction of other investors to new information, such as third-party signals. In light of Wade et al.'s (2006) finding that investors are aware of, and respond to, third-party quality signals, it would be reasonable to expect other institutional investors to react to the Focus List. Accordingly institutional investors will likely view the CII Focus List as a particularly salient signal as it is generated by an industry group that was specifically founded to represent the interests of institutional investors. Thus, institutional investors may interpret inclusion of firms on the CII Focus List as an indication that other institutional shareholders are likely to reduce their holdings in these firms as a result of these external pressures. This would prompt them to adjust their

own holdings, resulting in a reduction in the institutional holdings of such firms. On the other hand, if a given institutional investor ignores this signal and maintains its holding at current levels in Focus List firms, relative to its peers, such investors open themselves up to criticism as well as potential reduced legitimacy in the eyes of their peers. Accordingly, the CII Focus List may not only provide a direct signal, but also provide an indirect effect through its interpretation by institutional investors.

Additionally, since the Focus List is announced through the business press, its publication is likely to influence investors beyond the CII membership. In considering the CII as a legitimate external monitor (Eesley and Lenox, 2006), and the publication of their Focus List as a signal to focal firms, institutional investors may regard the signal as a warning that the firms are in need of reform or potentially subject to a change of control. Accordingly, those institutional investors, with a limited ability to actively monitor the firms in their portfolio (Dharwadkar et al., 2008) and who are interested in managing their portfolios for liquidity and short-term profits such as mutual funds that comprise the majority of institutional ownership (Ryan and Schneider, 2003), will likely reduce their holdings in these companies. These investors will potentially be replaced by more specialized investors, such as turnaround companies, 'vulture' investors, hedge funds or private equity groups (Dharwadkar et al., 2008). In sum, although the Focus List itself may provide no new information per se on the actual performance of these firms, it provides an informational context that will influence others and cause institutional investors to re-evaluate and reduce their holdings in these firms:

HYPOTHESIS 1 Firms placed on the CII Focus List will experience a drop in the proportion of their outstanding equity held by institutional investors.

Corporate governance to align shareholder interests

By spotlighting the underperformance of particular firms, the CII Focus List may draw investors' attention to the governance mechanisms available to reduce agency costs. Indeed, as Shleifer and Vishny (1997: 737) note, 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.' Thus, investors are likely to become concerned about governance issues when their expected return on investment is threatened. In other words, when governance is weak in poorly performing firms, investors risk losing their ability to extract value from the firms and they will look for governance changes.

While, as noted earlier, institutional investors may have holdings in thousands of firms and thus have a limited capacity to monitor individual firms (Dharwadkar et al., 2008), their focus on the governance practices of

firms highlighted in the Focus List is likely to increase for a couple of reasons. First, the potential for the divergence of managerial and shareholder interests may be exacerbated under extreme financial pressures that are likely being experienced by firms on the Focus List. For instance, when performance is poor, managers may seek to decouple their compensation from performance outcomes (Bebchuk and Fried, 2003). Second, management may try to engage in diversification to reduce the firm's unsystematic risk and enlarge the firm, given that most of their human capital, and income from that capital, is tied to the firm. Such risk-reducing diversification of the firm is generally not in the interest of shareholders as it may cause inefficiencies by taking management time and resources away from the core business of the firm (Amihud and Lev, 1981; Eisenhardt, 1989). As the primary purpose of governance mechanisms is to serve to align the interests of principals and agents (Walsh and Seward, 1990), when firms are performing poorly, and where managerial and shareholder interests may have diverged, shareholders may anticipate that the market for corporate control will intervene to restore value in these firms (Jensen, 1988). As Jensen (1988: 27–8) elaborates:

The internal control mechanisms of corporations, operating through the board of directors, should encourage reluctant managers to restructure. But when the internal processes for change in large corporations are too slow, costly, and clumsy to bring about the required restructuring or change managers efficiently, the capital markets, through the market for corporate control, are doing so. The takeover market serves as an important source of protection for investors in these situations.

Jensen (1988) thus recognizes the role of internal governance mechanisms as being the first line of defense in being able to correct underperformance. At the same time, he also recognizes that, when governance is poor, the market for corporate control intervenes. However, empirical evidence suggests that the market for corporate control may not function effectively either if the firm's underperformance or divergence of interests becomes extreme. For instance, Hambrick and D'Aveni (1992) in a study of failing firms found that in the four years preceding bankruptcy, managers tend to increase their level of control and outside directors leave without being replaced. This indicates that in such failing firms the interests of managers and shareholders have completely diverged to the point that shareholders lose their ability to monitor, discipline and regain control over top management, and begin to abandon the firm. Further, Hambrick and D'Aveni found that these bankrupt firms failed to be acquired, indicating either a failure in the market for corporate control, or that the firm was under such entrenched managerial control that they were able to institute protective mechanisms to thwart potential bidders. Walsh and Seward (1990) also found that the market for corporate control did not function for firms on the brink of bankruptcy. Additionally, DePamphilis (2007) notes that there is considerable empirical evidence that

the market for corporate control acts as a disciplining mechanism only for firms that have relatively weak internal corporate governance structures (Kini et al., 2004).

