The Nominating Committee As An Antecedent of Effective Corporate Governance

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THE NOMINATING COMMITTEE AS AN ANTECEDENT OF EFFECTIVE CORPORATE GOVERNANCE

Brooke Stanley, Winthrop University  
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In this paper, we examine a possible antecedent to board effectiveness – the presence of a nominating committee. We argue that director cooptation by CEOs, and therefore ineffectual governance, may result from allowing CEOs to appoint sympathetic directors. Thus, because outside independent board members are more likely to be effective in their roles as monitors of the CEO, and because such members are more likely to have been selected by nominating committees, measures of board effectiveness should be positively associated with the presence of a nominating committee. Our results are largely consistent with our hypotheses, and are thus instructive in the design of optimal governance mechanisms. We find that firm profitability, frequency of compensation committee meetings, compensation committee size, and CEO experience of compensation committee members are all higher among firms with nominating committees.

Despite the abundance of research on corporate boards of directors in general, there is little research on board committees in particular. Some of the most important decisions made by corporate boards are made by these committees, especially the nominating and compensation committees, rather than the board at large. Board committees are among the most important mechanisms to facilitate director decision-making (Singh & Harianto, 1989). It is largely through the actions of the committees that the board can attempt to provide incentives to maximize managerial effort and minimize executive opportunism. However, CEOs may circumvent board control through their involvement in the director selection process.

Perhaps it is because the media and investors are concerned about executive compensation plans that they see as excessive, that there are a few papers that study the role of the compensation committee. The extant literature includes the work of Conyon and Peck (1998), who found executive compensation is more closely aligned with performance at firms with compensation committees dominated by outside directors. Conyon and He (2004) found the level and type of compensation granted to the CEO varies depending on the composition of the compensation committee, in a way consistent with the predictions of agency theory. Finally, evidence from Vafeas (2003) showed that regulatory reforms regarding compensation committee membership helped to reduce CEO opportunism in setting pay.

There is, however, almost no literature on the board’s other key committee, the nominating committee. Although one of the board’s most important responsibilities is to monitor the CEO, few board tasks are as crucial to the successful achievement of this goal as deciding which individuals merit director status. We believe that nominating committees are central to effective corporate governance because this committee can serve to screen for qualified and independent board nominees. Absent a nominating committee, new board members are typically recommended by an existing board member, who may even be the CEO that the board is responsible for monitoring. Alternatively, directors at firms with nominating committees may be more likely to be independent and may be more likely to objectively monitor the CEO, and to mitigate agency problems that result from the separation of ownership and control. Vafeas (1999) found that nominating committees are often comprised of directors who are most likely to act independently and in the shareholders’ interests. Similarly, Shivdasani and Yermack (1999) found that firms with nominating committees appoint more independent outside directors and have fewer directors with conflicts of interest.

When a company lacks a nominating committee, it permits the direct involvement of the CEO in board decisions regarding director selection and recruitment, as well as subsequent director assignments to committees and the organization of activities by those committees. We argue that a CEO’s involvement in director nominations may ultimately be manifested in the functioning of the compensation committee, since this would allow the CEO to influence the terms of his/her compensation.

HYPOTHESES

We expect that when firms lack nominating committees, it is a reflection of agency problems within the firm, which may also manifest themselves in other ways (Fama and Jensen, 1983). According to managerial power theory, there are numerous reasons for boards and their committees to cooperate with CEOs in ways that are not in the best interest of the shareholders, most notably in the form of a suboptimal compensation contract (Bebchuk & Fried, 2004). Directors may be inclined to agree to such contracts to win reelection to the board, garner higher compensation for their board service, or attempting to preserve the friendly nature of their relationship with the CEO. One possible explanation for this may be the lack of a nominating committee. Without a nominating committee, it may
become easier for CEOs to exert power over the board. This may lead to increased influence with regard to the design of his/her compensation arrangements so that his/her self-interest is maximized, instead of firm value. Therefore, agency problems that boards are expected to mitigate will instead be exacerbated at firms without nominating committees.

