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Abstract

I review the empirical research on the role of stakeholders in corporate governance with an emphasis in contributions from the accounting literature. In particular, I focus on the following stakeholders: employees, the general public, the media, related firms, the government, private regulators, gatekeepers, and foreigners. This list does not include capital providers (shareholders and debt-holders), as the governance role of these stakeholders has already been covered by prior surveys in the academic literature. The discussion is structured around each stakeholder's incentives to influence managerial behavior, the mechanisms through which stakeholders act on managerial actions, as well as any concerns about this influence. All the analyzed stakeholders appear capable of influencing managerial actions to some extent, but the efficacy of stakeholders' monitoring role is controversial. Empirical research uncovers several factors that undermine stakeholders' incentives to discipline corporate managers. And more critically, in some cases stakeholders' incentives appear to be misaligned not only with shareholders' interests but also with the public interest. Taken together, the reviewed evidence suggests that the monitoring role involves a wide range of actors beyond the board of directors and capital providers. The review also points out that there is still much to learn about stakeholder monitoring.

1. Introduction

In recent years, few business topics have sparked as much interest in the general public as corporate governance. Politicians, regulators, and market participants have expressed widely divergent views on the topic. Aware of these views, academics have intensely debated the relative efficiency of, and the case for reforming, corporate governance practices. This debate has generated a rich academic literature that focuses on managerial compensation, board composition, and the disciplining effects of shareholder monitoring and the market for corporate control. Some survey papers suggest that corporate governance mechanisms follow an economic rationale and help reduce agency frictions (e.g., Bushman and Smith, 2001; Core, Guay, and Larker, 2003; Armstrong, Guay, and Weber, 2010). However, other authors point out empirical problems with these conclusions, including issues with measurement (Bhagat, Bolton, and Romano, 2011) and correlated omitted variables (Adams, Hermalin, and Weisbach, 2010). Adding to these concerns, several empirical papers find evidence of managerial rent extraction and opportunistic behavior, suggesting that our current corporate governance system suffers from substantial inefficiencies (e.g., Shleifer and Vishny, 1997; Bebchuk and Fried, 2004).

While this literature focuses on efficiency of compensation contracts, boards of directors, shareholder monitoring, and the market for corporate control, these are not the only governance mechanisms affecting managerial behavior.[1] Indeed, a growing number of scholars maintain that

[1] In fact, there is no widely-accepted definition of corporate governance, but rather a multiplicity of definitions reflecting a diversity of conceptual approaches. The concept is often understood by economists and legal scholars as referring to the protection of shareholders' interests; a protection that is necessary due to the agency problem generated by the separation of ownership and control (Berle and Means, 1932). This view of corporate governance often emphasizes the role of contracting (for example, Armstrong, Guay and Weber (2010) view corporate governance as "the subset of a firm's contracts that help align the actions and choices of managers with the interests of shareholders"). Other definitions include other stakeholders. For example, Shleifer and Vishny (1997) also include creditors among the parties protected by the corporate governance system, a system that they define as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Other authors avoid focusing on any specific party and define corporate governance more broadly as a set of (monitoring) mechanisms that influence managerial decisions (Larcker, Richardson and Tuna, 2007) or as the system to direct and/or control operations at a company (Gillan and Starks, 1998). Similarly, Bushman and Smith (2001) define the

a wider range of actors should be included in the discussions of corporate governance (e.g., Dyck and Zingales, 2002; Acharya, Myers, and Rajan, 2011). For example, Brickley and Zimmerman (2010) argue that, "To better understand the incentives of the top-level decision makers, one must look beyond compensation policy and shareholder/board monitoring. Multiple parties and mechanisms (including, auditors, regulators, credit rating agencies, stock analysts, courts, the media, monitoring by banks and other creditors, regulation, the markets for corporate control, product market competition, and corporate policies relating to takeovers) influence the behavior of the top-level decision makers in the corporation." Brickley and Zimmerman (2010, page 236) conclude that ignoring the potential influence of these parties could result not only in an incomplete understanding of corporate governance, but also in a problem with correlated omitted variables.

This paper reviews the empirical evidence on stakeholders' influence on managerial behavior focusing on stakeholders other than shareholders and debt-holders (i.e., providers of monetary capital). The accounting and finance literatures offer excellent reviews of extant research on executive compensation, board of directors, shareholder monitoring, the market for corporate control, and debt contracting, but do not—to my knowledge—systematically review the potential governance effect of stakeholders other than capital providers.[2] This survey addresses that need, *not* by exhaustively reviewing the (often large) literatures touching on each

concept as "the means by which managers are disciplined to act in the investors' interest". The definition of corporate governance provided by Zingales (1997) even avoids the notion of monitoring and instead takes an incomplete contracting approach (he characterizes the governance system as "the complex set of conditions that shape the outcome of the ex post bargaining over the quasi-rents that are generated in the course of a relationship").

[2] Some prominent recent examples include Core, Guay, and Larcker (2003); Adams, Hermalin and Weisbach (2010); Armstrong, Guay and Weber (2010); and Edmans, Gabaix and Jenter (2017). These surveys do not touch on the role of stakeholders in corporate governance. Rather, these reviews cover executive compensation, board composition, and debt contracting.

stakeholder type, but by culling the contributions that speak to stakeholders' influence on managerial actions.[3]

In my review, I follow the definitions of the term "stakeholder" in Freeman (1984) and Jensen (2002). The latter author argues that anyone who can potentially benefit from an engagement with the firm is a stakeholder, and that the stakeholder's interest in the firm could arise from issues related to human rights, the environment, and the community. Similarly, Freeman (1984) defines a stakeholder as "any group or individual who can affect or is affected by the achievement of an organization's purpose." This second definition encompasses parties that can be negatively affected by the firm's actions through externalities such as unemployment, pollution, or financial instability. Based on these definitions, I consider the following parties to be stakeholders: employees, the general public, the media, related firms, the government, private regulators, gatekeepers, and foreigners.[4]

When analyzing the role of stakeholders in corporate governance, I focus on their ability and incentives to discipline corporate managers. By "disciplining" I mean acting on managerial opportunism, where opportunism includes: shareholder expropriation (e.g., misappropriation of corporate assets or self-serving financial transactions) and other agency costs (e.g., managerial consumption, undue perquisites, excessive compensation, shirking, or self-dealing investment decisions), as well as law-breaking behavior (fraud or other violations).

[3] Some stakeholders are the focus of specific literature surveys. For example, Mehran and Stulz (2007) review the evidence on analysts, and DeFond and Zhang (2014) survey the literature on auditing research. Other surveys tangentially touch on issues that help explain the role of some stakeholders (one example is Leuz and Wysocki (2016)'s review of the literature on securities regulation). My review makes an incremental contribution with respect to such surveys in at least two ways. First, I cross-sectionally integrate the findings of those specific literatures in the corporate governance institutional framework, with the purpose of shedding light on the question of whether stakeholders affect managerial behavior, a question that is not addressed by prior reviews. Second, a number of the papers I analyze in this review are recent and thus have not been covered by prior surveys.

[4] I refer as "foreigners" to economic actors based outside the country in which the firm is incorporated. Specifically, I focus on foreign institutions (e.g., foreign regulators) and foreign shareholders. For example, a European firm cross-listed in the US is subject to the scrutiny of a foreign regulator: the SEC. This firm could also have foreign shareholders such as sovereign wealth funds from non-European countries.

Analyzing the disciplining role of stakeholders on managerial behavior requires going beyond the agency problem generated by the separation of ownership and control by including situations where the aggrieved parties are stakeholders other than capital providers. Pollution, price-fixing, consumer fraud, or unfair competition are some examples. While these actions could be beneficial for shareholders, they impose costs on stakeholders and thus can hardly be considered socially desirable.[5] Consistent with this notion of managerial misbehavior, this review includes as part of the corporate governance system all the mechanisms that curb managerial opportunism (e.g., Tirole, 2001).[6]

Considering stakeholder monitoring as part of the corporate governance system does not imply taking a particular side in the debate of whether corporations should focus on maximizing shareholder wealth or harmonizing stakeholders' interests.[7] In fact, this paper does not address the question of what firms' objective function should be, nor whether the design of institutions should induce or force management to internalize the welfare of stakeholders. Rather, the question I address is whether, under the current institutional design, stakeholders can help reduce

[5] I recognize that whether certain unpopular behaviors are indeed undesirable from a social perspective is a matter of debate. A prominent example is whether insider trading enhances or hurts economic efficiency (e.g., Manne, 1966; Schotland, 1967).

[6] Given the difficulty to measure the effect of managerial actions on social welfare, my review often discusses the implications of stakeholder influence on firm valuation. Interpreting this evidence from a social welfare perspective requires caution, as in some situations there could be a tension between the interests of shareholders and those of the rest of society. For instance, a positive stock market reaction to stakeholder influence does not necessarily imply that this influence improves social welfare; some actions could be detrimental for society as a whole but beneficial for shareholders (e.g., pollution, price-fixing, consumer fraud, or unfair competition). Similarly, a negative stock market reaction to stakeholder influence does not necessarily imply that this influence decreases social welfare; the negative reaction could reflect a (socially) optimal wealth transfer from shareholders to other stakeholders. For example, social pressure could induce managers to incur costs to reduce carbon emissions, costs that might not translate into higher profitability.

[7] While the shareholder-centric perspective has gained widespread acceptance among economists, recent theoretical work uncovers important tradeoffs between both perspectives (e.g., Tirole, 2001; Allen, Carletti, and Marquez, 2015). For example, as explained by Tirole (2001), the shareholder-centric perspective avoids problems related to dearth of pledgeable income, deadlocks in decision making, and lack of clear mission for management. However, this perspective could also result in biased decision making. Perhaps as a consequence of this tradeoff, the relative support for the two approaches differs substantially across countries. The stakeholder perspective is more popular in Japan, Germany, and France, while shareholders' interests represent the primary concern in the USA and the UK (see, for example, survey evidence in Yoshimori, 2005).

managerial behavior that is socially undesirable. Shedding light on this question is interesting regardless of where one stands in the debate.

For each stakeholder, the review analyzes the economic forces that determine how and to which extent the stakeholder contributes to discipline managerial behavior (see Table 1 for a summary). First, I discuss the *incentives* of each stakeholder to influence managerial actions, incentives that vary substantially across stakeholders. Some stakeholders extract a *monetary* benefit from disciplining managers. To name some examples, employees seek to secure their payments and jobs, media companies increase viewership (and thus revenues) by uncovering cases of corporate fraud, and partner firms negotiate contractual clauses to secure a fair share of the partnership profits. But stakeholders' incentives to discipline managerial behavior do not always have a direct translation into monetary terms. For example, *reputational* incentives are key for gatekeepers such as auditors or rating agencies. Also, the motivation of social activists to put pressure on firm managers is often *ideological*.

Second, I describe the channels or *mechanisms* through which stakeholders influence managerial actions. *Monitoring* of managerial actions is one of these mechanisms. Some examples are the monitoring of the media, regulatory oversight by government agencies, or the scrutiny conducted by gatekeepers. Other stakeholders discipline managerial actions through *contracting*, either explicit or implicit. The contractual clauses to limit managerial opportunism negotiated with suppliers, clients, and partners firms are one example, but there are many others (the firm also writes contracts with employees, gatekeepers, and often also with the government). Some stakeholders might exert a disciplining effect on corporate officials without directly monitoring managerial actions or entering into contracts with the firm. The competitive pressure

imposed by rival firms or the influence of social norms imposed by the general public are two prominent examples.

Third, I identify the *frictions* that potentially prevent stakeholders from disciplining managerial behavior. One important friction is stakeholder *opportunism*. Private benefits, corruption, conflicts of interest, or pressure from special interest groups are some examples of the potential drivers of stakeholders' opportunistic behavior. Other frictions relate to the *costs* and *constraints* faced by stakeholders. For example, regulatory enforcement is subject to resources constraints, and the collective action of the general public on corporations faces substantial coordination costs. At best, these frictions could undermine the disciplining role of stakeholders. But even more critically, they could also induce a (socially) suboptimal wealth transfer from shareholders to other stakeholders. For example, employee pressure could induce managers to invest below the socially-optimal level, and social pressure could lead managers to incur excessive costs to improve the social image of the organization. As a result of these frictions, the disciplining effect of stakeholders on managerial behavior is empirically intriguing.

Based on this framework (see Table 1), the review discusses the available empirical evidence on the disciplining effect of stakeholders on managerial behavior, as well as the evidence on the frictions affecting this disciplining effect and the mechanisms used by stakeholders to influence managerial actions. In addition to more specific conclusions (which follow each section), the following broad points emerge from the review. First, all the analyzed stakeholders appear to influence managerial actions to some extent. This suggests that discussions about corporate governance should consider the monitoring roles of many actors—not just the board of directors and financial stakeholders—and implies that stakeholder monitoring could substitute for costly corporate governance mechanisms.

Second, the review of the literature reveals that the efficacy of the stakeholders' monitoring role is not clear-cut. Some of the empirical research provides evidence of factors that undermine stakeholders' incentives to discipline corporate managers. Other research indicates that the value implications of stakeholder influence are unclear, suggesting that the incentives of some stakeholders might be misaligned not only with shareholders' interests but also with the public interest. In general, there is a paucity of evidence on the monitoring role of some of the analyzed stakeholders. All of this calls for further research.

The remainder of the paper is organized in nine sections. The next eight sections each analyze the governance role of one of the following stakeholder groups: firm employees (section 2), the general public (section 3), the media (section 4), related firms (Section 5), the government (Section 6), private regulators (Section 7); gatekeepers (section 8); and foreign stakeholders (section 9). Section 10 concludes the review with a summary of the main conclusions and suggestions for future research.

2. Employees

The workforce represents one of the key stakeholders of a firm. Firms sell employees a package of explicit and implicit claims, with explicit claims expressed through employment contracts and implicit claims expressed through promises about working conditions, ongoing employment, and advancement opportunities (Cornell and Shapiro, 1987). Employees' explicit claims on the company's cash-flows can take the form of debt (mainly salary and pensions) or equity (restricted stock, stock options, and other equity claims). In return for investing their human capital in the firm, employees also receive implicit claims relating to career/job opportunities within and outside the firm. As a result, the employees have an incentive not only

to secure their payments and jobs in the firm, but also to prevent top managers from appropriating the returns on the employees' human investments in the firm.

However, the monitoring role of firm employees is controversial for several reasons. One concern is that, as individual employees have limited ability to influence management decisions, employee monitoring needs to be articulated through collective action, which in turn requires to nominate employee representatives. This delegation introduces an agency problem between these representatives and the rest of employees. A second, more critical, concern is that employees' interests could not be aligned with those of shareholders, and perhaps not even with those of society as a whole. For example, excessive employee protection could increase unemployment and decrease productivity, among other things.

Employees can pressure top management through several mechanisms, including collective bargaining, stock ownership, board representation, and threat to leave. In what follows I analyze each of these mechanisms.

2.1. Collective Bargaining

A traditional mechanism for employees to exert pressure on management is to organize themselves into unions, which then negotiate with management for pay increases and enhanced benefits. Unions have substantial bargaining power because they can call strikes (the right to strike is protected by law in most countries).

