EXECUTIVE GATEKEEPERS: THE PARADOX OF LAWYERS IN THE FIRM

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February 2015

Abstract

We study the paradox of executive lawyers serving multiple tasks, being both gatekeepers and executives. We document that general counsels impact outcomes associated with both tasks; general counsel fixed effect explains 4.6% of variation in governance across firms and 2.8% in investment. We then consider whether compensation incentives drive the effort choice among tasks. Using an identification strategy based on the sociology literature of what it means to be a professional with dual loyalties, we find that a one standard deviation increase in executive lawyers' compensation delta diverts at least 2/3^{rds} of the prevention of securities fraud associated with hiring an executive gatekeeper. Our evidence suggests that these executive lawyers instead spend time on mitigating innovation legal risk, thereby facilitating R&D. Gatekeepers do not get diverted, however, in regulatory compliance. We provide evidence refuting an (interesting) alternative interpretation that lawyer gatekeepers are hired as strategy officers and are only totems of governance.

JEL Classification: G32, G34, J33, K22, M52
Keywords: General counsel, gatekeepers, equity incentives, multi-task, governance, fraud, litigation, insider trading, backdating, monitoring

*Authors are respectively from University of California at Berkeley and NBER; Queens University; and Queens University. We thank Andres Almazan, Jennifer Arlen, Paul Calluzzo, Qiang Cheng, Carola Frydman, E. Han Kim, Byungjin Kwak, Ross Levine, Yinghua Li, Ulrike Malmendier, and seminar participants at Auburn University, Harvard University (Law School), Queen's University, Stanford/Berkeley joint seminar, Tsinghua University (PBC School), University of Alberta, University of Amsterdam, University of Minnesota, Yale University (Law School), Econometric Society Meetings at the AEA Meetings (Boston), Canadian Law and Economics Association annual meetings (Toronto), Conference on Empirical Legal Studies (Berkeley), Northern Finance Association annual meetings (Ottawa), Singapore Management University Accounting Symposium, Washington University Corporate Finance Conference, as well as our team of dedicated research assistants, including Any Ung, Lindsay Carter, Elise Craig, Jun Lee, Erin Shin, Ahrun Thiyagarajah, and Peter Willett. We thank Blair Morrison, Chief Compliance Officer and Deputy General Counsel of BMO Financial Group for useful conversations. Wang and Wu thank Queen's School of Business Research Program for their generous funding support. Morse: 510-643-1425, morse@haas.berkeley.edu; Wang: 613-533-3248, wwang@business.queensu.ca; Wu: 613-533-3275; swu@business.queensu.ca.

"*Lawyers are what today we call crucial gatekeepers, responsible for safeguarding shareholders' interests*"
– SEC Chairman Christopher Cox
– Address to the Corporate Counsel Institute, March, 8, 2007

"*As long as the music is playing, you've got to get up and dance*"
– CEO of Citigroup and corporate lawyer Charles Prince, III.
– Interview with Financial Times, July 9, 2007

I. Introduction

Over two-fifths of S&P Index firms now have lawyer gatekeepers among their executives. These executive gatekeepers typically hold the title of general counsel or chief legal officer and are charged with ensuring firm compliance with regulations and monitoring for corporate misconduct (Duggin, 2006; Rostain, 2008; DeMott, 2012). The idea of internal governance is appealing (Acharya, Myers, and Rajan (2011), Kim and Lu (2012), and Khanna, Kim and Lu (2013)). However, the very notion of an executive being a gatekeeper seems, at best, a difficult juxtaposition for executive lawyers. Executives are agents of corporate owners, compensated to maximize value (Berle and Means, 1932). Gatekeepers are reputation intermediaries positioned by owners to prevent managerial wrongdoing (Coffee, 2006). Maximizing compensation through a manager-agent's contract and maximizing reputation capital as a gatekeeper need not imply the same actions.

Our broad goal is to draw attention to the prominence of lawyers in the executive office and introduce a paradox of their multi-task charge. We begin with a fixed effects analysis of the form of Bertrand and Schoar (2003), Güner, Malmendier, and Tate (2008), Malmendier and Tate (2009), and Custodio and Metzer (2014). We show that over and above firm and CEO fixed effects, general counsel fixed effects on average explain 4.6 percent of the variance in governance measures and 2.8 percent in investment. As a contrast, CEO fixed effects on average explain 11.0 percent in governance and 3.9 percent in investment; thus the general counsel effects are very material. Therein lies our paradox; executive lawyers face the call to be legal guardians (adding merit to the firm in governance) and to be strategic officers (adding value in mitigating risk concerns associated with innovation property rights or growth complexity). We posit that incentive contract plays a role as the pivot of this paradox.

Executive lawyers divide time among four duties. Prior legal studies (Duggin, 2006; Rostain, 2008; DeMott, 2012) detail the three traditional duties as (i) compliance with regulation, (ii) monitoring for misconduct, and (iii) supervision of the legal department. The rise of lawyers into executive ranks reflects an increasing need for legal expertise to manage complexities of regulation and litigation exposure,[1] as well

[1] SOX Section 307 emphasizes the responsibility of general counsel as an internal governance mechanism for transparent disclosure and monitoring. Pursuant to Section 307 of SOX, the SEC adopted minimum standards of

as a desire by corporate executives to gatekeep themselves. This rise of lawyers in executive ranks also reflects the importance of a fourth duty, (iv) strategic value-creation. Daily operations in a world with intangible assets and growth options increasingly mandate that expertise in intellectual property rights be a part of the value-adding executive team (Sorkin, 2012; Heineman, 2012). The fact that executive general counsel preside over duties both as the chief legal guardian and as a strategic member of the executive team surely puts a stress on time and focus. In surveys of Deloitte (2011) and KPMG (2012) on general counsel, roughly two-thirds of general counsels cite *maintaining regulatory compliance* as their greatest challenge.[2] If compliance (i) and the mundane task of supervision (iii) are the non-negotiable baseline duties of executive lawyers, monitoring (ii) and strategic value-creation (iv) would then vie for the residual executive lawyer attention in a multi-task frame.

With a broad agenda of drawing attention to the importance and paradox of executive lawyers, our specific question is whether the efforts exerted by executive lawyers across the multi-tasks of ensuring compliance, monitoring for corporate misconduct, and mitigating risk depend on incentives created by equity compensation. In a world without equity incentives, executive lawyers' incentives would be primarily tied to reputational capital. Their objective function would minimize downside risk (through gatekeeping), to which their reputation benefits are most sensitive. When executive lawyers have both reputational capital and equity incentives in their payoff function, they face not only further downside risk of governance failures but also an upside benefit from firm growth. Therefore, equity incentives will tilt a lawyer's actions toward tasks that generate higher marginal firm value, especially in tasks that do not greatly increase reputational capital exposure. Whether equity incentives would divert executive gatekeepers away from gatekeeping in this multitask framework depends on how much firm value is created by effort in each task and how much loss of reputational capital is lost by not focusing full-time on gatekeeping.

If the market heavily penalizes corporate malfeasance, then giving gatekeepers an equity stake should not change governance relative to a purely reputational capital maximizing story, unless the additional incentives encourage greater effort, and thus more gatekeeping. We know that internal gatekeeping has crept further and further into everyday corporate decision-making as a reaction to a series

professional conduct for attorneys, which require, among other things, attorneys to report evidence of material violations of securities laws or any breaches of fiduciary duties "up-the-ladder" within the company. General Counsels are required to "report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company." They could be held liable for management misconduct. SOX provided the SEC with the necessary power to discipline attorneys. In 2007 a record number of general counsels were charged with or pleaded to civil or criminal fraud in federal courts, most in the wake of the stock-options backdating scandal. The penalties imposed on charged general counsels were severe. For example, former General Counsel of Comverse Technology William F. Sorin paid over $3 million in penalties, and was permanently barred from serving as an officer or director of any public company as well as suspended from appearing before the SEC in an attorney role or practicing as an attorney.

[2] See Deloitte Global Corporate Counsel Report 2011: How the game is changing; Beyond the Law: KPMG's global study of how General Counsel are turning risk to advantage (2012).

of pressures – the hostile takeovers of the 1980s, the scandals and subsequent Sarbanes-Oxley legislation of the 2000s, Dodd-Frank, and now shareholder activism. Karpoff, Lee, and Martin (2008a and 2008b) show that severe monetary and reputational penalties are imposed on firms targeted by SEC enforcement actions, and top managers suffer substantial financial losses through inability to secure future employment after turnover. Thus, equity incentives may encourage greater effort to prevent governance lapses, particularly compliance lapses.

On the other side, if (a) the marginal value of lawyers effort increases firm value more through their role in mitigating legal risk exposure in strategic initiatives such as innovation and expansion into new markets and (b) the effort exerted in mitigating strategic initiatives' legal risk does not greatly reduce the lawyer's reputational capital as a lawyer, then equity incentives may divert gatekeepers' attention away from monitoring for corporate wrongdoings and toward strategic risk mitigation in innovation or expansion.

The problem resonates of Coffee's (2002; 2006) criticisms of gatekeeper conflicts-of-interests.[3] However, we do not take the strong stance that gatekeepers compensated by gatekeepees are captured; our focus is rather the multitask allocation of effort between gatekeeping and strategic advising roles that the compensation structure may influence.

Our empirics study two types of governance failures – compliance failures (AAERs and insider trading) and monitoring failures (shareholder securities fraud as measured by class action suits, option grants backdating, and uncaught financial misrepresentation fraud as measured by the accounting score of Dechow, Ge, Larson, and Sloan (2011)). Our identification strategy is a matched difference-in-differences around the hiring of an executive gatekeeper. We avoid the endogeneity of the hiring decision by having both the treated and the control be firms hiring executive gatekeepers, but from different sources. The setup compares two firms matched in time, industry, and the ex-ante propensity of committing a fraud. The difference we exploit compares one firm that hires the executive gatekeeper from a law firm with another that poaches an executive lawyer from another corporation.

Our assertion draws from sociology literature which studies organization behavior when individuals define loyalties in dimensions of both a professional association (as in the legal bar) and an organization (the employer) (Goode, 1957; Hall, 1968). Building off these foundation papers, Wallace (1995) examines lawyers that work in law firms versus those working in corporations, and finds that lawyers working in corporations are significantly less committed to the legal profession than those working in law firms. Our assumption follows directly; we assume that executive gatekeepers hired from law firms are initially less likely to alter their lawyering behavior (gatekeeping) as a reaction to equity incentives. The

[3] Rostain (2008) suggests that financial dependence raises concerns about the alacrity with which gatekeepers will pursue potential wrongdoings if revealing such problems would materially damage the firm's profits. Our view is that the diversion need not be with malintent.

logic is threefold: law firm lawyers (i) have their entire reputational capital built on their successful careers as effective lawyers, (ii) have the habit, community, and commitment of being a lawyer, and (iii) are not yet skilled in value-creation beyond lawyering industries. Most law firm lawyers arriving in the executive suite have never before been exposed to equity incentives with payoffs tied to outcomes unrelated (or not closely related) to legal milestones.

The dimension that this setup leaves omitted is that the optimal contracting use of equity incentives varies in a way correlated with the selection of choosing a law firm lawyer versus corporate attorney as a hire. We find no evidence of ex ante or ex post differences in firms in selection tests. We also implement a specification which we add CEO equity incentives as a third dimension in the matched differencing specification, thereby aligning firms in the firm-level optimal contracting use of equity incentives.

We find that compensation does not distract executive gatekeepers from regulatory compliance, where they are most exposed in personal liability and reputation. However, equity incentives do affect the multitask choice between monitoring and mitigating legal risk in strategic initiatives. Our results suggest that giving executive lawyers more compensation sensitivity to stock prices increases the future likelihood of class action law suits and uncaught fraud. In particular, a one standard deviation increase ($52,851) in the sensitivity of general counsel's wealth to a one percent change in stock price (the compensation "delta") associates with 22% higher likelihood (1.4 raw percentage points) of class action lawsuits, unwinding 67% of the governance improvements in terms of avoiding securities fraud associated with hiring an executive gatekeeper. In our more stringent specification, the unwind increases to 89.9% of the governance improvements. Said another way, if a gatekeeper were hired to avoid class actions suits, a larger compensation delta would decrease at least two thirds of the securities fraud prevention that gatekeeper brought. In terms of uncaught financial misrepresentation, we find that the gatekeeper unwinds 12% -19% of governance improvements.

In a multitask setup, this means that equity compensation rewards the upside from time spent on strategic initiatives more than the lawyer's time spent as a gatekeeper. We empirically uncover evidence of this flip side as well. Our results suggest that giving equity incentives to executive lawyers increases the time they spend mitigating risk concerns in innovation initiatives. A one standard deviation increase in the compensation delta associates with an increase in investments in R&D in the range of 5.7% (a raw ratio increase of R&D expenditures-to-assets by 0.003). This result is more robust when considering only the role of option grants, consistent with non-linear payoffs inducing enough upside gain to change the effort task allocation.

Our inference leaves one alternative interpretation as a possibility. It may be that some firms hiring executive lawyers from other corporations hire them partially as gatekeepers and partially as strategy officers in the world of increasing need for intellectual property strategy and planning. Our specification

tests suggest that this is not the case. Nevertheless, even if so, the gatekeepers may only be *totems of governance*, while firms divert their duties to other value-creating activities.