**CEO Share Ownership**

When executives have little equity at stake in their company, they have a diminished interest in promoting shareholder wealth, and can be expected to be more self-serving (Malatesta & Walkling, 1988). As CEO stock ownership increases, there will be greater degrees of alignment with the interests of the firm and its shareholders (Eisenhardt, 1988; Jensen & Meckling, 1976). When CEOs hold substantial equity in their firms, risk and reward perceptions are explicitly linked with those of shareholders, making CEOs more likely to behave in shareholders’ interests (Dalton, Daily, Certo, & Roengpitya, 2003). Greater CEO share ownership more closely aligns CEO interests with those of shareholders, thus reducing the kind of agency problems that require monitoring by the board of directors. Therefore CEOs who are not prone to agency problems are less likely to appoint sympathetic directors over whom they can exert their power, making nominating committees less necessary. In other words, CEO share ownership and nominating committees can act as substitutes to mitigate agency problems.

**Hypothesis 1:** CEO share ownership will be negatively associated with the presence of a nominating committee.

**Firm Profitability**

Firm profitability is known to be related to governance structure (Gompers, Ishii, & Metrick, 2003). The directors of underperforming firms tend to exercise their power and authority more readily, holding management to higher standards of accountability (Alderfer, 1986; Mizruchi, 1983). We expect that profitable firms are those governed by independent outside directors who effectively monitor the CEO, and who successfully provide incentives to maximize managerial effort and minimize executive opportunism. Therefore, we predict that such directors are most likely appointed by firms with nominating committees (Shivdasani & Zemmer, 2004).

**Hypothesis 2:** Firm profitability will be positively associated with the presence of a nominating committee.

**CEO Compensation**

Agency theory predicts that when monitoring is weak, as when a firm lacks an independent nominating committee to select directors, CEO compensation will increase (Fama & Jensen, 1983). Otherwise, the board as a whole, invariably including the CEO, will evaluate candidates for directorship. Excessive executive compensation has been linked to managerial entrenchment and domination over directors (Borokhovich, Brunarsi, & Parrino, 1997) and interlocking boards (Hallock, 1997). When a firm faces significant external control because of the presence of a large external block owner of shares, CEO compensation diminishes (Hambrick & Finkelstein, 1995). Additionally, several studies have cast doubt on the relationship of executive pay and firm performance (Deckop, 1988; Murphy, 1985). In sum, high CEO compensation may indicate weak board oversight and heightened CEO influence over the compensation committee.

**Hypothesis 3:** Total CEO compensation will be negatively associated with the presence of a nominating committee.

**Number of Compensation Committee Meetings**

If unconstrained by the presence of a nominating committee, a CEO may succeed in influencing board nominations to favor individuals who are less likely to constrain managerial autonomy (Fleischer, Hazard, & Klipper, 1988). A key safeguard to board independence is to hold more meetings. Meetings represent the fundamental prerequisite for collaboration (McGrath, 1991), which can have a significant impact on the performance of teams such as boards of directors and their committees. Meetings provide executives and directors with the opportunity to share information, and more frequent meetings facilitate better communication between these parties (Shivdasani & Zemmer, 2004). Increased board or committee meetings also allow more time for directors/members to more actively monitor management (Evans, Evans, & Loh, 2002). For example, audit committees that meet more frequently are more likely to be better informed and more diligent in carrying out their duties (Abbott, Parker, Peters, & Raghunandan, 2003; Goodwin-Stewart & Kent, 2006). Finally, some researchers suggest that the number of meetings in a year reveals the diligence of a board or committee (Persons, 2006; Raghunandan & Rama, 2007) and that increasing committee meeting time is key to improving the effectiveness of boards and committees (Conger, Finegold, & Lawler, 1998).

In addition, several studies document a relation between meeting frequency and firm performance. Miller & Norburn (1986) found that the frequency of board meetings is related to the board’s ability to make decisions, and to company performance. Zahara and Pearce (1989) concluded that the
amount of interaction the board has with the CEO also affects firm performance. Similarly, Vafeas (1999) found that the frequency of board meetings is related to firm value, suggesting it is an important feature of board function.

