



ADVANCES IN FINANCIAL ECONOMICS
VOLUME 11

CORPORATE GOVERNANCE
A GLOBAL PERSPECTIVE

MARK HIRSHEY
KOSE JOHN
ANIL K. MAKHIJA
Editors

CORPORATE GOVERNANCE: A GLOBAL PERSPECTIVE

ADVANCES IN FINANCIAL ECONOMICS

Series Editors: Mark Hirschey, Kose John and
Anil K. Makhija

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CORPORATE GOVERNANCE: A GLOBAL PERSPECTIVE

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FOREIGN OWNERSHIP AND FIRM VALUE: EVIDENCE FROM JAPAN

Stephen P. Ferris and Kwangwoo Park

ABSTRACT

We find a significant curvilinear relation between Japanese firm value and the percentage of equity held by foreign investors. Firm value rises until foreign ownership reaches approximately 40%, and then it begins to decline. It appears that large foreign institutional investors invest in well-performing firms and serve as effective monitors. Our results remain robust even after controlling for other corporate governance variables, such as equity ownership by main banks and board membership by foreign investors. It seems that most of the increase in firm value and the performance improvement are due to rising levels of equity ownership in non-keiretsu (independent) firms by foreign investors. We also show that an increase in foreign ownership is correlated with a rise in R&D expenditures, suggesting that foreign institutional investors contribute to the long-term viability and competitiveness of Japanese firms.

1. INTRODUCTION

Recent academic research describes the inefficiency in the ownership structure and corporate governance mechanisms of Japanese firms, results which are contrary to the documented successes of a bank-centered governance system of the 1980s and early 1990s. Weinstein and Yafeh (1998) argue that, on average, the cost of

capital for Japanese firms, with close ties to main banks is higher than unaffiliated firms. Kang and Stulz (2000) observe that during the economic downturn of the early 1990s, bank-dependent firms invested less and performed worse than more independent firms. Morck and Nakamura (1999, 2000a, b) further document the practice of Japanese banks “propping up” weak firms that are members of a bank group, and conclude that the Japanese corporate governance system is ineffective.

In this study, we examine a different issue regarding equity ownership and value for Japanese firms. We investigate how equity ownership by foreign investors is related to firm value. This research is motivated partly by the emergence of a literature documenting poor Japanese corporate governance and partly by the observation that the economic distress and deregulation of the 1990s has encouraged massive foreign investment in Japan. It has therefore become interesting to explore what kinds of Japanese firms attract large foreign ownership and the impact that ownership exerts on firm value.

The fraction of foreign ownership within Japanese firms has significantly increased in recent years. Figure 1 shows that the percentage of market value of firms listed on the Tokyo Stock Exchange (TSE) owned by foreigners is only 4.2% in 1989, but rises to 18.6% in 1999.

Figure 1 also indicates that the percentage of firm ownership by Japanese financial institutions (banks) declines from 43.5% (15.7%) to 36.5% (11.3%) over the same period. The Anti-Monopoly Act of 1977 in Japan limits banks to an equity ownership in any firm to 5% by 1 April 1987, thus preventing banks from amassing dominant equity positions in Japanese firms.¹

Along with this increased foreign ownership, the influence of large foreign shareholders on managerial decisions has recently received greater attention by Japanese firms. This trend is in sharp contrast to the 1990 case of Koito Manufacturing Company discussed by Gerlach (1992) and Morck and Nakamura (1999), in which Boone Pickens was unsuccessful in obtaining a seat on the board of directors in spite of his 26.3% ownership of the firm. Management argued that Pickens was just a short-term investor and lacked expertise in the automobile industry.²

In fact, several recent foreign acquisitions of Japanese firms have been accompanied by appointments of foreigners to top executive positions or board memberships. This suggests that the Japanese practice of viewing foreign investors as negative might be changing. Yet, the academic literature has largely ignored the role of foreign investors in Japanese corporate governance. Thus, an examination of the monitoring provided by foreign shareholders in Japan and an exploration of the relation between foreign ownership and firm value are timely research issues.

We find strong evidence of a non-monotonic relation between Tobin's q and the fraction of equity owned by foreigners in Japan. The value of q rises until foreign ownership reaches a level of approximately 40–45%, and then begins to decline.

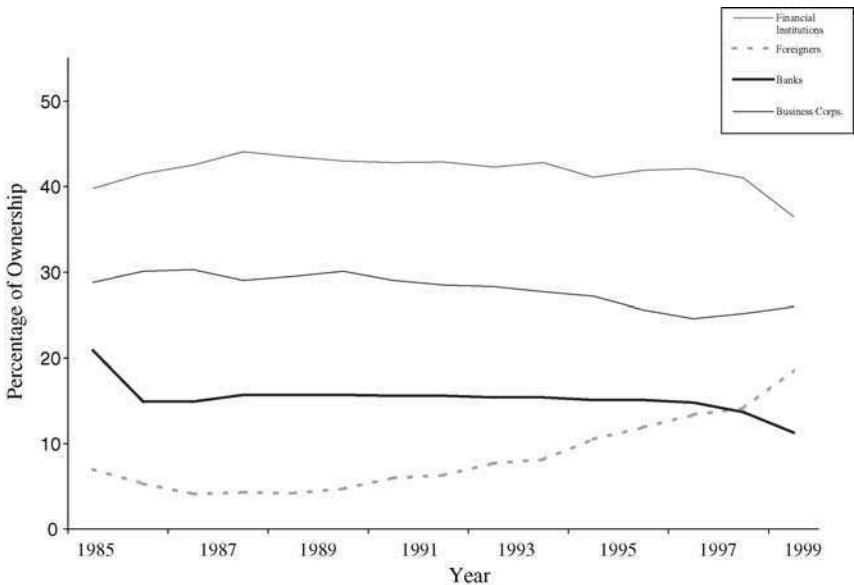


Fig. 1. Historical Market Values of Exchange Listed Stocks by Investor Type. Note: This figure plots the historical market values of Tokyo Stock Exchange-listed firms owned by different types of investors. Financial institutions include banks, trusts, life and property-casualty insurance, and other finance companies. Banks include long-term credit banks, city banks, and regional banks.

Our analysis using the earnings rate defined as the earnings before interest and taxes standardized by the replacement value of assets and the fraction of foreign ownership demonstrates a similar curvilinear relation. It appears in Japan that foreign institutional investors invest in well-performing firms and serve as effective monitors. On the other hand, foreign industrial firms increase their equity holdings in poorly performing Japanese firms. We find that most of the increase in firm value and performance improvement is due to the increase in foreign ownership within non-keiretsu or independent firms. For keiretsu affiliated firms we observe a significant negative relationship between foreign ownership and the annual change in the earnings rate.

We also find that an increase in foreign ownership is correlated with a rise in research and development (R&D) intensity, while concentrated foreign ownership is negatively associated with R&D intensity. This suggests that foreign institutional investors in Japan are concerned with corporate long-run vitality contrary to common perceptions that they are merely short-term speculators. We further find

that at concentrated foreign ownership levels, R&D expenditures decrease due to cost sharing with foreign owners.