This paper is related to several lines of research. First, our study contributes to the internal governance literature. Up till now the topic of internal governance specifically through legal gatekeepers has received only sparse academic attention. Little scientific evidence exists on the effectiveness of general counsels, either in preventing governance breaches or in adding value, building off the general idea of internal governance of Acharya, Myers, and Rajan, (2011), Kim and Lu (2012), and Khanna, Kim and Lu (2013). Internal gatekeeping brings a few twists to internal governance, because internal gatekeepers are hired, paid, and promoted by agents of corporations. A recent legal literature (Duggin, 2006; Rostain, 2008; DeMott, 2012) outlines the compliance and monitoring roles of general counsel. For example, Demott (2012) describes gatekeeping roles in a very instructive essay on how general counsel monitor with case examples. We build on Demott's expertise and put out the question of whether her description of the actions that general counsel can take is empirically effective. Further, our study is related to Litov, Sepe, and Whitehead (2013), who study the governance effect of lawyers in the board of directors.

A recent set of articles has considered specific compliance roles of prominent lawyers working inside the firm. Kwak, Ro, and Suk (2012) find that so-called *super lawyers* enhance the frequency and accuracy of management earnings forecast, whereas Hopkins, Maydew, and Venkatachalam (2014) find the opposite that executive general counsels are associated with more aggressive accounting practices. Further, Jagolinzer, Larcker, and Taylor (2011) show that the informed corporate insider trading can be mitigated by the requirement of general counsel's execution approval. Finally, Krishnan, Wen, Zhao (2011) find that financial reporting quality is higher when the board has a legal gatekeeper. Different from the existing papers, our study examines how equity incentives affect the effectiveness of gatekeepers, with identification set on lawyers hired from different sources[4]. From an internal governance angle, we offer a big-picture view on both compliance roles and monitoring roles of executive gatekeepers, and find that gatekeepers prioritize their mandates so that compliance is the utmost important non-negotiable task yet monitoring can be compromised when gatekeepers are incentivized to create value for the corporation.

Second, our paper contributes to bringing together the literatures of governance and equity incentives. Particularly, we introduce the interaction of reputation and incentives with a novel setting of gatekeepers in the executive suite. Internal gatekeepers maximize shareholder wealth through two channels: gatekeeping and value creation through investments. Coffee argues these roles can be in direct conflict, as we have seen with the external gatekeepers. The nature of our test, is whether equity incentives divert-or-not while the perfectly reasonable alternative hypothesis is that equity incentives align executive

[4] Hopkins, Maydew, and Venkatachalam (2014) argue that their findings may be attributed to general counsels' compensation, especially equity grants, yet they do not formally test it.

gatekeepers with governance effort. Such a finding would contribute to the literature stemming from seminal papers in governance (e.g., Shleifer and Vishny (1998), Jensen (2000), Gompers, Ishii, and Metrick (2003)) asking not just whether well-governed firms command higher valuations, but how incentives and governance mechanisms interact.[5]

Finally, our contribution adds executive lawyers to the literature on the importance of characteristics of individuals inside the executive suite and board (e.g., Bertrand and Schoar, 2003; Güner, Malmendier, and Tate. 2008; Malmendier and Tate, 2009; Custodio and Metzer, 2014).

The rest of the paper is organized as follows. Section two describes data construction and sources. Section three addresses the general counsel fixed effect in explaining governance and investment outcomes. Section four delineates our methodology to test the impact of equity incentives on executive lawyers' gatekeeping and strategic advising roles. Section five presents descriptive statistics and the results of selection tests. Section six reports the main results of the equity incentive tests. Section seven concludes.

II. Data

Our analysis measures the importance of lawyers inside the firm and also speaks to paradox of creating value versus lawyering, a tension that pivots on pay structure. Thus, from the start, we limit our analysis to ExecuComp firms for which we have compensation data. ExecuComp covers all firms in the S&P large, mid and large cap indices. The ExecuComp sample covers 1994-2012, including 32,617 annual firm level observations for more than 3,000 unique firms.

II.a. General Counsel, Executive General Counsel and Compensation Data

To identify the general counsel, sometimes called chief legal officer, we identify individuals holding the requisite titles searching three key words: "Counsel," "Legal," and "Law" or abbreviations thereof we manually search 10-K filings (items 4b and 10) and proxy statements for such key words, and read each signatory as the company legal representative, looking for the title of the company lawyer that signs. Each company should have a lawyer that carries the responsibility of the legal signatory to the SEC. If the name signing the legal certification does not have a general counsel or chief legal officer designation,

[5] A large literature finds that firm performance overall improves when executives are exposed to firm performance; e.g., Demsetz and Lehn (1985), McConnell and Servas (1990), Core and Guay (1999), Guay (1999), Himmelberg, Hubbard, and Palia (1999), Core and Larcker (2002), and Goyal and Wang (2014). In contrast, some hold the opposite view that equity-based compensation is a double-edged sword, inducing managers to exert productive effort but also to divert valuable firm resources to opportunistic activities. For example, equity incentives induce managers to manipulate earnings (Cheng and Warfield, 2005; Bergstresser and Philippon, 2006), misreport financial statements (Efendi, Srivastava, and Swanson, 2007), rig the performance measure chosen (Morse, Nanda, and Seru, 2011), conduct fraud (Denis, Hanouna, and Sarin, 2006; Erickson, Hanlon, and Maydew, 2006), and opportunistically time option grants (Aboody and Kasznik, 2000).

it is likely that the lawyer position is not an important corporate office in the firm. We look to Execucomp titles for the same legal recognition, just in case the legal counsel also holds another title which she uses to sign the SEC documents.[6] In our sample, 70% percent of firms on average have a general counsel, relatively stable over time.

When we move to the main tests of the paper, we impose an additional attributes to designate general counsel as being in the inner executive office as executive gatekeepers (ExecGKs).[7] We apply a monetary proxy for the importance of the general counsel in the firm; individuals must be among the top paid officers in a company in ExecuComp. We force stringency that this proxy is not transitory in requiring that the officer remain in the top paid executives for three years.

Our empirical design relies on the employment history of these ExecGKs. Thus, we then look up the full career path of work experiences from law school graduation to prior to becoming ExecGK of a firm by collecting information on the names of prior employers, whether the prior employer is a law firm, the job title at the firm, and the duration of the employment. In particular, we hand-collect ExecGK's background from bios in corporate filings and then from online sources such as LinkedIn and law firm websites.

We use compensation data for the ExecGK, CEO, and the highest paid executives, which are from ExecuComp. We value option grants using the Black-Scholes model[8] and define total pay as the sum of salary, bonus, other cash compensation, restricted stock grants and option grants. We follow Core and Guay (2002) to estimate the sensitivity of the value of the ExecGK's accumulated equity-based compensation (including both stocks and options) to a one-percent change in the stock price, which is

[6] ExecuComp often records the abbreviation of an executive title. For example, the title of a GC could be spelled as "gen cou," "gncns," "gen cns," etc. We add all versions of these words we can find. Further, the initial search of the three key words resulted in many executives who are not GC (e.g. "Special Counsel", "Former Counsel"). We verify whether the executive officer identified is in fact a general counsel of the firm through further reading their full executive titles.

[7] The other potential gatekeepers within a corporation are secretary, chief risk officer, and controller. We choose to focus on legal guardians because they are the gatekeeper designated by regulators, with the legal expertise to fulfill the gatekeeping role and with reputational capital exposed to misconduct. As a matter of fact, 60% of the general counsels in our sample also serve the role of corporate secretary, reporting to board.

[8] We follow Core and Guay (2002) with minor modifications to estimate the grant date value of options. First, if the grant date is missing, it is assumed to be June 30 of that year. Option maturity is assumed to be seven years if the maturity date is missing. Second, the expected stock return volatility is measured as the annualized standard deviation of daily stock returns over the fiscal year in which the grant was made. A firm must have 50 observations for its volatility to be estimated, or else we use the median of the volatility distribution of all firms in ExecuComp in a given year. Following the practice of ExecuComp, we replace the volatility with its 5th and 95th percentile, respectively, if it is either below the 5th percentile or above the 95th percentile of all observations in a given year. Third, expected dividend yield is the ratio of cash dividends paid in the fiscal year of the grant and the fiscal year-end stock price. Finally, the Treasury bond yield corresponding to the option's expected time to maturity is used as the risk-free rate.

referred to as "delta".[9] Because we focus our attention on the hiring year delta, we are intentionally isolating incentives created by the sign-on and first year equity grants (both restricted and not) as our measure of equity incentives.

Table 1 profiles ExecGKs' presence in the top management team and their characteristics on an annual basis. Statistics of this table are based on our full sample of 32,617 firm-year observations and tabulated by fiscal years. A few statistics are of particular interest. The first column, labelled ExecGK, reports the percentage of firms' having an ExecGK by year. There is a secular trend on having an ExecGK in a corporation. In the year 1995, 33% of the S&P 1,500 firms have an ExecGK; the percentage increases to 44% as of year 2012.

Conditional on having an ExecGK, the remaining statistics report that ExecGK compensation has increased as a fraction of CEO pay from 34% to 43%. The delta of the ExecGK over the sample (at $55,000) is just 6% of CEO delta. These executive lawyers earn $1.442 million on average over the last two decades, and for every 1% increase in shareholder value, executive gatekeepers make another $55,000 in equity income. About one third of the ExecGK deltas are zero, and the ExecGK delta is right skewed even without the zeros. Our results are robust if we toss out the zeros, but instead, we choose to deal with both the zeros and the skewed distribution by adding the sample mean of the ExecGK delta before taking the natural log transformation, namely *LogExecGKDelta =log(ExecGK delta×1,000+55)*, where 55 represents is the sample mean of ExecGK delta in thousands of dollars and delta ×1,000 also translates delta in to thousands of dollars.

II.b. Compliance Failures

In the introduction, we listed the four general counsels duties: (i) compliance on all regulation fronts, (ii) the monitoring of all types of misbehaviors, (iii) the supervision of all internal and external lawyering, and (iv) strategic value creation to the corporation more generally (first three duties: Duggin (2006), Rostain (2008) and DeMott (2012); last duty: Sorkin (2012) and Heineman (2012)). Our governance failure and investment outcome measures map directly to (i), (ii), and (iv) of this list.

The *Deloitte Global Corporate Counsel Report 2011* cites fraud, insider trading, and stock market disclosure as among the top issues for regulators and thus to which general counsels pay close attention. Corporate attorney recruiters and corporate executive compensation firms often list compliance as tantamount in importance in recruitment and remuneration (KPMG report, 2012). We measure the

[9] In order to calculate delta, we require information on the number of shares and both the number and value of unexercised options held by the ExecGK. We find that ExecuComp often does not report the actual share ownership for non-CEO executives. In such cases, we assume the delta of stock holdings to be zero. Nevertheless, for robustness purpose, we perform additional multivariate tests by using the sub-sample after dropping delta that carries missing/zero values.

failures of regulatory compliance in two dimensions –accounting fraud and profitable insider sales, resulting from insiders' ability to exploit private information. Because internal gatekeepers sign off filings with the SEC and insider trades often require approval of general counsels, general counsels' reputation capital is severely at stake when a failure occurs in these types of compliance.

We measure accounting fraud with Accounting and Auditing Enforcement Releases (*AAERs*) issued by the SEC. The releases pertain to financial reporting enforcement actions from civil lawsuits brought by the SEC in federal court, issued during or at the conclusion of an investigation against a company, an auditor, or an officer for alleged accounting and/or auditing misconduct. We code the variable AAER to capture when the alleged accounting misconduct takes place rather than when the enforcement action is launched, i.e., AAER is set to 1 if financial statements in that firm year were restated and later became a subject for SEC enforcement action. AAERs that are not related to misstatement (e.g., for reasons such as bribery and disclosure) are excluded from our sample.

We obtain AAERs from the Center for Financial Reporting and Management Center at the Haas School of Business, UC Berkeley. We truncate the analysis to 2009 when we use AAERs because it takes a year and a half for frauds to emerge (Dyck, Morse, and Zingales, 2010) and another span of a year or two for the SEC to complete an investigation. Thus, the frauds committed during the 2010-2012 period will likely not yet be reported in the AAER list, which is updated to summer 2012.

As our measure of misconduct in insider trading, we follow recent studies (e.g., Jagolinzer, Larcker and Taylor (2011), Ravina and Sapienza (2010)) that measure insider trading performance by calculating the market-adjusted return after the trade. The underlying assumption is that if the trade does not involve nonpublic information then the insider should on average earn zero abnormal return. Following Dechow, Lawrence and Ryans (2013) and Skaife, Veenman, and Wangerin (2013), we focus on the profitability of insider sales and compute for each firm-year the 12-month buy-and-hold returns following the sales weighted by the value of insider sales by all executives in the executive suite. We use the post-trade return to gauge whether sales were made to avoid a foreseen loss. Insider trading profits can be interpreted as the outcome of opportunistic trading because insider sale for other reasons like liquidity or hedging should not result in profits, on average. Insider trading data come from the Thomson Reuters Insider Transaction database, which are then merged to CRSP to calculate the post-trade market-adjusted returns.

II.c. Monitoring Failures

The other three types of governance failure relate not directly to compliance, but to monitoring. These monitoring failures are securities fraud allegations, "uncaught" likelihood of accounting fraud, and option grants backdating.

Securities fraud occurs when management destroys shareholder value by misrepresentations, omissions of disclosure, or other violations securities law. These frauds are more general than misconduct caught in AAERs. Dyck, Morse and Zingales (2010; 2014) show that nearly 40 percent of securities fraud are outside of accounting compliance activities and instead relate to misleading or omissions in communication or self-dealing. (See Karpoff, Koester, Lee, and Martin (2013) for a comparison of fraud data.) Thus, this measure of fraud contains a mixture of governance failures resulting from compliance and monitoring lapses. To construct a securities fraud variable, we collect the class action lawsuits filed during 1995-2012 from the Stanford Law School Securities Class Action Clearing House and merge them to Compustat.[10] There are altogether 1,187 lawsuits filed against public firms during this period, with 582 cases that were dismissed by the court and 78 that were not settled, which are removed from the sample. Our measure of governance failure is an indicator (*Class Action*) that takes the value of one if the firm fiscal year coincides within the class period (the period during which the alleged fraud was occurring), and zero otherwise.