In summary, a higher frequency of committee meetings reflects increased monitoring of the CEO by the board and may result in better overall governance of the firm. We consider meetings of the compensation committee in particular, because we believe that if the CEO has power over the board, this is most likely to manifest itself in the functioning of this committee, since this would enable a self-interested CEO to influence his own pay. And because nominating committees are more likely to nominate independent outside directors, and such directors are more likely to monitor the CEO rather than rubber-stamp his/her decisions, we believe that nominating committees are more likely to be found in firms whose compensation committee meets more frequently.

**Hypothesis 4:** The number of a firm’s compensation committee meetings will be positively associated with the presence of a nominating committee.

### Compensation Committee Size

Much empirical evidence suggests that small group size may facilitate the manipulation of a board or committee by the CEO for his own personal gain. Several studies suggest that smaller groups tend to be more cooperative and thus more susceptible to tit-for-tat strategies. There is ample evidence in the social dilemma research that cooperation declines as group size increases (Allison, McQueen, & Schaerfl, 1992; Liebrand, Messick, & Wilke, 1992; Messick & Brewer, 1983; Seijts & Latham, 2000). Evidence also suggests that larger groups may be more effective at creating an opportunity for dialogue (Tindale, Davis, Vollrath, Nagao, & Hinsz, 1990) and more likely to consider minority points of view (Tindale, Smith, Thomas, Filkins, & Sheffey, 1996). Furthermore, numerous researchers have demonstrated that cooperation decreases as group size increases (Bantel & Finkelstein, 1991; Haleblian & Finkelstein, 1991; Hoffman & Maier, 1961; Katz; 1949; Wiersema & Bantel; 1992). Additionally, organization theory literature suggests that large groups and organizations experience dynamic tension due to the challenges related to coordination and cooperation among more people. As a result, as organizations or groups grow in size, they tend to become more control-oriented (Mintzberg, 1979) using more formal rules, regulations and processes than smaller organizations or groups (Lawrence & Lorsch, 1967; Smith, Smith, Olian, Sims, O’Bannon, & Scully, 1994).

This size of boards and committees has also been the subject of much research. There is evidence in the existing literature to suggest that larger boards or committees are more difficult for the CEO to control. For example, researchers have suggested that group size is important because as size increases, so does the potential for dissimilarity (Wiersema & Bantel, 1992). As dissimilarity increases, so does the diversity of perspectives and input, making tit-for-tat strategies less likely. Zahara and Pearce (1989) suggest that larger boards are more likely to be heterogeneous in their industry experience and expertise, which can improve the strategic direction of the firm. Furthermore, as group size increases, group cohesion and communication intensity become strained (Shaw, 1976). Therefore, larger boards may not be as susceptible to management domination as small boards (Davidson, Pilger, & Szakmary, 1998). CEO domination of boards becomes more difficult with larger boards because they are more likely to resist managerial domination (Rosenstein, 1987). In sum, this body of literature suggests that because of the increased potential for homogeneity, group cohesion, and intense communication, smaller compensation committees are more likely to accept the status quo and yield to the demands of the CEO.

To reiterate an earlier point, we believe that board cooption by the CEO is most likely to manifest itself in the functioning of the compensation committee in particular, and so we examine the size of this committee as it relates to the presence of a nominating committee. Based on the extant research regarding group size, we argue that larger compensation committees are less prone to being controlled by the CEO. That a compensation committee is independent in its decision-making instead of cooperating with the CEO suggests that its members were appointed to the board by a nominating committee rather than by the CEO himself.

**Hypothesis 5:** The size of a firm’s compensation committee will be positively associated with the presence of a nominating committee.

### CEO Experience of Compensation Committee Members

Experience, especially executive experience, plays an important role in decision-making in organizations. The effects of executive experience have been examined in numerous contexts. Several studies have examined CEO experience and its effect on firm strategies (Chaganti & Sambharya; 1987; Govindarajan, 1989; Geletkancyz, & Black, 2001; Hambrick, Geletkancyz, & Fredrickson, 1993; Miller, 1991; Smith & White, 1987; Thomas, Litschert, & Ramaswamy, 1991). Although this body of research concerns how CEO experience affects CEO decision-making, it also has implications for how CEO experience affects the decision making of CEOs when they serve on compensation committees.