The primary purpose of unions is to protect employees' specific interests, but the unions' monitoring role could be beneficial for the rest of stakeholders, including shareholders. Unions can curb managerial rent extraction by reining in executive compensation, preventing suboptimal investment, and supporting needed turnover in management, among other activities. Consistent with this idea is the evidence in Huang, Jiang, and Que (2016), who find that firms with strong

unions pay their CEOs less. Moreover, managers may respond to the threat of unionization by conceding higher wages and/or better working conditions. While such concessions could reduce the firms' profits in the short term, they could eventually translate into higher profitability through an increase in productivity. Finally, as explained by Friedman (1950), unions could moderate wage demands because they know that above-market wages could adversely affect job security.

However, the monitoring role of labor unions is controversial. To begin with, there is an agency problem between union leaders and workers (see early studies by Ross (1948) and Martin (1984)), as evidenced by the often-large pay gaps between union leaders and workers and by frequent reports of corruption among union leaders. Union leaders could also extract rents from shareholders by exploiting bargaining opportunities. For example, a union's political connections could be used to extract rents during negotiations with management (Stanfield and Tumarkin, 2016).

There is substantial empirical evidence that labor unions affect firm policies. In particular, prior studies find that unionization affects firms' innovation activities (Hirsch, 1992; Bradley, Kim, and Tian, 2015), risk-taking behavior (Chen, Kacperczyk, and Ortiz-Molina, 2011, 2012), and tax aggressiveness (Chyz, Leung, Zhen, and Rui, 2013). Other studies find evidence that firms take strategic actions to lower their real or apparent ability to meet union demands. These actions include leverage increases (Bronars and Deere, 1991; Hanka, 1998; Matsa, 2010) and curbing of cash balances (Klasa, Maxwell, and Ortiz-Molina, 2009).

The presence of unions can also affect firm reporting and disclosure. A stream of the accounting literature has analyzed whether firms change reporting behavior around union negotiations. In particular, there is evidence that, during union negotiations, firms manage

earnings and analysts' expectations in order to project a negative outlook and obtain concessions from the union (Bova, 2013).[8]

While the above studies suggest that labor unions influence managerial behavior, the literature does not clarify whether this influence increases firm value. If anything, the available evidence indicates the opposite, since most of the managerial actions that are affected by unions have unclear value implications. Moreover, several studies show that unionization is associated with lower firm profitability (early evidence on this association is in Ruback and Zimmerman, 1984; more recent evidence is in Lee and Mas, 2012). In these papers, the negative correlation between unionization and profitability hints at a potential destruction of wealth.

2.2. Stock Ownership by Employees

Employees could also exert influence over management through share ownership. Though relatively rare in other countries, employee-owned equity blocks are frequent in the U.S. According to the National Center for Employee Ownership, employees own several hundred billion dollars of their employers' stock through Employee Stock Ownership Plans (ESOPs), stock bonus plans, and profit sharing plans as of 2016.[9] Moreover, a large number of employees own their employers' stocks through pension funds and 401(k) plans.

As shareholders, employees are eligible to vote on corporate matters and can introduce proposals. In fact, union-backed funds and individual activists are among the most active proposal sponsors, initiating more than 80 percent of shareholder-sponsored proxy proposals (Larcker and Tayan, 2011). This activism could result in a reduction of managerial rent extraction, which would benefit non-employee shareholders. Moreover, employee ownership

[8] Other papers providing evidence of reporting behavior around union negotiations are Cullinan and Knoblett (1994); Bowen, DuCharme and Shores (1995); D'Souza, Jacob and Ramesh (2000).

[9] https://www.nceo.org/articles/statistical-profile-employee-ownership

could lead to increasing employee–manager goal alignment and productivity gains. Consistent with this intuition, the evidence in Cramton, Mehran, and Tracy (2008) suggests that ESOPs increase the efficiency of labor negotiations by reframing disputes and avoiding costly strikes. Employee ownership may also play a role in corporate governance by pressuring firms to take action. In support of this conjecture, Bova, Dou, and Hope (2015) find a positive link between employee ownership and firm transparency—specifically, they find that voluntary disclosure increases when employees have greater bargaining power.

Other empirical evidence, however, suggests that employee influence may conflict with value creation. Faleye, Mehrotra, and Morck (2006) document that firms in which labor owns at least 5 percent of shares (and, therefore, has a voice in corporate decision making) exhibit lower valuations and other negative outcomes.[10] The proxy voting of labor union pension funds is also controversial. Critics argue that union pension funds use their votes in corporate director elections to pursue worker interests under the guise of increasing shareholder value. Consistent with this criticism, Agrawal (2012) finds that AFL-CIO–affiliated shareholders become significantly less opposed to directors once the AFL-CIO labor organization no longer represents a firm's workers, and documents negative valuation effects around union opposition.

2.3. Board Representation

In some countries employees have the right of board representation. This right—commonly known as "codetermination"—is intended to give employees a voice in corporate governance. In Germany, for example, the supervisory board of each corporation is required to include employee representatives; the percentage of employee members depends on the corporation's headcount.

[10] These firms invest less in long-term assets, are more risk averse, exhibit slower growth, have lower employment growth, and have lower labor productivity.

In addition to improving coordination, employee representation can reduce managerial rent-seeking behavior through monitoring of managers and independent directors. The downside is that board representation could also allow employees to extract rents for themselves—by demanding excessive wages or preventing necessary downsizing, for example.

The empirical evidence on the effect of employee representation on firm value is not conclusive. On the positive side, companies with employee representation are more likely to pay a dividend, which reduces expropriation of capital by management. Some papers suggest that the relation between employee representation and firm value is non-linear. For example, Fauver and Fuerst (2006) document that employee representation is positively related to market valuation in industries that require high levels of coordination and in concentrated industries with less competition. Other papers document a "U-shaped" relation between employee representation and firm value. The average effect, in Germany at least, does not appear positive: Gorton and Schmid (2004) find that the level of employee representation in German firms is negatively associated with market valuation.

2.4. Threat to Leave

A well-functioning labor market could make it easier for employees to exert pressure on management. Acharya, Myers, and Rajan (2011) note that subordinate managers can discipline management by threatening to withdraw their contributions to the firm. Two considerations suggest that managers care about this threat. First, human capital is increasingly seen as one of the most important factors for a firm's competitive success (Pfeffer, 1994) —so much so, in fact, that Rajan and Zingales (2000) provide an alternative approach to corporate governance that emphasizes human capital instead of agency problems between managers and shareholders.

Second, replacing an employee can be costly due to labor market frictions, including dismissal, selection, and hiring costs.

While this internal corporate governance mechanism has theoretical and intuitive appeal, there is (to my knowledge) no direct empirical evidence on whether the empowerment of subordinates through the labor market effectively limits the self-serving actions of top management.

In sum, the results from the literature suggest that employees can and do influence managerial behavior, but the consequences of this influence for shareholder value are unclear. While this does not necessarily mean that the current institutional design requires reform, more research is needed to more clearly identify the social benefits of employee monitoring in its current form. One possibility is to explore whether employees help reduce managerial behavior that is commonly perceived as socially suboptimal. For example, employees could be instrumental in detecting law violations and in reducing firm externalities such as pollution or greenhouse emissions.

3. The General Public

Companies generate externalities on communities and the environment. Examples of externalities are air, noise, or water pollution; greenhouse gas emissions; loss of natural resources; loss of nature-based services such as carbon storage by forests; and effects on climate change. Some externalities are mainly financial, such as the credit shortage and depressed economic conditions following the 2007-2008 Financial Crisis. In addition to damaging nature and human health, externalities can translate into economic burdens for society, in the form of healthcare costs, reimbursements for property damage, and corporate bailouts, among other expenses.

To the extent that the cost of these externalities is borne by society at large and only partially internalized by shareholders, one would expect a social effort to prevent or reduce these costs by disciplining corporate behavior. Some authors suggest that the general public's concerns about corporate behavior have crystalized in "social norms" that can curb managerial self-dealing (e.g., Coffee, 2001; Dyck and Zingales, 2002). The key questions, however, are whether this social pressure is enough to counterbalance the strong economic incentives of corporate managers, and whether social norms have an effect that adds to that of the legal system.

There are reasons for doubt in both cases. The population of individuals affected by corporate externalities is often large and diverse. To have an effect on externalities, this population must first overcome substantial coordination costs and align heterogeneous preferences. Even if these hurdles are overcome, the costs imposed by society on corporate managers may not be sufficient to affect the managers' behavior. In line with this concern, Karpoff, Lott, and Wehrly (2005) document that corporations bear few reputational costs from environmental violations, and that such violations appear to be disciplined largely through legal and regulatory penalties.

The role of the general public in monitoring managerial behavior also faces other difficulties. Critically, societal pressure could induce corporations to engage in actions of a questionable value. This would be the case if, for example, social demand were subject to manipulation by special interest groups. Moreover, the social welfare consequences of some corporate actions targeted by social activism are hard to assess, suggesting that social pressure could be subject to bounded rationality. As a result of these difficulties, the social role of corporations has spurred widespread debate.

Societal pressure can operate through several channels. One channel is the influence of socially or environmentally conscious consumers. Corporations appear to engage in measures that target these consumers. For example, Navarro (1988) provides evidence consistent with corporate charity contributions representing a form of advertising, and Fombrun (2005) suggests that firms adopt social policies in order to improve the effectiveness of their marketing. Consistent with these papers, Servaes and Tamayo (2013) show that corporate social policies and firm value are positively related for firms with high customer awareness.

Another channel is the preferences of prospective (and/or current) employees. Certain employees could generate incentives for firms to be socially and environmentally conscious. Along these lines, Greening and Turban (2000) argue that commitment to social activities may help firms attract and retain high-quality employees who are sensitive to social and environmental issues.

A third channel is societal representatives and monitors who are responsible for protecting social interests. Firms could reduce externalities and engage in social initiatives in order to appease such individuals. For example, Peloza (2006) argues that such expenditures may act as a form of reputation insurance, and Hillman and Keim (2001) claim that these initiatives reduce the likelihood of regulatory action.

Activism by socially committed shareholders is a fourth channel through which societal norms could be enforced on corporations. Dimson, Karakas, and Li (2016) analyze the engagements of a large institutional investor who is committed to responsible investment with U.S. public companies, and find that a significant number of these engagements are successful; this suggests that shareholder activism is an effective channel to discipline corporate behavior.

The recent surge of Corporate Social Responsibility (CSR) introduces an opportunity to empirically study the effect of social pressure on firms. CSR initiatives include charity contributions, the development of eco-efficient products, actions to reduce emissions and consumption of natural resources, initiatives to improve labor conditions, and commitments to avoid practices that violate human rights. Companies channel significant resources to CSR investments—hundreds of millions of dollars, in some large US corporations (Hong, Kubik, and Scheinkman, 2012).

In the context of CSR, some papers provide evidence that social pressure exerts a disciplining effect on corporate executives. A commitment to CSR can discipline managerial behavior because such commitment builds a positive, caring image for the organization and thus imposes additional costs on executive behaviors that are perceived as self-serving. Consistent with this idea, Gao, Lisic, and Zhang (2014) find a negative association between CSR and insider-trading profits, and Kim, Park, and Wier (2012) observe that socially responsible firms are less likely to misreport. Also along these lines, Dimson, Karakas, and Li (2016) analyze the shareholder activism of a large investor who is committed to responsible investment and find that this activism is associated with positive returns, increases in accounting performance, governance changes, and increased institutional ownership. Finally, Dhaliwal, Li, Tsang, and Yang (2011) find that the voluntary disclosure of CSR activities leads to reduced cost of capital, higher institutional investor ownership, and broader analyst coverage.

The evidence on the welfare consequences of the social pressure on corporate managers is more controversial. Given the difficulty to conduct direct tests of the social role of corporations, most of the empirical literature focuses on the consequences of the social pressure on corporations on shareholder wealth. In particular, the debate centers mostly on the valuation

implications of CSR, and the research has often yielded inconclusive results: some studies find a positive relation, others a negative or no relation.[11] One possible explanation of the mixed effect of CSR on firm value is that social investments could also be driven by agency problems inside the firm. For instance, CSR could be a way for managers to earn personal favors from key stakeholders (e.g., local politicians, non-governmental organizations, or labor unions) at the expense of shareholders. Relatedly, several papers suggest that CSR expenditures may constitute perquisite consumption by firm executives, as, for example, when managers use shareholder money to finance their own pet (CSR) projects (see Tirole, 2001; Bénabou and Tirole, 2010; Cheng, Hong, and Shue, 2016) Finally, CSR expenditures may represent a form of delegated philanthropy at the expense of shareholders (Bénabou and Tirole, 2010).

Overall, while the extant empirical work provides mixed evidence on the welfare consequences of the influence of societal pressure on corporate behavior, the literature does offer some evidence suggesting that this influence is non-trivial. That is, the general public appears to be able to affect managerial behavior. Nevertheless, there is still much to learn about how managers' social incentives can be exploited to promote social welfare. This is an especially interesting line of inquiry, as social pressure could be an efficient substitute for costly regulation.

[11] While a detailed analysis of this work is beyond the scope of this article, I refer the interested reader to Margolis, Elfenbein, and Walsh (2007), who conduct a meta-analysis of many such empirical studies and conclude that the average relation between CSR and profitability is positive but small. Empirical issues may contribute to the differing inferences from these studies. One such issue is the difficulty in accurately quantifying CSR, given the qualitative nature of many CSR-related aspects (i.e., measurement error). For example, no legally binding standards require publicly listed companies to report coherently or truthfully on the extent to which they impose positive or negative externalities on their stakeholders. Overall measures of the effects of corporate actions on the welfare of stakeholders either do not exist or are susceptible to greenwashing (i.e., the firms' tendency to overstate good deeds and understate bad deeds). A second important issue is reverse causality: Lys, Naughton and Wang (2015) argue and provide suggestive evidence that firms are more likely to undertake CSR expenditures in the current period if they anticipate stronger financial performance in the future. A recent paper by Kruger (2015) addresses these limitations using textual analysis and event study methodology. The author empirically classifies CSR news as reflecting either managerial opportunism or efficient investment, and finds that the stock market reaction to this news varies accordingly, being positive (negative) in the former (latter) case. The evidence in Kruger (2015) helps explain the mixed evidence in prior research and counters the assertion that, on average, CSR increases firm value.

4. The Media

Media outlets are often counted among firms' stakeholders because they sell information about firms to the public and thus have an interest in those firms. Examples of these outlets include newspapers, trade publications, newswires, broadcasts, and financial news websites. From a theoretical perspective, the role of the media in the economy is to aggregate and disseminate information, thereby reducing the costs, to individuals, of collecting and evaluating the information. This press's role as information intermediary has been documented by prior empirical literature. Notably, Bushee, Core, Guay, and Hamm (2010) provide evidence that greater press coverage reduces information asymmetry around earnings announcements.

In addition to disseminating information, the media could play a governance role, in that media coverage might not only report on, but could also influence, events (Dyck, Volchkova, and Zingales, 2008). In particular, the media can play a role in corporate governance by shaping the creation and accumulation of reputation (Dyck and Zingales, 2002). This can happen at least three ways. First, media attention can drive politicians to introduce corporate law reforms or enforce corporate laws in the belief that inaction would hurt their political careers and/or reputations. Second, in the traditional understanding of reputation (see, for example, Fama, 1980; Fama and Jensen, 1983), managers' wages in the future depend on whether shareholders and future employers believe the managers will attend to their interests in situations that are difficult to monitor. Managers who are concerned about a future monetary penalty may pass up opportunities for self-dealing in order to build a reputation that will increase their value in the labor market. Media coverage may play a role in this reputation building by managers. Third, media attention affects managers' and board members' reputations in society, which may also have an effect on governance.