The uncaught likelihood of accounting fraud is captured by *Fraud Score*, which is calculated using the misstatement prediction model and coefficient estimates of Dechow, Ge, Larson, and Sloan (2011). We relegate a full list of inputs and the formula to Appendix Table 1.

Finally, our *backdating* measure of governance is the list published by the *Wall Street Journal* of companies that have disclosed government probes on misdated options and related restatements as of September 2007.[11] For each listed company, we manually searched for the ultimate findings of the investigation. Backdating indicator (*Backdating*) is set to one for firm years when firms are convicted of backdating or misdating. Although after the backdating scandal, gatekeepers might face large ex ante reputation concern about backdating, this should not be the case before 2007, as this was not a compliance issue until the scandals were discovered.

II.d. Investment Data

Our final analysis considers corporate investment as a flip-side measure of general counsel attention on productive risk-taking. Bagley (2008) points out that firms characterize their executive general counsels more as counsels and entrepreneurs rather than policing lawyers. This view is echoed on the practitioners' side, that general counsels participate in valuable strategic decision-making at the highest executive levels,

[10] The Stanford Law School Securities Class Action Clearing house database has been employed by a number of prior studies (e.g., Lowry and Shu (2002), Field, Lowry, and Shu (2005), Dyck, Morse, and Zingales (2010), Hanley and Hoberg (2012), and Kim and Skinner (2012)). These securities frauds are alleged rather than proven, in that no case ever goes to trail, but rather settles out of court because D&O insurance do not cover the executives with court convictions.

[11] See http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html

particularly when it comes to mitigating risks in intellectual property initiatives. Horner (2007) discusses how corporate lawyers are involved in early stages when strategic initiatives are developed or transactions are contemplated, and that they are expected to be advising the CEO and the board in the same way that the CFO or COO would.[12]

We use two measures that gauge the result of lawyer's effort in strategic investment. The first is the ratio of capital expenditure to PP&E as in Eisdorfer (2008). It captures the investment intensity in tangible assets. Second, we use R&D expenses scaled by assets as a proxy for investment intensity in intangible assets.[13] Prior studies (e.g. Shaked and Sutton (1987) and Valta (2012)) suggest that firms use R&D to differentiate their products from those of competitors. This investment in intangibles makes it difficult for rivals to enter and to compete with these firms.

II.e. Other Company Outcomes and Measures

Our analysis also considers a number of typical measures on corporate governance that characterize internal and external monitoring. We will use these measures to gauge whether the firm strengthens other governance mechanisms when bringing in a gatekeeper, to speak to the mechanisms of our results. To strengthen the board, the chair may encourage board turnover or the initiation of more independent board members. We gather these data from Riskmetrics. Finally, we obtain the G-index of governance of Gompers, Ishii and Metrick (2003) from Riskmetrics to measure shareholder rights. A higher value of G-index indicates weaker shareholder monitoring.

We later investigate firm-level measures of the need for ExecGKs to speak to an alternative interpretation of our story. The first is patents activity of the firm, captured by an indicator variable that equals to one if the firm files patents in a fiscal year and zero otherwise. Data come from the National Bureau of Economics Research (NBER) Patent Citation Database[14], which contains annual information from 1976 to 2006 on patents and citations for U.S. publicly traded firms. The second is the number of completed domestic and cross-border acquisitions in a year, with data from SDC. The last two measures speak to the complexity of the business and business diversification (Cohen and Lou (2012)). In

[12] We find that general counsels that make to the executive office on average garner an impressive 32% of CEO pay, comparable to the total pay of CFOs, which is 34% of the CEO's (Jiang et al (2010)).
[13] Koh and Reeb (2014) find that firms reporting no information about R&D actually file more patents than firms reporting zero R&D, suggesting that the non-reporting firms may have made non-trivial investment but opted to classify R&D expenditures into other expenses, putting into question the practice of treating missing R&D as zero. We, therefore, replace missing R&D with industry median based on 2-digit SICs.
[14] We thank Jin Wang for providing us the data.

particular, we use the number of business segments and the Entropy measure, which is calculated as the sum of Ps*Ln(1/Ps) where Ps is the proportion of the firm's total sales in industry segments).[15]

III. General Counsel Fixed Effects

We begin with a general counsel fixed effect model, following Bertrand and Schoar (2003) and Malmendier and Tate (2009), who study the amount of fixed effect associated with CEOs, to measure to what extent differences among individual CEOs matter. Their empirical insight is to use the movement of CEOs across firms to gauge how much variation in the performance of relevant firm metrics is due to individual managers versus firm fixed effects. Subsequent work by Güner, Malmendier and Tate (2008) and Custodio and Metzer (2014) implements the same methodology for CFOs.[16] Thus, we use this methodology to accomplish two goals. First, we build on the literature of Kwak, Ro, and Suk (2012), Hopkins, Maydew, and Venkatachalam (2014), Jagolinzer, Larcker, and Taylor (2011) and Krishnan, Wen, Zhao (2011), by offering a quantification of the governance importance of individual lawyers across firms. Second, we motivate our analysis of the paradox of executive lawyers by studying the top lawyer fixed effects on both governance and investment dimensions. We interpret the total magnitude of partial r-square of the general counsel over and above CEO and firm fixed effects as a metric for saying (a) how important the institution of general counsel is and (b) how important it is across governance outcomes relative to investment outcomes.[17]

Table 2 produces this result, mimicking layout of Bertrand and Schoar (2003). The estimation regresses governance on firm and year fixed effects, and then iteratively adds in CEO fixed effects and general counsel fixed effects. The table reads down by rows. The first row reports just the firm and year fixed effects result for AAERs. The adjusted r-squared is 0.299; firm and year fixed effects account for about 30 percent of the variation in realized AAERs. The CEO addition (the second row) increases the r-squared to 0.499. The general counsel adds another 7 percent, increasing the adjusted r-squared to 0.570.

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[15] The measure was developed by Jacquemin and Berry (1979), and used in prior studies such as Bushman, Indjejikian, and Cassell, Huang, Sanchez, and Stuart (2012).

[16] Recent accounting research documents significant top mangers' individual effects on firms' voluntary disclosures, tax avoidance, and a wide range of financial reporting choices (Bamber, Jiang and Wang (2010); Dyreng, Hanlon and Maydew (2010); Ge, Matsumoto and Zhang (2011)). Yang (2012) finds that the market recognizes managers' individual style and reacts to their earnings forecasts accordingly. Most of the existing studies focus on CEOs and CFOs, and Bamber, Jiang and Wang (2010) is the only study we know of that examines general counsel's fixed effect on management earnings forecast. Different from their paper, we offer a big-picture view on both compliance roles and monitoring roles of executive gatekeepers.

[17] In the rest of the paper, we focus on executive general counsels, i.e, those in the inner executive suite as proxied by stable compensation. In this section, we used the larger set of general counsel because we were not constrained to have compensation data and because using a more complete dataset allows for a cleaner identification of true moves of lawyers across firms. It is worth noting that these magnitudes may be conservative as compared to executive general counsel especially for investments in that lower-rank general counsel probably have less impact on strategic decision-making.

This represents a 14% change increase in adjusted r-squared. The f-test for the joint significance of the general counsel fixed effects has a p-value of <0.0001.

Doing the same exercise for the other governance failure dependent variables finds that the general counsel fixed effect explains 1.2 percent of the variation in insider trades profits (representing 17% increase in adjusted r-squared), 6 percent of the variation in securities class action suits (representing 18% increase in adjusted r-squared), 4 percent of the variation in accounting fraud score (representing 10% increase in adjusted r-squared), and 3 percent of the variation in backdating (representing 4% increase in adjusted r-squared). The f-tests all can be interpreted as that the general counsel fixed effects being jointly significant in explaining variation. An observation is that the general counsel's role is most pronounced in the compliance measures, with AAER and insider trading profits experiencing the largest percentage increase in adjusted r-squared.

The last two rows report the general counsel fixe effect on investment decisions. The addition of general counsel fixed effect explains an additional 4.9 percent of the variation in capital expenditure (representing 12% increase in adjusted r-squared), and 0.6 percent of the variation in in R&D investment (representing 2% increase in adjusted r-squared).

In sum, over and above firm and CEO fixed effects, general counsel fixed effects on average explain 4.6 percent of the variance in governance measures and 2.8 percent in investment. CEO fixed effects on average explain 11.0 percent in governance and 3.9 percent in investment. To the extent that the literature on CEO fixed effects deems the CEOs important in governance and investments, general counsel are as well, confirming the notion from prior literature that they preside over gatekeeping and strategic advising roles.

IV. Methodology

The prior section motivates the paradox of being an executive general counsel – fulfilling executive gatekeeper duties and being a strategic value-creator for the firm at the same time. The pivot mechanism we propose is compensation. Thus, our empirical goal is to identify the impact of equity incentives on the compliance, monitoring and investment activities of executive gatekeepers (ExecGK). If firms compensate gatekeepers with equity, money incentives might divert gatekeepers' attention away from monitoring for corporate wrongdoings and toward strategic lawyering activity. On the other hand, if the market heavily penalizes corporate malfeasance, then giving gatekeepers an equity stake should enhance internal governance.

The intuition of our methodology is as follows. Imagine two firms wanting to hire a prominent lawyer to be the ExecGK. One firm hires a lawyer from a law firm; the other, from another corporation. The reason for hiring an ExecGK is certainly endogenous, but because we are comparing only within the

set of firms that hire, the endogeneity task we face is to address the selection of hiring from a law firm versus from a corporation. If we can handle this selection, we build off our main identifying assumption that because a lawyer hired from law firm has built his or her (i) reputational capital, (iii) human capital, and (iii) habit solely as a lawyer, the impact of equity incentives is unlikely (or less likely) to alter his/her gatekeeping behavior *initially*. Lawyers from law firms will not want or will not know how to step away from lawyering-gatekeeping at first, and thus equity incentives will not alter their gatekeeping behavior initially. If we are wrong in this assumption, our tests will be conservative.

Before proceeding, we frame our identification in the sociology literature on professionalism. The foundations are found in Goode (1957), who defines a professional community (e.g., doctors, lawyers, professors, etc.) as occupations where all members are bounded by a sense of identity and share values in common. Hall (1968) discusses how professionals in an organization may identify less with the organization compared to other employees, because of conflicts between administrative imperatives and professional norms. For our setting, Wallace (1995) provides the evidence on our assumption. He finds that lawyers working in corporations are significantly less committed to the legal profession than those working in law firms.

We begin with a simple difference-in-differences equation for an outcome variable *y* measuring compliance failures, monitoring failures, or investment. The sample is firms that hire an ExecGK externally from either another company (*Treat =1*) or law firm (*Treat =0*). None of the firms included have an ExecGK in the pre-period (i.e. two years before the hire), and all hires must remain as ExecGKs for three years. We match the treatment and control in year of the hire, tertile of firm market capitalization, and one-digit industry, and then within these matched buckets, we draw three nearest neighbor matches on the litigation propensity following Choudhary, Schloetzer, and Sturgess (2012), who find that firms that are more complex, and with higher litigation risk are more likely to hire top tier corporate attorneys.

To construct ex ante litigation propensity, we follow the procedure in Kim and Skinner (2012) to construct an *ex ante* litigation risk measure for all sample firm years. In particular, we implement a litigation determinant logit model using all securities class action lawsuits filed during 1995-2012 from the Stanford Law School Securities Class Action Clearing House. Kim and Skinner identify industry (such as membership in the biotechnology, computers, electronics, and retail industries), size, sales growth, stock returns, return volatility, skewness, and liquidity as among the most important factors in

determining firm litigation risks. *Litigation propensity* is calculated based on the coefficient estimates of this logit regression.[18]

With the match done, a simple difference-in-differences estimating equation would be:

$$y_{it} = \alpha_1 Post_{it} + \alpha_2 Treat_i + \alpha_3 Post_{it} Treat_i + \mu_{year} + \mu_{industry} + \mu_{hireyear} + \varepsilon_{it}. \quad (1)$$

Indices *i* and *t* denote firm and year respectively. *hireyear* indexes the year of the hiring. Notation μ denotes fixed effects, including year, hire year, and industry (at the two-digit SIC code level). We only keep the two years prior to the hiring and the two years subsequent in the panel, tossing out the year of hiring to allow for the transition in outcomes. In all estimations, we will cluster standard errors at the firm level. *Post* is an indicator for time *t* being after the hiring.

Equation (1) does not include any role for equity incentive. Instead it is a matched difference-in-differences comparing corporate versus law firm hires to check whether fraud/investment levels (α_2) and changes (α_3) are sensitive to the selection of hiring an ExecGK from a law firm or a corporation. To implement tests on equity incentives, we introduce the delta of the gatekeeper *i*, $X^{GK}_{i,hireyear}$, interacted with the treatment framework.:

$$\begin{aligned} y_{it} &= \alpha_1 Post_{it} + \alpha_2 Treat_i + \alpha_3 Post_{it} Treat_i + \mu_{year} + \mu_{industry} + \mu_{hireyear} \\ &+ \alpha_4 X^{GK}_{i,hireyear} + \alpha_5 Treat_i X^{GK}_{i,hireyear} + \alpha_6 Post_{it} X^{GK}_{i,hireyear} + \alpha_7 Post_{it} Treat_i X^{GK}_{i,hireyear} + \varepsilon_{it} \end{aligned} \quad (2)$$

$X^{GK}_{i,hireyear}$ is static, defined only at the hiring year to avoid confounding effect of performance. Although this variable is in the future for the *Post = 0* observations, its interaction with *Treat* allows us to difference out a selection effect that the treated and control groups may exhibit differing sensitivities of the outcome measures to the level of incentive pay. (Our results hold when removing this level effect as well.)