Thus, when there is a third-party signal of underperformance, investors may look to internal governance as an indicator of their ability to protect or extract value from the firm. One of the most universally understood and taken-for-granted characteristics of good governance is an independent board of directors (Davis, 2005; Davis et al., 1994). Prior research suggests that board independence is foundational to good governance (Clark, 2005), and is highly correlated with other measures of good governance practices (Rediker and Seth, 1995), such that board independence is a necessary precondition for other indicators of effective governance practices to exist (Finkelstein et al., 2009). Indeed, Dalton et al. (1998) in their meta-analyses point to the fact that independent boards are critical to controlling agency costs. Thus, the ability to monitor and constrain the decision discretion of management is contingent on board independence (Fama and Jensen, 1983). Independent boards can more effectively monitor agents through a variety of mechanisms, including the ratification of major decisions, the threat of replacement of top management team members and the implementation of policies to constrain agents' decision-making (Hart, 1995; Strebler, 2004; Weir and Laing, 2003). The presence of an independent board can reassure investors that, even during times of underperformance, shareholder interests will be protected. Lin (1996) reported that outsider-dominated boards are more likely to participate in restructuring events like mergers, takeovers and tender offers and Cotter et al. (1997) found that outside directors enhance shareholder wealth, even during tender offers. An independent board can be an effective source of internal governance in the monitoring of management as well as a protector of shareholder interests in the event the company needs to turn to the capital markets. Further, outsider-dominated boards are more likely to remove poorly performing CEOs (Weisbach, 1988). In their summation of the literature on boards of directors, Finkelstein et al. (2009) point out that board independence affects the balance of power between boards and management and, in turn, facilitates the introduction of other governance mechanisms.

Therefore, while placement on the CII Focus List may highlight financial underperformance for institutional investors, the presence of an independent board can reassure institutional investors that their interests are being protected; as such, these institutional investors may be more likely to have confidence in companies where the board independence is greater and thus be less aggressive in selling shares of these firms. In this way, an independent board can moderate the influence of negative signaling:

HYPOTHESIS 2 The independence of the board will moderate the relationship between placement on the CII Focus List and institutional ownership such

that for firms placed on the CII Focus List, the more independent the firm's board, the less the subsequent drop in the proportion of their outstanding equity held by institutional investors.

Firms' response to third-party signals: signaling back to shareholders

Having examined how institutional investors may react to negative third-party signals of quality concerning firms in their portfolio, we now turn to how firms that receive such repudiations may respond by sending their own signals through changing their CEO incentive compensation. There is evidence to suggest that firms respond to direct pressure for governance changes from institutional investors (Johnson et al., 1997; Thomas and Martin, 1999). In turn, there is also evidence that shareholders respond positively to signals of improved alignment between managerial and shareholder interests (Westphal and Zajac, 1994). Furthermore, Zajac and Westphal (1994) propose that the desired purpose of external monitoring may in fact be to get the company's attention and provoke a response in return. Thus, external monitoring through the CII's Focus List may serve as a signal that 'gets the board's attention' and provokes a change in governance practices. When the firm responds, investors are provided evidence that the managers and board members are conscious of the need to maintain an alignment between shareholder and managerial interests in the face of poor performance, and that they are not on the path toward thwarting the intervention of the market for corporate control. In Davis's (2005: 145) terms, 'To survive, public corporations must demonstrate their fitness to financial markets by showing that they are oriented toward shareholder value. The institutions of corporate governance could thus be seen as a sort of financial global positioning system, a set of devices that mesh to guide corporate executives toward the North Star of shareholder value.' By improving their governance, firms are signaling their fitness to financial markets. Signaling theory explains this concept as focal firms respond by action to reduce uncertainty surrounding their managerial practices.

Similar to the role of certifications noted earlier, signaling theory addresses problems of reducing the uncertainty caused by information asymmetry that is pervasive in principal-agent relationships. However, signaling theory focuses on how firms send signals to reduce uncertainty regarding others' evaluation of the firm, rather than the role of third parties in providing these signals through certifications. That is, signaling theory focuses on the party with more information sending signals to others in order to reduce uncertainty surrounding that party. As Morris (1987) notes, signaling allows firms to distinguish themselves from other firms along some dimension of quality. In the absence of such a signal, firms of superior quality are undervalued and suffer an 'opportunity loss' (Morris, 1987: 48) as they are valued equivalently

to poorer quality firms due to the lack of information available to observers to distinguish between the firms.

