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THE ROLE OF INSIDER DIRECTORS IN MODERN PUBLIC COMPANIES WITH DISPERSED OWNERSHIP

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Abstract: *The present research examines the role of inside directors in publicly held companies with dispersed ownership. The number of inside directors on boards of public firms has been decreasing over the past few decades, while outside directors are obtaining more and more board seats. In the modern corporate governance system, the addition of independent directors to boards of directors aims to protect the interests of shareholders and is considered an effective mechanism to counterbalance the excessive influence and authority of C-suite executives. In such circumstances, the role of insiders may seem outdated and lacking relevance for public companies. Nevertheless, as this research suggests, inside directors are an important part of boards of directors and may contribute to improving corporate governance, in particular, the activities of all board members, including independent outsiders.*

Keywords: *insiders, independent directors, public companies, board of directors, management*

INTRODUCTION

The issue of the composition of the board of directors has been for many years and remains one of the most pressing in corporate law. Strong boards of directors are considered a pivotal mechanism for mitigating the shareholder-management agency problem, which can protect the interests of company shareholders (Cosenza, 2007). Contemporary corporate governance standards define the independence of directors as one of the main indicators of the effectiveness of the board of directors.

Kraakman et al. (2016) found that currently, most jurisdictions have adopted mandatory provisions or recommendations regarding the minimum number or ratio of independent outside directors on the board. Eventually, this trend has led to a gradual decrease in the proportion of insiders working on boards of directors. At

present, insiders are seen as exclusively dependent on upper management employees who do not contribute to better monitoring of top executives. However, the presentation of insiders exclusively in a negative light and their complete replacement with outsiders does not seem completely objective and correct.

MATERIALS AND METHODS

The theoretical framework of the present research is based on materials and statistical data from the studies of authors and sources that have previously examined the boards of directors of public companies, in particular, the functions and roles of inside directors. All sources used are publicly available.

The research method of the study is based on a review and synthesis of previously published literature. In the course of this research, both general research methods, such as comparative and qualitative, and special methods of scientific research, including abstract-logical, analysis and synthesis, as well as logical and analytical generalizations, have been implemented. In the research, the focus is on publicly held companies with a dispersed ownership structure where no single individual or group has a sufficient percentage of shares to gain control over the governance of the company.

RESULTS

According to OECD Corporate Governance Factbook 2019, the vast majority of jurisdictions have adopted mandatory provisions or recommendations regarding the minimum number or ratio of independent directors on the board of directors. Such statistics indicate that are currently considered as a source of effective and unbiased monitoring, which insiders are not able to provide due to their dependence on top management. It should be noted that studies by various authors confirm the assertion that the presence of independent outside directors has a positive effect on the quality of monitoring carried out by the board of directors. In particular, effective monitoring by independent board members makes CEO turnover become more sensitive to company performance (Masulis & Guo, 2015), reduces overly lavish CEO compensations (Adams, 2003), and precludes earnings management (Klein, 2002). Thus, the modern model of effective corporate governance of publicly traded firms considers the replacement of insiders with independent outsiders as a step towards improving the quality of monitoring of C-suite executives.

Nevertheless, boards of directors of public companies still include positions held by inside directors. An inside director can be defined as a person who is an employee, officer or stakeholder of the company (Fairfax, 2011). Insiders are also members of the board of directors. The list of insiders in the company, in most cases, includes C-level executives, for example, the chief financial officer (CFO), chief information officer (CIO), chief operating officer (COO) and so on. The CEO of the company, who is acting as the chairman of the board, may also be included in this list. Furthermore, insiders can be representatives of large shareholders or creditors, as well as the company's other stakeholders, such as labor unions or local community members (Chen, 2018). Involvement in the daily management and employment relations with the company make insiders important sources of business-related information and their presence on the board of directors can facilitate an increase in the effectiveness of the company performance.

The presence of a large number of insiders on the board of directors was common practice in the first half of the 20th century. Referring to Patro, Lehn, & Zhao (2004), it can be noted that the percentage of board seats occupied by insiders dramatically decreased from 1950 to 2000. In this paper, the authors show that the percentage of inside directors which reached its peak in 1950 and amounted to 49%, fell in subsequent years, and by 2000 it was only 16% of all the seats on the board. Such a shift towards a decrease in insiders on boards of directors was largely associated with an increase in the requirement for effective monitoring of top management of *publicly traded* firms. Nowadays, inside directors sometimes are portrayed as unreliable, biased and fully dependent on the CEO employees, who cannot serve the best interests of the company's shareholders and ensure proper monitoring (Bhagat & Black, 2001). A modern concept of effective corporate governance is characterized by the involvement of outsiders rather than insiders. Thus, it can be argued that insiders on the board of directors are almost an extinct breed.