The empirical literature in finance and accounting provides evidence of the disciplining role of the media on several governance issues. Dyck, Volchkova, and Zingales (2008) focus on disenfranchisement and dilution,[12] and find that coverage in the Anglo-American press increases the probability of a corporate governance violation being reversed. Miller (2006) studies the role of the media in monitoring accounting fraud, and suggests that the press performs direct monitoring by producing information used in corporate prosecution (i.e., journalistic investigation). In his sample, approximately 29% of the cases of accounting malfeasance are identified by the press prior to a public announcement by the SEC or the firm. This evidence is consistent with Dyck, Morse, and Zingales (2010), who show that the press is a frequent whistle-blower in corporate fraud.

The monitoring role of the media may also include the dissemination of information gathered by others (for example, the rebroadcasting of news provided by other information intermediaries such as analysts, auditors, and lawsuits), which could facilitate the scrutiny of corporate actions by other agents. Miller (2006) shows that rebroadcasting news about fraud is common, but his evidence on its disciplining effects is inconclusive (rebroadcasting appears to elicit little investor reaction). Dai, Parwada, and Zhang (2015) provide stronger evidence about the disciplining effect of news dissemination by the media. They show that the media reduces future insider-trading profits by disseminating news on prior insiders' trades from regulatory filings.

However, the media is not immune against opportunism. Media professionals select which information to communicate to the public, so their coverage could be opportunistic. At least some empirical evidence supports this conjecture. Dyck, Volchkova, and Zingales (2008)

[12] They study six types of dilution, namely share issuance, share swap, reorganization, bankruptcy, asset stripping, and other.

show that press coverage can be affected by lobbying. Core, Guay, and Larcker (2008) find that negative coverage is greater for CEOs with more option exercises; the authors interpret this to mean that the press engages, to some degree, in sensationalism. And Miller (2006) finds systematic biases in the types of firms and frauds on which articles are published: the press tends to cover highly visible firms, which attract a larger readership, and to report on situations where the cost of investigation is lower.

Any opportunism in press coverage is troublesome since it could diminish the efficacy of the media in corporate governance. The Dyck, Volchkova, and Zingales (2008) evidence of lobbying effects on media coverage is especially troubling, as it suggests that media influence could be used to pursue special interests at the expense of overall shareholder wealth. This problem may be mitigated by journalists' reputational incentives, but whether these incentives are strong enough remains an open question. In fact, while some papers provide evidence of a monitoring role of the media in specific governance issues (e.g., insider trading); papers studying other governance problems find a weak effect of media monitoring. For example, Core, Guay, and Larcker (2008) study the role of the popular and business press as a potential monitor of executive pay and find little evidence that firms respond to negative coverage by decreasing excess CEO compensation or increasing CEO turnover.

In summary, while the extant literature suggests that the press may be an important factor in corporate governance, more research is needed to understand the determinants of its efficacy. That is, there is still much to learn about the monitoring incentives of media and the deterring effects of the reputational penalties imposed by the press on corporations.

Another interesting avenue for future research relates to the recent evolution of the media. In recent decades the media industry has been transformed by Internet technologies that

allow for the direct access of information. These include social networks such as Twitter and Facebook; Really Simple Syndication (RSS) feeds; and corporate email alerts. While television, newspapers, and radio are still active in producing and disseminating corporate news, they face stiff competition from the interactive online media. In fact, there is a recent proliferation of internet information intermediaries that influence price formation (Drake, Thornock and Twedt (2016). Also, firms can now disseminate news directly to investors rather than rely solely on third-party intermediaries. Indeed, Blankespoor, Miller, and White (2014) provide evidence that firms' news dissemination via these new information technologies reduces information asymmetry.

Critically, the Internet offers countless forums where corporate stakeholders can exchange information. Web publishers such as Wikipedia, MySpace, Facebook, and YouTube provide only platforms and leave the content creation to the end users. Anecdotal evidence suggests that the effect of these online communities on corporations can be rapid and substantial. For example, in 2011, members of LawnSite.com, a professional forum, uncovered problems with E. I. duPont's new herbicide, Imprelis. Three months later, the U.S. Environmental Protection Agency forced a recall of the product, and DuPont found itself liable for millions of dollars in settlements and legal fees. This anecdote (and other similar ones) suggests that social media can have a disciplining effect of on corporate behavior. Whether cases like the Imprelis recall reflect a general and sizable economic phenomenon is another question, which is open for future research.

5. Related Firms

5.1. Competitors

Competition is believed to discipline managerial behavior in several ways. Hart (1983) suggests that lower (competitive) prices can limit the opportunity for discretionary behavior. Investors can observe the behavior and disclosures of other market players as they evaluate their own managers' actions. And Schmidt (1997) argues that the need to preserve a firm's competitive edge prevents managers from wasting or excessively consuming corporate resources.

Despite its intuitive appeal, the idea that competition unambiguously reduces agency problems has been questioned by some theorists.[13] Critically, Schmidt (1997) argues that the reduction in profits due to competition can make it less attractive for managers to exert high effort. This suggests that the relation between competition and managerial slack is not monotonic. Moreover, competition could also induce suboptimal behavior. For example, managers under intense competitive pressure could be tempted to bend the law, misreport, or seek other ways to increase profits at the expense of other stakeholders. Perhaps for these reasons, early research on the association between competition and corporate performance provides sparse and not fully conclusive evidence (see Allen and Gale, 2000, section 3.2 for a review).[14]

Rather than exploring the empirical association between competition and corporate performance, more recent empirical work has focused on the interaction between competition and other governance mechanisms. This alternative research avenue has proven more fruitful at

[13] The effect of competition on managerial slack has been shown to be sensitive to theoretical assumptions. For example, Hermalin (1992) shows that the conclusion that competition reduces agency costs requires the assumption that agency goods (e.g., shirking) are normal goods for the executive.
[14] A prominent example of this early literature is Nickell (1996).

providing evidence that competition mitigates agency costs, as it speaks of the specific channels by which competition affects executive behavior. In particular, Guadalupe and Perez-Gonzalez (2010) document a negative cross-country association between two indexes of product and input market competition and the voting premia between shares with differential voting rights. They interpret this evidence as suggesting that competition can help curb the private benefits of control.

Other papers have studied the interaction between competition and the disciplining effect of the takeover market. Giroud and Mueller (2011) examine whether the association between Gompers, Ishii, and Metrick (2003)'s governance index (the G-index) and stock returns varies with industry competition, and find that the relation between the G-index and equity returns holds only in noncompetitive industries.[15] Some of these recent papers enhance identification by exploiting changes in governance regulation. Giroud and Mueller (2010) exploit legislation that reduces the threat of a hostile takeover—legislation they interpret as a reduction in corporate governance intensity.[16] They find that, while firms in non-competitive industries experience a significant drop in operating performance after the laws' passage, firms in competitive industries experience no significant effect. They support this finding with additional tests on input costs, wages, overhead costs, and abnormal returns around the regulatory announcements. Beyond the takeover market, Chhaochharia, Grinstein, Grullon, and Michaely (2017) show that SOX (a regulation aimed at mitigating agency conflicts) improved efficiency mainly in the less competitive industries. Overall, the results of these papers are consistent with competition being a powerful substitute governance mechanism.

[15] More recently, Cosset, Some and Valery (2016) extend this literature by showing that the governance role of competition is especially pronounced in countries with relatively lower level of economic and financial development and investor protection.

[16] Specifically, they analyze business combination laws imposing a moratorium that hindered corporate raiders from gaining access to the target firm's assets for the purpose of paying down acquisition debt, thus making hostile takeovers more difficult and often impossible.

Another recent strand of the corporate governance literature explores the interaction between competition and managerial contracting. Theoretically, the effect of competition on managerial slack has been shown to be sensitive to the manager's compensation scheme (Scharfstein, 1988). But firms may also adjust monetary incentives (i.e., pay-performance sensitivities) depending on the level of competition. On the one hand, competition and incentives could be substitutes. If competition acts as a disciplinary mechanism to reduce managerial slack, then firms under greater competitive pressure will provide weaker incentives, because their managers are already motivated by competitive pressure. On the other hand, competition and incentives could be complements. Raith (2003) proposes a model for how this might work: Firms subject to greater competitive pressure (modelled as product substitutability) provide stronger incentives (modelled as pay-for-performance sensitivity) to induce managers to compete, and prices become more volatile.

The empirical evidence is generally consistent with the notion that competition and incentives are complements. To begin, the literature documents a positive empirical association between competition and incentives (e.g., Karuna, 2007).[17] Other papers enhance identification by exploiting regulatory changes. In particular, Cuñat and Guadalupe (2009) study two deregulation episodes in the banking industry and find that the variable components of pay increased along with performance-pay sensitivities (though compensation levels remained similar as the fixed component of pay fell). Assuming that deregulation results in more

[17] Besides identification issues, this research also faces the challenge of measuring competition. As explained by Karuna (2007), product competition is a multidimensional concept related not only to industry concentration but also to product substitutability, market size, and entry costs. The traditional measures of competition based on industry structure (e.g., Herfindahl Hirschman indices) require that industry or market membership be explicitly defined, but industry classification of firms is a long-standing problem in financial research (Kahle and Walkling, 1996; Bhojraj, Lee, and Oler, 2003). Recent literature provides new ways of identifying competitors based on text analysis (Hoberg and Phillips, 2010), but measuring the degree of competition still faces important challenges given the complexity of the competition dynamics.

competition, the authors interpret these results as consistent with tighter competition in the product markets leading to more powerful incentives.[18]

An alternative way for firms to incorporate product market dynamics when designing compensation contracts is to make the managerial pay-off depend on the performance of industry peers. Two measures—firm performance and peer performance—would be used, each having an optimal weight in equilibrium. When the weight on peer performance is negative, the adjustment is commonly referred to as "relative performance evaluation" (RPE). The usual argument in favor of placing a negative weight on peer performance is that peer performance captures the part of firm performance that reflects common industry variation and cannot be attributed to managerial actions. Accordingly, subtracting peer performance isolates the part of performance for which the manager deserves credit and shields the manager from risk (see Holmstrom, 1982).

While this perspective of RPE provides important insights, it does not fully incorporate the effect of strategic competition. Aggarwal and Samwick (1999) show that this consideration is particularly important when the assumption of perfect competition is relaxed. In particular, their model shows that, when peers' products are strategic complements, the optimum weight on peer performance is *positive*, because this incents their managers to soften product market competition (which is optimal for shareholders when peers' products are complements). In contrast, when peers' products are strategic substitutes, the optimum weight on peer performance is negative. In this case, the optimum contract would resemble relative performance pay, but is

[18] As explained by Dunning (2012) and Gow, Larcker and Reiss (2016) using regulatory shocks for identification is not completely free from endogeneity and interpretation issues.

motivated by the nature of the strategic competitive interaction rather than by a desire to filter out common industry variation.[19]

The empirical literature has tested the hypothesis that compensation contracts incorporate RPE. The hypothesis is formulated in a strong form and a weak form. The strong form considers whether compensation contracts completely remove the component of performance that is common to all peers. Failure to remove this component would suggest that, to an extent, executives are "paid for luck." The weak form considers whether compensation contracts remove to some extent (though perhaps not completely) the common performance component; that is, whether firms include some measure of peer performance in compensation contracts. Failure to make this adjustment would suggest that compensation contracts are suboptimal.

The early literature generally rejects the RPE hypothesis in its strong form (i.e., that managers appear to be "paid for luck," at least to some extent) and provides mixed evidence on the weak form (i.e., that firms use RPE adjustments at all) (see Alburquerque, 2009 for a review of this early literature). The mixed evidence spurred substantial debate. On the theoretical side, some authors argued that a degree of "pay for luck" might make economic sense (see Edmans and Gabaix, 2009; 2017 for a review).[20] On the empirical side, the inferences of this early evidence were found to be sensitive to which peer firms were used as benchmarks. More recent research, which uses more refined benchmark groups or publicly disclosed peer firms (in 2006 the SEC introduced the requirement to disclose the peers used as benchmarks in compensation

[19] Although from a different perspective, the evidence in DeFond and Park (1999) also highlights the importance of competition to understand how firms use relative performance evaluation. These authors find that RPE is used more often for CEO dismissal decisions in firms operating in more competitive industries.

[20] A brief summary of the arguments is as follows. First, because managers have private information about industry prospects, making the contract contingent on industry prospects avoids interim renegotiation (Axelson and Baliga, 2009). Second, tying pay to industry performance induces the risk-averse manager to choose firm's exposure optimally (Gopalan, Milbourn, and Song, 2010). Third, past performance unrelated to CEO effort provides information about intrinsic firm quality (and thus future cash flow generation potential) (Noe and Revello, 2008).

contracts), does find evidence of RPE.[21] However, these findings have not closed the debate about RPE. In particular, it is still unclear why a substantial number of firms do not use RPE (Carter, Ittner, and Zechman, 2009; Gong, Li, and Shin, 2011; Li and Wang, 2016). Moreover, there is conflicting evidence on whether firms' selection of benchmark peers is opportunistic (Gong, Li, and Shin, 2011; Bizjak, Kalpathy, Li, and Young, 2017).

Despite all this research, we need more work to better understand the role of peer benchmarking in corporate governance. Particularly interesting is the potential disciplining effect of peers through shame and aspiration. Spill-overs and mimicking reactions in corporate governance are still under-researched.

The discussion so far has focused on the governance of firms competing in the product markets, yet firms also compete in the labor market. Does competition for labor help curb managerial rent-seeking? Not necessarily, according to Acharya and Volpin (2010). These authors argue that corporate governance decisions in one firm could introduce distortions in the market for executive talent. Specifically, if firms with weaker governance offer excessively generous compensation packages, other firms could be induced to overpay their management in order to match the industry norms. Unlike competition in the product market, this could detrimentally affect corporate governance. More research is needed to understand whether such governance externalities outweigh the potential disciplining effect of competition in the labor market.

[21] See Albuquerque, 2009; Lewellen, 2015; Jayaraman, Milbourn and Seo, 2015; Nam, 2016; Drake and Martin, 2017.

5.2. Suppliers, Customers, and Partners

Firms often engage in contracts with other firms, agreements that are either "vertical" (e.g., supply contracts) or "horizontal" (e.g., joint ventures or strategic alliances). Because corporate suppliers, customers, and partners have economic interests in the firm, they too are considered stakeholders.[22] To the extent that contracting parties have incentives to ensure that the firm honors its contractual commitments, they can exert a disciplining effect on managerial behavior.

Inter-firm relationships are subject to a number of information asymmetry and moral hazard problems. Competitors can use knowledge flows to extract information rents from the relation (Baiman, Fisher, and Rajan, 2001). Firms can use funding from partners to cross-subsidize other projects (Lerner and Malmendier, 2010). And an established firm can exploit a strategic alliance with an entrepreneurial firm to take over the market of the younger firm (Mathews, 2007).