Firms wishing to set themselves apart send a signal that cannot easily or costlessly be copied by lower quality firms. This results in a reduction of information asymmetry between the party sending the signal and the party receiving the signal such that observers are able to value the sending firm more accurately, and the remaining firms are considered to be of poorer quality. Sending a signal by changing CEO compensation to better align with the interests of shareholders is not a costless signal to the firm, particularly to management of the firm who are putting more of their compensation at risk. Equity compensation packages that promote a greater alignment of agents' interests with those of owners increase the overall effectiveness of the governance of the firm by curbing the incentive for self-serving agent behaviors (Bryan et al., 2000). Indeed, structuring the proper compensation contract for executives has long been the primary focus of agency theory (Devers et al., 2007; Fama and Jensen, 1983) and a properly specified contract is a signal that the firm's board is effectively monitoring the CEO on behalf of shareholders (Bebchuk and Fried, 2003; Finkelstein et al., 2009). As such, increasing incentive alignment serves to send a signal to investors that the firm is aware of the severity of the performance shortfall and is restructuring its governance to focus management on restoring the performance of the firm.

However, the ability of the board to respond to a negative third-party quality signal may be constrained by some of the very structural characteristics that led to the negative signals. Boards that have little independence may have less ability or willingness to respond with substantive change following a negative signal. While the board and the CEO may recognize the potential impact of the negative signal, sending such a quality signal is not costless, especially if managers in poorly performing firms have to give up some control, or put more of their compensation at risk. On the one hand, an entrenched, non-independent board may be unable to enact more substantive changes under the influence of managerial control (Walsh and Seward, 1990). As noted earlier, in the face of poor performance, managers are likely to seek a decoupling of their compensation from performance outcomes, rather than a closer alignment (Bebchuk and Fried, 2003). On the other hand, independent boards are more likely to respond to negative signals by signaling their potency and their responsiveness to investor concerns by increasing alignment of managerial incentives even if managers are opposed to this.

Prior studies suggest that internal governance mechanisms like board independence influence levels of CEO incentive alignment. Liu and Taylor (2008) found that board composition and independence, in particular, can influence public disclosures of remuneration because independent boards are sensitive to the information and needs of shareholders. Kang et al. (2006) found that CEO compensation structure is influenced by the strength of a firm's internal governance mechanisms, supporting the idea that CEO

incentive alignment will be promoted by a more independent board. Further, the presence of an independent board reduces the possibility of managers effectively structuring their own compensation packages and helps ensure that the incentive structure puts some portion of managerial compensation at risk (Fama, 1980; Hoskisson and Hitt, 1990). Accordingly, an independent board may be the key factor in the firm's ability to respond to investors' concerns about firm performance.

Therefore, we expect that firms with more independent boards will respond to the public repudiation of being put on the CII Focus List by increasing the degree to which CEO compensation is aligned with shareholder interests. Thus we hypothesize:

HYPOTHESIS 3 For firms placed on the CII Focus List, board independence will be positively related to subsequent realignment of their incentive structure such that more of the CEO's compensation becomes contingent on performance.

Data and research methods

Sample

Our analysis focuses on a sample of firms selected by the CII for inclusion on their annual Focus List over the years 2000–5. Until 2005, this list was available at the CII website at: www.cii.org/focus.htm. During this time period 150 firms were named to the Focus List. This resulted in only 120 unique firms as some firms were named to the list multiple times during this period. As most of the Focus List firms were components of the S&P500 Index, in order to provide a comparison group, we took those firms in the bottom quartile in stock performance of the S&P500 over the same period that were not named in the Focus List. This resulted in 101 firms whose stock market performance was comparably poor than those on the Focus List. Missing data reduced our final sample to 189 firms, which included 93 firms that appeared on the Focus List and 96 firms that did not. Firms that appeared on the Focus List were not significantly different from non-Focus List firms. Focus List firms averaged US\$1.1 billion in sales, a five-year stock return of 4.76 percent and an average ROE of –14.55 percent, while non-Focus List firms averaged US\$1.0 billion in sales, a five-year stock return of 7.34 percent and had an average ROE of –12.64 percent.

Dependent variables

Institutional investor holding percentage

We measured institutional holdings as the percentage of total shares owned by institutional investors. This measure has been used extensively in the finance literature as a measure of institutional holdings (e.g. Nofsinger

and Sias, 1999; Sias and Starks, 1997). These data were collected from the Thompson Financial Securities Data, which provides information on Institutional 13(f) Common Stock Holdings and Transactions. As the Focus List is released near the beginning of the fourth quarter of the calendar year, we capture institutional holding percentage as of the beginning of the fourth quarter every year so we can examine how this changes in light of the release of the Focus List.