What we are left with is a plausible conditional mean independence assumption for interpreting our main variable of interest, α_7: Had the firm hired an ExecGK from law firm rather than a corporation, the firm's governance/investment sensitivity to equity incentives would have evolved as a similar firm that chooses to hire a lawyer from a law firm once we:

(i) match on litigation risk within the year, industry and size of firm,

(ii) control for both the selection of hiring from a corporation (*Treat, Post, and Post*Treat*),

(iii) control for the level of incentive pay for the selection of a corporate hire

[18] The explanatory variables used in the logit model (lagged by one year), including FPS, natural logarithm of sales, sale growth, market-adjusted returns, volatility, skewness, and liquidity, are defined in Appendix Table 1. Our estimation results are similar to those presented by Kim and Skinner. The coefficient of estimates is 0.536 for FPS, 0.463 for natural logarithm of sales, 0.229 for sales growth, 0.002 for market-adjusted returns, 0.315 for volatility, -0.260 for skewness, 0.0002 for liquidity, and -8.418 for the intercept, respectively. There are a total 86,062 observations for the estimation.

$\left(X^{GK}_{i,hireyear}, TreatX^{GK}_{i,hireyear}\right)$.

With so many differencing and interactions, it is perhaps more straightforward to state the opposite, which is, what it would take for our identification to fail. Contract theory predicts that firms with different contracting environment vary in optimal incentive levels. Studies on executive compensation (e.g. Core, Holthausen and Larcker (1999), Armstrong, Jagolinzer, and Larcker (2010)) suggest that both innate firm economic characteristics such as size, complexity, growth, and firm corporate governance characteristics affect managerial compensation. A possible endogeneity concern is that the firm's selection of hiring a gatekeeper from another company versus hiring from a law firm may reflect some omitted variable correlated with the effectiveness of equity incentives.

To address this concern, we take a final step to ensure the robustness of interpreting a causal effect of ExecGK equity contracts. The idea is a form of a triple difference as follows:

$$\begin{aligned} y_{it} &= \alpha_1 Post_{it} + \alpha_2 Treat_i + \alpha_3 Post_{it} Treat_i + \mu_{year} + \mu_{industry} + \mu_{hireyear} \\ &+ \alpha_4 X^{GK}_{i,hireyear} + \alpha_5 Treat_i X^{GK}_{i,hireyear} + \alpha_6 Post_{it} X^{GK}_{i,hireyear} + \alpha_7 Post_{it} Treat_i X^{GK}_{i,hireyear} \\ &+ \alpha_8 Post_{it} X^{CEO}_{i,hireyear} + \alpha_9 Post_{it} Treat_i X^{CEO}_{i,hireyear} + \varepsilon_{it} . \end{aligned} \quad (3)$$

We introduce the level of equity incentives of the CEO to difference around the endogenous use of equity incentives for firms. Thus, the "triple" effect is that we isolate the sensitivity of governance/investment to ExecGK equity incentives by comparing (i) over time, (ii) against outcomes when similar equity incentives are granted to ExecGKs hired from law firms, and (iii) compared to the sensitivity of governance/investment to within-firm equity incentives granted to CEOs. (We omit the CEO forward looking variables.)

To deal with the concerns of serial correlation and over-rejection of the null, we adopt the collapsed estimation procedure recommended by Bertrand, Duflo, and Mullainathan (2004). Following their approach, we collapse our time series observation around ExecGK hiring into a pre and post period and calculate the change in fraud/investment measures of the treatment group and the control group respectively. In essence, we collapse time series information of each firm into one observation in which Δ implies the average in the post period minus the average in the pre period.

$$\Delta y_i = \lambda_1 Treat_i + \lambda_2 X^{GK}_{i,hireyear} + \lambda_3 Treat_i X^{GK}_{i,hireyear} + \lambda_4 X^{CEO}_{i,hireyear} + \lambda_5 Treat_i X^{CEO}_{i,hireyear} + \mu_{industry} + \mu_{hireyear} + \varepsilon_i \quad (3)$$

The collapsed version is our preferred specification, but we present both forms for robustness.

V. Statistics and Selection Tests

V.a. Summary Statistics: Firms that Hire versus Firms that do not Hire

To provide a sense of company attributes that correlate with hiring an ExecGKs externally, Table 3 provides summary statistics for the fiscal year in which an external ExecGK is hired compared to firms that have no ExecGK five years in a row. The statistics show that firms with smaller market capitalization, lower market-to-book ratio, higher volatility, and higher litigation risk tend to hire an ExecGK. In terms of investment activity, firms that hire ExecGK have lower investment in intangible assets but no difference in tangible assets. Governance in some dimensions, e.g., AAER fraud, profitability of insider trading, and class action law suits seem to be weaker in the group of ExecGK hiring firms than no-ExecGK firms, but not so in fraud score and backdating. The results on other governance metrics are also mixed in sign. In sum, the firms appear quite different, not in an easily characterizable way.

V.b. Governance and Investment Effect Associated with Hiring

Before we move to our identified sample of corporate versus law firm hires, we first look at the governance and investment changes associated with hiring an ExecGK. We take firms hiring ExecGKs from either a law firm or corporation as treatment group and compare their pre and post outcomes to otherwise matched firms that choose not to hire. We do the same matching as in the design of the methodology section, using a propensity score within industry-size-year bins. We do not claim the resulting statistics to be formal 'tests" of the effect of ExecGK on governance and investment because we cannot prove causality of the design. Rather, we use Table 4 to set up the effectiveness of our law firm-versus-corporate hire matching and as a way to scale our results later. The conditional mean independence assumption would have to be that in the absence of hiring an ExecGK, the firm's governance [investment] would have evolved as other firms in the same industry and in the same year with similar governance risk [investment intensity]. Violations to a causal interpretation of such a design might be (1) that firms hiring ExecGKs should correlate with those desiring to mitigate a future strain on governance [or those having a need for future investment], or (2) that the hiring of ExecGKs reflects boards or CEOs with an overall strategy to improve governance on many dimensions [or embark on strategic investments].[19] We therefore cautiously refrain from interpreting these around-hiring differences as governance and strategic investment causal effects from hiring ExecGK. A literature (Kwak, Ro, and Suk (2012), Hopkins, Meydew, and Venkatachalam (2012), Jagolinzer, Lacker, and Taylor (2011)) already documents that ExecGKs tend to improve governance. Our result is consistent with this. These papers take up the issues and struggles with identification, often with competing results reflecting the difficulty therein.

[19] For the interested reader, the first assertion is conservative in finding improvements in governance associated with ExecGK and the second one is not supported in other governance measures we have considered. In a prior draft, we put more emphasis on these governance findings.

Table 4 shows that firms hiring an ExecGK experience improvement in both corporate compliance and monitoring, with the changes from pre-hiring to post-hiring being negative for four of the five measures on compliance failures (Panel A). AAER fraud falls by 0.021 with an ExecGK hiring. Relative to the pre-hiring two-year mean of 0.042, this decline represents a 50% reduction. Insider trading profits falls by 2.3%. This decline represents a large 85% change reduction relative to the pre-hiring mean of 2.7%. Compared to firms hiring ExecGK, those matched firms that do not hire experience negligible changes in both compliance measures.

In terms of monitoring variables (Panel B), we find ExecGK-hiring firms experience a significant 0.02 reduction in being class action sued for securities fraud, representing 33 percentage change relative to the pre-hiring mean of 0.06. We find smaller effects for accounting statements suggesting of fraud; the *Fraud Score* significantly decreases by 0.16 after hiring of ExecGKs. This coefficient implies that the perceived likelihood of the corporation committing fraud is 13 percentage lower relative to the *Fraud Score* pre-hiring two-year mean of 1.248. Backdating likelihood is unrelated to the presence of an executive gatekeeper in our tests. In comparison, the matched firms experience no changes in the probability of class action law suits while seeing a reduction in "uncaught" accounting fraud. However, the 5% reduction in *Fraud Score* of matched firms is statistically significantly less than the reduction experienced by ExecGK-hiring firms.

Panel C shows that both hiring firms and matched firms experience reduction in capital expenditures; R&D expenditures are reduced in the matched firms but not in the hiring firms. The difference in changes between the two sets of firms is statistically significant only in tangible capital investment. The reduction in investment is consistent with our prior that lawyers are concerned with the risks that corporate investments may entail. Without equity incentives, corporate lawyers put their attention to corporate compliance and monitoring rather than strategic growths, reflecting their conservative bias with regard to risk tolerance.

Next, we look for evidence on whether ExecGK hiring is within the board's agenda to improve corporate governance. The firm may take other steps to improve governance such as reshuffling the board in addition to hiring an ExecGK. Panel D shows that both ExecGK hiring firms and matched firms improve board structure by having more independent directors. However, the hiring firms do not experience more or less changes than matched firms in G-index and board turnover. In addition, Panels A and B of Table 4 presents evidence that governance improvements are prioritized in a way that is consistent with how ExecGKs prioritize their tasks, i.e., most improvement is seen in regulatory compliance (AAER and insider trading profit) and improvement in monitoring aspects (securities fraud and accounting statements suggesting of fraud) are to a lesser extent. It is not clear that other governance mechanisms would result in such a ranking, especially if the board's other actions are aimed at curbing the power of the CEO.

V.c. Selection tests on the choice of corporate hires

Table 5 compares the summary statistics in the year of ExecGK hiring for the corporate hire firms and the law firm hire firms. In Table 5, we have already matched the two groups of hiring firms in size, year, industry and the litigation propensity of Kim and Skinner (2012).[20] Thus, the objective of this table is to ask whether comparison of firms hiring from law firms versus those hiring from other companies display any differences in firm or executive characteristics. The results of Table 5 are noticeably different from those in Table 3. ExecGKs hired from law firms and their hiring firms have statistically similar characteristics in means and medians to ExecGKs hired from other companies and their firms across all dimensions except for one.

The only difference we observe is that the law firm hires garner higher equity incentives (*ExecGKDelta*) than their matched corporate hires. The incentive pay scheme may be designed to counteract a conservative bias, which is at the core of our identification. Since we are interested in the sensitivity of ExecGKs' gatekeeping behavior to a unit change in delta, we naturally control for the level of these deltas and can focus our empirical attention to the marginal effect of the delta. Overall, the statistics in Table 5 alleviate concerns that two groups are different in dimensions that are indicative of the effectiveness of incentive pay.

VI. Results

VI.a. Governance Results: Compliance & Monitoring

Tables 6 and 7 report the results as to whether equity incentives impact executive lawyers' effort exerted in compliance. Before looking explicitly at the equity incentive interactions, we first use column 1 (for the AAER dependent variable) and column 4 (for insider profits) of Table 6 to test for selection on the difference between law firm hires (*Treat=0*) and corporate hires (*Treat=1*) not on ex ante firm characteristics (as in Table 5), but on expected ex post governance. The selection story of concern is that a firm knowingly facing a future governance stress or a need for future improvement in governance would systematically choose either law firm lawyer or a corporate lawyer to mitigate the governance strains forthcoming. In columns 1 and 4 of Table 6, we find that neither the coefficients on *Treat* nor the coefficients on *Treat*Post* are significant for compliance outcomes. As in all of our specifications, we first match treatment and control samples on the fraud risk within the industry-year-size. Both the governance

[20]We present results based on the litigation match, because it follows directly from Kim and Skinner (2012) in being a predictor of hiring super lawyers, but no other significant difference emerge when we match on the other dependent variables in pre-period scorings.

quality of the firm and the change in governance quality of the firm are unrelated to selection of hiring source. Likewise, in the collapsed implementation of Table 7, the coefficient on *Treat* in columns 1 and 4 again reaffirm that the on average effect of treatment into the corporate hire group is unrelated to changes in compliance governance.

The main variable of interest in Table 6 is *Post*Treat*Log(ExecGKDelta)*.[21] This coefficient speaks to whether equity incentives cause a diversion of or an enhancement to gatekeeping effort in compliance. Columns 2 and 3 consider AAER fraud outcomes, and columns 5 and 6, insider trading profits. Columns 3 and 6 add in the additional dimension of controlling for the equity incentives of the CEO, differentially for the treated and the control. We include a series of fixed effects for industry, year and hiring year, and cluster errors at the firm-hire level. Overall, we have 283 firm-hires which result in about four times that number of observation.

Under the identification assumption that ExecGKs hired from law firms are unlikely to change gatekeeping practices because of equity incentives at least in the short term, we interpret the coefficient on *Post*Treat*LogExecGKDelta* as causally identifying the impact of equity incentives on the gatekeeper-governance relationship. (We will push back a bit on the causal language before we conclude.) We find little evidence that equity incentives divert regulatory compliance efforts, as manifested in AAER fraud and insider trading profits. The coefficient of interest is positive and marginally significant in columns 2 and 5, but the addition of the differencing around the CEO equity incentives erodes this coefficient. More importantly for our skepticism of interpreting any impact are the collapsed results in Table 7, where we find coefficients more precisely estimated to be zero and in some cases, with the opposite sign from Table 6. The lack of an effect of incentive pay on compliance outcomes is consistent with our conjecture that among all mandates with which general counsel are charged, compliance is least likely to be compromised. The tradeoff in time is more likely between monitoring and risk mitigation in strategic investment.

Tables 8 and 9 repeat the exercise of Tables 6 and 7, but this time for the monitoring aspect of gatekeeping. We measure gatekeeping monitoring effectiveness in three dimensions – class action frauds, the scoring of uncaught fraud, and option backdating. The sample is thinner for option backdating because backdating stops in 2007. Again, we first start by looking at selection gauged ex post. Herein again, we find no evidence than on average the hiring of a lawyer from a corporation is any different from the hiring from a law firm. None of the coefficients on *Treat* or *Post*Treat* in columns 1 (class actions), 4 (fraud score) and 7 (backdating) are significant in Table 8. Likewise, the *Treat* coefficients in Table 9 columns 1, 4 and 7 are also not significant.