We organize this paper into five sections. In the following section, we discuss the existing literature on firm value and equity ownership structure, while describing the hypothesized effects of foreign ownership. Section 3 describes our basic methodology and the data used in our analysis as well as presents select summary statistics. Section 4 contains our empirical evidence on the relation between foreign ownership and firm value. Section 5 concludes with a brief summary and an interpretation of our findings.

2. FIRM VALUE, OWNERSHIP STRUCTURE, AND HYPOTHESIZED EFFECTS OF FOREIGN OWNERSHIP

The literature documenting the relation between firm value and equity ownership by management or banks is well established. [Jensen and Meckling \(1976\)](#) and [Demsetz \(1983\)](#) argue that managerial equity ownership provides managers with incentives to maximize firm value. [Stulz \(1988\)](#), however, provides a model of entrenched managers, where increased managerial ownership allows managers to pursue non-value maximizing projects. Using U.S. data, [Morck, Shleifer and Vishny \(1988\)](#) find a non-linear relation between firm value and managerial ownership. Confirming results are found by [McConnell and Servaes \(1990\)](#), [Hermalin and Weisbach \(1991\)](#), and [Kole \(1995\)](#).

[Morck, Nakamura and Shivdasani \(2000\)](#), however, fail to observe evidence of a non-linear relation between firm value and managerial ownership within their sample of Japanese firms. They find that firm value is positively related to managerial ownership in Japan. This result is consistent with [Jensen and Meckling \(1976\)](#), but contrasts with the empirical findings reported for the U.S. [Morck, Nakamura and Shivdasani \(2000\)](#) attribute their findings to extensive inter-corporate shareholdings and bank ownership present in Japan. They also find that at low to moderate levels of equity ownership by main banks, Tobin's q declines as bank equity ownership rises. But at higher levels of bank ownership, this relation shows signs of reversal. [Claessens, Djankov, Fan and Lang \(2000\)](#) provide further evidence that the blockholders of financial institutions largely expropriate Japanese minority shareholders. This finding is contrary to the arguments of [Admati and Pfleiderer \(1994\)](#) and [Mahrt-Smith \(2000\)](#) that equity ownership by informed financial institutions benefits firms as informed creditors mitigate information asymmetry.

[Morck, Nakamura and Shivdasani \(2000\)](#), however, do not examine how values of q are affected when a firm is largely owned by foreign investors. Examining this issue with data from India, [Khanna and Palepu \(1999\)](#) find that foreign institutional

investors provide valuable monitoring unlike Indian domestic financial institutions. Tobin's q is positively correlated with the presence of foreign institutional ownership and is negatively correlated with domestic institutional ownership. Khanna and Palepu further contend that Indian domestic institutions are less transparent and more likely to engage in practices detrimental to minority shareholders.

Thus it would be useful to develop hypotheses exploring the effects of foreign ownership on the value of Japanese firms. It might be that there exists a non-linear relation between foreign ownership and the value of Japanese firms. Morck, Nakamura and Shivdasani (2000) find a convex relation between bank equity ownership and firm value in Japan. Their findings are consistent with the view of Weinstein and Yafeh (1998) that greater levels of bank equity ownership increase bank power, and hence are associated with higher interest costs for firms dependent upon banks. We suggest that the expropriation of minority shareholders is mitigated in those Japanese firms reporting a significant level of foreign ownership.

Such empirical findings are also consistent with Rajan (1992) who explains how banks can extract rents from their borrowers by using their informational advantage. An increase in foreign ownership of Japanese firms suggests a possible decline in equity ownership by main banks. Thus, we hypothesize a concave relation between foreign ownership and firm value. As foreign equity ownership increases, the influence of Japanese financial institutions will correspondingly decrease. The foreign investors' monitoring will likewise increase. This will discourage the value-destroying policies of banks.

At high ownership levels, it is assumed that both ownership and managerial control are closely associated. It might be that increased levels of foreign ownership will allow foreign owner-managers to become entrenched and pursue non-value maximizing managerial activities. Alternatively, we can consider a "rescue acquisition" hypothesis. Zeckhauser and Pound (1990) describe the issue of the "poor-performance-attracts-large-shareholders" phenomenon, whereby foreign investors acquire poorly performing domestic firms. Indeed, such a trend has widely been observed in several emerging markets after the Asian financial crisis of 1997.

3. METHODOLOGY, DATA AND SAMPLE SELECTION

3.1. Methodology

We use Tobin's q as the primary dependent variable in our analysis. Our measure of Tobin's q is similar to that computed by Hoshi and Kashyap (1990), Hoshi, Kashyap and Scharfstein (1991), Hayashi and Inoue (1991), and Morck, Nakamura and Shivdasani (2000). The q values in these studies are adjusted to account for factors

idiosyncratic to firms operating in Japan. More specifically, Hoshi and Kashyap, and Morck, Nakamura and Shivdasani argue that their method of measuring Tobin's q effectively corrects errors in estimating Japanese firm value due to inter-corporate shareholdings, land price appreciation (or depreciation), and taxes.

The numerator in our estimate of q is the market value of equity plus the book value of long- and short-term debt minus the estimated market value of shares held in other firms. The estimated market value of shares held in other firms is obtained by dividing the total annual dividends paid by firms listed on the Tokyo Stock Exchange (TSE) by the corresponding dividend-price ratio. The market value of equity is obtained using the product of the fiscal year end stock price and the total number of shares outstanding. Unlike studies using U.S. data, preferred stocks are not included when calculating q 's numerator.³ The denominator of q includes the following seven items: non-residential buildings, structures, machinery, transportation equipment, instruments and tools, land, and inventories.

To evaluate the relation between foreign ownership and firm market value, we regress q against the equity ownership of foreign investors. To capture the marginal effects of additional foreign ownership and profitability, we follow Morck, Shleifer and Vishny (1988) and Hermalin and Weisbach (1991) by estimating a series of piecewise linear regressions. We divide foreign equity ownership into six ranges: less than 1%, between 1 and 5%, between 5 and 10%, between 10 and 20%, between 20 and 40%, and greater than 40%. Our range of foreign equity ownership is similar to that used by Hermalin and Weisbach (1991) in their study of CEO ownership.

We not only use Tobin's q as a dependent variable, but also the earnings rate as a dependent variable in the regression analyses. Firms in financial services, transportation, wholesale and retail industries are excluded. By using the earnings rate as another dependent variable, we obtain empirical results that are insensitive to changes in either capital structure or tax considerations.

We also include several firm characteristics as explanatory variables. These are expenditures on advertising, research and development, directory salary, and firm size variable. We regress q and the earnings rate against these variables along with the six ranges of foreign equity ownership. Yafeh and Yasha (2003) find that large shareholders efficiently monitor Japanese firms by reducing those activities with a potential for managerial moral hazard such as advertising, R&D, and entertainment expenses.

3.2. *Endogeneity in Foreign Ownership*

Issues of endogeneity might exist when relating foreign equity ownership to firm value. To control for this potential problem, we employ the two stage least squares

estimation method using the lagged values of foreign ownership as an instrumental variable consistent with [Hermalin and Weisbach \(1991\)](#).