CEO incentive intensity

Using a method similar to other measures for changes in CEO pay (Hambrick and Finkelstein, 1995), we calculated CEO incentive mix by dividing CEO incentive compensation into total CEO compensation. We considered incentive compensation to include: the total value of restricted stock grants, the total value of stock options granted (using Black-Scholes) and long-term incentive payouts. Our measure of CEO total compensation is total direct compensation 1 from the COMPUSTAT database which includes all forms of compensation paid to an executive in a given year including salary, bonus, other annual compensation, the total value of restricted stock grants, the total value of stock options granted (using Black-Scholes), long-term incentive payouts and all other miscellaneous forms of compensation. As shown by Milgrom and Roberts (1992), an increase in the intensity of incentives provided to an executive will generally move the firm and executive closer to 'goal congruence' or incentive alignment. While this variable is the dependent variable in Hypothesis 3, we included the lagged value of the variable in all models in Table 2 which test Hypotheses 1 and 2.

Independent variables

Focus List indicator

Placement on the CII Focus List is denoted by a (0,1) dummy variable for firms placed on the Focus List in the current year. This variable was used to test Hypothesis 1. To test the remaining hypotheses, this variable was interacted with board independence (Hypotheses 2 and 3). In each case we used being named to the Focus List in the current year to predict institutional investor holding or CEO incentive compensation in the following year.

Board independence

Boards of directors can also achieve goal congruence via effective monitoring rather than through strong incentives (Rutherford et al., 2007). As Johnson et al. (1996) note in their review of the governance literature, the ability of the board to effectively monitor management has 'typically focused on individual directors' independence from the CEO' (Johnson et al., 1996: 416). Daily et al. (1995) identified three complementary constructs (inside director proportion, outside director proportion and affiliated director proportion)

with acceptable psychometric properties. We therefore use the percentage of outside directors as our measure of board independence, indicating the balance of control between management and the board and the consequent potential to effectively monitor and discipline management. These data were collected from RiskMetrics (formerly IRRC) and proxy statements filed with the Securities and Exchange Commission (SEC).

Control variables

Total directors on board

Board size is included as a control variable as Johnson et al. (1996) note that while the measure of the percentage of outside directors uses board size as the denominator, the ratio is essentially an interaction term and variance in either numerator or denominator may contribute to the variance explained in the dependent variable. Additionally, studies have found that there is a negative correlation between board size and firm performance (Eisenberg et al., 1998; Johnson et al., 1996; Yermack, 1996). These data were collected from RiskMetrics (formerly IRRC) and proxy statements filed with the SEC.

Firm size

Consistent with previous studies we also included a control for firm size, as measured by the log of firm sales, as a control variable in our hypothesis tests. Values were transformed into their natural logarithms so that extreme values would not unduly bias our analyses. This variable was lagged in all analyses.

Times on Focus List in the past

Consistent with previous studies of iterative certification contests (e.g. Wade et al., 2006), we controlled for the number of previous certifications a firm may have received. As appearing on the Focus List repeatedly may carry a different meaning than appearing for the first time, we control for the number of times a firm has appeared on the Focus List since its inception in 1994.

CEO tenure

For our analysis of incentive realignment, we also included CEO tenure, which has been cited in the literature on executive compensation as an important control (Gibbons and Murphy, 1992).

New CEO

As the changing of the CEO indicates a major change in the management of the company, we include CEO succession as a control. This dummy variable takes on a value of 1 when a firm experiences turnover at its CEO position in the current year and 0 otherwise.

Firm performance

We controlled for both accounting and market return measure to assess firm performance. We obtained a measure of the five-year compounded market returns² that consisted of the total yearly stock return of the company, assuming reinvestment of dividends $((\text{Price}_{\text{beg}} - \text{Price}_{\text{end}} + \text{Dividends}) / \text{Price}_{\text{beg}})$. We also obtained annual return on equity (ROE), which is a measure of how well a company is using the equity provided by stockholders (Teitleman, 1996). Both measures were obtained from COMPUSTAT, and both were lagged one year in all analyses.

Year dummies

Year dummy variables were included in the models to control for any period effects in our panel data, with 2000 as the omitted value. For example, year dummies control for changes in general economic conditions from year to year. Because of our fixed-effects analyses (see later), firm dummies were also included in all models, but are not listed in the tables.

Method of analysis

To control for unobserved differences between firms, we estimated fixed-effects regression models to test our hypotheses. Fixed-effects models are equivalent to adding a dummy variable for each firm (Greene, 1993). The firm dummies control for constant unmeasured differences across firms that may explain differences in the dependent variables. Including firm dummies via fixed-effects regression controls for such systematic differences. As such, fixed-effects models are considered conservative because only changes in independent variables *within* a firm can produce significant effects. Thus, a positive coefficient in fixed-effects models can be interpreted as signifying that a positive change in an independent variable within a firm is associated with a positive change in the dependent variable within the same firm. Industry dummies are not included in these models as firm dummies control for variance due to industry membership to the extent that a firm's industry membership is relatively constant during the time period studied.