[21] Recall in reading the magnitudes that we have shifted delta to its mean value of $55,000: *LogExecGKDelta =log(ExecGK delta+55)*. We will translate significant results into magnitudes shortly.

Turning to the results, the coefficients on *Post*Treat*LogExecGKDelta* in columns 2, 3, 5, 6, 8 and 9 are all positive and significant, consistent with an interpretation that equity incentives increase the likelihood a firm finds itself committing a fraud that will be later the subject of a class action suit, will increase the fraud scoring of Dechow et al. (2011), or is later backdating. Before looking to the magnitude, we check robustness in our preferred collapsed specification, with one observation per firm. We find that our results remain similar to Table 9 in all but the backdating cases.

In terms of the magnitude, we focus on a one standard deviation higher value of the *ExecGKDelta* in the cross section, or $52,851 (0.053 in the scaling of the table). A $52,851 larger ExecGK delta translates into an increase in the independent variable (*Post*Treat*LogExecGKDelta)* equivalent of 0.112, because of the log transform and bulk of zeros from the interaction terms *Post* and *Treat*.[22] In Table 8, a one standard deviation larger *ExecGKDelta* increases probability of class actions law suits and fraud scores each by 0.014 and 0.012 respectively, using the conservative estimates in columns 2 and 5. This marginal effect represents a percentage increase in class actions by 22% (shown at the bottom of Table 8). The fraud score percentage change is a more modest percentage change of 1%, but this is a score and not a likelihood. We ignore the backdating significant results since they do not hold in Table 9 robustness. Our preferred way to interpret these results is as monitoring diversion as a percentage of the governance improvements associated with hiring an ExecGK from Table 4. In particular, a one standard deviation increase from the mean *LogExecGKDelta* diverts 67% of the governance improvements in litigation law suits we found in Table 3. The more rigorous triple difference result in column 3 suggests that a standard deviation larger equity incentive divert nearly all of the monitoring improvements (89.9%). For the uncaught measure of fraud score, diversion unwinds 11.7% - 19.1% of the governance improvements.

Before leaving this section, we want to emphasize a point or two about the magnitude of our main results. A one standard deviation increase in the cross section of equity incentives is a much larger spectrum to consider than a time series deviation. Thus, we speak of diversion, even under our largest magnitude results, very few firms experience a complete diversion from the governance monitoring task for which the ExecGK was at least partially hired. Nevertheless, the magnitude suggests a gatekeeping-diverting result from compensation structures.

VI.b. Investments Results

In this section, we explore evidence that ExecGKs' efforts may have been diverted away from gatekeeping to another dimension of their multiple tasks, that is, equity incentives may encourage general counsels to spend more effort facilitating investment. We set up the tests in the identical design as in tables

[22] Alternatively, a one standard deviation increase in this independent variable is more than two-times larger, but we did not think this was a fair magnitude statistic to present.

6 – 9, by comparing the effect of equity incentives on investment for firms hiring a corporate ExecGKs against the control of ExecGKs hired from a law firm. We want to qualify these results in that the mechanism is less direct than the governance tests. Governance results are a direct outcome of an ExecGK's effort, whereas strategic investment is an outcome of the set of executives at large. Nevertheless, our empirical design allows us to narrowly look to the role of different ExecGKs by differencing out the hiring endogeneity. Moreover, the academic literature has numerous examples of managerial incentives being identified with greater effort. Brown, Harlow, and Starks (1996) and Chevalier and Ellison (1997) examine how managers change the riskiness of their activities in response to incentives and find that risk-taking is induced when managers' payoff is convex. Coles, Daniel, and Naveen (2006) document a strong positive relation between CEO equity incentives and riskiness of investment and leverage policies. Low (2009) show that in response to an exogenous shock that leads to risk-reduction, firms counter such adverse effects by providing managers with higher equity incentives. Following this evidence, we expect that equity incentives imposed on executive general counsels would turn their attention to mitigating legal risk and providence strategic initiative input on investment and innovation.

Tables 10 and 11 report our results as to whether equity incentives induce investment goals for a gatekeeper. Our measures of investment are capital expenditure relative to property, plant and equipment as a measure of tangible strategic investment intensity, and R&D relative to assets as measure of intangible intensity, capturing innovation and intellectual property initiatives. As before, we start by looking at the difference-in-differences to see if selection in law firm versus corporate hires seems at play. In columns 1 and 4 of Table 10 and Table 11, we find no significant on *Treat* or *Treat*Post* variables.

Again, our main independent variable is *Post*Treat*LogExecGKDelta* in Table 10 or *Treat*LogExecGKDelta* in Table 11, i.e., the treated wealth sensitivity of the ExecGK to firm equity performance. Across our two investment measures in Table 10, we find support for investment increasing incentives in both the capital expenditure measure of investment intensity (columns 2 and 3), and the R&D measure of investment intensities (columns 5 and 6). The collapsed estimation in Table 11 suggests that equity incentives have effects on R&D investment only, and even this is a bit weaker. We interpret the R&D results as robust because in the subsequent analysis breaking down equity incentives into options and stock grants, we consistently find that stock options are robust in their effect on R&D expenditures. Using the same economic magnitude gauge as before, a one standard deviation increase in the sensitivity of ExecGK's equity wealth to a one percent change in stock price increases R&D investment by 5.7% (column 5 of Table 10).

Our results indicate that equity incentives somewhat induce more investment-related efforts of ExecGKs, consistent with the idea that these internal gatekeepers can be diverted from gatekeeping

activities to strategic initiatives in response to equity incentives. We chose to not run value estimations because we could not interpret the source of any value increase.

VI.c. Multi-tasking and incentives

The tradeoff between gatekeeping and adding value to strategic investment relates to the "multi-tasking" problem of agency theory, i.e., how to provide agents with the right incentive to get them choose the right combination of actions that maximize shareholder value in a world of multi-dimensional actions. Prior theoretical work suggests that in a multi-tasking framework providing incentives to perform one task can potentially affect the incentives to perform others, and since no single performance measure can perfectly reflect the agents' actions in all dimensions, optimality would involve having multiple performance measures to gauge effort or effectiveness across tasks (Baker (2000); Datar, Kulp, Lambert (2001); Feltham and Xie (1994); Holmstrom and Milgrom (1991); Indjejikian (1999)).

Multitask theories have proven difficult to investigate in empirical studies, mainly due to the difficulty of measuring outcomes associated with different tasks. Our research seems to have provided a unique setting for such agenda. Particularly relevant for our discussion is Burns and Kedia (2006), who study the differential impact that stock options and stocks themselves have on managers' willingness to get exposed to downside risks. Stock options limit the downside risk and reward upside potential due to the convexity of the payoff function; therefore they provide incentives for good risk-taking in terms of corporate investment but also induce bad risk-taking in terms of opportunistic misconduct (or underinvestment in deterring such behavior). In comparison, stocks holdings expose managers equally to both upward and downward risks; therefore managers are not incentivized to engage in misconducts in fear of their wealth loss upon detection.

To implement our study in a multitask measurement along the lines of Burns and Kedia (2006), we split the equity incentive measures into stock delta and option delta, and examine how each of the two types of incentives affect the gatekeeping and strategic value creating mandates respectively. The idea is that stocks offer a linear trajectory, whereas options offer only a non-linear upside payoff. Table 12 reports the results of this analysis. For brevity, only the collapsed version is tabulated.

Consistent with executive gatekeepers prioritizing their tasks, the two measures in compliance dimension (i.e., AAER and Insider Trading) are not affected by either stock or option delta. While option delta unwinds governance improvement in monitoring dimension (i.e. class action law suits and fraud score), stock delta does not seem to do the same. In terms of investment, R&D expenditures, which is the riskier type of investment, goes up with option delta, consistent with options creating risk-taking incentives. Taken together, the results suggest that stock options are effective in promoting risk-taking investment, yet at the same time can be a double-edge sword that weakens monitoring strength. Equity incentives from

stock holdings do not seems to create such a tradeoff, though the evidence in Table 12 is not enough to draw an inference on their efficiency in one task or the other.

VI.d. Causality of Lawyers versus Lawyers as Totem Gatekeepers

The results from above are consistent with the notion that an executive lawyer is situated in a paradox of facing multiple duties as governance lawyers but also as strategic executives, and that incentive contract plays a role as the pivot of this paradox. An alternative explanation for our findings is that it is possible that firms hiring ExecGKs from corporations sometimes are hiring a lawyer to be partially the internal gatekeeper and partially to be a strategy officer to handle strategic issues involving intellectual property and growth. It would certainly be more likely that a firm would hire such a lawyer with a dual role from another corporation rather than from a law firm. And it is certainly reasonable to expect that these strategic lawyers would be given more equity incentives and would spend more time away from monitoring. Therefore, our earlier results on equity incentives and monitoring failures could merely reflect such underlying facts. In such case, it must be that the firms hiring strategic officers are not an artifact of industry, time, or anything else correlated with the use of CEO incentive contracts, items for which we control. In addition, it must be that the lawyers hired from other corporations not hired as strategic officers must be better gatekeepers than those from law firms to generate the results of no difference in governance patterns for corporate versus law firm hires. This is possible; however the result that general counsels hired from law firms receive, if anything, higher compensation suggests this is not likely to be the case.

Nevertheless, we investigate whether firms that hire ExecGKs from corporations have more *needs* for future corporate events such as patent licensing and strategic acquisitions, both of which require legal expertise on intellectual properties and antitrust laws. Table 13 presents the selection tests. Panel A shows that there is no difference in all four measures on patents, acquisitions, and diversification needs between firms that hire ExecGKs from corporations and those that hire from law firms. Panel B further presents evidence that firms hiring executive gatekeepers from corporations experience no different post-hiring patterns in these measures than firms hiring the executive gatekeepers from law firms.

Our intuition from the analysis is that indeed we are picking up a causal role for equity compensation affecting monitoring failures. However, we do not fully rule out the interesting alternative interpretation that general counsels hired from corporations and given large equity incentives are not really full-time gatekeepers but rather valuable executives and potentially only *totems* of the gatekeeping role suggested by their titles.

VII. Conclusion

Internal governance is an idea that has grown in popularity among executives, as they have increasingly become exposed to regulation and punishment for misconduct. In this paper we investigate an important and special facet of internal governance, i.e., lawyer gatekeepers in the executive suite, and examine the paradox introduced by the fact that these gatekeepers preside over the role of monitoring corporate misconduct as well as participating strategic value-creation.

We start off with a fixed effect analysis to document the impact of individual general counsels on governance and investment outcomes. Prior literature guides our intuition that individual executives matter; using movement of executives for identification, the fixed effect of CEOs explain a host of variation in firm outcomes (Bertrand and Schoar, 2003; Malmendier and Tate, 2009). In addition, financial expertise matters inside the firm (Custodio and Metzger (2014)). We introduce legal expertise into the box, documenting that general counsel commands meaningfully large governance and investment fixed effects. Hopefully this simple result itself will stimulate further work into lawyers in the firm.[23]

For our purposes, however, investment and gatekeeping roles of lawyers in executive offices together imply a paradox, pivoting on compensation structure. We view the ExecGKs as time constrained and situated in a paradox of being gatekeepers as well as part of the top management team. We find that equity incentives granted to the ExecGKs introduce a tradeoff between the two commands that vie for gatekeepers' attention. In particular, equity incentives are misaligned with governance outcomes, diverting much of the improvement in governance associated with having an internal gatekeeper. These diversion, however, only happen in monitoring dimensions of gatekeepers' jobs and are not observed in compliance measures. On the flip side, equity incentives align ExecGKs with strategic investment tasks, suggesting that they are diverted away from traditional monitoring jobs to strategic tasks when incentivized to create value for the firm. Coffee (2002) might fairly interpret our results that compensation distorts gatekeeping. We do not, however, offer the welfare implication, as any value estimations would be fraught with speculation in interpretation.

We conclude with the thought that as long as intellectual property continues to be a major part of production, legal expertise will continue to be needed in decision making, and the lines between legal value-creators and legal guardians will remain blurry. Intellectual property is not going away.

[23] New work by on the effect of lawyers on M&A negotiations by Karsten, Malmendier and Sautner (2014) also serves this motivating purpose.