A substantial body of theoretical literature has explored the role of explicit and implicit contracting on inter-firm relations. This literature recognizes the need to deal with incompleteness in contractual relations, and proposes solutions designed to minimize inter-firm transaction and agency costs. For example, both partners could write an initial contract with commitments not to renegotiate (Edlin and Reichelstein, 1996), or buy an equity stake in the partner firm (e.g., Allen and Phillips, 2000; Fee, Hadlock, and Thomas, 2006; Mathews, 2006). Other contractual solutions rely on accounting numbers. In particular, the contract could include financial covenants (Costello, 2013) and selected performance measures. Partner firms could

[22] Dhaliwal, Judd, Serfling and Shaikh (2016) provide evidence consistent with the notion that customer suppliers have a substantial economic interest in customer firms. Their results are suggestive that a more concentrated customer base increases a supplier's risk.

renegotiate the contract or enter implicit contracts based on an outcome that is observable but not contractible (Baiman, Fisher, and Rajan, 2001).

The literature provides evidence that certain corporate actions are affected by contracts with suppliers and customers. One example of these actions is reporting behavior. In particular, Hui, Klasa, and Yeung (2012) show that when a firm's suppliers or customers have greater bargaining power, the firm recognizes losses more quickly. However, these contracts could also induce opportunistic behavior. For example, Raman and Shahrur (2008) provide evidence of strategic reporting around inter-firm relations, which suggests that accounting discretion could be used opportunistically to influence the suppliers' and customers' perceptions about the firm's prospects.

In sum, while the literature suggests that firms' actions are influenced by suppliers, customers, and partners, more research is needed to understand to which extent these stakeholders are an effective force to discipline managerial behavior.

6. The Government

Governments have a variety of interests in the firms incorporated in their jurisdiction. To begin with, governments often hold a substantial equity stake in individual corporations—a number of companies around the world are fully owned and/or controlled by a national government. But even governments not involved in direct ownership have an interest in corporations, because firms generate employment and tax revenue, and because corporate behavior exerts social, environmental, and economic externalities on the community.

Whether, and to what extent, the government should be involved in corporate governance is part of a broader debate about government intervention in the economy.[23] This debate centers on whether market forces alone can rein in rent-seeking behaviors by management. If market forces are not enough, then other questions arise: Can the government monitor individual firms effectively enough to justify the cost in public resources? And are the government's incentives to monitor individual firms aligned with public interests?

To address these questions, one must first clarify who, exactly, the government is. According to the *Oxford English Dictionary*, the government is "the group of people with the authority to govern a country or state." This broad definition contrasts with the term's frequent use as a descriptor for the top officials of the executive branch (i.e., "the ministry," also known as "administration" or "cabinet" in the US). In this article, I use this term in its broadest sense, as referring to the institutions at all levels of the legislative, executive, and judicial branches, as well as to the individual members of these institutions.[24] Because different members of the government can have different incentives, I analyze separately the three groups of government members that are most likely to affect managerial behavior: judges, politicians, and government agencies.

6.1. Judges

Courts interpret and apply the laws in the name of the society. In the common law system, the judiciary also "makes" law by setting precedents for subsequent cases. Therefore, if a country's legal system provides protections against managerial abuse, then judges should play a

[23] The Government establishes monetary and fiscal policies (income and corporate taxes), gives subsidies and imposes tariffs, among other things.
[24] For example, in the US, this definition of "the government" includes both state and federal institutions (legislative, executive, or judicial), agencies corresponding to executive departments (e.g., the Department of Justice or DOJ), and independent agencies (e.g., the Securities and Exchange Commission or SEC).

role in corporate governance—a role that includes protecting not only capital providers but a variety of stakeholders of firms. For example, competition law and consumer law are intended to protect consumers, and labor laws are designed to protect employees. The effects of these laws depend partly on the efficacy of the judiciary. This efficacy may be questioned if judges' reputational incentives are not strong enough to preserve their integrity. In addition, firms could self-select into the judiciary system in a way that is most favorable to managers. As such, the efficacy of the judiciary system to discipline managerial behavior is an empirical question.

A series of papers, starting with La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997), provide evidence that protection of shareholders and creditors by the legal system is central to international patterns of corporate finance and market valuations (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 2002). Using country-level data on commercial (primarily corporate and bankruptcy) laws, these papers show that legal origin (i.e., whether a country has common law or civil law) can explain a substantial variation in legal rules, and that countries with a common law tradition appear to have more developed financial systems, as reflected in the breadth and depth of the capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation. This suggests that, in places where common law system judges "make" law by setting jurisprudence, the judiciary plays a significant role in shareholder protection.

A strand of the accounting literature supports the findings in La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 2002) by documenting that firms in countries with stronger investor protection are less likely to manage earnings and use more conservative accounting (Leuz, Nanda, and Wysocki, 2003; Bushman and Piotroski, 2006), while enjoying a lower cost of capital (Hail and Leuz, 2006). However, the evidence in La Porta el al (1997; 2002) has been

widely debated, for reasons both theoretical and empirical (notably measurement error and omitted correlated variables). Some critics view the empirical issues as serious enough to call into question some of the studies' inferences (e.g., Spamann, 2010).[25]

6.2. Politicians

Politicians have legislative power in both common law and code law countries. While these government officials have strong reputational and electoral incentives to promote social welfare, nothing guarantees that the politicians' use of legislative power will align with the public interest. Notably, politicians could pass laws to extract personal rents or to please special interest groups. They may also act for electoral reasons. For example, critics of government interventions in the economy often argue that such interventions too often are rushed, political responses to populist demands following crises or scandals, as opposed to being grounded in economic analysis.

In common law countries (notably the US), critics question whether legislators should introduce statutory rules in situations where case law can substitute for them. Moreover, US federal laws are often viewed as interference by the central government in the affairs of the states. The replacement of state law with federal law is hotly debated in the legal literature, as state law could also be affected by political opportunism (e.g., Bebchuk and Hamdani, 2006). The debate is not unique to the US; similar conflicts between local and central authorities exist in other parts of the world, notably in the European Union.

[25] Spamann (2010) makes several corrections to the "antidirector rights index" in La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998). The corrected index fails to support some of the previously documented results. Moreover, Mahoney (2009) argues that legal indices like those used in La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998) miss large differences in legal institutions because coding substantive and procedural rules fails to capture how the law is actually used. For a thorough analysis of this literature and its criticisms I refer the interested reader to La Porta, Lopez-de-Silanes and Shleifer (2008).

At the heart of the debate over federal statutory laws lies corporate governance—and, more specifically, securities laws that are designed to protect capital providers through disclosure requirements, liability standards, and enforcement powers. The creation of a legal system is easily justified by the presence of externalities, but the need for securities law is less obvious. In addition to their general critiques of federal statutory law, critics question whether a government-specified contracting framework can really improve upon shareholder-designed mechanisms for preventing managers' self-interested behavior. Securities law also begs the question of why, in the case of a breach of agreement, contract and tort law are not sufficient to deal with the contractual abuses.

In the literature, the theoretical justification for securities laws is that they address frictions that undermine contracting efficiency (e.g., Hart, 2009; Zingales, 2009). I will highlight two such frictions. The first is asymmetric information between contracting parties. Although the parties have an incentive to reveal their type to one another, proprietary costs and bounded rationality prevent complete unravelling. The second is that the contractual relationship could face significant enforcement challenges, which erode the parties' ability to commit ex-ante. While the parties can design their own contractual sanctions, the penalty necessary to deter bad behavior may be too large for the offending party to pay. In contrast, the government can enforce regulatory contractual terms by imposing jail penalties. Moreover, specific rules can reduce enforcement costs below those of private tort and contract litigation, which are expensive and unpredictable.[26]

[26] Hart (2009) mentions two additional justifications of regulation: Moral hazard (i.e., some situations the pressure on government to intervene ex post is so great that it cannot credibly commit not to do so, thus leading to suboptimal ex-ante behavior) and influencing tastes (i.e., regulation or law may be implemented at least partly to legitimize or de-legitimize an activity in the public's mind).

During the last decade, politicians' interest in corporate governance has extended beyond corporate disclosure and securities markets. For example, in Sarbanes-Oxley and Dodd-Frank, the U.S. Congress introduced specific requirements about board composition and shareholder empowerment (e.g., say-on-pay, proxy access). The rationale for these laws is that market forces lack sufficient power to curb managerial opportunism. Moreover, Congress's imposition of specific practices seems to reflect an assumption that, while some features in the design of corporate governance systems are socially desirable, other features should be avoided. This line of reasoning is controversial; the distinction between intrinsically "good" and "bad" corporate governance practices and the idea of imposing uniform practices on all firms (i.e., a "one-size-fits-all" approach) have generated substantial debate among practitioners and academics (e.g., Armstrong, Guay, and Weber, 2010).

One way of empirically analyzing the role of politicians in corporate governance is to examine the economic consequences of the legislation described above. In this regard, cross-country evidence suggests that stricter and better-enforced securities regulation is associated with higher financial market development (La Porta, Lopez-De-Silanes, and Shleifer, 2006). While this evidence supports the use of securities regulation in general, the literature on specific US regulations is less conclusive. As explained by Leuz and Wysocki (2016), the early empirical literature on disclosure regulation primarily analyzes the effects around the Acts of 1933 and 1934 and, overall, is somewhat negative or at least skeptical about the net benefits of such regulation.[27] The evidence on subsequent developments in securities law, notably the Sarbanes Oxley Act of 2002 (SOX), is mixed and even conflicting.[28] Research on the impact of SOX on

[27] That said, these studies and their interpretations have been heavily debated and repeatedly challenged.
[28] For example, Akhigbe and Martin (2006), Jain and Rezaee (2006), and Li, Pincus and Rego (2008) find positive abnormal returns to events that increased the likelihood of the passage of SOX. In contrast, Zhang (2007) finds

shareholder wealth suggests that the act had heterogeneous effects: it introduced significant costs and benefits, resulting in clear winners and losers.

Several studies use standard event study methodologies to analyze how federal corporate laws that impose specific governance standards affect shareholder wealth. Larcker, Ormazabal, and Taylor (2011) take a broad sampling of legislative events related to say-on-pay (SOP), proxy access, and specific governance provisions (e.g., classified boards, CEO duality) and conclude that broad government actions that impose specific governance choices are value destroying. Other studies focus on specific legislative requirements. Cai and Walkling (2011) examine shareholder returns to the passage of the Say on Pay Bill of 2007 and conclude that the legislation increases value for firms with inefficient compensation but can destroy value for others. Becker, Bergstresser, and Subramanian (2013) and Cohn, Gillan, and Hartzell (2016) study more recent events related to the SEC's proxy access rule and interpret their evidence as suggesting that financial markets place a positive value on shareholder access *except* in firms with shareholders whose interests may deviate from value maximization.

In sum, studies on events related to US federal laws imposing governance practices do not allow for definitive conclusions about the effects of these laws on social welfare. Moreover, any conclusions that are based on the stock market reactions to these legislative events are subject to at least two caveats. First, although the cross-sectional variation in announcement returns documented by these studies suggests that the laws introduce costs and benefits for shareholders, gauging the average net effect of these legislations on shareholder value is challenging (note, for example, that average sample returns could be confounded by concurrent

negative abnormal returns to legislative events leading up to the passage of SOX. Moreover, studies on specific disclosure rules.

market-wide news). Second, these studies focus on shareholder wealth and thus do not speak to the broader social welfare effects of the legislation.

Adding to the controversy about the role of politicians in corporate governance is a substantial body of literature on corporate political connections. This literature, which is mainly interested in managers' objectives in building political connections, notes that managers often spend corporate resources to build political connections, which can either result in an increase of corporate profits (for example, political connections can be instrumental in obtaining government contracts) or be used to extract personal benefits (for example, the connection can expand the manager's personal network). Managers may also spend shareholder money to support politicians they prefer, which may not align with shareholder interests.

The evidence generally supports the notion that political connections are valuable for shareholders (e.g., Faccio, 2006; Goldman, Rocholl, and So, 2009; Cooper, Gulen, and Ovtchinnikov, 2010).[29] However, there is also evidence that political links are associated with lower enforcement (e.g., Yu and Yu, 2011; Correia, 2014).[30] The effects of lower enforcement on shareholder wealth are not straightforward—a lower likelihood of prosecution could benefit shareholders, but could also reduce managers' liability and therefore increase opportunism.

[29] A substantial part of this literature suggests that political connections are beneficial to shareholders. In particular, several papers provide evidence of a positive association between political connections and firm value. For example, Cooper, Gulen and Ovtchinnikov (2010) find that political contributions are positively correlated with future firm performance; Goldman, Rocholl and So (2009) find positive abnormal returns to adding a politically connected individual to the firm's board of directors; and within the context of the Crisis, Acemoglu, Johnson, Kermani, Kwak and Mitton (2016) report that financial institutions connected to Timothy Geithner experienced an abnormal return of 6% on the day he was announced as nominee for Treasury Secretary. Other studies examine specific benefits of political connections. These studies generally find that political connections facilitate access to capital (e.g., Khwaja and Mian, 2005; Faccio, Masulis and McConnell, 2006; Leuz and Oberholzer, 2006; Claessens, Feijen and Laeven, 2008), can be instrumental in winning government procurement contracts (e.g., Goldman, Rocholl and So, 2013; Tahoun, 2014), can favorably influence tax policy (e.g., Brown, Drake, and Wellman, 2015), and can reduce the negative effects of government policy uncertainty on corporate investment (e.g., Wellman, 2016).

[30] The results in Yu and Yu (2011) and Correia (2014) suggest that political lobbying reduces and delays the likelihood of prosecution by the SEC. Outside the US, Bourveau, Coulomb and Sangnier (2016) show that managers connected to Nicolas Sarkozy were shielded from prosecution for violations of French insider trading laws after Sarkozy won the 2007 French presidential election.

Whether the cost is borne by shareholders or other stakeholders (for example, society as a whole), an increase in managerial opportunism can hardly be optimal from a societal perspective. Moreover, the abundant evidence of political favoritism documented by this literature seriously questions the efficacy of politicians in corporate governance.

6.3. Government Agencies

Government agencies are a core part of the enforcement system required for the application of the law. In the United States, some agencies are administered by executive departments (e.g., the U.S. Department of Justice); others are called "independent" because the president has only limited power to dismiss the agency head or agency members (e.g., the SEC). The agencies differ not only in their realms of authority but also in their power to develop and enforce regulation (i.e., to bring civil and/or criminal cases and impose administrative sanctions on firms and individuals for violations). The officers and staff of these agencies have reputational and career incentives, as they can be promoted to higher positions or receive an offer from the industry.

The importance of enforcement for the development of financial markets is widely recognized. In fact, after La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) documented an association between legal tradition and financial development, their critics noted that the country's enforcement intensity could be a confounding effect; that is, the development of the financial markets could depend as much on enforcement as on the letter of the law. Since then, the literature has worked to empirically distinguish the effect of enforcement from that of the underlying rules. Christensen, Hail, and Leuz (2013, 2016) study enforcement changes in the European Union and find substantial capital market benefits associated with these changes, but mainly in countries with stronger pre-existing enforcement intensity.

While the need for enforcement is widely accepted, enforcement efficacy is controversial. The debate involves not only the existence of frictions in the enforcement process but also the substitutability of enforcement mechanisms. To clarify, the literature distinguishes between "private enforcement" and "public enforcement." The former refers to the actions taken by private parties (e.g., investors or interest groups) to enforce laws and/or regulations; these actions include market discipline and any other non-regulatory force that induces firms to comply with a regulation (Jackson, 2008; Karpoff, Lee, and Martin, 2008a, 2008b). The latter refers to the actions taken by public parties (e.g., government agencies).