For most firms the annual percentage change in foreign ownership is likely to be small, so using the previous year's foreign ownership is comparable to the current year's value of foreign ownership. Hence, one might argue that the lagged values of foreign ownership are imperfect instrumental variables. Consequently, we use annual changes in Tobin's q as the dependent variable in our regression analysis. The explanatory variables include industry controls and the change in foreign ownership interacted with dummy variables representing one of the six foreign ownership ranges. More specifically, we estimate the following equation:

$$Q_t - Q_{t-1} = \sum_{i=1}^{20} \beta_i D_i + \sum_{j=1}^6 \beta_j (fo_t - fo_{t-1}) D_{j,t-1} + \varepsilon_t \quad (1)$$

where q_t is Tobin's q and fo_t is the fraction of foreign equity ownership for year t . D_i is a dummy variable assuming a value of 1 if the firm resides in industry i and is zero otherwise. $D_{j,t-1}$ represents a set of dummy variables which assume a value of 1 for levels of foreign ownership located in ownership range j , and is zero otherwise. Thus, the β_j coefficients indicate if changes in foreign ownership originating from range j in the previous year lead to subsequent changes in Tobin's q .

3.3. Data Description

Nihon Keizai Simbun's NIKKEI Needs database is used to obtain firm characteristics including R&D expenditures, advertising expenditures, and director salary. The remaining accounting and stock price data are retrieved from the Pacific Basin Capital Markets (PACAP) Research Center database. There are a total of 1,593 firms which are listed on the Tokyo Stock Exchange (TSE) for the three consecutive years of 1995 to 1997, without any missing data. We obtain the equity ownership levels of main banks from the *Japan Company Handbook* and board of director membership by foreigners from *Mergent's International Manual*.

The sample firms are limited to industrial firms listed in the first section of TSE for the fiscal year 1997. Except for a few firms, most firms' balance sheet data relate to the fiscal year ending March 31, 1998. Firms in the first section are larger and more actively traded, and consequently have less concentrated ownership than second section firms. Due to the difference in several listing conditions, foreigner investors chiefly focus on firms in the first section. We also exclude 251 firms

in services industries such as real estate, transportation, financing and consumer credit, warehousing, and wholesale and retail industries.

Our final sample consists of 945 firms contained in manufacturing, utilities, construction, and agriculture, forestry, fishery, and mining. Using the PACAP provided three-digit industry code, we are able to identify twenty different industries among our sample firms. For our sample of 945 firms, foreign ownership averages 7.70%. The fraction of foreign ownership in manufacturing firms is 7.93% while that in agriculture, forestry, fishery, and mining is only 8.63%. Foreign ownership is below the sample average in the construction (5.43%) and utilities (4.08%) sectors. These results are consistent with industry values reported by [Kang and Stulz \(1997\)](#).

3.4. Summary Sample Statistics

Descriptive statistics regarding firm characteristics for our sample firms are provided in [Table 1](#). Panel A of [Table 1](#) reports mean (median) values of Tobin's q and the earnings rate as 2.71 (2.12) and 10.6% (7.9%), respectively. The mean (median) for total assets (TA) is 301.29 (92.81) billion yen. Our value for Tobin's q is higher than that observed by [Morck, Nakamura and Shivdasani \(2000\)](#), who use the sample year of 1986. Total assets also exhibit substantially higher values. Similar to Morck, Nakamura and Shivdasani, however, we find that the distribution of these values is positively skewed.

[Table 1](#) also provides descriptive statistics concerning advertising, R&D intensity and director compensation. We define ADV/RV, R&D/RV, and DIR/RV as the expenditures for advertising, R&D, and directors' salary standardized by the replacement value of assets. The mean (median) values of ADV/RV, R&D/RV, and DIR/RV are 2.6% (0.7%), 3.7% (1.1%) and 0.9% (0.7%) respectively. LRATIO is estimated as the ratio of the sum of short-term and long-term bank loans to total assets, and is distributed with a mean (median) value of 18.6 (13.9). Our value of LRATIO is slightly lower than that calculated by [Morck, Nakamura and Shivdasani \(2000\)](#). PROF represents the earnings before taxes and interest, with a mean (median) value of 11.41 (2.85) billion yen.

Panel B of [Table 1](#) contains the summary statistics for the fraction of equity held by foreign investors. We see that sample firms with foreign equity ownership in the 20–40% range have remarkably high value of q . Consistent with [Kang and Stulz \(1997\)](#), firms in this category are also very large, and exhibit superior operating performance. These firms have a mean (median) total assets size of 603.22 (400.86) billion yen and an earnings rate of 24.2% (22.2%). Firms with a foreign ownership of less than 1%, however, have a mean (median) total assets of only 63.61 (41.32)

Table 1. Characteristics of Exchange-Listed Industrial Firms.

Panel A: All Sample Firms

Descriptive Statistics	Tobin's q	PRATE	ADV/RV	R&D/RV	DIR/RV	LRATIO	TA	PROF
Mean	2.71	0.106	0.026	0.037	0.009	0.186	301.29	11.41
Std. Error	0.062	0.004	0.002	0.002	0.001	0.006	27.339	1.336
Median	2.12	0.079	0.007	0.011	0.007	0.139	92.81	2.85
25th percentile	1.51	0.037	0.002	0.001	0.003	0.037	49.32	1.08
75th percentile	3.09	0.156	0.025	0.042	0.013	0.292	223.18	7.67

Panel B: Descriptive Statistics by the Fraction of Foreign Equity Ownership

Foreign Ownership	Tobin's q	ERATE	ADV/RV	R&D/RV	DIR/RV	LRATIO	TA	PROF
0–1%								
Mean	2.23	0.045	0.013	0.018	0.014	0.305	63.61	0.97
Std. Error	0.095	0.008	0.002	0.002	0.001	0.016	6.550	0.157
Median	1.89	0.048	0.005	0.007	0.011	0.287	41.32	0.76
$N = 150$								
1–5%								
Mean	2.11	0.083	0.026	0.031	0.010	0.184	173.29	5.75
Std. Error	0.064	0.005	0.004	0.003	0.001	0.005	26.893	1.321
Median	1.84	0.069	0.006	0.008	0.009	0.137	68.13	1.90
$N = 322$								
5–10%								
Mean	2.61	0.123	0.028	0.032	0.007	0.169	467.41	18.49
Std. Error	0.112	0.008	0.004	0.004	0.001	0.011	94.035	4.847
Median	2.21	0.098	0.007	0.013	0.005	0.127	152.86	5.38
$N = 220$								
10–20%								
Mean	3.34	0.141	0.028	0.053	0.007	0.148	423.69	15.46
Std. Error	0.165	0.011	0.003	0.008	0.001	0.011	51.111	1.956
Median	2.52	0.107	0.009	0.014	0.005	0.100	168.00	7.36
$N = 192$								
20–40%								
Mean	5.88	0.242	0.050	0.100	0.007	0.055	603.22	33.54
Std. Error	0.437	0.029	0.014	0.018	0.001	0.010	131.507	5.903
Median	5.55	0.222	0.022	0.054	0.004	0.034	400.86	18.95
$N = 46$								
Over 40%								
Mean	3.92	0.092	0.024	0.052	0.007	0.151	497.12	13.78
Std. Error	0.848	0.031	0.008	0.023	0.002	0.037	210.451	6.948
Median	2.03	0.073	0.010	0.003	0.004	0.086	205.08	4.07
$N = 15$								

Note: This table provides descriptive statistics regarding industrial firms listed on the first section of the Tokyo Stock Exchange at the end of the 1997 fiscal year. Firms in financial services, transportation, and the wholesale and retail industries are excluded. Tobin's q is defined as the ratio of the market value of assets to the replacement value of assets. ERATE is earnings before taxes and interest standardized by the replacement value of assets. ADV/RV, R&DRV, and DIR/RV are expenditures on advertising, research and development, and directors' salary standardized by the replacement value of assets, respectively. LRATIO is the sum of short and long-term bank loans divided by total assets. TA and PROF represent total assets and the earnings before taxes and interest, respectively.

billion yen and an earnings rate as low as 4.5% (4.8%). Thus, we see foreign investors prefer large firms that demonstrate superior operating performance.