Results

Table 1 provides the descriptive statistics for all variables included in the analysis. Table 2 shows our results for our tests of Hypotheses 1 and 2. Hypothesis 1 predicted that institutional investors would reduce their equity holdings in firms on the Focus List. Model 1 presents the control model while Model 2 presents the test of Hypothesis 1. The results in Model 2 show that the coefficient estimate on the Focus List indicator is negative and

Table I Descriptive statistics and correlations

Variable	Mean	SD	Min.	Max.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
1. Institutional inv. holding percentage	0.68	0.23	0.02	0.99	1.00																
2. Focus List indicator	0.08	0.28	0.00	1.00	-0.03	1.00															
3. Times on Focus List in past	0.03	0.22	0.00	4.00	-0.03	.41	1.00														
4. CEO incentive intensity	0.56	0.30	0.00	1.00	.12	.01	.00	1.00													
5. Total directors on board	8.67	2.16	3.00	17.00	.07	.07	.02	.06	1.00												
6. Board independence (% outsiders)	0.80	0.11	0.00	1.00	.19	.03	.07	.12	.21	1.00											
7. Firm 5-year market return	5.91	55.88	-97.84	705.6	.00	-.09	-.05	.11	-.06	-.12	1.00										
8. Firm ROE	-12.17	133.73	-697.4	927.1	.14	-.02	-.04	.04	.11	.04	-.10	1.00									
9. CEO tenure	6.90	6.18	0.00	32.00	-.03	-.04	.00	-.12	-.06	-.19	.06	.05	1.00								
10. New CEO	0.15	0.07	0.00	1.00	-.05	-.02	-.01	.02	-.01	-.04	.16	.02	-.09	1.00							
11. Ln firm sales	6.95	1.71	-2.36	10.96	.34	.02	.01	.18	.43	.17	.02	.22	-.05	-.01	1.00						
12. 2001 dummy	0.18	0.34	0.00	1.00	-.08	.03	-.04	.02	-.02	-.05	-.02	-.06	-.01	-.03	-.01	1.00					
13. 2002 dummy	0.17	0.34	0.00	1.00	-.01	.06	.09	-.03	.02	-.01	-.10	-.01	-.01	-.03	.00	-.15	1.00				
14. 2003 dummy	0.17	0.34	0.00	1.00	.02	.05	.06	-.06	.01	.03	-.04	.00	-.01	.01	-.05	-.15	-.15	1.00			
15. 2004 dummy	0.17	0.33	0.00	1.00	.11	.05	.01	-.05	.01	.03	-.07	-.03	.02	-.03	.00	-.15	-.15	-.15	1.00		
16. 2005 dummy	0.16	0.33	0.00	1.00	.11	-.11	-.05	-.07	.00	.08	-.02	.04	.02	-.03	.02	-.15	-.15	-.15	-.14	1.00	

Table 2 Fixed-effects models predicting institutional investor holding percentage

Variable	Model 1	Model 2	Model 3
ROE (lagged)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Cumulative 5-year return (lagged)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Ln firm sales (lagged)	0.045** (0.011)	0.047** (0.011)	0.045** (0.011)
CEO tenure	0.001 (0.002)	0.001 (0.002)	0.001 (0.002)
New CEO	-0.081* (0.036)	-0.080* (0.036)	-0.077* (0.036)
CEO incentive intensity (lagged)	-0.029 (0.017)	-0.027 (0.017)	-0.023 (0.017)
Total directors on board	0.002 (0.004)	0.002 (0.004)	0.002 (0.004)
Board independence (% outsiders)	0.279** (0.064)	0.278** (0.064)	0.247** (0.065)
Firm dummies	Included	Included	Included
2001 dummy	-0.053** (0.013)	-0.052** (0.013)	-0.056** (0.013)
2002 dummy	-0.036** (0.013)	-0.033* (0.013)	-0.036** (0.013)
2003 dummy	-0.010 (0.013)	-0.007 (0.013)	-0.011 (0.013)
2004 dummy	0.030** (0.013)	0.033** (0.013)	0.032** (0.013)
2005 dummy	0.025† (0.064)	0.023† (0.013)	0.022† (0.013)
Times on Focus List in past		-0.009 (0.020)	-0.024 (0.022)
Focus List indicator dummy		-0.029* (0.017)	-0.357** (0.136)
Focus List * board independence			0.411** (0.169)
Constant	0.149 (0.097)	0.138 (0.097)	0.171† (0.097)
Observations	1090	1090	1090
R ²	.775	.776	.778
Adj. R ²	.719	.720	.722

† = $p < .10$, * = $p < .05$, ** = $p < .01$; significance levels are one-tailed for hypothesized effects, two-tailed for control variables.