A key issue in the debate on enforcement efficacy is whether public enforcement is needed, given that laws can be enforced by private parties. If private litigation can address conflicts between market participants, then why should society spend significant resources on regulatory enforcement? Indeed, La Porta, Lopez-de-Silanes, and Shleifer (2006) interpret their results as suggesting that public enforcement has little effect on stock market development, and that laws facilitating private enforcement through liability rules do benefit stock market development.

Adding to skepticism about the efficacy of public enforcement is the perception that the process is subject to substantial frictions. The literature has pointed out two such problems: inefficient bureaucracies and regulatory capture (Stigler, 1971; Watts and Zimmerman, 1978, 1986).[31] Moreover, even if, despite these frictions, public regulators are effective in enforcing penalties for observed (i.e., already identified) violations, it is unclear whether they have enough resources and expertise to proactively identify a sufficient number of violations.

[31] The expression "regulatory capture" refers to a regulatory agency not acting in the interest of society as a whole but rather favoring commercial or specific ideological interests.

The above suspicions are supported by a substantial body of empirical work. In the accounting literature, several papers provide evidence that the SEC's enforcement activity is not immune to political influence. Correia (2014) finds that firms with higher political contributions and more intense lobbying are less likely to be involved in an SEC enforcement action and face lower penalties when they are. More recently, Mehta, and Zhao (2016) document that firms with powerful representation on the U.S. congressional committees that oversee the SEC are less likely to face regulatory scrutiny for financial misconduct.[32] There is also evidence that limitations in SEC resources affect enforcement intensity. For example, the location of SEC offices appears to affect not only the probability of investigation (Kedia and Rajgopal (2011) but also the auditor's behavior (DeFond, Francis and Hu, 2011).

But private enforcement could also be subject to its own problems. Private ordering might degenerate into an anarchic situation where the strong prevail. Courts, like regulators, could be biased, uninformed, and corruptible (Johnson, McMillan, and Woodruff, 2002; Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2003). And some scholars question the efficacy of private litigation. They argue that the costs that executives and directors incur from litigation are too low to discipline managers (Alexander, 1991; Coffee, 2006), and that shareholders' incentives to litigate are insufficient, since recovery rates from litigation usually amount to only a small percentage of losses (Milev, Patton, and Starykh, 2011). The evidence in Jackson and Roe (2009) suggests that the frictions in the private enforcement process could be substantial enough to justify the use of public enforcement. Unlike La Porta, Lopez-de-Silanes, and Shleifer (2006), these authors find that public enforcement is more important than private

[32] However, Heese, Khan, and Ramanna (2017) find that firms' political connections positively predict comment letter reviews and substantive characteristics of such reviews, including the number of issues evaluated and the seniority of SEC staff involved. Their findings, which are specific to SEC oversight (which is not necessarily related to financial fraud), contrast with the findings in papers that study SEC enforcement actions (e.g., Correia, 2014).

liability rules in explaining financial market outcomes around the world. The key difference of the Jackson and Roe (2009) study is that the authors measure intensity in public enforcement using securities regulators' resources, whereas La Porta et al. used enforcers' empowerment.

The accounting literature also provides some evidence that public enforcement works. Del Guercio, Odders-White, and Ready (2017) suggest that SEC efforts may have a deterrent effect on insider trading. Jennings, Kedia, and Rajgopal (2011) find that greater SEC fraud enforcement deters peer firms from making aggressive financial reporting choices. Jayaraman (2012) shows that insider-trading enforcement is associated with a significant increase in timely loss recognition in firms from a variety of countries. Thevenot (2012) shows that the threat of public enforcement deters insider trading around GAAP violation episodes. And when De Haan, Kedia, Koh, and Rajgopal (2015) analyze career incentives for a sample of trial lawyers at the SEC's enforcement division, they find evidence that "revolving door" incentives lead to higher enforcement efforts.

Overall, the existing empirical research suggests that, while judges, politicians, and regulatory agencies are an important part of corporate governance, their role in disciplining managerial behavior is subject to inefficiencies. To better understand how to mitigate these problems, researchers must change the dialogue from *whether government monitoring matters* to *what matters in government monitoring*. In particular, little is known about the magnitude of enforcement costs, about the determinants of the cost of regulatory actions, and about the optimal assignment of enforcement authority.[33] This line of inquiry opens interesting avenues for

[33] There is an ongoing debate in the US over the consolidation of regulatory agencies and the delegation of authority to second-tier regulators such as SROs (see Coffee, 2009). Unlike other countries, the US maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures. This might cause a problem of fragmented authority. For example, the US has one agency (the SEC) to regulate securities and another (the CFTC) to regulate futures. The world of derivatives is thereby divided between the two, with the SEC having jurisdiction over options, while the CFTC has jurisdiction over most other derivatives.

accounting research. One example is the design of metrics to measure enforcement effectiveness.[34] A second example is the role of disclosure in enforcement; while the literature has established that mandatory corporate disclosure is a key component of enforcement (e.g., La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997), there are a number of dimensions of this role that call for further research.[35]

7. Private Regulators

Government agencies often delegate significant regulatory authority to private industry organizations that are owned and operated by their members and are commonly referred to as self-regulatory organizations (SROs). One of the SROs' tasks is to design rules governing their members' practices. In addition, some SROs are responsible for enforcing their own rules as well as certain federal laws (they conduct disciplinary proceedings and impose sanctions on members for violations). Examples of SROs include stock and option exchanges (notably the New York Stock Exchange and the Chicago Board Options Exchange) and securities associations such as the Financial Industry Regulatory Authority (FINRA). The SEC delegates responsibility for standard setting in the accounting profession to the Financial Accounting Standards Board

[34] Some examples of metrics to measure enforcement effectiveness are the percentage of enforcement cases successfully resolved (i.e. resulting in a settlement), the percentage of cases deemed to have "high impact," and the percent of cases that are internally generated.

[35] For example, the evidence in Files (2012) suggests that voluntary disclosure can be a mechanism through which firms obtain more lenient treatment by the enforcing authority. In particular, the author shows that forthright disclosure of a restatement (e.g., disclosures reported in a timely and visible manner) reduces the likelihood of an SEC sanction or SEC monetary penalties. Equally if not more important are disclosures by and about the enforcing agency itself. The effects of such disclosures are unclear. On the one hand, information about SEC activity could weaken enforcement. For instance, Kedia and Rajgopal (2011) show that firms located closer to the SEC and in areas with greater past SEC enforcement activity—both of which proxy for firms' information about SEC enforcement—are less likely to restate their financial statements. On the other hand, Duro, Heese, and Ormazabal (2017) show that, after the SEC began publicly disseminating comment letters in 2005, the oversight efficacy of these letters increased substantially. They explain these results as suggesting that the public disclosure of the letters enhances the disciplining effect of the market.

(FASB), and regulation and oversight of the audit profession to the Public Company Accounting Oversight Board (PCAOB).[36]

Self-regulation in the securities industry has traditionally been understood to have several advantages over government regulation. To begin with, self-regulation can save taxpayer money; SROs are funded by the entities they regulate and not the government. A second advantage is access to expertise. Private regulators consist of practicing professionals, who may be aware of nuances of market practice that elude government rule-makers with less (or less up-to-date) industry experience. Moreover, the standards imposed by private regulators often include rules of ethics and conduct that extend beyond strictly legal requirements, so self-regulation by private regulators could help raise the standard of conduct in the industry.

Less positive, however, is the notion that self-regulation could serve particular interests and not the public at large. This potential for self-interest, which is inherent in the self-regulatory model, means that oversight by the public regulator—the regulator who is delegating authority to the SRO—is essential. Indeed, DeMarzo, Fishman, and Hagerty (2005) show theoretically that, without government intervention, the objective to maximize members' welfare leads SROs to choose an enforcement policy that is more lenient than is socially optimal. This potential for self-interest has led to the requirement that the government approve the rules and standards issued by private regulators (for example, the SEC approves accounting standards and listing rules).

The specific characteristics of the different SROs call for a separate analysis of their incentives to discipline managerial behavior and the frictions that could hamper this disciplining

[36] Compared to other private regulators, the PCAOB has some unique features. It is neither a not-for-profit corporation nor a government agency, but was established by congressional legislation substituting a prior self-regulatory body, the American Institute of Certified Public Accountants (AICPA). Moreover, unlike other self-regulatory organizations, the PCAOB is funded by public companies rather than by the industry it regulates (i.e., the audit industry). Finally, no more than two of its five full-time members can have professional backgrounds as accountants or auditors. The purpose of these organizational features is to preserve the independence of PCAOB from the accounting profession, even at the expense of sacrificing some advantages of the more self-regulatory framework prior to SOX, notably the industry expertise of regulators.

role. I conduct this separate analysis focusing on the two private regulators that have attracted most of the attention of accounting researchers; stock exchanges and standard setters.

7.1. Stock Exchanges

Stock exchanges have an incentive to create trust among buyers and sellers of securities. Any lack of trust would reduce the depth and liquidity of the securities market, resulting in less trade (which is a main source of revenue for exchanges). To create trust among market participants, exchanges design trading mechanisms, monitor trading, and impose requirements on listed companies. In particular, exchanges impose disclosure and corporate governance standards on issuers. For example, the NYSE mandates that a majority of directors on the board be independent, as well as other board and director characteristics.

A usual concern about exchanges' regulatory role is that competitive pressures could temper the incentive for high governance standards. That is, exchanges could be reluctant to discipline companies for fear of discouraging listings (firms could select an alternative, less demanding, exchange). While plausible, this argument implicitly assumes that liquidity traders are unable to allocate their demands to the exchanges and firms of their choice. As shown by Huddart, Hughes, and Brunnermeier (1999), once this assumption is relaxed, competition leads to a "race-to-the-top" (as opposed to a "race-to-the-bottom") in listing standards.

Another concern is the recent tendency of exchanges to move towards demutualization—the process of converting exchanges from nonprofit, member-owned organizations to for-profit, investor-owned (and sometimes even publicly traded) corporations.[37] Critics maintain that demutualization engenders a conflict of interest between an exchange's profit motive and its regulatory function, making the exchange reluctant to pursue enforcement actions and impose

[37] See Aggarwal (2002) for an explanation of the institutional details of demutualization and the causes of its recent increase.

penalties on major providers of revenue. The counterargument is that the exchange's reputation and branding could be even more important in a demutualized environment, as the exchange works to protect its commercial viability. These differing views seem to find counterparts in the disparate regulatory approaches adopted by for-profit stock exchanges around the world (Aggarwal, 2002).[38]

There is some evidence supporting the notion that stock exchange rules are effective. The literature on international cross-listings (see section 9) documents market benefits to listing on an exchange with higher governance standards. Also consistent with higher listing requirements being beneficial to shareholders, the share price reaction for exchange listings is higher than that of SEC Rule 144a private placements and OTC listings (e.g., Miller, 1999). However, these market effects could be confounded by other institutional features, including the legal system of the foreign country. De Carvalho and Pennacchi (2012) provide evidence that is less sensitive to this concern. They study the creation by Bovespa (São Paulo Stock Exchange) of three markets for listing, each with its own corporate governance listing requirements,[39] and find a positive impact on stock prices, trading volume, and liquidity for Brazilian companies that migrate their listing to these new exchanges. The authors conclude that shareholders view the governance changes associated with the new listing requirements as value-increasing. By showing that listing requirements are not inconsequential, this evidence suggests that stock exchanges can exert influence on firms' corporate governance. That said, we need more evidence to better understand whether and how stock exchanges curb managerial opportunism.

[38] The main variation is as follows: i) the exchange performs all regulatory functions, ii) the exchange establishes a separate entity to conduct regulatory functions, and iii) the exchange outsources this function to a separate entity.

[39] "Nivel 1" (the first level) has the least stringent governance requirements; "Nivel 2" (the second level) has more stringent requirements; and the "Novo Mercado" (the third level) has the most stringent requirements.

7.2. Standard Setters

High-quality reporting standards are believed to be critical to the information production required for informed investment decisions. Thus, accounting standards are seen as a core element of the regulation of capital markets.[40] A significant body of literature documents not only substantial capital market effects, but also real effects, of accounting rules (e.g., Leuz and Wysocki, 2016).[41] The growing literature on real effects suggests that accounting standards affect (and possibly discipline) managerial behavior.

Public criticism could harm standard setters' reputation and the social image of the accounting profession. As such, these regulators have an incentive to produce high-quality standards. However, decisions by standard setters often generate substantial debate, suggesting that the standard setting process is subject to significant frictions. Perhaps the most cogent criticism pertains to whether politics and the standard setters' individual preferences influence the standard-setting process. Starting with Watts and Zimmerman (1978, 1979), several studies have described the influence of political pressures on the formation of accounting regulation (Sunder, 1988; Zeff, 2002, 2005; Skinner, 2008). Lo (2003), Ramanna (2008), and Hochberg, Sapienza, and Vissing-Jorgensen (2009) all provide empirical evidence of the consequences of public lobbying by firms affected by accounting changes. More recently, Allen and Ramanna (2013) find that FASB members' financial background and political affiliations determine the likelihood of their proposing certain standards. Overall, these papers call for research on how to mitigate frictions in the standard setting process.

[40] https://www.sec.gov/rules/concept/34-42430.htm

[41] Leuz and Wysocki (2016) define the real effects of disclosure mandates as "situations in which the disclosing person or reporting entity changes its behavior in the real economy (e.g., investment, use of resources, consumption) as a result of the disclosure mandate".

8. Gatekeepers

Securities markets have long employed independent professionals who pledge their reputational capital to protect the interests of dispersed investors who cannot easily take collective action. These professionals—commonly referred to as "gatekeepers"—are another set of stakeholders of firms.[42] Typical gatekeepers include auditors (who assess issuers' financial statements), credit rating agencies (who assess issuers' creditworthiness), and security analysts (who assess issuers' capacity to generate future profits). In addition, proxy advisors, whose roles have been enhanced through recent institutional changes, can be considered gatekeepers, since they independently assess issuers' corporate governance practices in order to assist in investors' voting decisions.

Two incentives may encourage gatekeepers to provide credible certification. On the downside, the gatekeeper has an incentive to avoid misconduct in order to preserve its reputational capital. On the upside, the gatekeeper has a smaller economic interest in the company than the managers do, and thus receives only a limited payoff from involvement in misconduct. However, as explained below, this general objective function varies across gatekeepers.

8.1. Analysts

Financial analysts produce forecasts and opinions about the firms they follow. The theoretical justification of the role of financial analysts in corporate governance dates back to

[42] The term "gatekeeper" requires a clarification. As explained by Coffee (2002), this language has also been used more broadly to describe anyone who must give a necessary consent for a transaction or activity, literally or metaphorically (i.e., someone possessing blocking or veto authority). This broad definition encompasses a wide range of people and institutions such as directors and executive lawyers (e.g., the general counsel). Following the legal literature, this article will use the term "gatekeeper" more narrowly to mean a reputational intermediary who provides verification or certification services to investors. The notion that this verification disciplines managerial behavior is also explicitly stated in the literature. For example, Kraakman (1986) refers to gatekeepers as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers".