Hambrick and Mason (1984) argued that important organizational outcomes would reflect characteristics of firms' "upper echelons" (top managers). If executive’s backgrounds affect organizations as upper echelon theory proposes, it seems reasonable to hypothesize that the CEO
experience of compensation committee members has some type of effect on the functioning of the committee. We believe that more experience as a CEO among compensation committee members will result in increased vigilance as a compensation committee member. Several studies provide evidence that boards with more experience tend to be more attentive. Factors such as education, job status, and experience have been shown to be related to organizational voice such that higher levels of the former are related to higher levels of the latter.

Qualifications such as education and experience provide members with more general knowledge resulting in a greater ability to recognize problems or opportunities and to offer a greater number of potential solutions (LePine & Van Dyne, 1998). This also results in greater confidence in one’s ability to make suggestions at work making it more likely that members will express concerns, make suggestions for improvement, etc. (Farr & Ford, 1990). Furthermore, job status provides access to information and freedom regarding one’s behavior on the job. More status equates to more information, more latitude to challenge the status quo, and a greater sense of responsibility for outcomes (LePine & Van Dyne, 1998).

Taken together this literature suggests that directors with more CEO experience will be more effective in their roles as monitors of a CEO. Due to the importance of the compensation committee in particular, we consider the CEO experience of its members. We propose that higher CEO experience among compensation committee members is associated with increased vigilance and effectiveness, which should follow from these board members having been selected by a nominating committee.

**Hypothesis 6:** The CEO experience of compensation committee members will be positively associated with the presence of a nominating committee.

**METHOD**

**Design**

We randomly selected 100 publicly-listed firms that possessed nominating committees. Next, we selected control group firms in the same industry that lacked nominating committees. We employed case-control procedures described by Seabright, Levinthal, and Fichman (1992). Case-control designs are suited to studying events that are relatively rare in occurrence. Firm size was selected as a matching variable because it could potentially confound results. We obtained a matching of control group firms within 2-digit SICs, stratifying controls on the basis of total assets and selecting firms lacking nominating committees that were nearest in total assets within the same 2-digit SICs to each in the experimental group (Singh & Harianto, 1989). This resulted in a total of 200 firms to be examined in our study. Before we analyzed data in a multivariate model, we first performed a t-test to determine whether asset size differed between the groups and found an insignificant t-statistic of .03. Thus, we were assured that the companies remaining in our study were of similar size. We selected 2000 as the examination year because the passage of the Sarbanes-Oxley Act in 2002 led to widespread changes in board structures and processes that would likely obscure our investigation.

**Measures and Analysis**

The dependent variable was whether a firm employed a nominating committee, coded 1 or 0. The independent variables included compensation committee, CEO, and firm performance factors. We identified three compensation committee variables; the number of times it met, its size, and the proportion of its members with CEO experience. Next, we included two CEO variables; total CEO compensation and the proportion of the firm’s shares he/she owned. Lastly, return on equity was selected as the firm performance variable.

We introduced three control variables; duality, the proportion of shares held by five percent owners, and firm size (log of employees). Duality occurs when the CEO also serves as chairman of the board. With such positioning he/she may buffer or limit the amount of control a board might impose on management (Donaldson & Davis, 1989, 1991; Williamson, 1985). Duality has been linked to board independence (Chatterjee, Harrison, & Bergh, 2003) and to firm profitability (Donaldson & Davis, 1991; Frankforter, Davis, & Vollrath, 2001). Duality is a dichotomous variable in which 0 represents outside board leadership, known as the independent governance structure, and 1 represents instances where the CEO also serves as the chairman of the board.