Panel B also shows that firms with substantial foreign ownership have greater advertising and R&D expenditures, but a lower director compensation ratio than firms with minimal foreign ownership. Those firms with foreign ownership in the 20–40% range have mean (median) values of ADV/RV, R&D/RV, and DIR/RV of 5.0% (2.2%), 10.0% (5.4%), and 0.7% (0.4%), respectively. The corresponding values for firms with minimal equity ownership are lower, with respective mean (median) values of 1.3% (0.5%), 1.8% (0.7%) and 1.4%(1.1%), respectively.

Finally, we observe low leverage for firms with significant foreign ownership, consistent with [Kang and Stulz \(1997\)](#). Panel B shows that firms with substantial foreign ownership levels have a mean (median) LRATIO of only 5.5% (3.4%), compared to mean (median) values of 30.5% (28.7%) for firms with minimal foreign ownership.

4. EMPIRICAL RESULTS

4.1. *A Nonlinear Relation*

We initially test for a non-linear relation between Tobin's q and foreign equity ownership (FOROWN) by estimating a model similar to [McConnell and Servaes \(1990\)](#). We obtain the following results, with t -statistics for the coefficients in parentheses:

$$q = 1.7714 + 15.38 \text{ FOROWN} - 17.47 \text{ FOROWN}^2, \quad (2)$$

(19.66) (11.44) (−6.12)

The corresponding regression statistics are: F -statistic = 103.34 while the adjusted $R^2 = 0.18$. These results provide strong evidence of a curvilinear relation between q and the fraction of common stocks owned by foreigners. The negative coefficient for FOROWN^2 implies concavity. A plot of Eq. (2) shows that the maximum value is reached with 44% foreign equity ownership.

[McConnell and Servaes \(1990\)](#) contend that arguments concerning the relation between firm value and equity ownership are more properly interpreted as descriptions of the relation between corporate performance and equity ownership. Consequently, we examine whether there exists a consistent curvilinear relation between operating performance and foreign equity ownership. We use the earnings rate as a proxy for firm operating performance. Comparable to the regression using q as the dependent variable, the earnings rate is regressed against the linear

and quadratic terms of foreign ownership. We obtain the following results, with t -statistics for the coefficients in parentheses:

$$\text{ERATE} = 0.053 + 0.949 \text{FOROWN} - 1.441 \text{FOROWN}^2 \quad (3)$$

(8.36) (9.95) (-7.12)

The corresponding regression statistics are: the F -statistic = 56.30 while the adjusted $R^2 = 0.11$.

A plot of Eq. (3) reveals that the inflection point decreases to 32.9% for foreign ownership, suggesting that firms with moderate to substantial levels (10–40%) of foreign ownership generally receive a favorable market valuation beyond that implied solely by firm performance.

4.2. Large Shareholders of Firms with Foreign Ownership

In this section we attempt to identify the determinants of the curvilinear relation between firm value and foreign equity ownership. The PACAP database, unfortunately, does not provide detailed information regarding large shareholders. Therefore, we hand-collect the identities of the large foreign shareholders appearing in the list of the top 10 shareholders from various issues of the *Japan Company Handbook*. Table 2 lists selected characteristics of the sample firms which are largely held by foreigners.

These large foreign shareholders among the top ten shareholders are largely industrial firms or institutional investors. Those sample firms with foreign ownership in the 40–70% range mostly have foreign industrial firms included among their top 10 shareholders. Akai Electric (foreign ownership of 67.37%) and Sony Corporation (foreign ownership of 45.27%) are the two exceptions where large foreign institutional investors appear among the firm's largest shareholders.

Firms with foreign ownership in the 30–40% range, on the other hand, often have foreign institutional investors included among their top 10 shareholders list. Table 2 shows that Boston-based State Street Corporation and Chase Manhattan Bank's London investment banking affiliate are major foreign institutional investors in the Japanese equities. Our results are consistent with those of Dahlquist and Robertson (2001) who examine Swedish firms and find that the majority of foreign investors are typically U.S. institutional investors. In unreported results, we also find that firms with 20–30% foreign ownership also frequently have foreign institutional investors included among their top 10 shareholders. Our findings of a positive relation between foreign ownership and firm value is consistent with Pound (1988) and McConnell and Servaes (1990).

Table 2. Characteristics of Industrial Firms Listed on the Tokyo Stock Exchange Which are Largely Held by Foreigners.

Company Name	Overall Foreign Ownership (%)	Total Assets in Billion Yens	Tobin's q	Foreign Owners Among Top 10 Shareholders (Ownership in Percentage)
Teisan	69.06	68.21	1.81	Air Liquide International (64.8), Air Liquide Pacific (1.3)
Akai Electric	67.37	86.10	5.92	Bankers Trust (42.2), Percula B. V. (23.8)
Banyu Pharmaceuticals	65.13	244.35	8.10	MSD International (26.3), MSD Ireland Holdings (13.1), Merck (11.3)
Showa Shell Sekiyu K. K.	63.37	827.91	4.32	Shell Petroleum (39.1), Anglo-Saxon Petroleum (7.6), Mexican Eagle Oil (3.2), Schroder Investment Management (1.5)
Hokuriku Seiyaku	57.77	49.83	1.78	BASF Group (59.6)
Tonen Corporation	54.64	499.96	2.42	Esso Eastern (25.0), Mobil Petroleum (25.0)
General Sekiyu	54.54	347.29	1.85	Esso Eastern (48.5), State Street Corp. (0.9)
Nippon Light Metal	54.15	374.99	2.52	Alcan Aluminium (37.1), Alcan Nikkei Asia Holdings Ltd. (8.4)
Osaka Sanso Kogyo	53.36	57.99	1.26	BOC Japan (49.6)
Densei-Lambda K. K.	52.45	24.61	5.61	Lambda Holdings Inc. (51.8), Lambda Far East Ltd. (10.0), Wady (2.0), State Street Corp. (1.5)
KOA Oil Co.	52.29	205.07	1.50	Caltex Petroleum (50.0)
Yamatake Honeywell	48.54	121.93	5.85	Honeywell Asia Pacific Inc. (21.6), Northern Trust (AVFC) American (2.0)
Sony Corporation	45.27	3,057.00	12.45	Moxley & Co. (4.9), Chase London (4.6), State Street Corp. (4.3), Ray Kay Inc. (2.2)
Mazda Motor Corp.	42.98	1,014.86	1.99	Ford Motor (33.3), Chase London (1.8)
Rohm Co.	42.32	385.95	17.62	Rohm Music Foundation (5.6), Chase London (4.8), State Street Corp. (4.7)
Isuzu Motors	41.40	964.65	1.80	GM (37.4)
Nihon Unisys Ltd.	40.20	252.96	2.31	Unisys Corp. (29.5)