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Table 1: Summary Statistics of Executive Gatekeeper (ExecGK) Characteristics by Fiscal Year

This table presents ExecGK characteristics (mean) by fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Statistics reported in (1) and (2) are for the whole sample while statistics reported in (3)-(8) are for firm years with the presence of ExecGK. *ExecGK* is an indicator variable equal to one if a general counsel appears in ExecuComp as one of the top paid executives. *ExecGK pay* is the executive gatekeeper's total compensation (salary, bonus, other cash compensation, option grants, and restricted stocks) in constant 2012 dollars. *CEO pay* is the CEO's total compensation. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. Detailed variable definitions are provided in Appendix Table 1.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Year	N	ExecGK	Age	ExecGK pay	CEO pay	ExecGK pay / CEO pay	ExecGK delta	CEO delta
1994	245	0.278	47.6	910	3,753	0.377	0.016	0.449
1995	1,727	0.328	49.3	1,032	4,550	0.344	0.025	0.516
1996	1,926	0.320	49.5	1,351	6,716	0.364	0.034	0.653
1997	1,993	0.330	49.5	1,477	8,289	0.353	0.044	0.898
1998	2,030	0.353	49.7	1,600	12,523	0.335	0.047	0.933
1999	1,928	0.377	49.9	1,964	10,007	0.381	0.068	1.351
2000	1,831	0.398	50.1	2,088	11,067	0.346	0.064	1.247
2001	1,786	0.411	50.4	1,747	9,155	0.353	0.048	0.995
2002	1,821	0.426	50.6	1,436	6,740	0.369	0.041	0.821
2003	1,866	0.429	50.8	1,547	7,021	0.335	0.057	0.947
2004	1,810	0.408	51.1	1,567	7,403	0.345	0.068	0.789
2005	1,697	0.357	51.8	1,841	7,651	0.358	0.085	0.921
2006	1,858	0.377	51.3	1,196	4,793	0.416	0.097	1.279
2007	1,857	0.395	51.2	1,175	4,102	0.442	0.066	1.017
2008	1,790	0.410	51.2	973	3,359	0.414	0.039	0.509
2009	1,727	0.412	51.5	1,350	4,940	0.398	0.046	0.507
2010	1,666	0.466	52.0	1,133	4,034	0.394	0.049	0.603
2011	1,593	0.466	52.4	982	3,568	0.402	0.047	0.705
2012	1,466	0.440	53.3	1,537	3,355	0.431	0.059	0.852
All	32,617	0.392	50.9	1,442	6,566	0.378	0.055	0.863

Table 2: General Counsel Fixed Effects on Compliance, Monitoring and Investments

This table presents the general counsel fixed effects on compliance and monitoring failures and investments. Included firm years are those in which a general counsel can be indentified from 10-K filings. For each dependent variable, the fixed effects included are: year and firm fixed effects in row 1; year, firm, and CEO fixed effects in row 2; year, firm, CEO, and general counsel fixed effects in row 3. Reported in the second and third columns are F-tests for the joint significance of the CEO fixed effects and general counsel fixed effects, respectively. For each F-test, we report the value of the F-statistic, the p-value, and the number of constraints). Column 4 reports the number of observations and column 5 reports the adjusted R-squared for each regression. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. Fraud Score is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1.

	F-tests on fixed effects for			
	CEOs	General Counsels	N	Adjusted R-squared
AAER Fraud			21,342	0.299
	4.19 (<.0001, 2,353)		21,342	0.499
	3.93 (<.0001, 2,353)	3.01 (<.0001, 1,354)	21,342	0.570
Insider Sale Profit			19,690	0.045
	1.22 (<.0001, 2,190)		19,690	0.070
	1.20 (<.0001, 2,190)	1.15 (.0003, 1,292)	19,690	0.082
Class Action			22,523	0.192
	2.88 (<.0001, 2,489)		22,523	0.345
	2.88 (<.0001, 2,489)	2.31 (<.0001, 1,438)	22,523	0.408
Fraud Score			22,396	0.320
	1.87 (<.0001, 2,497)		22,396	0.386
	2.03 (<.0001, 2,497)	1.81 (<.0001, 1,431)	22,396	0.424
Backdating			15,889	0.634
	4.09 (<.0001, 1,786)		15,889	0.740
	4.60 (<.0001, 1,786)	2.55 (<.0001, 979)	15,889	0.770
CapEx				
			21,674	0.349
	1.98 (<.0001, 2,409)		21,674	0.420
	1.69 (<.0001, 2,409)	2.10 (<.0001, 1,369)	21,674	0.469
R&D				
			22,300	0.283
	1.09 (0.0031, 2,467)		22,300	0.290
	0.94 (0.9795, 2,467)	1.08 (0.0222, 1,425)	22,300	0.296

Table 3: Summary Statistics with ExecGK Hiring Firms vs. No-ExecGK Firms

Executive gatekeeper (ExecGK) refers to a general counsel that appears in ExecuComp as one of the top paid executives. This table presents the mean and standard deviation of ExecGK and CEO compensation, firm characteristics, compliance, monitoring, investments and other governance measures taken in the year when the ExecGK is hired. Firms with no ExecGK include firm years where there is no ExecGK in a five-year window (i.e., from two years prior to two years after). *ExecGK pay* is the executive gatekeeper's total compensation (salary, bonus, other cash compensation, option grants, and restricted stocks) in constant 2012 dollars. *CEO pay* is the CEO's total compensation. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *Assets* , *Sales* , and Market Capitalization (*Marketcap*) are from the balance sheet in millions of constant 2012 dollars. *Market to Book* is the ratio of market value of asset (market value of equity, plus book value of debt and book value of preferred equity, minus deferred taxes) to book value of assets. *Sales Growth* is sales in the current year scaled by the average sales of last three years, minus one. *Market-adjusted returns* are annual cumulative stock returns minus cumulative market (CRSP value weighted) returns over the fiscal year. *Volatility* is the annualized standard deviation of daily stock returns over the fiscal year. *Probability (shareholder suit)* is the predicted probability of being litigated based on the coefficient estimates from the logit regression of determinants of litigation risk, following Kim and Skinner (2012). *Firm age* is the number of years since a firm first appears on CRSP. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. *Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. *Board independence* is the percentage of independent directors on board. *Governance index* is the Gompers, Ishii and Metrick (2003) governance index. *Board turnover* is the number of board members leaving in a year scaled by the number of total board members at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1.

	ExecGK		No ExecGK		Difference
# of Obs.	576		9,124		
	Mean	Std	Mean	Std	p-value
Compensation					
ExecGK Pay ($ thousand)	1,034	2,028	.	.	
CEO Pay ($ thousand)	6,031	10,783	7,013	28,499	0.412
ExecGK pay / CEO pay	0.318	0.437	.	.	
ExecGK delta ($ million)	0.016	0.053	.	.	
CEO delta ($ million)	0.996	4.114	3.533	60.667	0.325
Firm characteristics					
Assets ($ million)	16,722	78,694	19,609	110,396	0.536
Sales ($ million)	5,993	16,314	6,493	20,695	0.570
Marketcap	7,410	21,052	9,763	31,283	0.075
Market to Book	1.596	1.554	1.765	2.097	0.059
Sales Growth	0.254	0.642	0.223	0.487	0.139
Market-adjusted returns	0.065	0.640	0.112	0.769	0.149
Volatility	0.504	0.275	0.470	0.245	0.001
Probability (shareholder suit)	0.020	0.026	0.018	0.020	0.028
Firm age	21.8	17.4	21.7	16.6	0.826
Compliance					
AAER Fraud	0.034	0.182	0.021	0.145	0.052
Insider Sale Profit	0.035	0.255	0.005	0.282	0.024
Monitoring					
Class Action	0.047	0.212	0.028	0.165	0.010
Fraud Score	1.185	0.903	1.169	1.075	0.718
Backdating	0.020	0.141	0.023	0.150	0.698
Investment					
CapEx	0.314	0.389	0.299	0.363	0.353
R&D	0.047	0.114	0.063	0.186	0.042
Other internal governance measures					
Board indpendence	0.689	0.165	0.664	0.169	0.003
Governance Index	9.262	2.524	8.801	2.642	0.001
Board turnover	0.198	0.272	0.189	0.276	0.502

Table 4: Compliance, Monitorint and Investment around ExecGK Hiring

This table presents the mean of compliance and minitoring failures, investment, and other internal governance measures for both two years prior and three years subsequent to the year of ExecGK hiring. The change from pre- to post-hiring is tablulated, and then compared against the change in the no-ExecGK sample, which includes firm years where there is no ExecGK in a five-year window (i.e., from two years prior to two years after). The last column shows the p-values of t-tests in the difference between the mean of two years prior to hring and the mean of three years after hiring. There are 513 ExecGK firms and 1,438 matched No ExecGK firms based on ex ante litigation risks. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. *Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. *Board independence* is the percentage of independent directors on board. *Governance index* is the Gompers, Ishii and Metrick (2003) governance index. *Board turnover* is the number of board members leaving in a year scaled by the number of total board members at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1.

ExecGK by hiring sources (year 0 is the hiring year)	Before	After	Diff	P-value
	Mean (Year -2 to -1)	Mean (Year +1 to +2)	(after - before)	difference test
Panel A: Compliance				
AAER Fraud				
ExecGK	0.042	0.021	-0.021	*0.035*
No ExecGK - Matched	0.020	0.027	0.006	*0.305*
Diff-in-Diff			-0.028	
P-value of diff (ExecGK vs. No ExecGK)	*0.017*	*0.429*	*0.002*	
Insider Trading Profit				
ExecGK	0.027	0.003	-0.023	*0.066*
No ExecGK - Matched	0.014	0.002	-0.011	*0.156*
Diff-in-Diff			-0.012	
P-value of diff (ExecGK vs. No ExecGK)	*0.285*	*0.895*	*0.426*	
Panel B: Monitoring				
Class Action				
ExecGK	0.061	0.041	-0.020	*0.095*
No ExecGK - Matched	0.025	0.025	0.000	*0.997*
Diff-in-Diff			-0.020	
P-value of diff (ExecGK vs. No ExecGK)	*0.000*	*0.058*	*0.072*	
Fraud Score				
ExecGK	1.248	1.088	-0.160	*0.001*
No ExecGK - Matched	1.172	1.117	-0.055	*0.042*
Diff-in-Diff			-0.105	
P-value of diff (ExecGK vs. No ExecGK)	*0.082*	*0.365*	*0.014*	
Backdating				
ExecGK	0.016	0.015	-0.001	*0.878*
No ExecGK - Matched	0.018	0.020	0.002	*0.734*
Diff-in-Diff			-0.003	
P-value of diff (ExecGK vs. No ExecGK)	*0.855*	*0.553*	*0.482*	

Panel C: Investment				
CapEx				
ExecGK	0.359	0.259	-0.100	*0.000*
No ExecGK - Matched	0.308	0.253	-0.055	*0.000*
Diff-in-Diff			-0.045	
P-value of diff (ExecGK vs. No ExecGK)	*0.010*	*0.588*	*0.027*	
R&D				
ExecGK	0.049	0.045	-0.004	*0.609*
No ExecGK - Matched	0.064	0.053	-0.011	*0.080*
Diff-in-Diff			0.008	
P-value of diff (ExecGK vs. No ExecGK)	*0.037*	*0.146*	*0.342*	
Panel D: Other internal governance measures				
Board Independence				
ExecGK	67.304	72.039	4.736	*0.000*
No ExecGK - Matched	64.785	69.061	4.276	*0.000*
Diff-in-Diff			0.460	
P-value of diff (ExecGK vs. No ExecGK)	*0.007*	*0.000*	*0.100*	
Governance Index				
ExecGK	9.208	9.400	0.193	*0.310*
No ExecGK - Matched	8.557	8.853	0.296	*0.020*
Diff-in-Diff			-0.104	
P-value of diff (ExecGK vs. No ExecGK)	*0.000*	*0.000*	*0.763*	
Board turnover				
ExecGK	0.243	0.241	-0.002	*0.890*
No ExecGK - Matched	0.225	0.198	-0.027	*0.006*
Diff-in-Diff			0.024	
P-value of diff (ExecGK vs. No ExecGK)	*0.218*	*0.002*	*0.118*	

Table 5: Summary Statistics with ExecGKs Hired from Corporations vs. ExecGKs Hired from Law Firms

This table presents the mean and median of ExecGK and CEO compensation, firm characteristics, compliance, monitoring, investments and other governance measures taken in the year when the ExecGK is hired, by the two different career sources from which ExecGKs are hired, i.e., externally hired from law firms and externally hired from other corporations. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. *ExecGK pay* is the executive gatekeeper's total compensation (salary, bonus, other cash compensation, option grants, and restricted stocks) in constant 2012 dollars. *CEO pay* is the CEO's total compensation. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *ExecGK age* is the age of the ExecGK. *Assets* , *Sales* , and Market Capitalization (*Marketcap*) are from the balance sheet in millions of constant 2012 dollars. *Market to Book* is the ratio of market value of asset (market value of equity, plus book value of debt and book value of preferred equity, minus deferred taxes) to book value of assets. *Sales Growth* is sales in the current year scaled by the average sales of last three years, minus one. *Market-adjusted returns* are annual cumulative stock returns minus cumulative market (CRSP value weighted) returns over the fiscal year. *Volatility* is the annualized standard deviation of daily stock returns over the fiscal year. *Probability (shareholder suit)* is the predicted probability of being litigated based on the coefficient estimates from the logit regression of determinants of litigation risk, following Kim and Skinner (2012). *Firm age* is the number of years since a firm first appears on CRSP. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. *Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. *Board independence* is the percentage of independent directors on board. *Governance index* is the Gompers, Ishii and Metrick (2003) governance index. *Board turnover* is the number of board members leaving in a year scaled by the number of total board members at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1.