Diffused shareholders may have reduced incentives to monitor management and thus, characterize management-controlled firms (Hambrick & Finkelstein, 1995). Shareholders possessing significant equity holdings above the five percent threshold that requires a section 13(d) filing with the Securities and Exchange Commission often have significant influence because the benefits of their involvement in monitoring a company’s management outweigh the costs (Demsetz, 1983). These large-block owners have material influence over corporate policy (Demsetz & Lehn, 1985), board composition (Pound, 1992), and help to ensure the firm’s executives and officers act to further the interests of shareholders (Bethel & Liebeskind, 1993). The greater combined holdings of five percent owners, the greater their ability to monitor the firm, thus, curbing agency issues (Brickley, Lease, & Smith, 1988). We measured the total percentage of common stock held by five percent owners.

Firm size may influence the form of power and governance structures. For example, Finkelstein and D’Aveni (1994) reported that organization size tended to
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affect the use of dual structures, the power of its executives, and firm performance. We controlled for firm size by computing the log of the total number of employees (Frankforter et al., 2001).

We obtained total CEO compensation data from ExecuComp. Total CEO compensation included the sum of salary, bonus, other annual compensation, total value of restricted stock granted, total value of stock options granted, long-term incentive payouts, and all other total compensation. We computed and used the log of total CEO compensation to control for nonlinear data. Firm size and return on equity were obtained from Research Insight. All other data were identified from an examination of proxy statements. We employed hierarchical logistic regression analysis to test our model and used one-tailed tests because our hypotheses predict direction. The model is described below:

The adoption of a nominating committee by a corporation (no = 0; yes = 1) is a function of:

A) the following control variables:
1. presence of a dual governance structure
2. The proportion of shares held by five-percent owners
3. firm size (log of employees)

as well as:

B) the following experimental variables:
1. the number of compensation committee meetings
2. the side of the compensation committee
3. the proportion of compensation committee members with experience as a CEO at another company
4. total CEO compensation
5. the proportion of the firm’s shares the CEO owned
6. the firm’s return on equity

RESULTS

Table 1 reports descriptive statistics, variation inflation factors, and the correlation matrix. We addressed multicollinearity concerns by examining correlations and variation inflation factors. No correlation coefficient exceeded .36. Additionally, none of the variation inflation factors surpassed 1.30, far from the critical limit of 10 (Neter, Wasserman, & Kutner, 1989). These results supported our conclusion that multicollinearity did not threaten to contaminate our results.

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*p < .05
**p < .01
***p < .001
Table 2: Logistic Regression Results

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<td>Constant</td>
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<td>(Standard Error)</td>
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<td>Return on equity</td>
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-2 log-likelihood           266.899  234.031
Cox and Snell $R^2$         0.046    0.190
Nagelkerke $R^2$            0.061    0.254
chi-square                  9.380    42.247
Percent correctly classified 60.0  67.5
n                             200     200
$df$                         3       9

* $p < .05$
** $p < .01$
*** $p < .001$

Table 2 displays the logistic regression results. Model 1 reports the results for the control variables with a Nagelkerke $R^2$ of .061. Model 2 adds the six experimental variables to the equation. The Nagelkerke $R^2$ for this model is .254, with a substantial increment in the multiple squared correlation coefficient ($ΔR^2 = .193$). Model 2 reveals significant main effects for the number of compensation committee meetings, compensation committee size, CEO experience of compensation committee members, and return on equity. Greater numbers of compensation committee meetings, larger compensation committee size, greater CEO experience of compensation committee members, and increased firm return on equity were associated with the presence of nominating committees. However, the main effects for CEO ownership and CEO compensation were not significant. In summary, hypotheses 2, 4, 5 and 6 were supported.

With the proliferation of committees in corporate governance structures, our results suggest that increased attention may be warranted regarding the presence of certain committees and how committees are organized. This study reveals evidence supporting a contention that firms possessing nominating committees are typified by a more active board and improved financial performance.