Standard errors are in parentheses.

statistically significant ($p < .05$), which provides support for Hypothesis 1. Institutional holdings of Focus List firms fell an average of 3 percent beyond what would be predicted by the control variables included in the model. As a robustness check, we reran our analyses using tobit and fixed-effects GLS models and our results and conclusions were substantively unchanged.³

Hypothesis 2, which predicted that the drop in institutional holdings would be lessened for those firms that had more independent boards prior to inclusion on the Focus List, is tested in Model 3. The interaction of board independence and the Focus List indicator is positive and statistically significant ($p < .01$). This suggests the negative main effect of being placed on the CII Focus List is attenuated, or even reversed, as board independence increases. Specifically, the coefficients in Model 3 suggest that when a firm appears on the Focus List and its board independence is at the mean of sample (80 percent outsiders on board), institutional investors sell off 3 percent of its shares, but when board independence increases one standard deviation above the mean (91 percent outsiders on board), institutional investors actually increase their holdings in such companies by 2 percent. This relationship is graphically depicted in Figure 1. Additionally, we reran our analyses using tobit and fixed-effects GLS models and our results and conclusions were substantively unchanged.

Hypothesis 3, which theorized that firms selected for the Focus List that had more independent boards would subsequently make more of the CEO's pay contingent on performance, is tested in Table 3. Model 1 presents the control model while Model 2 adds the interaction between the Focus List

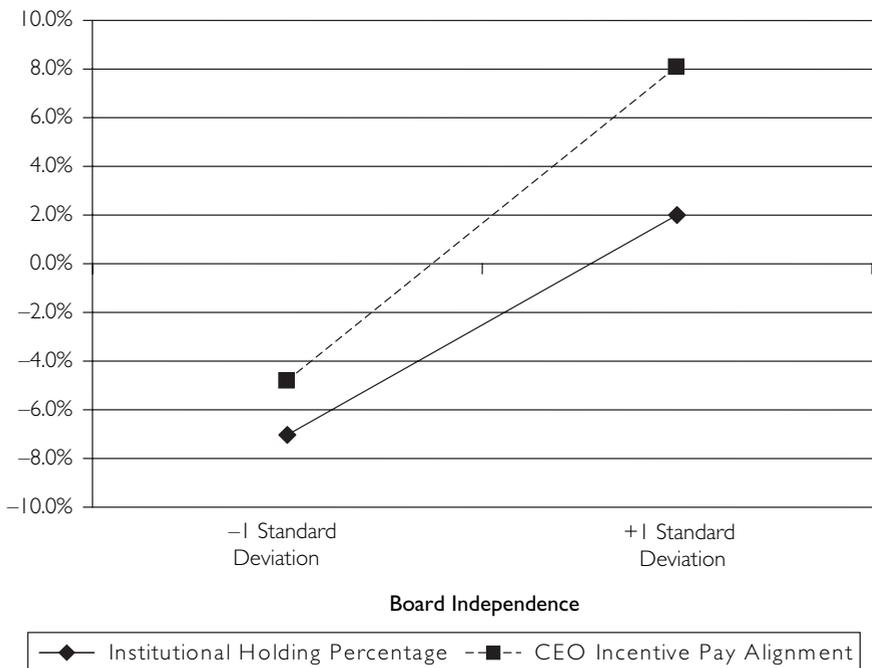


Figure 1 Moderating impact of board independence on the relationship between Focus List placement and (1) institutional investor holding percentage and (2) CEO incentive alignment

Table 3 Fixed-effects models predicting CEO incentive alignment

Variable	Model 1	Model 2
ROE (lagged)	0.000 (0.000)	0.000 (0.000)
Cumulative 5-year return (lagged)	0.003 [†] (0.002)	0.003 [†] (0.002)
Ln firm sales (lagged)	0.033 (0.023)	0.029 (0.023)
CEO tenure	-0.008** (0.003)	-0.008** (0.003)
New CEO	-0.059 (0.111)	-0.060 (0.111)
Institutional investor holding percentage	0.202** (0.065)	0.198** (0.065)
Total directors on board	-0.002 (0.007)	-0.002 (0.007)
Board independence (% outsiders)	0.006 (0.119)	-0.032 (0.120)
Firm dummies	Included	Included
2001 dummy	-0.032 (0.024)	-0.037 (0.024)
2002 dummy	-0.073** (0.025)	-0.078** (0.025)
2003 dummy	-0.118** (0.025)	-0.122** (0.025)
2004 dummy	-0.116** (0.026)	-0.116** (0.026)
2005 dummy	-0.126** (0.026)	-0.126** (0.026)
Times on Focus List in past	-0.041 (0.041)	-0.061 (0.042)
Focus List indicator dummy	0.016 (0.032)	-0.454* (0.253)
Focus List * board independence		0.587* (0.314)
Constant	0.321 [†] (0.183)	0.382* (0.186)
Observations	1090	1090
R ²	.478	.480
Adj. R ²	.359	.360

† = $p < .10$, * = $p < .05$, ** = $p < .01$; significance levels are one-tailed for hypothesized effects, two-tailed for control variables. Standard errors are in parentheses.

indicator and board independence. This interaction is positive and significant ($p < .05$), which provides support for Hypothesis 3. Specifically, the coefficients in Model 2 suggest that when a firm appears on the Focus List and its board independence is at the mean of sample the board of directors increase the incentive pay alignment of CEOs by 2 percent, but when board

independence increases one standard deviation above the mean the board of directors increase the incentive pay alignment of CEOs by 8 percent. This relationship is graphically depicted in Figure 1. Again, we re-ran our analyses using a fixed-effects GLS model and our results and conclusions are substantively unchanged.