	Mean			Median		
	Corp	Law	Diff (p-value)	Corp	Law	Diff (p-value)
Observations (unmatched)	363	213		363	213	
Observations (matched)	157	126		157	126	
Compensation						
ExecGK Pay ($ thousand)	841	1,098	0.277	503	549	0.441
CEO Pay ($ thousand)	6,118	5,692	0.780	2,598	3,139	0.184
ExecGK pay / CEO pay	0.262	0.332	0.183	0.171	0.208	0.115
ExecGK delta ($ million)	0.008	0.020	0.033	0.000	0.002	0.084
CEO delta ($ million)	1.121	0.838	0.667	0.166	0.204	0.219
ExecGK age	48.7	49.5	0.456	49	49	0.904
Firm characteristics						
Assets ($ million)	19,154	16,635	0.778	1,507	2,302	0.212
Sales ($ million)	5,491	7,299	0.432	1,431	1,799	0.441
Marketcap	8,239	8,064	0.954	1,452	1,812	0.312
Market to Book	1.482	1.517	0.855	1.243	1.027	0.092
Sales Growth	0.289	0.293	0.964	0.121	0.160	0.414
Market-adjusted returns	0.142	0.048	0.288	0.029	-0.003	0.632
Volatility	0.462	0.466	0.904	0.433	0.408	0.338
Probability (shareholder suit)	0.019	0.018	0.732	0.012	0.013	0.770
Firm age	23.7	23.9	0.935	16.4	18.3	0.287
Compliance						
AAER Fraud	0.060	0.034	0.417	0.000	0.000	0.556
Insider Sale Profit	0.036	0.051	0.675	0.000	0.000	0.806
Monitoring						
Class Action	0.073	0.063	0.804	0.001	0.002	0.330
Fraud Score	1.256	1.161	0.631	0.947	1.022	0.212
Backdating	0.000	0.019	0.157	0.000	0.000	0.121
Investment						
CapEx	0.295	0.306	0.859	0.200	0.226	0.250
R&D	0.044	0.040	0.712	0.022	0.014	0.336
Other internal governance measures						
Board indpendence	0.686	0.668	0.427	0.714	0.692	0.185
Governance Index	9.258	9.187	0.855	10.000	9.000	0.136
Board turnover	0.180	0.178	0.941	0.111	0.100	0.754

Table 6: ExecGK Incentive Pay and Compliance Failures

This table presents difference-in-differences tests on ExecGK incentive pay and compliance failures. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. *Post* is set to zero for the two years prior to the hiring of ExecGK, and one for the two years subsequent. The year of hiring is tossed out. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	AAER Fraud OLS	AAER Fraud OLS	AAER Fraud OLS	Insider Sale Profit OLS	Insider Sale Profit OLS	Insider Sale Profit OLS
Post	0.024	0.386	0.387	0.024	0.226	0.23
	[0.071]	[0.270]	[0.271]	[0.078]	[0.183]	[0.183]
Treat (Hire=Corporate)	-0.035	-0.156	-0.151	-0.043	0.022	0.04
	[0.026]	[0.248]	[0.249]	[0.039]	[0.262]	[0.264]
Post*Treat	0.005	-0.435	-0.435	-0.016	-0.352*	-0.360*
	[0.033]	[0.270]	[0.270]	[0.045]	[0.211]	[0.211]
Log(ExecGKDelta)		0.007	0.009		-0.068	-0.064
		[0.036]	[0.036]		[0.046]	[0.046]
Post*Log(ExecGKDelta)		-0.089	-0.087		-0.044	-0.048
		[0.060]	[0.060]		[0.042]	[0.048]
Treat*Log(ExecGKDelta)		0.03	0.029		-0.019	-0.023
		[0.062]	[0.062]		[0.061]	[0.061]
Post*Treat*Log(ExecGKDelta)		**0.108***	**0.102**		**0.082***	**0.073**
		[0.064]	**[0.066]**		**[0.048]**	**[0.056]**
Post*Log(CEODelta)			-0.001			0.003
			[0.007]			[0.017]
Post*Treat*Log(CEODelta)			0.005			0.008
			[0.010]			[0.021]
Clustered s.e. at firm-hire year level	Y	Y	Y	Y	Y	Y
Hire Year F.E.	Y	Y	Y	Y	Y	Y
Calendar Year F.E.	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y
Observations	951	951	951	734	734	734
R-squared	0.168	0.189	0.189	0.146	0.157	0.158

Table 7: ExecGK Incentive Pay and Compliance Failures - Collapsed Estimation

This table presents the collapsed difference-in-differences tests on ExecGK incentive pay and compliance failures. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. The dependent variable is the change of compliance failure measure from pre- to post-hiring period. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	AAER Fraud OLS	AAER Fraud OLS	AAER Fraud OLS	Insider Sale Profit OLS	Insider Sale Profit OLS	Insider Sale Profit OLS
Treat (Hire=Corporate)	-0.006	0.526	0.482	-0.042	-0.178	-0.433
	[0.039]	[0.500]	[0.545]	[0.054]	[0.295]	[0.678]
Log(ExecGKDelta)		0.036	-0.002		0.105	0.065
		[0.042]	[0.065]		[0.079]	[0.124]
Treat*Log(ExecGKDelta)		**-0.13**	**-0.082**		**0.085**	**0.141**
		[0.121]	**[0.160]**		**[0.145]**	**[0.210]**
Log(CEODelta)			0.016			0.018
			[0.022]			[0.040]
Treat*Log(CEODelta)			-0.028			-0.031
			[0.038]			[0.054]
Hire Year F.E.	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y
Observations	237	237	237	185	185	185
R-squared	0.212	0.216	0.221	0.389	0.404	0.407

Table 8: ExecGK Incentive Pay and Monitoring Failures

This table presents difference-in-differences tests on ExecGK incentive pay and monitoring failures. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms.*Post* is set to zero for the two years prior to the hiring of ExecGK, and one for the two years subsequent. The year of hiring is tossed out.*ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999).*CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits.*Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. Governance reduction for a standard deviation change in ExecGK delta in the hiring year is presented at the bottom of the table. It is then compared to the pre-hiring mean of the governance failure measure (Table 4, Column B) to calculate reduction percentage. Reduction as a percentage of governance improvement is the ratio of governance reduction to governance improvement (Table 4, Diff-in-Diff). Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1) Class Action OLS	(2) Class Action OLS	(3) Class Action OLS	(4) Fraud Score OLS	(5) Fraud Score OLS	(6) Fraud Score OLS	(7) Backdating OLS	(8) Backdating OLS	(9) Backdating OLS
Post	0.076	0.495**	0.522**	-0.022	0.209	0.226	0.047	0.284***	0.284***
	[0.065]	[0.216]	[0.210]	[0.090]	[0.236]	[0.232]	[0.035]	[0.104]	[0.104]
Treat (Hire=Corporate)	0.000	0.315	0.311	-0.109	0.001	-0.031	-0.019	0.105	0.107
	[0.033]	[0.237]	[0.241]	[0.075]	[0.661]	[0.668]	[0.012]	[0.144]	[0.144]
Post*Treat	-0.055	-0.552**	-0.580***	0.012	-0.432*	-0.450*	-0.01	-0.275***	-0.275***
	[0.050]	[0.220]	[0.213]	[0.082]	[0.256]	[0.252]	[0.015]	[0.103]	[0.103]
Log(ExecGKDelta)		-0.034	-0.036		0.124	0.114		0.035	0.035
		[0.042]	[0.044]		[0.102]	[0.107]		[0.029]	[0.029]
Post*Log(ExecGKDelta)		-0.102**	-0.178***		-0.042	-0.110*		-0.063**	-0.060**
		[0.049]	[0.054]		[0.054]	[0.062]		[0.027]	[0.026]
Treat*Log(ExecGKDelta)		-0.078	-0.077		-0.023	-0.016		-0.03	-0.03
		[0.056]	[0.057]		[0.154]	[0.156]		[0.034]	[0.034]
Post*Treat*Log(ExecGKDelta)		**0.121****	**0.162*****		**0.110***	**0.180****		**0.066*****	**0.063****
		[0.049]	**[0.060]**		**[0.057]**	**[0.074]**		**[0.025]**	**[0.024]**
Post*Log(CEODelta)			0.053***			0.048*			-0.002
			[0.017]			[0.025]			[0.005]
Post*Treat*Log(CEODelta)			-0.027			-0.05			0.002
			[0.026]			[0.042]			[0.004]
Clustered s.e. at firm-hire year level	Y	Y	Y	Y	Y	Y	Y	Y	Y
Hire Year F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y
Calendar Year F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y
Observations	1,128	1,128	1,128	1,120	1,120	1,120	753	753	753
R-squared	0.118	0.139	0.167	0.312	0.315	0.317	0.223	0.251	0.251
In Sample Pre-Hire Mean		*0.061*	*0.061*		*1.248*	*1.248*		*0.016*	*0.016*
Value of governance reduction		*0.014*	*0.018*		*0.012*	*0.020*		*0.007*	*0.007*
Reduction % given one s.d. change of Log(ExecGKDelta)		*22.1%*	*29.6%*		*1.0%*	*1.6%*		*45.1%*	*43.1%*
Reduction as % of governance improvement		*67.1%*	*89.9%*		*11.7%*	*19.1%*		*n/a*	*n/a*

Table 9: ExecGK Incentive Pay and Monitoring Failures - Collapsed Estimation

This table presents the collapsed difference-in-differences tests on ExecGK incentive pay and monitoring failures. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. The dependent variable is the change of monitoring failure measure from pre- to post-hiring period. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. *Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1) Class Action OLS	(2) Class Action OLS	(3) Class Action OLS	(4) Fraud Score OLS	(5) Fraud Score OLS	(6) Fraud Score OLS	(7) Backdating OLS	(8) Backdating OLS	(9) Backdating OLS
Treat (Hire=Corporate)	-0.086	-0.489**	-1.186**	0.034	-0.712**	-1.863**	0.000	-0.169	-0.386
	[0.061]	[0.248]	[0.527]	[0.066]	[0.354]	[0.749]	[0.003]	[0.135]	[0.304]
Log(ExecGKDelta)		-0.124	-0.296***		-0.209*	-0.337**		-0.091	-0.081
		[0.081]	[0.106]		[0.115]	[0.132]		[0.076]	[0.069]
Treat*Log(ExecGKDelta)		**0.219***	**0.428*****		**0.408****	**0.630*****		**0.092**	**0.087**
		[0.117]	**[0.152]**		**[0.180]**	**[0.195]**		**[0.075]**	**[0.071]**
Log(CEODelta)			0.082**			0.041			-0.009
			[0.033]			[0.029]			[0.006]
Treat*Log(CEODelta)			-0.125***			-0.131***			0.005
			[0.042]			[0.048]			[0.005]
Hire Year F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y
Observations	281	281	281	279	279	279	188	188	188
R-squared	0.249	0.256	0.309	0.52	0.528	0.548	0.532	0.595	0.607

Table 10 ExecGK Incentive Pay and Corporate Investment

This table presents difference-in-differences tests on ExecGK incentive pay and corporate investment. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. *Post* is set to zero for the two years prior to the hiring of ExecGK, and one for the two years subsequent. The year of hiring is tossed out. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. Investment increase for a standard deviation change in ExecGK delta in the hiring year is presented at the bottom of the table. It is then compared to the pre-hiring mean of the investment measure (Table 4, Column B) to calculate increase percentage. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
		CapEx			R&D	
	OLS	OLS	OLS	OLS	OLS	OLS
Post	-0.071	0.178	0.169	0.070**	0.136***	0.140***
	[0.092]	[0.191]	[0.190]	[0.030]	[0.044]	[0.044]
Treat (Hire=Corporate)	0.028	0.171	0.157	0.01	0.11	0.108
	[0.038]	[0.434]	[0.432]	[0.010]	[0.115]	[0.117]
Post*Treat	-0.026	-0.451**	-0.444**	-0.017	-0.118***	-0.122***
	[0.043]	[0.216]	[0.214]	[0.022]	[0.036]	[0.036]
Log(ExecGKDelta)		0.087	0.078		0.022	0.021
		[0.064]	[0.064]		[0.015]	[0.015]
Post*Log(ExecGKDelta)		-0.033	-0.029		-0.024	-0.023
		[0.105]	[0.105]		[0.028]	[0.029]
Treat*Log(ExecGKDelta)		-0.051	-0.043		-0.014**	-0.027**
		[0.045]	[0.046]		[0.007]	[0.012]
Post*Treat*Log(ExecGKDelta)		**0.105****	**0.127****		**0.025*****	**0.033****
		[0.051]	**[0.054]**		**[0.007]**	**[0.016]**
Post*Log(CEODelta)			-0.004			0.009
			[0.011]			[0.009]
Post*Treat*Log(CEODelta)			-0.019			-0.005
			[0.015]			[0.011]
Clustered s.e. at firm-hire year level	Y	Y	Y	Y	Y	Y
Hire Year F.E.	Y	Y	Y	Y	Y	Y
Calendar Year F.E.	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y
Observations	1,084	1,084	1,084	1,127	1,127	1,127
R-squared	0.211	0.218	0.22	0.219	0.221	0.222
In Sample Pre-Hire Mean		*0.359*	*0.359*		*0.049*	*0.049*
Value of investment increase		*0.012*	*0.014*		*0.003*	*0.004*
% increase given one s.d. change of Log(ExecGKDelta)		*3.3%*	*4.0%*		*5.7%*	*7.6%*

Table 11 ExecGK Incentive Pay and Corporate Investment - Collapsed Estimation

This table presents the collapsed difference-in-differences tests on ExecGK incentive pay and corporate investment. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. The dependent variable is the change of investment measure from pre- to post-hiring period. *ExecGK delta* is the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars, following Core and Guay (1999). *CEO delta* is the CEO's total wealth to performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
		CapEx			R&D	
	OLS	OLS	OLS	OLS	OLS	OLS
Treat (Hire=Corporate)	-0.003	0.175	0.208	-0.01	-0.157**	-0.157*
	[0.048]	[0.868]	[0.913]	[0.008]	[0.074]	[0.080]
Log(ExecGKDelta)		-0.033	0.001		-0.023**	-0.018
		[0.099]	[0.106]		[0.011]	[0.012]
Treat*Log(ExecGKDelta)		**-0.044**	**-0.073**		**0.035****	**0.035**
		[0.214]	**[0.258]**		**[0.017]**	**[0.024]**
Log(CEODelta)			-0.018			-0.004
			[0.021]			[0.003]
Treat*Log(CEODelta)			0.016			0.001
			[0.039]			[0.006]
Hire Year F.E.	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y
Observations	271	271	271	280	280	280
R-squared	0.313	0.314	0.317	0.282	0.292	0.299