Jensen and Meckling (1976). These authors argue that, by conducting specialized monitoring, analysts reduce the agency costs associated with the separation of ownership and control. Specifically, analysts scrutinize firms' financial statements and ask questions of management during conference calls (Chen, Harford, and Lin, 2015). They also provide indirect monitoring by distributing public and private information to institutional and individual investors through research reports and media outlets such as newspapers and television (Miller, 2006). The investors can then use this information to detect managerial misbehavior.[43]

Analysts have incentives to produce accurate forecasts and recommendations, as their career opportunities increase with their professional reputation. However, the credibility of financial analysts—and thus their potential governance role—has been called into question. The concern mainly involves sell-side analysts, who often work for firms with investment banking operations. For these analysts, the need to develop and maintain profitable relationships with issuers could generate an incentive to offer optimistic advice (i.e., a conflict of interest with investors).[44] Indeed, there is empirical evidence on this bias (see Mehran and Stulz (2007) for a review).[45]

Public concern about analyst opportunism may have contributed to several regulatory developments in the 2000s. In 2000, Regulation Fair Disclosure (Reg FD) prohibited firms from making selective disclosures to analysts who worked for financial institutions with ties to the firm. In early 2002, the NYSE and the NASD approved rules that required research reports to

[43] Much of the academic research in this area centers on the conflicts of interest between analysts and sell-side or buy-side clients, which results in an optimistic bias in earnings forecasts. Firth, Lin, Liu, and Xuan (2013) provide a recent review of this literature.

[44] Analysts are also subject to other potential conflicts of interest. One such conflict arises from brokerage activities. A brokerage house benefits from more trading. If investors follow the recommendations of analysts, upgrades are more likely to generate trading than downgrades (when short-sales are expensive), since the investors most likely to trade on a downgrade are those who already hold the stock. Consequently, brokerage activities could make it advantageous for brokerage firms to produce more optimistic forecasts and recommendations.

[45] For a more recent review of this literature, see Firth, Lin, Liu, and Xuan (2013).

include information on the distribution of recommendations of the issuing firms. But the most important regulatory development affecting financial analysts may have come in 2003, when ten prominent financial institutions and several regulators signed The Global Settlement.[46] The signatory firms were forced to physically separate their research and investment banking departments to prevent the flow of information between the groups.

Although analysts' biases have been documented, the need for regulation of analysts depends not on whether these biases exist, but on whether the problems are sufficiently widespread and severe to justify costly regulation. When Mehran and Stulz (2007) review the research on regulations targeting financial analysts, they conclude that the regulations' net effect could be a reduction in market efficiency—less information is available for investors, but there is no observable decrease in analyst optimism.

The role of financial analysts in corporate governance has been explored empirically by Chen, Harford, and Lin (2015). Using broker closures and mergers for identification purposes, these authors find evidence consistent with the idea that financial analysts, by scrutinizing management behavior, play an important role in governance. Specifically, the authors show that, as analyst coverage of a firm decreases, the firm's shareholders value internal cash holdings less, the CEO receives higher excess compensation, the firm's compensation is less sensitive to the firm's performance, and the likelihood of value-destroying acquisitions increases.

There is also evidence that analyst coverage disciplines financial reporting. Yu (2008) and Chen, Harford, and Lin (2015) find that higher analyst following is associated with less earnings management. In a cross-country study, Degeorge, Ding, Jeanjean, and Stolowy (2013) document that this association is more pronounced in countries with highly developed financial

[46] The signatory regulators were the SEC, NASD, and the NYSE. Moreover, the document was signed by the New York State Attorney General.

systems. And Irani and Oesch (2013), exploiting reductions in analyst coverage resulting from brokerage house mergers, find that a reduction in coverage causes deterioration in financial reporting quality. Some of their results also suggest that a substitution effect may exist between analyst monitoring and other corporate governance mechanisms. In particular, they find that the effect of coverage on disclosure is more pronounced for firms with weak shareholder rights.

Taken together, the results from extant research indicate that, despite the issues in the analyst profession, analysts play a significant role on disciplining managerial behavior. However, there is still much to learn about the influence of analyst coverage on managerial actions and the interaction of the disciplining effect of these gatekeepers with that of other stakeholders. Also, more research is needed to inform the current debate on how to deal with the problems in the analyst industry.

8.2. Credit Rating Agencies

Credit rating agencies (CRAs) provide assessments (in the form of alphabetical ratings) on the creditworthiness of entities and their financial obligations (such as bonds and preferred stock). Because they certify the issuer's creditworthiness (or relative creditworthiness) and thus reduce informational frictions among issuers and investors, CRAs are part of the corporate governance system. Credit ratings are also used for regulatory and contracting purposes. For example, the minimum quality of short-term instruments required by US Rule 2a-7 is determined based on credit ratings, as is eligibility for issuers' use of streamlined SEC registration statements. In private contracting, letter ratings-based constraints appear in loan agreements, bond covenants, and other financial agreements.[47] Ratings are also used in institutional investors'

[47] Starting in the 1930s, financial regulators have required that their financial institutions heed the judgments of the rating agencies with respect to these institutions' debt investments. Credit ratings determine — as a matter of law — how much capital regulated institutions such as banks or insurance companies need to have on their balance sheets. The

in-house investment rules. The increasing use of credit ratings in financial regulation and contracting, together with the introduction of complex financial products and financial globalization, has greatly enhanced the role of CRAs in global capital markets.

At least two considerations suggest that credit ratings can exert a disciplining effect on managers. First, managers might be reluctant to pursue self-serving actions if these actions increase the probability of the firm receiving a downgrade. (And credit ratings reassessments are not inconsequential: research shows that reassessed ratings provide new information to the market (e.g., Katz, 1974) and affect the firm's cost of capital.) Second, CRAs directly assess the firm's corporate governance and incorporate this assessment into the ratings. The evidence in Anderson, Mansi, and Reeb (2004) and Ashbaugh-Skaife, Collins, and LaFond (2006) suggests that these assessments carry substantial weight in the ratings that are issued (the authors find statistically significant associations between credit ratings and certain governance variables). Thus, questionable governance practices could result in a lower rating.

As with other gatekeepers, CRAs have reputational incentives to produce unbiased credit risk assessments. However, the governance role of CRAs is controversial. CRAs have been cited as an important contributing factor not only in the accounting scandals of the early 2000's but also in the recent 2007-2008 Financial Crisis. Criticisms of CRAs focus on conflicts of interest, anticompetitive or unfair practices, poor disclosure practices, and the agencies' diligence and competence. The conflicts of interest arise because CRAs charge issuers for credit ratings while providing ancillary advisory services to those same issuers. Competition among rating agencies is limited due to a heavily concentrated industry; the regulators established barriers to entering this industry when they created the nationally recognized statistical rating organization (NRSRO)

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regulatory effects of credit ratings are not limited to banks and insurance companies. For example, money market funds are barred from investments rated lower than AAA (i.e., the highest rating category).

category, and have been criticized for using aggressive competitive practices to perpetuate their market power.[48] In their disclosure practices, CRAs have been accused of lack of transparency, selective disclosure of material information to their subscribers, and inadvertent disclosure of confidential information about rated issuers. Finally, critics have questioned the diligence and competence of CRAs along several dimensions.[49]

Empirical evidence of biases in the ratings of large CRAs is mounting. Rating inflation could exist even if CRAs adhere to their own standards, because issuers could engage in "rating shopping"—i.e., choosing the most favorable credit assessment. However, the available evidence suggests that a more likely explanation for rating inflation is "rating catering"—i.e, inflating ratings to attract or retain business (Griffin, Nickerson, and Tang, 2013). The problem has been shown to be critical in the ratings of securitizations (e.g., Barth, Ormazabal, and Taylor, 2012; Griffin and Tang, 2012; He, Qian, and Strahan, 2011; Bonsall, Koharki, and Neamtiu, 2015).

Credit rating distortion could also result from the incentives and subjectivity of individual credit analysts. Cornaggia, Cornaggia, and Xia (2016) study credit analysts that leave rating agencies to work at the firms they rated, and find that transitioning analysts inflate the ratings of their future employers. Fracassi, Petry, and Tate (2016) find that subjectivity by individual analysts plays an important role in determining ratings.

The literature also suggests that regulatory reliance on ratings may contribute to ratings inflation (e.g., Kisgen and Strahan, 2010; Cornaggia, Cornaggia, and Hund, 2017; Opp, Opp, and Harris, 2013; Bruno, Cornaggia, and Cornaggia, 2016). Regarding the use of ratings in

[48] The most prominent examples of such practices are the issuance of unsolicited ratings and "notching" (i.e., the practice of lowering ratings on, or refusing to rate, securities issued by asset pools unless a large share of the assets within those pools are also rated by the CRA).

[49] Specifically, the criticisms are the following (Frost, 2006): Failure to ask tough questions to issuers; ineffective use their special access to confidential information; inadequate warning of failures; and failure to provide timely and high quality information to financial markets.

contracting, Manso (2013) explains that such use generates a feedback loop, and, consistently, Kraft (2015) shows that rating agencies cater to borrowers whose loan contracts include performance pricing based on ratings.

Two basic approaches have been proposed for solving the problems in the credit rating industry. One is that, because the CRAs' ratings are closely tied to financial regulation, these agencies should be closely scrutinized.[50] The other is that rating agencies deserve the same freedom of speech as brokers who advise investors, but let the buyer beware. This second approach has spawned proposals relying on market mechanisms.[51]

Increasing competition among CRAs is a prominent initiative of this second group. While the idea has intuitive appeal, several studies provide evidence that speaks against this proposal.[52] Becker and Milbourn (2011) find that the entrance of Fitch into the ratings market was followed by lower-quality ratings from the incumbents. When Flynn and Ghent (2017) analyze the entry of new credit rating agencies into structured finance products, they find that entrants issue higher ratings than incumbents, and they provide suggestive evidence that incumbent rating levels become more generous as the entrants' market share in a product type increases. That said, there is also evidence suggesting that competition can discipline CRAs. Xia (2014), for example, documents a significant improvement in Standard and Poor's ratings quality following Egan-Jones Rating Company (EJR)'s coverage initiation.

[50] As an example of a recent regulatory initiative emphasizing the need for increased oversight of credit rating agencies, the Dodd-Frank bill in the US established a new Office of Credit Rating Agencies at the SEC. In Europe, proposals include mandatory registration with European Securities and Markets Authority (ESMA) and a requirement to force corporations to rotate their rating agencies.

[51] For example, some propose the establishment of centralized clearing platforms for ratings (from a sample of approved rating agencies, the centralized clearing platform chooses which agency will rate the debt for a flat fee). Others lean towards withdrawing the financial regulations that thrust the rating agencies into the center of the debt markets and tie capital and reserves requirements to market measures.

[52] For example, in the US it has been proposed to increase competition in the rating industry by revisiting the requirements for the NRSRO status. Notably, the Credit Rating Reform Act of 2006 in the US required the SEC to establish clearer guidelines for the NRSRO recognition process. As of December 2016, ten agencies have been recognized as NRSRO, whereas in the early 2000s only "the big three" (S&P, Moody's, and Fitch) were recognized as such.

Other proposals to avoid rating inflation include 1) using an "investor-paid" model, instead of the traditional "issuer-paid" model, to compensate CRAs, and 2) reconsider the CRA designation as NRSRO. Exploring the investor-paid model, Cornaggia and Cornaggia (2013) find that the ratings of a subscriber-paid agency provide a better ordinal ranking of credit risk than the Moody's ratings do, and Strobl and Xia (2012) document that the difference between the EJR ratings and the S&P ratings is more pronounced when S&P's conflict of interest is most severe.

Exploring whether NRSRO designation matters, Beaver, Shakespeare, and Soliman (2006) find that certified agencies are generally more conservative than non-certified peers; they conclude that their evidence is consistent with non-certified agencies not playing a role in contracting (i.e., only playing a role as information providers). Other studies analyze the SEC's decisions to grant the NRSRO designation. Kisgen and Strahan (2010) study the ratings methods of an issuer-paid CRA before and after the CRA becomes an NRSRO, and find that, after the NRSRO designation, the agency rates bonds more like the other major agencies. More recently, Bruno, Cornaggia, and Cornaggia (2016) exploit an investor-paid rating agency's designation as NRSRO to test whether this certification affects the agency's information production. Using a certified issuer–paid agency as a benchmark, they find that the NRSRO certification has little effect, but also that investor-paid ratings are consistently better than issuer-paid ratings. This suggests that ratings policies appear to be driven more by the CRA compensation model than by certification.

In sum, the literature has identified significant issues in the credit rating market, and while evidence suggests that changes to the compensation model might improve the CRAs' efficiency, other proposed changes (such as increasing competition) find modest empirical

support. Further research could help identify alternative (or complementary) ways to improve the monitoring role of CRAs. To cite an example, the evidence in Cheng and Neamtiu (2009) suggests that public criticism can contribute (at least to some extent) to improving the quality of ratings.

8.3.Auditors

External auditors, who provide investors with independent assurance that the firm's financial statements conform to accounting standards, are seen as another important part of the governance system. However, governance by auditors was heavily criticized after the accounting scandals of the early 2000s (including the demise of Arthur Andersen) and, more recently, the financial crisis of 2008. (Though not the main focus of public outrage following the financial crisis, audit firms were still accused of not sounding the alarm.[53]) The criticisms, which continue today, focus on disclosure practices, conflicts of interest (due to the provision of non-audit services), anticompetitive or unfair practices, and diligence and competence. Some argue that these problems have their origins in the late 1990s, when a combination of legal and organizational changes, in combination with a bull market, undermined the auditors' liability for audit failures (Coffee, 2001; 2002).

The criticism of auditors raises the question of how to best ensure that accounting firms' independently and accurately assess their clients' reporting practices. Before the accounting scandals in the early 2000s, the answer to this question was to rely on market discipline. As

[53] PwC, KPMG, and EY were accused of failure to raise accounting issues at Colonial Bank, TierOne, and Lehman Brothers, respectively.

explained by Dye (1993) and others, the market provides two incentives for auditor independence: litigation risk and reputation.[54]

The literature on auditors' litigation risk studies certain patterns in auditor behavior that are consistent with avoidance of litigation threat. In particular, auditors could be avoiding litigation risk when they increase effort and/or fees, drop risky clients, or engage in lobbying. While a substantial body of evidence links audit fees and risk, the literature does not conclusively disentangle the extent to which higher audit fees reflect higher effort or a risk premium. This distinction is important, because it determines whether auditors or their clients internalize the cost of litigation risk. Evidence does suggest that auditor effort explains at least some of the variation in audit fees, and the passage of Private Securities Litigation Reform Act (PSLRA) in 1995 (a law that increased plaintiffs' litigation costs) came on the heels of significant lobbying efforts by audit firms (Geiger and Raghunandan, 2001; Lee and Mande, 2003). In short, based on the extant literature, we can conclude that auditors do care about litigation risk. The strategies that auditors employ to reduce this risk have unclear consequences on the social welfare. For example, litigation risk could induce auditors to be excessively conservative, or to spend resources in lobbying activities.