Discussion

Our results contribute to a relational and social understanding of how signals work. We extend the literatures regarding the importance and effect of quality signals, both those generated by the firm and by third parties. Specifically, our results suggest that investors pay attention to quality signals generated by a reputable third party, in this case the CII, and reduce their holdings in firms highlighted by the CII as extreme underperformers. However, at the same time, the negative relationship between appearing on the Focus List and institutional investor holdings is moderated by the independence of the board of the targeted firm. Finally, we show that firms with more independent boards are able to actively interpret and respond to the third-party quality signals such that firms on the Focus List with more independent boards are more likely to realign CEO incentive compensation.

Broadly, our baseline finding that a negative quality signal negatively influences institutional investor holdings, contributes to a growing literature that examines the role of such third-party quality signals in influencing governance outcomes (e.g. Johnson et al., 2005; Malmendier and Tate, 2005; Wade et al., 2006). First, by focusing on a negative quality signal, or repudiation, our study allows for the examination of how shareholders respond to negative expert evaluations of firms. We provide evidence that third parties can repudiate and delegitimize firms, spurring responses from external stakeholders in the form of reduced holdings by institutional investors.

Second, this finding also helps to clarify the process by which third-party quality signals may influence stakeholder assessments of firms. The underlying premise of previous studies is that it is the information asymmetry between firms and external stakeholders, who may have difficulty directly assessing governance quality, which makes such signals valuable. However, our results are not entirely consistent with this contention as placement on the Focus List does not provide any new information as to how these firms have actually performed. Nevertheless, the publication of the Focus List may still provide some new information to institutional investors who, lacking the ability to constantly monitor every firm in their portfolio, may have not had their attention drawn to these particular firms. As such, placement on the Focus List does shine a scrutinizing spotlight on the underperformance of specific firms. This spotlight and associated scrutiny may delegitimize such firms and lead to external pressure being placed on institutional investors

to reduce their holdings in such firms. Consistent with the idea that status flows through affiliations (Graffin et al., 2008; Podolny, 2005), we suggest that institutional investors may feel pressure to reduce their holdings in such stigmatized firms or run the risk of delegitimation by continuing to associate with these repudiated firms.

Third, Wiesenfeld et al. (2008) recently suggested that the degree to which an individual will be stigmatized in the long-term is moderated by characteristics of the individual such that not all individuals associated with stigmatized firms will be stigmatized themselves. Generalizing this idea to the organization level, we find that the degree to which firms are delegitimated in the eyes of institutional investors is moderated by the firms' governance characteristics. Specifically, we found that the degree to which institutional investors reduced their holdings in companies on the Focus List was moderated by the independence of a firm's board. This finding suggests that there is an interdependent relationship between third-party quality signals, firm-specific characteristics, and external stakeholder responses. These interdependencies suggest that prior studies may not have fully captured the nuanced effects of how third-party signals influence a process of interpretation which unfolds over time.

Our results also suggest that the importance of strong governance characteristics may ebb and flow over time. Institutional investors seemed to take note of the independence of a firm's board when that firm is spotlighted for its underperformance. Specifically, we found that institutional investors' reduction in holdings of firms on the Focus List was moderated by the independence of a firm's board. This suggests that under the condition of underperformance governance characteristics become particularly salient to external stakeholders. While strong firm-level governance may be substantively important in such contexts, our results suggest governance characteristics also have a symbolic importance to external stakeholders who infer that their investments are receiving competent oversight by the board of directors. This finding contributes to agency theory by suggesting that, in addition to the substantive benefits firms may receive from adopting agency theory prescriptions of firm governance, such adoptions may also have symbolic value in the eyes of external stakeholders. Future research could further explore the potential symbolic benefits of such adoptions.

Regarding the substantive impact of firm-level governance characteristics, we found that board independence moderated the relationship between placement on the Focus List and CEO compensation realignment. This finding helps to highlight the interdependence between third-party quality signals and firms' ability to respond to such a public repudiation. Objectively, it seems reasonable that the directors of all firms would wish to respond to such a public repudiation by signaling that they are actively working in the best interest of shareholders to turn around the underperforming firm. However, as this signal does not come without cost to managers, firms that lack an

independent board may not be able to force managers to incur such costs in order to send this signal to investors.

