Discussion of “Risk Perception, Board Networks, and Directors’ Monitoring”

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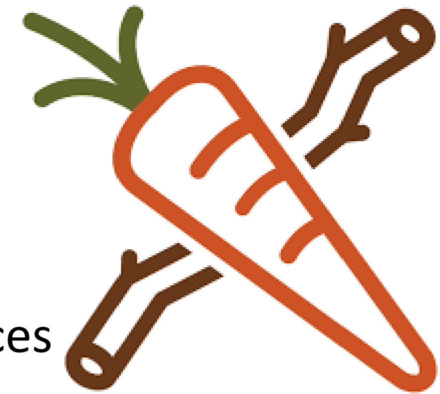
What is the paper about

- How to motivate board directors to exert effort of monitoring?
- Carrots and sticks
  - “Direct” sticks
    - Penalty and wealth consequences for not performing his/her job
  - “Indirect” sticks
    - The (perceived) risk of being penalized and bearing the consequences



- Observing a colleague director being penalized changes a director’s incentive to monitor

Empirical evidence

- A sample of 3728 listed firms in China during 2004-2019
- A manually collected large dataset on the voting behaviors of individual independent directors
- Linking a director’s observation of a “penalized” colleague to his/her voting behaviors
  - The observing director is more likely to vote against a board proposal after a colleague director in another board is sanctioned by the government (penalized director)

Comments

- Documents intuitive and robust findings on penalty spillover
  - Generate rich implications for academics and policymakers
  - How to design a penalty schedule that maximizes the disciplinary effect above and beyond individual misconduct case itself?
    - Given that government sanctions are costly and resource-depleting…
- Large, granular dataset to build director networks and (directly) link an individual’s observations to his/her actions
  - A clean separation of performance of individuals from that of firms they work for
  - May be able to use the same network idea and data to explore other CF issues
- Already polished work
  - Will focus on potentially sharpening some of these tests and possible development of follow-up projects

Further thoughts on the disciplinary effect of risk perception on monitoring incentive

- Can the results say something about *when and whether the penalty is optimal*?
  - Do they capture an upper or a lower bound of the effect of risk perception?
- The spillover effect may not be linear
  - The reward of exerting effort to monitor < the cost of perceived penalty
  - The penalty may affect all directors (connected and unconnected) if it is sufficiently large
  - What about the social consequences?

The case of Kangmei Pharmaceutical

- November 12, 2021: a Chinese court ruled Kangmei Pharmaceutical for corporate fraud
  - Under the ruling, Kangmei must compensate investors for losses of 2.46 billion yuan ($385.51 million).
- Five of the firm's independent directors were ordered to assume 5%-10% joint liability
  - Three of them: 10% of 2.46 billion yuan
    - For signing the 2016-2017 annual reports, and the 2018 semi-annual report
  - Two of them: 5% of 2.46 billion yuan
    - For signing the 2018 semi-annual report
    - Only served as independent directors for three months

The five unfortunate independent directors

- The combined compensation during their tenure: 1.794 million yuan
  - The average annual pay for being a Kangmei Pharmaceutical's independent director: 120,000 yuan
- Total personal fines: 368 million yuan

Name	Tenure Period	Age	Compensation (in 000 Yuan)
Zhenping Jiang	2015.05-2020.12	65	562.6
Dingan Li	2012.05-2018.05	76	409.5
Hong Zhang	2014.04-2020.12	51	270.9
Chonghui Guo	2018.05-2020.12	48	310.1
Ping Zhang	2018.05-2020.0.6	46	241

The great escape of independent directors

- Within one week
  - A flood of resignations of independent directors of listed companies
- Many highly trained experts or academia refused to take a job of independent directors
  - Too much liabilities and work, but too little reward
- → Suggest a social cost
  - In a country with an urgent need to involve expert individuals to help improve corporate governance

The effect of penalty spillover may not be linear

- Individual trades off the benefits of exerting efforts and the costs from perceived risk (of penalty)
  - When the perceived risk and associated penalty are too high, can just walk away
    - No monitor
- Is it possible to also incorporate director turnover in this context?
- Will there be (unintended) social consequences?
  - When the perceived risk is (too) high, director turnover constrains local director market
  - When the perceived risk is high, a director exerts more effort to monitor → reducing board seats to focus
    - High-paying firms or low-risk firms attract talented directors, crowing out small (low-paying) firms or high-risk firms?

What does the variable "dissension" capture?

- *Assume* that we allow for a nonlinear effect of penalty spillover
- In this context, what does director *dissension* capture?
  - In the absence of director turnover
- Increased effort to monitor by connected directors?
  - Value-enhancing for firm
- Or, connected directors become overly risk-aversion?
  - Value-destruction for firm
  - Figure 3 seems to suggest that *abstention* increases faster than *objection*
- May be both, depending on the stage of the utility
  - Not sure if the CAR results help here
  - May want to show examples of proposals being voted down

Other potential cross-sectional tests to consider

- So far the cross-sectional tests capture *social connections*
- May also consider *professional connections* to take advantage on the data
  - Larger effect if the observing directors are in *closer* connections to the penalized ones
  - More past interactions
    - P and O attend board meetings more frequently
  - Similar/same committee functions
    - O serves on similar/same committee as P for the other firm
- The personal costs may also vary
  - Smaller effect when there is a tight local market for directors
  - Larger effect if observing directors have a higher wealth stake
    - e.g., holding high-paying board seats

Conclusion

- A nice paper with intuitive and robust results that have rich policy implications
- A nice dataset that may allow for exploring other corporate finance topics
- Look forward to the next version of the paper