Auditors' reputational incentives are empirically more elusive. Several studies look for reputational effects by testing whether the Enron failure imposed costs on other Andersen clients. These studies find a negative market reaction for Andersen clients following Enron, particularly for large NAS purchasers. Other studies find similar results in low-litigation jurisdictions outside the US (Weber, Willenborg, and Zhang, 2008; Skinner and Srinivasan, 2012). Overall, there is

[54] See DeFond and Zhang (2014) for a detailed review of the empirical evidence of the effect of these two potential drivers of audit independence.

some evidence that reputation incentives do affect audit quality, but direct evidence on this is rare and difficult to generalize.[55]

The scandals of the early 2000s generated a widely held perception that market incentives were insufficient to discipline auditors' rent-seeking behavior. Accordingly, US legislators decided to end the self-regulatory regime of the audit market. As part of SOX, The U.S. Congress created the Public Company Accounting Oversight Board (PCAOB), a private-sector, nonprofit corporation that reports to the SEC and has broad powers to regulate the audit market (i.e., issue audit standards) and oversee and discipline public accounting firms.[56] The potential effect of this new post-SOX regime is intriguing, since the regime change involves a tradeoff of professional expertise (unlike AICPA reviewers in the pre-SOX period, the PCAOB members cannot be practicing CPAs) for independent monitoring—an exchange that is central to the debate about the relative benefits of self-regulation and government regulation (e.g., Stigler, 1971; Peltzman, 1976).[57]

How can empirical research help us understand whether these regulatory changes are warranted? One way is to analyze patterns in audit behavior that suggest opportunism, such as "low-balling" (i.e., discounting fees in the initial engagement year to win the client, with the intention of subsequently recouping these losses) and favoring large clients. Studies that target these practices find limited or even contrary evidence of opportunism. Specifically, there is little

[55] The effect of auditors' litigation and reputational incentives can be shaped by market conditions. For example, there is evidence that auditors provide less effort for IPOs when market conditions are favorable.

[56] Importantly, SOX also introduced a proscription of non-audit services. Other SOX reforms focus on the client side. In particular, SOX mandates rotation for the lead engagement partner (some countries mandate rotation for the whole audit firm) to prevent long auditor-client relations, and 8-k disclosure of audit changes to prevent "opinion shopping" (i.e., select the most favorable auditor). For the purpose of this review I focus on regulatory reforms focused on disciplining auditor (rather than client) behavior.

[57] PCAOB inspections have also been criticized on the grounds that reviewers are under pressure to identify problems.

evidence that low-balling impairs audit quality, or that client size affects audit quality (DeFond and Zhang, 2014).

By directly analyzing the effect of the PCAOB, the empirical literature could provide additional insights on whether the audit profession should be regulated. To date, there is no systematic evidence on whether the new audit standards of the PCAOB affect auditor behavior differently from the standards during the self-regulatory regime. However, there is recent suggestive evidence on the enforcement role of the PCAOB. In particular, PCAOB inspections appear to exert significant disciplining effects on small auditors (after the review, small accounting firms are more likely to issue going-concern opinions or exit the audit market); the effect on large auditors is less clear.[58] Inspections at audit firms are rarely followed by auditor–client realignment, and sanctions elicit negative responses by some clients (e.g., Lennox and Pittman, 2010; Boone, Linthicum, and Poe, 2013). That said, recent evidence exploiting variation in jurisdictions and internal control audit deficiencies suggests that the PCAOB inspections do increase audit quality (Lamoreaux, 2013; DeFond and Lennox, 2015) and enhance reporting credibility (Gipper, Leuz and Maffett, 2016).

More empirical work must be done before we can conclude whether regulating the audit profession is necessary, but the available evidence suggests that financial statement verification matters. Notably, recent papers using data on private firms (which exploit variation in the presence of an audit) suggest that audited firms have a significantly lower cost of debt (e.g., Blackwell, Noland, and Winters, 1998; Kim, Simunic, Stein, and Yi, 2011; Minnis, 2011). Although questions remain about whether the credibility of audited reports result from the

[58] Some studies document that clients dismiss small auditors following deficient inspection reports that small auditors with deficient inspection reports are more likely to issue going-concern opinions, and that investors react to inspection reports. Moreover, DeFond and Lennox (2011) find that the PCAOB regime led to an exodus of smaller and lower-quality auditors from the public company audit market. In contrast, Lennox and Pittman (2010) do not find that unfavorable reports lead to auditor-client realignment. Boone, Khurana and Raman (2015) in turn show that PCAOB sanctions against Deloitte and Touche in 2007 led to negative client responses.

assurance provided by auditors or from other sources, the evidence suggests that, despite the imperfections in the audit market, auditors play a significant governance role.

8.4. Proxy Advisors

In 2003, the SEC implemented a requirement that mutual funds disclose their votes on all shareholder ballot items as well as the policies and procedures on which the vote was based (SEC, 2003). One objective of this requirement was to encourage mutual funds to more actively monitor firms through proxy voting. The primary objective, however, was to reduce conflicts of interest between financial services firms that operate mutual funds and the funds' shareholders.[59] The proxy voting rules and a subsequent interpretative letter from the SEC state that the use of proxy voting policies and recommendations developed by an independent third party such as proxy advisors (PA) would be deemed free of a conflict of interest and would meet mutual fund proxy voting obligations. As a result, many institutional investors rely on proxy advisory firms, primarily Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (GL), for data and analysis to guide their voting choices.

Proxy advisors appear to exert significant influence on investors' voting decisions. Although each institution ultimately controls the votes cast for its own shares, funds often rely partly or wholly on the recommendations of proxy advisory firms. Consistent with proxy advisors exerting significant influence on shareholder voting, empirical research documents a strong association between PA recommendations and voting outcomes. Morgan, Poulsen, and Wolf (2006) investigate shareholder voting on management-sponsored compensation programs

[59] Possible conflicts of interest may arise from the various business dealings of the mutual fund parent company. For instance, a family of funds may be owned by a diversified financial services firm that offers investment banking and corporate banking services. Thus, the proxy votes of institutional investors might also be motivated by the potential opportunities to sell additional investment services to a firm, such as pension management, as opposed to increasing shareholder value.

and find that negative vote recommendations of a proxy advisory firm resulted in a 20% increase in negative votes cast. Similarly, Bethel and Gillan (2002) and Cai, Garner, and Walkling (2009) find that a negative ISS recommendation on a management proposal can sway close to 20% of votes.

Although this research suggests that proxy advisors do exert influence, the association between the advisors' recommendations and voting outcomes is subject to alternative interpretations. In particular, Thomas, Palmiter, and Cotter (2012) argue that proxy advisors' recommendations could represent an aggregation of institutional investor perspectives, allowing the industry to coordinate and effect corporate governance changes. In fact, proxy advisors develop their voting guidelines in consultation with institutional investor clientele. But when Larcker, McCall, and Tayan (2013) evaluate the public disclosures of the processes by which proxy advisors develop their voting guidelines, they conclude that the proxy advisors apply significant discretion when translating the feedback from investors and corporate issuers into algorithms that determine the voting recommendations. More recently, Malenko and Shen (2016) use a regression discontinuity design to empirically identify causal effects of ISS recommendations on shareholder voting. The authors conclude that ISS recommendations do influence on shareholder votes and do not simply reflect shareholder preferences.

Regardless of whether the proxy advisors' role is to provide independent research or to aggregate the views of institutional investors, evidence suggests that firms care about the proxy advisors' recommendations. For example, Ertimur, Ferri, and Oesch (2013) document that more than half of firms respond to declines in shareholder vote following a negative recommendation by engaging with investors and making ex-post changes to their compensation plan. But firms could also react ex-ante, to prevent negative recommendations. In particular, firms could make

governance changes so that the features of the firm's governance system more closely align with PA voting policies before the proxy statement is released and the PAs issue their recommendation. In a survey conducted by The Conference Board, NASDAQ, and the Stanford Rock Center for Corporate Governance (2012), over 70% of the director and executive officer respondents indicated that the design of their compensation program was influenced by the policies of, and/or guidance from, proxy advisory firms. Consistent with this survey evidence, Larcker, McCall, and Ormazabal (2015) analyze the first say-on-pay vote in the US in 2011 and find that 1) a substantial number of firms change their compensation programs in the time period before formal shareholder votes, and 2) the changes they make are consistent with features that are known to be favored by proxy advisory firms. The authors interpret these changes as being the firms' efforts to avoid negative voting recommendations.

The potential influence of PA recommendations on firms' governance practices raises an important question: Do these recommendations induce boards of directors to change corporate governance in the best interest of shareholders? In other words, are proxy advisory policies value enhancing for shareholders? If the policies and guidelines of proxy advisors effectively identify poor governance practices, then changes that align executive compensation programs with these policies will decrease rent extraction and increase shareholder value. If, however, the policies and guidelines do not identify poor governance practices, the opposite will occur.

But why would PAs issue recommendations that are not in the best interest of shareholders? And why would investors pay for such recommendations? As explained by Larcker, McCall, and Tayan (2013), shareholder voting is subject to a free-riding problem, in that institutional investors expect only a very small benefit from casting the correct vote. As a consequence, these investors desire a mechanism that will satisfy their fiduciary responsibility to

vote proxies at the lowest cost, such as outsourcing this process to proxy advisory firms. Thus, it is unclear whether proxy advisory firms have a strong incentive to invest in research that will ensure correct recommendations, since any such effort would decrease the profitability of advisory firms while having no substantive impact on their ability to attract new institutional customers or generate additional revenue. Competition among proxy advisors is a possible solution to this incentive problem, but, as of today, the bulk of the market for PA services in the US is concentrated in two firms, ISS and Glass-Lewis. Furthermore, there is the concern that PAs face a potential conflict of interest because, in addition to selling voting recommendations, they consult firms about governance practices such as equity incentive plans.

What does the empirical literature say about the valuation effects of PA recommendations? In the context of contested director elections, Alexander, Chen, Seppi, and Spatt (2010) conclude that an ISS recommendation in favor of the dissident slate inform about the likelihood that the dissident slate is elected and serve as a certification of the value of the dissidents to shareholders. In contrast, in the context of stock option repricings, Larcker, McCall, and Tayan (2013) find that firms that reprice in accordance with the restrictive policies of proxy advisors exhibit statistically *lower* market reaction to the repricing, *lower* operating performance, and *higher* employee turnover. The findings of the two papers are not necessarily contradictory. Proxy advisors can take advantage of customized processes and seasoned research teams when evaluating contested elections and merger and acquisition transactions (Winter, 2010). When evaluating stock option repricings (and more common management proposals generally), however, the proxy advisors compare the proposed programs to a fairly rigid set of policies, which are applied uniformly across all companies.

In the context of SOP, Ertimur, Ferri, and Oesch (2013) find no market reaction to the announcement of compensation changes triggered by negative PA recommendations. However, it is possible that firms make meaningful compensation changes ex-ante (i.e., before the PA issues the recommendation), rather than ex-post. Consistent with this idea, Larcker, McCall, and Ormazabal (2015), in their analysis of changes in compensation programs before the first SOP vote in the US, find a negative stock market reaction to compensation changes with features that are known to be favored by proxy advisory firms.[60]

There is also recent evidence that the PAs' conflicts of interest are a real concern, and that increased competition could help alleviate this problem. Li (2016) shows evidence that, for most types of voting proposals, competition from a new entrant reduces favoritism towards management by an incumbent advisor that serves both corporations and investors.

In summary, empirical work reflects the controversy about the governance role of proxy advisors. Some of the empirical evidence could be used to support possible reforms of the PA industry, such as increasing regulatory oversight and/or competition among PAs. But one could also argue that PAs act not as monitors but as information intermediaries, that their main role is not to identify and promote superior compensation practices but to process substantial information on executive pay on behalf of institutional investors (which, in turn, reduces the investors' cost of making informed voting decisions) (Ertimur, Ferri and Oesch, 2013). As discussed above, however, the latter view is not consistent with recent empirical evidence on the influence of PAs on shareholder voting (Malenko and Shen, 2016). In any case, the literature shows that the recommendations by PAs could induce firms to make governance changes that

[60] Ertimur, Ferri and Oesch (2013) find a negative stock market reaction to the release of PA recommendations. While this evidence could be interpreted as recommendations introducing a cost to shareholders, an alternative interpretation is that ISS *Against* recommendations help investors identify firms with low-quality compensation practices. In any case, this evidence is difficult to interpret without controlling for the recommendation expected by the market.

have unclear implications for shareholder value; this troubling result calls for more research to better understand—and perhaps reform—the role of PAs in the economy.

8.5. Other Gatekeepers

The professions discussed above (i.e., analysts, CRAs, auditors, and PAs) provide services that consist primarily of gatekeeping. In contrast, certain other professions, notably investment bankers and securities attorneys, engage in gatekeeping services only as ancillary activities. Investment bankers serve as distributors for the issuer and provide a form of risk sharing or insurance in connection with underwriting, but they also play a certification role in mergers and initial public offerings (Gilson and Kraakman, 1984). Securities attorneys are primarily advocates or transaction engineers, but they can be considered gatekeepers in that they pledge their reputation when performing due diligence services (the attorney provides an opinion to the underwriters that all material information concerning the issuer has been properly disclosed) (Coffee, 2003).

Public criticism after the accounting scandals of the early 2000s spared neither investment bankers nor securities attorneys. Investment bank employees were accused of assisting their clients' financial shenanigans through special purpose entities and fake asset sales, among other maneuvers. Many critics pointed to the repeal of the Glass-Steagall Act, which long separated investment banking from commercial banking due to perceived conflicts of interest, as abetting bad behavior by investment bankers. Attorneys were also criticized for failing to act when they became aware of their clients' financial malfeasance. For example, after the Enron collapse, the law firm Vinson & Elkins faced legal claims and scrutiny by news organizations, the U.S. Congress, and federal agencies (Enron was the largest client of Vinson & Elkins, paying fees of more than $30 million a year). One response to this perceived failure in attorneys'

gatekeeping function was Section 307 of the Sarbanes-Oxley Act of 2002, which required the SEC to prescribe minimum standards of professional conduct for attorneys. The SEC introduced the corresponding rule (17 CFR Part 205) in 2003.

Regulation of the gatekeeper role of attorneys—especially a proposed requirement that lawyers make a "noisy withdrawal" when unable to prevent or stop violations by their clients—has generated controversy. Skeptics argue that the gatekeeper role conflicts with attorneys' loyalty obligations to their clients and compromises attorney-client communication (Coffee, 2003). More empirical evidence is needed to guide this debate. The interaction between gatekeeping and other services provided by the same professional are not well understood.

9. Foreigners

In the current context of globalization, firms are exposed to an increasing number of economic actors from outside the country in which the firm is incorporated. I refer to these economic actors as "foreigners". My analysis focuses on two types of foreigners; foreign institutions (e.g., foreign regulators) and foreign shareholders.[61] For example, a European firm cross-listed in the US is subject to the scrutiny of a foreign regulator: the SEC. This firm could also have foreign shareholders such as sovereign wealth funds from non-European countries or mutual funds headquartered in the US.

9.1. Foreign Institutions

As globalization intensifies, many firms are expanding their activities beyond their country of origin. As they do, the firms are required to comply with the legal and regulatory

[61] The analysis of foreign shareholders might seem inconsistent with this paper's focus on stakeholders other than shareholders and debt-holders. However, I include these stakeholders for two reasons. First, an analysis of foreign stakeholders would not be complete without including these important actors. Second, research on the governance role of foreign shareholders is recent and, to the best of my knowledge, has not been reviewed by prior surveys of the accounting and finance literatures.

framework of foreign countries, and expose themselves to monitoring by the institutions of those nations. The exposure to foreign institutions involves not only operations but also investment and financing. When a firm decides to list shares on overseas exchanges (i.e., cross-list), it becomes subject to the law and regulation governing the exchange of securities in the foreign market. This is true regardless of how much the firm has internationalized its operations.