Our results are broadly consistent with Davis's (2005) position that corporate governance is actually a set of interdependent institutions that guide managers towards shareholder value. We found that external signals of firm performance influence subsequent governance changes within firms and that these changes are contingent upon the existing strength of governance at these firms. Indeed, this result suggests that the importance of good governance mechanisms to institutional investors may be moderated by the level of a firm's performance. In our study, board independence allowed firms to send a signal of quality to external parties assuring them of the firm's future prospects despite current poor performance levels. Consistent with this idea, a recent study by Amason and Mooney (2008) found that strong performance promoted an overly defensive mindset in top management teams leading to future dysfunctional decision-making and performance. This finding suggests that in times of exceptionally good performance, firms have a need for effective board governance to mitigate this tendency. Together these results are consistent with the idea that the importance of particular governance mechanisms are contingent upon a firm's level of performance and indicate that exploring such relationships represents fruitful ground for future research.

Our study also contrasts with prior studies of third-party quality signals that have mainly focused on the impact of such signals on observers who are attempting to make quality judgments. These studies have largely ignored how the firm or actor receiving the signal may actively respond. A notable exception to this generalization is the study by Elsbach and Kramer (1996), which looked at how business schools respond to the *Business Week* rankings of business schools. Their results suggest that business schools were keenly aware of the rankings and acted to reframe the *Business Week* data to protect their organizational identity. This exception notwithstanding, the response of the firm subject to third-party repudiations has largely been overlooked. While we contend that institutional investors pay attention to quality signals like the CII Focus List and anticipate the reactions of other investors to such signals, the precise nature of institutional investor behavior can be further examined through qualitative studies. We acknowledge that institutional investors are heterogeneous with multiple interests (Ryan and Schneider, 2003) and future research might explore the competing interests of different types of investor. As we have suggested, many institutional investors are constrained in their ability to effectively monitor the hundreds or even thousands of companies in their portfolios and may rely heavily on external monitoring of firms by groups such as the CII to bring underperformers to their attention. Others, such as index funds, may be constrained in responding even when they are aware of such signals due to the strategy of the fund. Still other investors, such as turnaround specialists, 'vulture' funds,

hedge funds or private equity groups, may see the signal provided by the CII as an opportunity to acquire stakes in these companies to effect change or anticipate or precipitate the market for corporate control. Additionally, future governance research may wish to share this conception of corporate governance as a complex and interdependent set of practices and institutions and focus on how multiple aspects of this context interact. Such a complex web of interdependencies may lead to reinforcing feedback loops between performance, internal governance mechanisms, the external monitoring provided by investor groups and stock market reactions.

Finally, our results address governance mechanisms as a critical contingency in determining whether shareholders will continue to invest in underperforming businesses, thereby linking governance to financial performance. Our study looks at firms that are on the boundary: that are performing poorly, but have not yet slipped into bankruptcy. In this range of performance, we see complementarity occurring among available governance mechanisms, as firms with a more independent board move to align CEO's compensation with shareholder interests at the prompting of the external monitoring signal provided by the CII Focus List. This provides fertile ground for future research in the areas of substitutability and complementarity of governance mechanisms (Beatty and Zajac, 1994; Milgrom and Roberts, 1992; Rediker and Seth, 1995; Tosi et al., 1997; Zajac and Westphal, 1994). Specifically, future research might explore under what performance conditions substitutability or complementarity of governance mechanisms might be feasible.

Conclusion

Our theoretical framework received general support. Specifically, we found that: (1) third-party quality signals cause institutional investors to reduce their holdings in targeted firms; (2) the independence of the board of directors moderates the relationship between receiving a negative third-party quality signal and changes in institutional ownership levels of those firms; and (3) firms that exhibit sufficient internal monitoring mechanisms prior to targeting by the third-party evaluator retain the ability to improve their governance by increasing incentive alignment. These findings suggest a complementary relationship between incentive alignment and monitoring as governance mechanisms in these firms.

Our findings contrast with prior studies of firms that are performing well in that we found that while targeting particular firms through the publication of a Focus List does not have a blanket positive effect on all targeted companies, there is a positive effect for those companies with more independent boards. Our results support the proposition that governance mechanisms are a contingency that provides a possible key to the unresolved debate regarding the effectiveness of shareholder activism (Karpoff, 1998; Karpoff et al., 1996).

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Notes

- 1 For instance, Dharwadkar et al. (2008) report that Fidelity has more than 2500 firms in its portfolio, while Vanguard has 296 investments above US\$100 million in its portfolio.
- 2 We reran our models using the one-year stock market return in place of the five-year return and our results and conclusions are substantively unchanged.
- 3 We performed supplemental analyses that suggest CII members divested more quickly than other institutional investors.

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