Table 2. (Continued)

Company Name	Overall Foreign Ownership (%)	Total Assets in Billion Yens	Tobin's q	Foreign Owners Among Top 10 Shareholders (Ownership in Percentage)
Canon Inc.	38.88	1,370.68	4.86	State Street Corp. (4.3), Chase London Omnibus Account (2.1), Chase London (2.0), Boston Safe Deposit (1.8)
Meitec Corporation	38.69	59.52	5.96	Bankers Trust (5.3), State Street Corp. (3.6), Chase London (3.3), Progressive Pension Management (3.1)
Minebea Co. Ltd.	37.81	384.83	13.76	Chase London (4.1), State Street Corp. (2.7)
Sansui Electric Co.	36.58	15.21	5.82	Bankers Trust (29.5)
Murata Mfg.	36.57	407.60	11.6	Chase London (11.1), State Street Corp. (3.5)
Fuji Photo Film	36.19	1460.78	8.66	State Street Corp. (3.4), Chase London Omnibus Account (2.4), Chase London (2.2)
TDK Corporation	35.47	511.64	10.27	Chase London (2.8), State Street Corp. (2.6)
Sankyo	32.59	713.25	9.70	State Street Corp. (3.1), Chase London (2.4)
Zexel Corporation	32.43	228.58	2.42	Robert Bosch (16.2), Robert Bosch Corp. (13.1)
Suzuki Motor	32.06	723.48	2.12	GM (10.0), Chase London (7.3), Chase London Omnibus Account (2.5)
Yamanouchi Pharmaceuticals	30.88	716.33	14.36	State Street Corp. (2.3), Chase London (2.2)
Shimura Kako	30.87	5.72	7.68	Societe General Paris (2.1), Goldman Sachs (2.1), UBS AG London (2.0), Morgan Stanley (1.5), Indosuez Securities (1.5)
Tokyo Electron	30.29	439.86	12.03	Chase London Omnibus Account (2.8), Chase London (2.7)

Note: This table lists characteristics of industrial firms which are largely held by foreigners and listed on the first section of the Tokyo Stock Exchange as of the end of the 1997 fiscal year. Firms in financial services, transportation, and the wholesale and retail industries are excluded. Tobin's q is defined as the ratio of the market value of assets to the replacement cost of assets. In the fifth column, the names of those foreign owners included among the top 10 shareholders of largely foreigner-owned TSE industrial firms are listed.

4.3. Piecewise Linear Regression Analysis of Tobin's q and Foreign Ownership

In this section we estimate several piecewise linear regressions to further examine the relation between Tobin's q and foreign ownership. A number of firm characteristics such as advertising and R&D intensity, management compensation, industry membership, and firm size are included as control variables. The first and second columns of [Table 3](#) contain the results from OLS estimates differentiated by the inclusion of an industry dummy variable. The results are broadly comparable to each other. They show that at low levels of foreign ownership, there exists no significant relation between firm value and foreign ownership. At intermediate levels of equity ownership, ranging from 1 to 40%, there exists a significantly positive relation between Tobin's q and foreign equity ownership. The majority of foreign investors in this range are institutional. The regression slope appears steepest with foreign ownership between 10 and 20%. Over this range, a 1% increase in foreign equity ownership results in a 0.1535 rise in the value of q . For foreign ownership levels in excess of 40%, the coefficient for foreign equity ownership is significantly negative.

These findings of a nonlinear relation between firm value and ownership are consistent with Stulz (1988), Pound (1988) and McConnell and Servaes (1990). Our results further indicate that foreign institutional investors serve as effective monitors of Japanese firms. These findings also partially confirm those of Khanna and Palepu (1999) who report that Tobin's q is positively correlated with foreign institutional ownership, but negatively correlated with domestic institutional ownership.

The first and second columns of [Table 3](#) also show that the standardized advertising and R&D expenditures along with directors' salary all have strong positive correlation with firm value. The logarithm of the replacement value of assets exhibits a significant negative correlation with q . These results for advertising and R&D expenditures are broadly consistent with Morck, Shleifer and Vishny (1988), McConnell and Servaes (1990), and Hermalin and Weisbach (1991) who use U.S. data in their studies.

We further estimate the relation between firm value and foreign ownership by using the 2SLS method. Foreign equity ownership variables are treated as endogenous in this estimation method and their lagged values are used as instrumental variables. The third and fourth columns in [Table 3](#) show the results using the 2SLS estimation method both with and without controls for industry membership. Both 2SLS results are broadly consistent with each other. There is also no clear pattern of an overall increase (or decrease) in the magnitude of the various coefficients as compared to the results from the OLS estimates.

Table 3. Piecewise Linear Regressions of Tobin's q on Foreign Ownership and Other Firm Characteristics.

Variable	Dependent Variable: Tobin's q			
	OLS Estimates	OLS Estimates (with Industry Dummies)	2SLS Estimates	2SLS Estimates (with Industry Dummies)
Constant	3.19*** (4.43)	3.33*** (4.10)	2.96*** (3.69)	3.46*** (3.91)
0–1% foreign ownership ^a	−38.01 (−0.90)	−25.55 (−0.62)	−35.03 (−0.54)	−48.69 (−0.77)
1–5% foreign ownership ^b	14.89*** (2.74)	10.29* (1.94)	7.93 (0.85)	7.25 (0.79)
5–10% foreign ownership ^c	8.21* (1.78)	10.10** (2.20)	14.21* (1.71)	16.16** (1.98)
10–20% foreign ownership ^d	16.61*** (5.91)	15.35*** (5.57)	11.87*** (2.83)	9.71** (2.35)
20–40% foreign ownership ^e	8.42*** (2.92)	6.37** (2.26)	11.83*** (3.49)	9.72*** (2.93)
Over 40% foreign ownership ^f	−12.12*** (−3.45)	−10.65*** (−3.07)	−12.93*** (−3.35)	−11.42*** (−2.98)
ADV/RV	4.31*** (4.90)	4.39*** (4.78)	4.71*** (5.35)	4.68*** (5.08)
R&D/RV	5.86*** (8.19)	5.15*** (6.55)	6.51*** (9.15)	5.71*** (7.29)
DIR/RV	36.59*** (5.04)	36.74*** (5.03)	36.51*** (5.02)	36.67*** (5.02)
ln (Replacement value of assets)	−0.151*** (−2.62)	−0.09 (−1.35)	−0.124** (−2.17)	−0.07 (−1.08)
Sample size	945	945	945	945
F -statistic (P -value)	48.55 (0.0001)	20.94 (0.0001)	43.12 (0.0001)	19.30 (0.0001)
R^2	0.34	0.40	0.32	0.38

Note: This table presents regression estimates between Tobin's q and levels of foreign equity ownership. The sample consists of 945 industrial firms listed on the first section of the Tokyo Stock Exchange as of the end of the 1997 fiscal year. Advertising intensity, R&D intensity, directors' salary, and firm size are included as control variables. The first two columns show ordinary least squares (OLS) estimates with t -statistics in parentheses. The third and fourth columns provide estimates using the 2-stage least squares (2SLS) instrumental variable method.

