As the governance landscape evolves, Drexel University's Raj & Kamla Gupta Governance Institute aims to provide research-based insights on how to adapt and lead strategically.

Director Appointments: It Is Who You Know

Composition of Boards of Directors

Research at Drexel University's LeBow College of Business points out that professional networks are powerful channels to achieve diverse Boards of Directors, adding value in an increasingly complex and uncertain environment.

Key Insights

- Appointments of new directors rely heavily on the professional connections of incumbent board members. This facilitates board coordination and reduces search costs in fast-growing and competitive industries.
- Appointments made through professional connections can improve the diversity of the board in terms of gender, skills, and industry background. In the absence of a

connection, a new director with different experience is less likely to be appointed. This suggests that incumbent directors with diverse networks can facilitate a board's efforts to add new knowledge and expertise.

- For firms in more complex sectors, the appointment of connected directors attracts more shareholder votes and increases the firm's stock price. This shows that better coordinated boards can add shareholder value. Conversely, if the connection of the new director is to the chief executive, the stock price decreases, suggesting that this type of appointment can exacerbate managerial entrenchment and reduce value.

Summary of Complete Findings

The role of the Board of Directors in safeguarding the interests of shareholders is central to corporate governance in U.S. public firms. Director appointments shape the composition of a board and are critical to the effective exercise of its functions.

A statistical analysis of almost 10,000 director appointments made between 2003 and 2014 provides new research-based evidence on the role of networks in director appointments and their impact on shareholder value.

The BoardEx database reveals that nearly 69% of newly appointed directors had at least one professional connection with the incumbent board members. Such observation is striking because the connected appointees represent only 13% of all available candidates. The percentage of connected appointees is even higher for S&P 1500 firms (78%) and S&P 500 firms (90%). This research clarifies why this happens and whether it adds value to a firm.

How do connections affect director appointments?

A connected candidate is twice as likely to be appointed than a candidate with no connections with the board. In the sample period, the likelihood is higher for connections with the CEO, showing that CEOs have great influence in the selection of directors.

A candidate is deemed to be "connected" if at least one board member has worked with them at the same firm in an executive capacity (first-degree connection) and/or the candidate has worked with a third person who has a direct connection with a board member (second-degree connection).

Considering appointments irrespective of connections, an all-male board is 22% more likely to add a female director, showing that boards have been seeking gender diversity. However, a candidate with new experience is 13% less likely to be appointed, signaling that boards prefer directors with similar backgrounds.

When candidates have connections with one or more incumbent directors, their appointment leads to a much more diverse board: Connected female directors are more likely to be appointed to an all-male board (33%), while connected directors with new experience and different industry backgrounds increase their chances to be appointed (by 19% and 34% respectively).

Connections are a powerful way to build trust. The board compensates for unknowns regarding the quality of a candidate. For candidates, connections reassure them that they can be successful in that board. A female candidate in an all-male board may be more likely to accept the position if she trusts an incumbent director who can act as her ally.

Many boards use search firms to help recruit new directors, yet even in those cases, the use of personal connections seems prevalent. Boards often use their network to validate or gain trust of the candidates that search firms propose, while search firms are mindful of the board's network when proposing candidates.

Which firms appoint a connected director?

Larger boards and more complex firms are more likely to use professional connections to appoint directors. One extra director on a board can make it 15% more likely that a connected director is appointed.

Complex firms are those in fast-growing and more competitive industries. For firms in high-growth industries, the probability of a connected director appointment grows by over 21%. Similarly, if market fluidity is high, connected appointments are 8.4% more likely.

Firms in fast-growing industries and facing fierce competition require boards to make quick decisions. The lack of board coordination can therefore be costly and detract value. In these industries, the market for directors is also more competitive, increasing search costs in the absence of a connection.

Professional networks can improve board coordination through trust, while also reducing search costs. In fact, connected directors are also more likely to stay longer in firms with greater coordination needs.

What is the market reaction to director appointments?

If a connected director benefits more complex firms, then this type of firm should experience a more positive market reaction at the announcement of a connected appointee. In contrast, if a connected director restricts the effectiveness of a board, such an appointment should be viewed negatively by the stock market. This study confirms both intuitions. It finds that a more complex firm leads to a 1.5% higher increase in the stock price when a connected director is announced. It also shows that when the connection of the appointee is with the CEO, the stock price decreases. A CEO-linked appointee is viewed as limiting the strength of a board.

A parallel result can be found with shareholder voting: Shareholders give more votes to a connected director in firms with larger boards, in fast-growing industries and in more competitive markets. Shareholder votes, however, decrease when the connection is with the CEO.

In conclusion, this original research provides a compelling case for the use of professional networks to appoint directors that can add value to a firm.

"Director Appointments: It Is Who You Know" by Jay Cai (Drexel University), Tu Nguyen (University of Waterloo), Ralph Walkling (Ohio State University and Drexel University), published in *The Review of Financial Studies, July 2021.*