Table 12: ExecGK Incentive Pay by Stock and Option Collapsed Estimation

This table presents the collapsed difference-in-differences tests on the effect of different components of ExecGK incentive pay on compliance, monitoring, and corporate investment. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. *ExecGK stock delta* and *ExecGK option delta* are the executive gatekeeper's total wealth to performance sensitivities based on stock holdings and option holdings, respectively, in constant 2012 (million) dollars. *AAER Fraud* is an indicator variable that is one if the financial statements of a given fiscal year are restated and later investigated by the SEC. *Insider Sale Profit* is the weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns. *Class Action* is an indicator that takes on the value of one for fiscal years coinciding with the class period identified by the securities class action lawsuits. *Fraud Score* is the firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. *Backdating* is an indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating. *CapEx* is the ratio of capital expediture to PP&E measured at the beginning of the fiscal year. *R&D* is the R&D expenses scaled by assets at the beginning of the fiscal year. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1. Standard errors are clustered at the firm level. Superscripts ***, **, * indicate statistical significance level at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
	AAER Fraud		Insider Sale Profit		Class Action		Fraud Score		Backdating		CapEx		R&D	
					OLS	OLS	OLS	OLS	OLS	OLS	OLS	OLS	OLS	OLS
Treat (Hire=Corporate)	0.063	0.55	-0.415	-0.26	-0.543	-0.901*	-0.462	-1.750**	-0.133	-0.429	0.043	0.051	-0.064	-0.153**
	[0.316]	[0.451]	[0.430]	[0.578]	[0.418]	[0.483]	[0.574]	[0.674]	[0.149]	[0.310]	[0.592]	[0.735]	[0.053]	[0.067]
Log(ExecGK stock delta)	0.025		0.108		-0.13		-0.09		-0.062		0.018		-0.019*	
	[0.046]		[0.081]		[0.080]		[0.080]		[0.062]		[0.121]		[0.012]	
Treat*Log(ExecGK stock delta)	**-0.022**		**0.128**		**0.145**		**0.16**		**0.042**		**-0.015**		**0.017**	
	[0.101]		**[0.129]**		**[0.131]**		**[0.180]**		**[0.048]**		**[0.196]**		**[0.017]**	
Log(ExecGK option delta)		0.036		0.095		-0.1		-0.252**		-0.105		-0.078		-0.023**
		[0.044]		[0.082]		[0.077]		[0.124]		[0.079]		[0.083]		[0.010]
Treat*Log(ExecGK option delta)		**-0.15**		**0.063**		**0.219***		**0.478*****		**0.115**		**-0.016**		**0.038****
		[0.120]		**[0.148]**		**[0.121]**		**[0.174]**		**[0.084]**		**[0.201]**		**[0.017]**
Hire Year F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Observations	237	237	185	185	281	281	279	279	188	188	271	271	280	280
R-squared	0.221	0.213	0.407	0.4	0.256	0.255	0.521	0.53	0.563	0.611	0.313	0.316	0.289	0.292

Table 13: A Test on Lawyers as Totem Gatekeepers

Panel A presents the mean and median of Patents, Acquisitions, and Business segments measures in the year when the ExecGK is hired, by the two different career sources from which ExecGKs are hired, i.e., externally hired from law firms and externally hired from other corporations. Panel B presents difference-in-differences tests on ExecGK hiring sources and changes in these measures. The treatment group is corporations hiring ExecGKs from other corporations, and the control group is firms that are matched within the year-industry-size and litigation risk and hire ExecGKs from law firms. *Post* is set to zero for the two years prior to the hiring of ExecGK, and one for the two years subsequent. The year of hiring is tossed out. *Patents* is an indicator variable that takes on the value of one if the firm files patents in a fiscal year. *Log(# of acquisitions)* is the natural logarithms of the number of (both domestic and cross-border) acquisitions made in a year. *NBSEG* is the number of business segments. *Entropy* is the sum of Ps*Ln(1/Ps) where Ps is the proportion of the firm's total sales in industry segment s. Our sample comprises firm years in ExecuComp from 1994 to 2012. Detailed variable definitions are provided in Appendix Table 1.

Panel A	Mean		
	Corp	Law	Diff (p-value)
Observations (matched)	157	126	
Patents	0.420	0.361	0.473
Log(# of acquisitions)	0.122	0.188	0.207
NBSEG	6.298	6.595	0.677
Entropy	1.235	1.259	0.823
	Median		
Patents	0.000	0.000	0.128
Log(# of acquisitions)	0.000	0.000	0.203
NBSEG	5.000	6.000	0.540
Entropy	1.247	1.134	0.671

Panel B	(1) Patents	(2) Log(# of acquisitions)	(3) NBSEG	(4) Entropy
	OLS	OLS	OLS	OLS
Post	-0.102	0.038	-0.127	-0.017
	[0.066]	[0.047]	[0.698]	[0.109]
Treat (Hire=Corporate)	0.091	-0.004	-0.301	-0.009
	[0.058]	[0.045]	[0.557]	[0.082]
Post*Treat	0.024	-0.044	-0.243	-0.02
	[0.062]	[0.048]	[0.387]	[0.064]
Clustered s.e. at firm-hire year level	Y	Y	Y	Y
Hire Year F.E.	Y	Y	Y	Y
Year F.E.	Y	Y	Y	Y
SIC Two-Digit F.E.	Y	Y	Y	Y
Observations	818	1,128	1,128	1,128
R-squared	0.492	0.187	0.406	0.451

Appendix Table 1: Variable Definition, Data Sources and Descriptive Statistics

This table presents the definition and sources of the variables used in the study and shows the summary statistics of the variables.

Variable name	Variable definition	Sources	N	Mean	Median	Std
ExecGK Background						
ExecGK	Indicator variable that takes on the value of one if a general counsel appears in ExecuComp as one of the top paid executives.	Execucomp	32,617	0.392	0	0.488
Age	The age of the ExecGK	Execucomp, Def 14As and 10-Ks	12,629	50.874	51	7.289
(The statistics below are based on unique ExecGK-Firm observations where the immediate job experience prior to ExecGK is available)						
Internal	ExecGK was internally promoted	Execucomp, Def 14As and 10-Ks	2,602	0.274	0	0.446
Law Firm Hire	Indicator variable that takes on the value of one if an ExecGC was hired directly from a law firm.	Def 14As, 10-Ks, Matindale-Hubbard, LinkedIn, online searches	2,602	0.271	0	0.445
Corporation Hire	Indicator variable that takes on the value of one if an ExecGC was hired directly from another corporation	Def 14As, 10-Ks, Matindale-Hubbard, LinkedIn, online searches	2,602	0.444	0	0.497
Government Officials	Indicator variable that takes on the value of one if an ExecGK held important government positions (e.g. Attorney General, White House Counsel, Judge, Federal Attorney, Department of Justice etc.) before becoming a GC.	Def 14As, 10-Ks, Matindale-Hubbard, LinkedIn, online searches	2,602	0.007	0	0.081
Compensation						
ExecGK pay	ExecGK total compensation (salary, bonus, other cash compensation, option grants, and restricted stocks) in constant 2012 dollars.	Execucomp	12,777	1,442	797	3,671
ExecGK payrank	The total pay rank of ExecGK among top paid executives.	Execucomp	12,777	4.503	4.000	1.479
CEO pay	CEO total compensation (salary, bonus, other cash compensation, option grants, and restricted stocks) in constant 2012 dollars.	Execucomp	12,268	6,566	2,993	26,338
ExecGK pay / CEO pay	Total compensation of the ExecGC to the total compensation of the CEO.	Execucomp	12,238	0.378	0.301	0.378
ExecGK delta	Total wealth for performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	12,429	0.055	0.020	0.200
CEO delta	CEO's total wealth for performance sensitivities based on stock holdings and unexercised options in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	11,853	0.863	0.201	4.490
ExecGK stock delta	Total wealth for performance sensitivities based on stock holdings in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	12,777	0.019	0.004	0.169
CEO stock elta	CEO's total wealth for performance sensitivities based on stock holdings in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	12,268	0.591	0.061	4.200
ExecGK option delta	Total wealth for performance sensitivities based on unexercised options in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	12,429	0.036	0.011	0.081
CEO option delta	CEO's total wealth for performance sensitivities based on unexercised options in constant 2012 (million) dollars based on Core and Guay (1999).	Execucomp	11,787	0.268	0.094	0.669
Compliance						
AAER Fraud	Indicator that takes on the value of one if the financial statements of a given fiscal year are restated and investigated by the SEC. Accounting and Auditing Enforcement Releases are issued by the SEC during or at the conclusion of an investigation against a company, an auditor, or an officer for alleged accounting and/or auditing misconduct. This variable is set equal to missing for fiscal years after 2009.	Center for Financial Reporting and Management Center at the Haas School of Business	27,689	0.020	0.000	0.140
Insider Sale Profit	The weighted average stock sale profits realized by all executives in the c-suit in a fiscal year, where the stock sale profit is calcualted as negative one times the 12-month buy-and-hold stock returns.	Thomson Reuters Insider Transation	28,204	-0.001	0.000	0.359
Monitoring						
Class Action	Indicator that takes on the value of one for fiscal years coinciding the class period identified by the securities class action lawsuits. Dismissed cases are dropped for defining this variable.	Stanford Law School Securities Class Action Clearing House	32,617	0.029	0.000	0.168

Variable name	Variable definition	Sources	N	Mean	Median	Std
Fraud Score	The firm's probability of fraud based on the fraud model of Dechow et al. (2011) divided by the unconditional probability of fraud. We calculate predicted probability using the coefficient estimates from Dechow et al. (2011). Predicted Value= -7.893+0.79*rsst_acc 2.518*ch_rec+ 1.191*ch_inv + 1.979*soft_assets+0.171*ch_cs+(-0.932)*ch_roa+1.029* issue. RSST accruals come from Richardson, Sloan, Soliman, and Tuna 2005. This measure extends the definition of WC accruals to include changes in long-term operating assets and long-term operating liabilities.WC=(Current Assets- Cash and Short-term Investments)-(Current Liab - Debt in Current Liab); NCO=(Total Assets - Current Assets - Investments and Advances) - (Total Liab - Current Liab - LT Debt); FIN=(ST Investments + LT Investment) - (LT Debt + Debt in Current Liab + Preferred Stock); Chg in Receivables is defined as chg in AR/Average Total Assets; Chg in Inventory is chg in Inventory/Average Total Assets; % Soft Assets = [Total Assets - PPE - Cash and Cash Equivalent]/Total Assets; Chg in cash sales is Pct chg in cash sales, cash sales=[Sales - Chg in AR]; Chg in ROA is Earnings_t/Average total asset_t - Earnings_t-1/Average total asset_t-1; Issue is an indicator variable equal to 1 if the firm issued securities.	Center for Financial Reporting and Management Center at the Haas School of Business, Compustat	32,234	1.161	0.976	1.024
Backdating	Indicator that takes on the value of one for firm years for which firms are convicted of backdating or misdating.	WSJ	24,144	0.014	0.000	0.117
Determinants of Litigation Risks – Kim and Skinner (2012) Model						
FPS	Indicator variable equal to one if the firm is in the biotech (SIC codes 2833-2836 and 8731-8734), computer (3570-3577 and 7370-7374), electronics (3600-3674), or retail (5200-5961) industry, and zero otherwise	Compustat	32,617	0.280	0.000	0.449
Sales	Sales in millions of constant 2012 dollars.	Compustat	32,604	5,992	1,416	18,254
Sales growth	Sales in the current year scaled by the average sales of last three years, minus one.	Compustat	31,664	0.216	0.112	0.547
Market-adjusted returns	Annual cumulative stock returns minus cumulative market (CRSP value weighted) returns over the fiscal year.	CRSP	31,956	0.079	-0.006	0.680
Volatility	Annualized standard deviation of daily stock returns over the fiscal year.	CRSP	31,839	0.450	0.390	0.243
Skewness	Skewness of daily stock returns over the fiscal year.	CRSP	31,955	0.213	0.210	0.935
Liquidity	Average daily stock turnover over the fiscal year.	CRSP	31,957	0.890	0.658	0.770
Probability (shareholder suit)	Predicted probability of being litigated based on the coefficient estimates from the logit regression on the determinants of litigation risk (following Kim and Skinner (2012)).	Compustat and CRSP	30,663	0.017	0.011	0.197
Investment and Other Firm Characteristics						
Capex	The ratio of capital expediture to PP&E measured at the beginning of the fiscal year	Compustat	31,309	0.306	0.202	0.419
R&D	R&D expenses scaled by assets at the beginning of the fiscal year	Compustat	32,306	0.055	0.014	0.155
Patents	Indicator variable that takes on the value of one if the firm files patents in a fiscal year (data available up to 2005).	NBER Patent Citation Database	20,469	0.334	0.000	0.472
Log(# of acquisitions)	Natural logarithms of the number of (both domestic and cross-border) acquisitions made in a year.	SDC	32,617	0.130	0.000	0.384
NBSEG	Number of business segments.	Compustat segments	32,617	4.841	3.000	4.473
Entropy	Diversification measure - the sum of Ps*Ln(1/Ps) where Ps is the proportion of the firm's total sales in industry segment s.	Compustat segments	32,617	0.990	1.099	0.775
Assets ($ million)	Book value of assets in millions of constant 2012 dollars.	Compustat	32,617	15,864	1,936	91,036
Marketcap	Market capitalization in millions of constant 2012 dollars.	Compustat	32,371	8,113	1,672	26,666
Market to Book	The ratio of market value of asset (market value of equity, plus book value of debt and book value of preferred equity, minus deferred taxes) to book value of assets.	Compustat	32,123	1.631	1.140	2.089
Firm age	Number of years since a firm first appears on CRSP (use the median of the sample if missing).	CRSP	31,971	22.644	17.000	18.600
Other Internal Governance Measures						
Board independence	Percentage of independent directors on board	Riskmetrics	25,024	69.292	71.429	16.914
Governance Index	Gompers, Ishii and Metrick (2003) governance index	Riskmetrics	17,663	9.226	9.000	2.648
Board turnover	Annual turnover rate of board - number of board members leaving in a year scaled by the number of total board members at the beginning of the fiscal year.	Riskmetrics	20,528	0.241	0.111	0.326