Table 3. (Continued)

^aIf the fraction of the company held by foreigners is less than 0.01, the variable equals the fraction itself and 0.01 otherwise.

^bIf the fraction of the company held by foreigners is less than 0.01, the variable equals 0. If the fraction of the company held by foreigners is greater than 0.01 and less than 0.05, the variable equals the fraction minus 0.01. If the fraction of the company held by foreigners is greater than 0.05, variable equals 0.04.

^cIf the fraction of the company held by foreigners is less than 0.05, the variable equals 0. If the fraction of the company held by foreigners is greater than 0.05 and less than 0.1, the variable equals the fraction minus 0.05. If the fraction of the company held by foreigners is greater than 0.1, variable equals 0.05.

^dIf the fraction of the company held by foreigners is less than 0.1, the variable equals 0. If the fraction of the company held by foreigners is greater than 0.1 and less than 0.2, the variable equals the fraction minus 0.1. If the fraction of the company held by foreigners is greater than 0.2, variable equals 0.1.

^eIf the fraction of the company held by foreigners is less than 0.2, the variable equals 0. If the fraction of the company held by foreigners is greater than 0.2 and less than 0.4, the variable equals the fraction minus 0.2. If the fraction of the company held by foreigners is greater than 0.4, variable equals 0.2.

^fIf the fraction of the company held by foreigners is less than 0.4, the variable equals 0. Otherwise, the variable equals the fraction minus 0.4.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

There is one variable, however, which is significant with the OLS estimation, but is insignificant using 2SLS. This variable is foreign equity ownership at a modest level (i.e. 1–5%). It is statistically significant at the 1% level and marginally significant with the industry-adjusted OLS regression. It is statistically insignificant when we treat the variable endogenously. It appears that firms with modest levels of equity ownership and high q values are consistently attracting new foreign investors for capital infusion.

The results of regressing the earnings rate against these same explanatory variables are presented in Table 4. A similar non-linear relation between operating performance and foreign ownership is observed for both the OLS and 2SLS regressions. The positive effect of foreign ownership on firm operating performance is pronounced at lower levels of foreign ownership. Table 4 also shows that advertising and R&D intensity as well as directors' salaries have strong positive correlations with operating performance, while firm size has an inverse relationship with the earnings rate in Japan.

4.4. The Effects of Equity Ownership by Main Banks and Foreign Board Membership

Morck, Nakamura and Shivdasani (2000) document the relationship between the equity ownership of main banks and firm value in Japan. They conclude that at low to modest levels of main bank ownership, there is a negative relation between main

Table 4. Piecewise Linear Regressions of the Earnings Rate on Foreign Ownership and Other Firm Characteristics.

Variable	Dependent Variable: ERATE			
	OLS Estimates	OLS Estimates (with Industry Dummies)	2SLS Estimates	2SLS Estimates (with Industry Dummies)
Constant	0.12** (2.25)	0.14** (2.22)	0.07 (1.12)	0.10 (1.45)
0–1% foreign ownership	5.52* (1.75)	5.93* (1.89)	9.21* (1.92)	7.71 (1.62)
1–5% foreign ownership	2.00*** (4.93)	1.72*** (4.29)	1.86*** (2.66)	1.97*** (2.84)
5–10% foreign ownership	–0.11 (–0.31)	0.25 (0.71)	–0.26 (–0.43)	–0.09 (–0.15)
10–20% foreign ownership	0.77*** (3.70)	0.68*** (3.26)	0.77** (2.47)	0.70** (2.25)
20–40% foreign ownership	–0.05 (–0.25)	–0.09 (–0.43)	–0.08 (–0.34)	–0.15 (–0.58)
Over 40% foreign ownership	–0.49* (–1.86)	–0.50* (–1.88)	–0.33 (–1.13)	–0.33 (–1.13)
ADV/RV	0.25*** (3.82)	0.24*** (3.40)	0.25*** (3.90)	0.23*** (3.31)
R&D/RV	0.31*** (5.74)	0.25*** (4.13)	0.33*** (6.39)	0.27*** (4.62)
DIR/RV	1.40*** (2.59)	1.33** (2.41)	1.43*** (2.65)	1.41** (2.55)
ln (Replacement value of assets)	–0.01*** (–3.43)	–0.02*** (–3.17)	–0.01*** (–2.93)	–0.01*** (–2.74)
Sample Size	945	945	945	945
F-statistic (P-value)	24.48 (0.0001)	10.58 (0.0001)	21.39 (0.0001)	9.70 (0.0001)
R ²	0.21	0.25	0.18	0.24

Note: This table presents regression estimates of the relation between the earnings rate and levels of foreign equity ownership. The sample consists of 945 industrial firms listed on the first section of the Tokyo Stock Exchange at the end of the 1997 fiscal year. The variables for the foreign ownership ranges are defined identically to those in Table 3. Advertising intensity, R&D intensity, directors' salary, and firm size are included as control variables. The first two columns show ordinary least squares (OLS) estimates with *t*-statistics in parentheses. The third and fourth columns provide estimates using the 2-stage least squares (2SLS) instrumental variable method.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

bank equity ownership and firm value, while an increase in bank ownership might have a positive relation with firm value. Morck, Nakamura and Shivdasani argue similar to Rajan (1992) that bank power and rent-seeking behavior is a possible explanation for the negative relation between firm value and low to moderate bank ownership. Morck, Nakamura and Shivdasani further argue that as banks' equity ownership in their client firms increases, interests will become increasingly aligned between banks and their client firms.

There are two reasons that we should reexamine the relation between equity ownership by main banks and firm value in Japan. First, Morck, Nakamura and Shivdasani (2000) study firms listed on the Tokyo Stock Exchange as of 1986, which is the last year that bank equity ownership of firms was able to exceed 5%. Second, the Japanese equity market was still expanding as part of the bubble economy, making it likely that the market values used in study were inflated. Therefore, it would be useful to examine the effect of the equity ownership by main banks on firm value with more recent data.

Using Tobin's q as a dependent variable in Table 5, we find no supporting evidence for Morck, Nakamura and Shivdasani (2000) in model specifications (3), (4), and (5). When the earnings rate is used in Table 6, however, we find a significantly negative relation between firm value and equity ownership for the main banks. The coefficients of the quadratic term for main bank ownership ($MnBKOwnSq$) are significantly positive in Models (4) and (5) of Table 6. Although this might initially suggest a convex relation between bank equity ownership and firm value, the possible inflection point is beyond the maximum limit (5%) of equity ownership allowable by a main bank under the Anti Monopoly Act. This suggests that there exists only a negative relationship between main bank ownership and firm value.

We also introduce a dummy variable into our analysis which controls for the existence of foreign board members. In Model (5) of Table 5, we find a negative relation between the foreign board member dummy ($ForBOD$) and firm value. It appears that at highly concentrated levels of foreign ownership, foreign board members are common and such firms tend to have low q . Of course, this does not indicate that foreign board members are poor monitors. This variable, however, is statistically insignificant when used in Table 6's analysis of the earnings rate.

4.5. Analysis Using Annual Changes in Firm Value

4.5.1. All Sample Firms

In this section, we use the annual change in Tobin's q as a dependent variable and estimate a regression like Model (1) in Section 4.2 to avoid the potential of

Table 5. Regression Analysis of the Tobin's q on Ownership, Governance, and Other Firm Characteristics Variables with Industry Fixed Effects.