**DISCUSSION AND CONCLUSION**

Although agency theory has been one of the most dominant management theories over the past few decades, empirical tests of its predictions often produce mixed and confusing results. For example, Eisenhardt’s (1989) concluded that agency theory was an empirically valid perspective. Other research suggests, however, that agency theory has little explanatory or predictive power. Dalton et al. (2003) conducted a meta-analysis of empirical ownership-performance studies and found few examples of systemic relationships and little support for agency theory. In contrast to the objections of these studies, we find
significant results suggesting that agency problems do arise. Improving our understanding how they might be mitigated or exacerbated may lead to improved governance standards and practices.

We begin with the observation that there is a dearth of extant literature regarding the existence and structure of board committees. This study contributes to our understanding of corporate governance by examining a possible antecedent to board effectiveness – the presence of a nominating committee. We argue that because outside independent board members are more likely to be effective in their roles as monitors of the CEO, and because such members are more likely to have been appointed by nominating committees, measures of board effectiveness should be positively associated with the presence of a nominating committee. Our results are largely consistent with our hypotheses, and are thus instructive in designing guidelines for firms to improve the efficacy of their boards.

Director cooptation by the CEO, and therefore an ineffective board, may be most readily achieved by allowing CEO involvement in board nominations. The results of this study suggest that four measures of board effectiveness are associated with the presence of a nominating committee. First, we find that firm profitability is positively associated with the presence of a nominating committee. This suggests that the nominating committee serves as a vital tool to ensure effective monitoring of the CEO by the board of directors to reduce the possibility of agency problems. Nominating committees reduce the amount of influence a CEO has over board composition and activities, thus increasing the amount of autonomy the board has in monitoring CEO activities and performance, which may reduce opportunistic behavior by a CEO.

Second, the results indicate that compensation committees at firms with nominating committees tend to meet more frequently. As discussed earlier, the number of meetings has been shown to be associated with numerous conditions necessary for effective corporate governance such as collaboration, communication, goal commitment, monitoring, informedness, and vigilance. Thus it appears that greater frequency of compensation committees meetings reflects improved governance that follows from directors being selected by a nominating committee rather than appointed by the CEO or another self-interested insider.

Third, the results indicate that firms with larger compensation committees tend to have nominating committees. We believe that one possible explanation for this is that it may be easier for CEOs to manipulate and control smaller committees. Smaller compensation committees may be symptomatic of director cooptation and ineffectiveness.

Finally, we find that CEO experience of compensation committee members is indicative of an independent committee that seeks to design an optimal compensation contract rather than cooperate with the CEO. This suggests that compensation committee members are more effective when they are selected by nominating committees instead of appointed by CEOs.

We conclude from these results that the presence of a nominating committee is a critical factor in the design of effective corporate governance mechanisms, and believe the findings of our study are important and informative to both researchers and practitioners. Although there is no shortage of guidance on how to improve board governance and mitigate executive opportunism, we feel that this study makes a significant and needed contribution by highlighting the importance of nominating committees in accomplishing these tasks. Most notably, practitioners would do well to ensure that their firms form nominating committees in order to ensure that appropriate directors are chosen, thereby increasing the efficacy of the board at large in its responsibility of monitoring management. It should be noted that the 2003 decision by the Securities and Exchange Commission to require all NYSE-listed companies to adopt nominating committees is consistent with the findings of this study. However, in light of our findings, its decision to exclude NASDAQ-listed firms from the same requirement should be revisited.

One limitation of this study is its examination of pre-Sarbanes-Oxley corporate governance conditions. Thus, we excluded evaluation of many of the independence-promoting facets that led to greater director autonomy vis-à-vis CEOs. However, we believe this approach to be appropriate so that it can distinguish between pre- and post-Sarbanes-Oxley corporate governance conditions and effects.

Future research on nominating committees should center on the details of how nominating committees function. Specifically, a greater understanding is needed of how they identify individuals who merit director status and how they resolve internal conflicts when multiple candidates are identified. In addition, future research should consider the evolution of the bargaining game between the CEO and shareholders, and whether or not the nominating committee can help to ensure that the balance of power remains in the hands of the board. Finally, the literature should examine the interactions of the board’s various committees, and whether there are a select few directors who serve on the board’s most important committees, such as the compensation and nominating committees.

REFERENCES


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