Managerial entrenchment and abuse are frequently seen as the results of the weak monitoring system. For this reason, reforms of the corporate governance system predominantly have focused on strengthening the role of directors operating on the board. As Fairfax (2011) emphasizes, conventional wisdom holds that directors-insiders are not independent due to close ties to top management, in particular to the CEO. Close relations with the management especially severely limit the objectivity of directors in companies with entrenched CEOs. The insider's lack

of ability or willingness to evaluate the work of the CEO from a critical point of view may be due to the fact that the CEO is often the one on whom the insider's career advancement depends on (Faleye, Hoitash, & Hoitash, 2013). Most directors do not dare to strictly control and question the CEO performance, for fear of losing their position in the company. Thereby, there is a strong belief that independent directors can provide the demanded monitoring of top management, which is needed by publicly traded companies with dispersed ownership.

From the foregoing, it may seem that insiders are currently an unnecessary class of employees in public companies and the board of directors works better with a supermajority of independent outsiders. However, this observation is not entirely true. The examination of insiders from the prism of monitoring does not reveal the full picture and presents them only in a bad light. The advantage of independent directors in monitoring does not mean that insiders completely lose their value for the company and should be replaced by independent outsiders. Indeed, insiders have an information advantage over outsiders. Unlike outsiders, insiders work on a regular basis in the company, i.e., they are associated with the company's day-to-day running and, accordingly, they have direct access to valuable firm-specific information. Although independent directors can monitor and protect shareholder interests in conflict-of-interest transactions, the role of insiders is more important when implementing ordinary business decisions. In addition, an independent director often faces informational asymmetry (Duchin, Matsusaka, & Ozbas, 2010) and the possible source of information for them, alongside the CEO, is insiders (Fairfax, 2011). Information asymmetry, which is one of the main obstacles to protecting the interests of shareholders from the managerial malfeasance, can be eliminated through cooperation between outsiders and insiders.

Moreover, the composition of the board, including the presence of insiders in it, is of great importance for the efficacy of independent directors. Sometimes outsiders are not fully able to employ received information due to deficiency of comprehension of the company's business line. Insiders can promote a better understanding and efficient use of information and, thereby, improve the monitoring system. In other words, insiders may not only be information providers to outsiders but also direction indicators, i.e. they can facilitate the proper use of the presented data by independent directors.

The complicated situation is that the listing rules and legal requirements for the board composition are the same for all publicly traded companies. All publicly traded

companies need to hire outsiders to form a board that meets independence requirements. In this case, non-compliant companies have two options available: first, reduce the number of insiders and replace them with independent outsiders; second, increase the composition of the board and add new independent directors. At the same time, both options have their drawbacks and may raise certain questions. In the first scenario, the company may suffer from a shortage of firm-based knowledge provided by experienced insiders. For example, Coles, Daniels, & Naveen (2008) concluded that the large, R&D-intensive firms need more firm-specific knowledge, thus, a big fraction of insider directors is crucial for these companies. The lack of the necessary number of insiders can not only lead to a general deterioration in the company's performance but also deprive independent directors of the information sources necessary for effective monitoring.

In the second scenario, an increase in the composition of the board of directors may lead to coordination problems and complicate the transmission and obtainment of the information. An overly large board is unlikely to be cohesive, and each member may simply pay less attention to company affairs, expecting less threat of personal liability and punishment in case of company failure. In addition, in larger boards, for the director questioning the CEO decisions, it seems more difficult to persuade other board members to join and support him. Ryan & Wiggins (2004) suggest that this situation worsens the monitoring conducted by outsiders, increase informational asymmetry, and allows the CEO to entrench his position.

CONCLUSION

Although existing requirements for the board composition are the same for all publicly traded companies, there is no one universal composition of the board. Not in all cases, the vast majority of independent directors contribute to effective corporate governance and protection of shareholder interests. Moreover, adding independent outsiders should not imply the removal of insiders from boards of directors. The findings of this research suggest that inside directors are still relevant as board members of public companies. Due to their awareness of the everyday management of the company and access to the necessary information, respectively, insiders are more effective at making daily business decisions. Moreover, insiders can contribute to more effective monitoring by independent outsiders. First, insiders are potentially the main source of significant firm-based information for independent directors who often face information asymmetries. Second, insiders can provide

considerable assistance to independent board members in a better understanding of the company's affairs and proper use of the information received.

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