Variable	Dependent Variable: Tobin's q				
	(1)	(2)	(3)	(4)	(5)
Constant	2.22*** (5.27)	2.09*** (4.84)	3.04*** (6.53)	2.90*** (5.61)	5.80*** (4.43)
Ownership and governance variables					
ForOwn	6.51*** (6.52)	9.25*** (4.40)			10.38*** (4.38)
ForOwnSq		-6.68 (-1.48)			-5.73 (-0.99)
MnBkOwn			-0.04 (-0.58)	0.12 (0.47)	0.12 (0.49)
MnBKOwnSq				-0.02 (-0.65)	-0.02 (-0.59)
ForBOD					-1.36* (-1.88)
Firm characteristics variables					
ADV/RV					1.58 (0.98)
RND/RV					5.01*** (3.64)
DIR/RV					-23.38* (-1.81)
ln (Replacement value of assets)					-0.35*** (-3.24)
Sample size	945	945	945	945	945
F -statistic (P -value)	4.58 (0.0001)	4.47 (0.0001)	2.36 (0.0007)	2.45 (0.0001)	4.86 (0.0001)
R^2	0.09	0.09	0.05	0.07	0.14

Note: This table presents regression estimates of the relation between Tobin's q and ownership, governance and other firm characteristics variables. ForOwn (ForOwnSq) and MnBkOwn (MnBkOwnSq) indicate the linear (quadratic) values of foreign ownership and main bank ownership, respectively. ForBOD assumes a value of 1 if the sample firm has at least one foreign investor on the board of directors, and is zero otherwise. ADV/RV, R&DRV, and DIR/RV are expenditures on advertising, research and development, and directors' salary standardized by the replacement value of assets, respectively. t -Statistics are provided in parentheses.

*Statistical significance at the 10% level.

***Statistical significance at the 1% level.

Table 6. Regression Analysis of the Earnings Rate on Ownership, Governance, and Other Firm Characteristics Variables with Industry Fixed Effects.

Variable	Dependent Variable: ERATE				
	(1)	(2)	(3)	(4)	(5)
Constant	0.09*** (5.05)	0.06*** (3.51)	0.15*** (7.31)	0.18*** (7.89)	0.20*** (3.70)
Ownership and governance variables					
ForOwn	0.33*** (7.34)	0.94*** (10.08)			1.06*** (10.46)
ForOwnSq		-1.48*** (-7.38)			-1.81*** (-8.01)
MnBkOwn			-0.007** (-2.39)	-0.04*** (-3.48)	-0.03*** (-2.83)
MnBKOwnSq				0.005*** (2.93)	0.004** (2.44)
ForBOD					0.03 (1.24)
Firm characteristics variables					
ADV/RV					0.24*** (3.53)
RND/RV					0.23*** (4.02)
DIR/RV					0.96* (1.74)
ln (Replacement value of assets)					-0.01*** (-2.72)
Sample size	945	945	945	945	945
F-statistic (P-value)	7.17 (0.0001)	9.82 (0.0001)	4.54 (0.0001)	4.77 (0.0001)	10.81 (0.0001)
R ²	0.13	0.18	0.08	0.09	0.24

Note: This table presents regression estimates of the relation between the earnings rate and ownership, governance and other firm characteristics variables. The earnings rate is earnings before taxes and interest standardized by the replacement value of assets. ForOwn (ForOwnSq) and MnBkOwn (MnBKOwnSq) indicate the linear (quadratic) values of foreign ownership and main bank ownership, respectively. ForBOD assumes a value of 1 if the sample firm has at least one foreign investor on the board of directors, and is zero otherwise. ADV/RV, R&DRV, and DIR/RV are expenditures on advertising, research and development, and directors' salary standardized by the replacement value of assets, respectively. *t*-Statistics are provided in parentheses.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

Table 7. Regression Estimates of the Annual Changes in Tobin's q Against Annual Changes in Foreign Equity Ownership.

Variable	Dependent Variable: Yearly Change in Tobin's q	
	OLS Estimates	OLS Estimates (with Industry Dummies)
Constant	-0.73*** (-13.26)	-1.17*** (-4.63)
Yearly change in foreign ownership \times foreign ownership dummy (0-1%)	1.56 (0.56)	1.71 (0.62)
Yearly change in foreign ownership \times foreign ownership dummy (1-5%)	4.49 (0.82)	5.77 (1.05)
Yearly change in foreign ownership \times foreign ownership dummy (5-10%) ^a	2.71 (0.64)	4.17 (0.98)
Yearly change in foreign ownership \times foreign ownership dummy (10-20%)	8.49** (2.56)	7.72** (2.33)
Yearly change in foreign ownership \times foreign ownership dummy (20-40%)	14.17** (2.57)	14.90*** (2.72)
Yearly change in foreign ownership \times foreign ownership dummy (over 40%)	-14.80 (-0.69)	-12.90 (-0.61)
Sample size	945	945
F-statistic (P -value)	7.78 (0.0001)	2.20 (0.0006)
R^2	0.07	0.06

Note: This table shows regression estimates of the relation between annual changes in Tobin's q and annual changes in the percentage of foreign equity ownership. The independent variables capture the interaction between the annual change in foreign ownership and a dummy variable for the specific range of foreign equity ownership. The variables for the foreign ownership ranges are defined identically to those in Table 3. t -Statistics are provided in parentheses.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

endogeneity. Our OLS results are reported in Table 7. The significant negative coefficients in both regression specifications suggest that Tobin's q has decreased for most firms from 1996 to 1997. It should be noted, however, that within the ownership range of 10-40%, an increase in foreign ownership results in an increase in Tobin's q . This is especially pronounced at the 20-40% foreign ownership level, where a 1% increase in foreign ownership leads to a 0.1490 increase in Tobin's q for the regression with industry controls. The coefficients for concentrated foreign ownership level (over 40%) are negative, but statistically insignificant.

Table 8. Regression Estimates of the Annual Change in the Earnings Rate Against Annual Changes in Foreign Equity Ownership.

Variable	Dependent Variable: Yearly Change in (EBIT ₁₉₉₇ -EBIT ₁₉₉₆)/RV ₁₉₉₇	
	OLS Estimates	OLS Estimates (with Industry Dummies)
Constant	-0.009*** (-4.14)	0.004 (0.45)
Yearly change in foreign ownership × foreign ownership dummy (0–1%)	0.20* (1.77)	0.20* (1.73)
Yearly change in foreign ownership × foreign ownership dummy (1–5%)	0.12 (0.51)	-0.03 (-0.17)
Yearly change in foreign ownership × foreign ownership dummy (5–10%)	0.006 (0.04)	-0.15 (-0.82)
Yearly change in foreign ownership × foreign ownership dummy (10–20%)	-0.16 (-1.16)	-0.14 (-1.06)
Yearly change in foreign ownership × foreign ownership dummy (20–40%)	0.55** (2.36)	0.56** (2.40)
Yearly change in foreign ownership × foreign ownership dummy (over 40%)	0.61 (0.67)	0.50 (0.55)
Sample size	945	945
F-statistic (P-value)	1.78 (0.0993)	2.29 (0.0003)
R ²	0.013	0.058

Note: This table shows regression estimates of the relation between annual changes in the earnings rate and annual changes in the percentage of foreign equity ownership. The independent variables capture the interaction between the annual change in foreign ownership and a dummy variable for the specific range of foreign equity ownership. The variables for the foreign ownership ranges are defined identically to those in Table 3. *t*-Statistics are provided in parentheses.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

To test the robustness of these results, we also regress the annual change in the earnings rate on the annual changes in foreign ownership at various categories of foreign ownership in Table 8. We find that at the 20–40% range in foreign ownership, an increase in foreign ownership leads to an increase in next year's earnings.