Cross-listing may have important consequences for corporate governance. After cross-listing, the firm becomes subject not only to foreign laws and regulations but also to the enforcement mechanisms (both public and private) of the foreign country, including the listing requirements of the foreign exchange. Moreover, as emphasized by Coffee (1999), cross-listing requires the certification of foreign gatekeepers.

In the light of the above considerations, it is not surprising that the "bonding hypothesis" —an explanation for cross-listing that takes a corporate governance perspective—has gained significant support in the literature (Karolyi, 2004). According to this hypothesis, managers commit or "bond" themselves to not extract rents from shareholders (they do this in order to generate trust among potential investors and thus facilitate access to finance); one way they signal this commitment to shareholders is to cross-list the firm's stock on an exchange that imposes higher legal and regulatory costs than the firm's primary exchange. The bonding hypothesis challenged the conventional wisdom that cross-listing is driven by barriers in local markets. But more importantly for the purpose of this article, this hypothesis highlights the potential governance role of foreign institutions.[62]

[62] Coffee (1999, 2002) and Stulz (1999) were the first to rationalize in the role of governance in the decision by non-U.S. firms to list on the NYSE or Nasdaq exchanges in the U.S., either directly or through an ADR program. As explained by Coffee (1999), after cross-listing the listing firm (1) becomes subject to the enforcement powers of the SEC; (2) becomes subject to class actions and derivative actions; (3) and commits to provide fuller financial information in response to SEC requirements and to reconcile its financial statements with U.S. generally accepted accounting principles (GAAP).

The theory behind the bonding hypothesis is supported by a fair amount of empirical evidence (see Karolyi, 2004 for a review of these studies), but it has also been challenged. The main source of concern relates to enforcement efficacy, and, more specifically, whether the increases in enforcement following a cross-listing are great enough to instill confidence in investors. Some authors suspect that the SEC's enforcement of corporate governance rules on foreign issuers is, in fact, weak (e.g., Licht, 2003). For example, the results in Siegel (2005) suggest that the intensity of SEC enforcement toward Mexican cross-listed firms is very low.

The literature offers a reply to this criticism. Coffee (2002) argues that, while the SEC has only conducted a small number of enforcement actions against foreign issuers, the actions were well publicized and could have had a strong deterrent effect. Moreover, a number of these prosecutions are settled out of court. Tribukait (2002) shows that there is significantly less information leakage around earnings announcements of Mexican firms listing in the US, compared with other Mexican firms, suggesting that corporate governance among cross-listed firms is stronger. A recent paper by Silvers (2016) examines the stock returns of foreign firms not targeted by the SEC during windows around enforcement actions that target foreign firms. The author documents that the "non-target" firms experience positive stock returns during the event windows, which is consistent with foreign enforcement constraining the risk of expropriation.

Another concern is whether the deterrence effect of US enforcement is offset by "type I error" in the prosecution process (i.e., prosecution of innocent firms). Mahoney (2009) argues that the US legal system provides substantial protections against wrongful conviction but substantially less protection against wrongful indictment. Whether the cost of wrongful indictment exceeds the benefits of cross-listing is unclear. What is clear is that this cost could be

substantial, at least for some firms. In fact, Mahoney (2009) argues that prosecutors' unpredictable use of criminal law and procedure could be a major cause of delisting from US exchanges.

Despite these difficulties, mounting evidence supports the bonding hypothesis, and this suggests that foreign institutions do play a governance role.[63] This is important given the current trend in the globalization of finance. More research is needed to further understand—and exploit—the disciplining role of foreign institutions.

9.2. Foreign Shareholders

One consequence of the globalization of finance over the last decades is that many companies have been moving toward a more dispersed and globalized shareholder structure, which deviates from the concentrated local ownership model that long predominated in continental Europe and Japan (Tirole, 2001; Allen, Carletti, and Marquez, 2015). This trend has been matched by a substantial increase in the weight of institutional investors in the global economy. According to a report by the International Monetary Fund, the volume of assets managed by institutional investors more than tripled during the 1990s and early 2000s (IMF, 2005). As countries have opened their capital markets to foreign investors, foreign direct investment and portfolio flows have boomed (Bekaert and Harvey, 2000; Stulz 2005). The result is an unprecedented internationalization of the shareholder base of corporations worldwide, both in developed and emerging markets (see Khorana, Servaes, and Tufano, 2005).

[63] That being said, there is also some evidence hard to reconcile with the bonding hypothesis. King and Segal (2003) find that cross-listing premiums for Canadian firms arise only for firms that attract a sufficient amount of turnover in the U.S. markets. Pinegar and Ravichandran (2003) do not find any voting premiums for Mexican firms with ADR listings on both of the dual classes of shares. Burns (2004) examines cross-border acquisitions of U.S. firms by non-U.S. acquirers with listed ADRs, and finds that the use of equity to finance the transaction still depends on the quality of home-country legal protections, which should no longer play an important role in the financing choices of a cross-listed firm in the U.S., according to the bonding hypothesis (see Karolyi, 2004 for a more detailed discussion of these studies).

The rise of foreign institutional investors could have important implications in corporate governance. As explained by Aggarwal, Erel, Ferreira, and Matos (2012), foreign institutions may be more independent and thus better positioned to monitor corporate insiders than are domestic institutional investors. Because domestic institutions are more likely to have business ties with local companies, they may be more likely to accommodate corporate insiders and less effective as external monitors (Gillan and Starks, 2003; Ferreira and Matos, 2008). In addition, Ferreira and Matos (2012) and Ferreira, Matos, and Pires (2015) observe that domestic institutional investors are often affiliated with banks that have ties with the firm (banks that extend credit, underwrite, provide advice, and even hold board seats in many corporations).

The monitoring role of foreign institutions can operate through several channels. Institutional investors may contact managers personally or pressure them indirectly by actively voting their shares or "voting with their feet." In cases of extreme disagreement they could also engage in proxy fights.

Empirical research supports the notion that foreign institutions can discipline managerial behavior. Ferreira and Matos (2008) and Leuz, Lins, and Warnock (2009) study institutional holdings around the world and find that foreign funds have a strong preference for firms with a lower risk of shareholder expropriation. In particular, their results highlight the roles of governance mechanisms, ownership structures, and legal systems in protecting the interests of non-controlling shareholders, and of the accounting system and disclosure in shaping foreign investors' monitoring costs. Their evidence suggests that, at the very least, foreign investors can discipline managers through portfolio investment decisions (i.e., by refraining from investing in companies with higher managerial rent-extraction).

In addition to adjusting their holdings, foreign investors could also actively induce governance reform at firms. Aggarwal, Erel, Ferreira, and Matos (2012) provide some evidence consistent with this conjecture. They find that changes in institutional ownership over time positively affect subsequent changes in firm-level governance, but that the opposite is not true. In addition, they find that firms with higher foreign ownership are more likely to terminate poor-performing CEOs.

Monitoring by foreign investors appears to be beneficial for shareholders. Ferreira and Matos (2008) observe that firms with higher ownership by foreign and independent institutions have higher firm valuations, better operating performance, and lower capital expenditures. Consistent with this, Bena, Ferreira, Matos, and Pires (2016) document that foreign institutional ownership fosters long-term investment in tangible, intangible, and human capital, and leads to significant increases in innovation output.

However, there is substantial cross-sectional variation across foreign investors, and this raises the question of whether similar variation exists in their monitoring effectiveness. A particularly important type of foreign investor, based on the size of holdings, is sovereign wealth funds (SWF).[64] It is plausible that SWFs have the capability and incentives to monitor portfolio firm managers and to increase firm value by engaging actively in corporate governance. They have few explicit liabilities, a long-term investment horizon, a low need for short-term liquidity, and the financial muscle to acquire large stakes. However, the fact that SWF investments represent foreign government ownership raises several concerns, which are intensified by a lack of transparency in some of these funds. Plenty of empirical evidence points to inefficiencies associated with government ownership, due to political interference and other problems (e.g.,

[64] The assets under management held by SWF amount to several trillions and is growing faster than any other institutional investor group (Bortolotti, Fotak and Megginson, 2015).

Shleifer and Vishny 1994; Megginson and Netter 2001). Similarly, the governments that sponsor SWFs could impose noncommercial or political objectives that are costly for other shareholders. Even if such meddling does not occur, SWFs might turn out to be passive investors who have no effect on corporate monitoring.

Several studies find a positive stock market reaction around announcements of SWF investments. While suggestive, this evidence is not enough to conclude that SWFs are efficient monitors, since the literature usually documents a positive reaction to all types of direct stock purchases. Thus, some researchers compare the magnitude of the abnormal returns around investment announcements of SWFs and other institutional investors. Kotter and Lel (2011) find that the magnitude is similar, but Bortolotti, Fotak, and Megginson (2015), who use a larger sample, document that the positive market reaction is substantially less pronounced for SWFs. Critically, the latter authors also find that the discount is greater when larger and controlling stakes are acquired by highly politicized SWFs. The evidence on the degree of engagement of SWFs is also mixed. Dewenter, Han, and Malatesta (2010) conclude that SWFs behave as active investors, but Bortolotti, Fotak, and Megginson (2015) and Knill, Lee, and Mauck (2012) find evidence that SWFs do not provide the same monitoring benefits as other institutional investors. Thus, the debate on the monitoring role of SWFs is still not settled.

The literature on the monitoring effect of SWFs highlights the need to better understand the nuances of foreign investor monitoring. SWFs could exert a positive influence on corporate governance, given the insufficient protection of minority investors in many countries. But the SWFs' specific characteristics and objectives could also introduce significant trade-offs in social welfare. The interaction of these investors with local institutions and investors is also intriguing

and under-researched; more evidence is needed to understand the potential long-term consequences of increased foreign stake-holding around the world.

10. Conclusions

This paper has surveyed the empirical literature on the role of stakeholders in corporate governance, including firm employees, the general public, the media, related firms (competitors as well as customers, suppliers, and partners), the government, private regulators, gatekeepers (analysts, credit rating agencies, auditors, proxy advisors, attorneys, and investment bankers), and foreign stakeholders (institutions and investors). The survey is structured around each stakeholder's incentives to influence managerial behavior, the mechanisms through which stakeholders act on managerial actions, as well as any concerns about this influence. The main findings can be summarized as follows.

All the analyzed stakeholders appear to be able to influence—at least to some extent—managerial actions. This suggests that, regardless of whether corporate governance is shareholder-centric or stakeholder-centric, the discussion about the mechanisms for managerial discipline should encompass a wide range of actors, and not just the board of directors and financial stakeholders. This is an important conclusion, as stakeholder monitoring could be an efficient substitute for regulation and other expensive corporate governance mechanisms.

However, the review of the literature also reveals that the efficacy of monitoring by stakeholders is hardly clear-cut. In some cases, empirical research provides evidence of factors that undermine stakeholders' incentives to discipline managers. In other cases, the value implications of stakeholder influence are unclear, suggesting that the stakeholders' incentives might be misaligned with shareholders' interest *and* with the public interest. Finally, the evidence on the monitoring role of some stakeholders is scant or absent.

In the light of these general conclusions, I close this article offering four additional considerations for future research. First, while the literature has explored *whether* stakeholder monitoring matters, there is still much to learn about *what* matters in stakeholder monitoring—about what determines the efficacy of this monitoring, and about the specific channels through which it operates. Second, the economic consequences of the role of stakeholders in corporate governance are still not fully understood. For instance, we know little about the potential spillovers, externalities, and interactions of stakeholders' actions. This is especially important, considering that the monitoring effects of stakeholders are not necessarily linear. Moreover, the value implications of stakeholder monitoring are intriguing, especially when one considers that their objective function differs in many ways from that of shareholders.

Third, there is still little research on the role of information in stakeholder monitoring; this role could extend beyond the use of accounting in contracts with certain stakeholders. Fourth, the empirical literature focuses heavily on the United States. Studies of other countries could provide tighter research designs and novel settings for hypothesis testing, resulting in a richer understanding of the role of stakeholders other than capital providers. These and other related lines of future research are likely to be especially relevant, given the current trends of globalization, social and environmental sensitivity, and information technology and digitalization.

Table 1. Framework of the Review

This table presents the framework structuring the review of the literature on the role of stakeholders on corporate governance. "Incentives" refers to the incentives of each stakeholder to influence managerial actions. These incentives are classified into three types: *monetary*, *reputational*, and *ideological*. "Mechanisms" refers to the economic mechanisms or channels through which stakeholders influence managerial actions. These mechanisms are classified into three types: *monitoring*, *contracting*, and *other specific mechanisms*. "Frictions" refers to the frictions that potentially prevent stakeholders from disciplining managerial behavior. These frictions are classified into three types: stakeholder *opportunism* and the *costs* and *constraints* faced by stakeholders.

		Incentives	Mechanisms	Frictions
		• *Monetary* • *Reputational* • *Ideological*	• *Monitoring* • *Contracting* • *Other*	• *Opportunism* • *Costs* • *Constraints*
Stakeholder	***Employees***	• Explicit claims (e.g., salaries) • Implicit claims (e.g., advancement opportunities)	• Unionization • Stock ownership • Codetermination (i.e., board representation) • Threat to leave	• Agency problem with employee representatives • Employees' specific preferences
	The General Public	• Reduce firm externalities (e.g., pollution)	• Consumer pressure • Pressure from the labor market • Monitoring by societal representatives • Shareholder activism	• Coordination costs and heterogeneous preferences • Manipulation of public opinion • People's bounded rationality
	The Media	• Increase sales • Increase viewership/readership	• Monitoring by shaping reputation • Dissemination of information for other monitors	• Lobbying on the media • Opportunism (e.g., sensationalism, ideological manipulation) • Cost of journalistic investigation
	Related firms *Competitors* *Suppliers* *Clients* *Partners*	• Gain/maintain competitive advantage • Obtain a share in the surplus of the inter-firm relationship	• Competitive pressure • Benchmarking • Contracting with suppliers, customers, and partners	• Competition can also induce misbehavior • Information asymmetry and moral hazard in inter-firm relations
	The Government: *Judges* *Politicians* *Agencies*	The Government as a whole: • Equity stake in the company • Collect taxes from firm revenues • Reduce firm externalities Individual government members: • Reputation • Gain/maintain social support	• Legislation (securities laws and other laws) • Regulation (in particular, regulation of corporate governance) • Enforcement	• Corruption • Special interests • Electoral interests • Inefficient bureaucracies • Regulatory capture • Resources constraints
	Private regulators: *Stock exchanges* *Standard setters*	• Increase the number of listed firms and trade volume • Build/preserve reputation	• Regulation (e.g., listing requirements, accounting standards) • Enforcement (by stock exchanges)	• Race to the bottom due to competition among exchanges • Reluctance to punish clients • Special interests • Political interests • Individual interests and biases
	Gatekeepers: *Analysts* *Rating agencies* *Auditors* *Proxy Advisors* *Other gatekeepers*	• Preserve/build reputation • Avoid litigation	• Specialized monitoring • Disciplining effect of certification	• Conflicts of interest • Lower standards to retain clients • Lack of competition
	Foreigners: *Foreign institutions* *Foreign shareholders*	• Protect domestic investors • Generate returns for domestic investors	• Enforcement of foreign regulation • Shareholder monitoring (direct interactions, threat of selling or not buying shares, shareholder activism)	• Enforcement difficulties • Investors' specific preferences • Inefficiencies of government ownership (sovereign wealth funds) • Political interests (sovereign wealth funds)

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