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# Effects of professional and non-professional investors' perceptions of board effectiveness on their judgments: An experimental study

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## Abstract

This paper investigates the effects of investors' perceptions of the effectiveness of the board of directors on their judgments. I hypothesize that investors' perceptions of the effectiveness of the board will be negatively related to their judgments of investment risk and positively related to the amount they are willing to invest. I also hypothesize that the association between effectiveness of the board and investment judgments will be moderated by investor type such that professional investors will be less conservative than non-professional investors. Forty non-professional investors and 33 professional investors participated in the experiment. Generally, the results of the study are consistent with the hypothesized effects. The results suggest that even in the context of sound financial performance, investors' perceptions of the effectiveness of the board are a key determinant of their investment judgments. This association is moderated by investor type and suggests professional investors are less conservative than non-professional investors. Such evidence is consistent with agency theory, "use of the house money" hypothesis and recent anecdotal scandals involving professional investors. Overall,

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the results provide evidence that investors are more confident in firms with effective corporate boards and support regulatory reforms strengthening corporate boards.


*Keywords:* Corporate governance; Board of directors; Judgment; Investors

## 1. Introduction

This paper reports the results of an experiment that investigates the effects of investors' perceptions of the effectiveness of the board of directors on their judgments.[1] Over the years, regulators such as the Securities and Exchange Commission (SEC) implemented rules emphasizing the pivotal role of boards of directors in ensuring investor protection. Following the recent string of corporate scandals, President George W. Bush signed into law the Sarbanes-Oxley Act (2002) that empowers the SEC to introduce new rules and revise existing rules to restore and further enhance investors' confidence in the financial reporting process and financial markets. On 4 November 2003 the SEC issued one of several rules (Release No. 34-48745) that strengthens the ability of the board of directors to yield greater power and monitoring over management.

While Congress legislated swiftly the Sarbanes-Oxley Act (2002) followed by the SEC rulings to restore investors' confidence in the world's largest economy and capital market, it is not apparent if the policies implemented will produce the intended effects for two reasons. First, commentators such as the Business Roundtable (BRT, 2002), the Association for Investment Management and Research (AIMR, 1999) and CalPERS[2] argue that the reforms may have extended too far and could yield unintended consequences. For example, these commentators argue that the costs of compliance with the new regulations are phenomenal and the requirement the board comprise majority independent directors is myopic. The BRT argues that a key role of the board is to focus on generating long-term shareholder value and for this purpose suitably qualified and experienced directors are essential. The BRT further argues that the imposition the board comprise majority independent directors will compound the current difficulty associated with finding independent directors with the requisite skills. According to media reports, since the introduction of the Sarbanes-Oxley Act, many eligible directors are declining appointments to the board due to the heightened focus on directors' duties, the expansion of their responsibilities, and

[1] Professional investors are analysts who manage investment portfolios in institutions such as investment banks and non-professional investors are ordinary individuals who invest without the aid of professional investors. Further details are provided in Section 3.

[2] CalPERS (The California Public Employees' Retirement System) is the largest pension fund in the US and is actively involved in the public policy making process.