We conclude that at substantial levels of foreign ownership where most investors are institutional investors, there is a positive correlation between foreign ownership and firm value. In the following section, we discuss whether

there are any cross-sectional differences between keiretsu affiliated firms and non-keiretsu firms in their relationship between foreign ownership and firm value.

4.5.2. Keiretsu versus Non-Keiretsu Firms

Since a keiretsu member firm has significant cross-shareholding with other member firms, we might easily expect that the role of a large foreign shareholder in the management of a keiretsu member firm will be more restricted than that in an independent firm. Consequently, we decompose our sample into keiretsu-affiliated and independent firms. We then conduct an analysis similar to that of the previous section. In untabulated results, we find that the increase in firm value is largely attributable to the increase in foreign ownership for non-keiretsu firms. For keiretsu firms, we find that the increase in foreign ownership across each of the ranges is not generally significantly related to annual changes in Tobin's q . But for non-keiretsu firms, we determine that an increase in foreign ownership is significantly related to the annual change in Tobin's q when foreign ownership is between 10 and 40%.

We obtain similar results using the annual change in the earnings rate. We find that for non-keiretsu firms an increase in foreign ownership is significantly related to the annual change in the earnings rate when foreign ownership is between 20 and 40%. We find for keiretsu affiliated firms that there is a significant negative relation between an increase in foreign ownership and the annual change in the earnings rate.

4.6. Foreign Investors: Industrial versus Institutional

Table 9 contains the 100 Japanese firms with the largest percentage of foreign owners. We introduce into our analysis a dummy variable, *IndForOwnDum*, which assumes a value of 1 if the majority of foreign ownership is due to industrial owners and is zero otherwise. Since the sample firms have substantial levels of foreign ownership, we remove all explanatory variables related to foreign ownership.⁴ Table 9 offers only weak evidence of an inverse relationship between the presence of foreign industrial investors and an increase in firm value.

In Models (1) and (2) of Table 10, the coefficients for *IndForOwnDum* are significantly negative. This effect disappears, however, when we control for ownership, governance, and firm characteristics variables in the other model specifications.

Table 9. Regression Estimates of Annual Changes in the Earnings Rate Against Ownership, Governance, and Other Firm Characteristics with Industry Fixed Effects for the Highly Foreign Owned Firms.

Variable	Dependent Variable: Yearly Change in Tobin's q			Dependent Variable: Yearly Change in Earnings Rate		
	(1)	(2)	(3)	(4)	(5)	(6)
Constant	-0.58 (-0.61)	-0.58 (-0.52)	-0.76 (-0.24)	0.03 (0.61)	-0.02 (-0.36)	-0.10 (-0.64)
Ownership and governance variables						
MnBkOwn			-0.74 (-1.41)			-0.05** (-2.01)
MnBKOwnSq			0.08 (1.03)			0.008** (1.99)
ForBOD			-0.16 (-0.30)			-0.02 (-0.73)
IndForOwnDum	-0.79* (-1.90)	-0.75* (-1.74)	-0.69 (-1.37)	-0.01 (-0.42)	-0.002 (-0.04)	0.003 (0.12)
Firm characteristics variables						
ADV/RV		2.77 (1.01)	2.52 (0.90)		0.04 (0.32)	0.002 (0.02)
RND/RV		-0.29 (-0.20)	-0.40 (-0.25)		-0.04 (0.32)	-0.05 (-0.68)
DIR/RV		-12.07 (-0.48)	-17.98 (-0.44)		2.24* (1.71)	2.77 (1.33)
ln (Replacement value of assets)			0.12 (0.54)			0.01 (1.04)
Sample Size	100	100	100	100	100	100
F-statistic (P -value)	1.09 (0.37)	0.96 (0.51)	0.96 (0.53)	0.75 (0.74)	0.85 (0.65)	0.98 (0.50)
R^2	0.19	0.20	0.24	0.14	0.18	0.24

Note: This table shows regression estimates of the relation between annual changes in the earnings rate and annual changes in the percentage of foreign equity ownership, governance and other firm characteristics. Only the 100 Japanese firms with the highest percent of foreign ownership listed on the first section of the Tokyo Stock Exchange are included. The multiplicative independent variables capture the interaction between the annual change in foreign ownership and a dummy variable for the specific range of foreign equity ownership. The variables for the foreign ownership ranges are defined identically to those in Table 3. MnBkOwn (MnBkOwnSq) indicate the level (square of the level) of main bank ownership. ForBOD assumes a value of 1 if the sample firm has at least one foreign investor on the board of directors, and is zero otherwise. IndForOwnDum assumes a value of 1 if a majority of foreign ownership is due to industrial owners, otherwise it is zero. ADV/RV, R&DRV, and DIR/RV are expenditures on advertising, research and development, and directors' salary standardized by the replacement value of assets, respectively. t -Statistics are provided in parentheses.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

Table 10. Piecewise Linear Regressions of R&D Intensity Against Foreign Ownership and Other Firm Characteristics.

Variable	Dependent Variable: R&D/RV			
	OLS Estimates	OLS Estimates (with Industry Dummies)	2SLS Estimates	2SLS Estimates (with Industry Dummies)
Constant	-0.05 (1.56)	-0.15*** (-4.34)	-0.06* (-1.68)	-0.15*** (-4.06)
0–1% Foreign ownership	2.69 (1.39)	1.34 (0.77)	3.32 (1.13)	1.44 (0.55)
1–5% Foreign ownership	-0.06 (-0.25)	-0.16 (-0.72)	-0.06 (-0.16)	-0.19 (-0.50)
5–10% Foreign ownership	0.09 (0.47)	0.12 (0.64)	0.06 (0.15)	0.21 (0.60)
10–20% Foreign ownership	0.37*** (2.97)	0.30*** (2.64)	0.27 (1.40)	0.19 (1.09)
20–40% Foreign ownership	0.25* (1.89)	0.19 (1.63)	0.34** (2.21)	0.22 (1.58)
Over 40% foreign ownership	-0.33** (-2.08)	-0.35** (-2.41)	-0.31* (-1.78)	-0.28* (-1.73)
ADV/RV	0.10** (2.39)	0.09** (2.27)	0.11*** (2.69)	0.10** (2.52)
DIR/RV	0.48 (1.44)	0.89*** (2.90)	0.47 (1.42)	0.89*** (2.92)
ln (Replacement value of assets)	0.004* (1.78)	0.01*** (4.47)	0.005** (2.00)	0.01*** (4.63)
Sample size	945	945	945	945
F-statistic (P-value)	7.78 (0.0001)	12.80 (0.0001)	6.08 (0.0001)	12.31 (0.0001)
R ²	0.07	0.28	0.05	0.28

Note: This table presents shows regression estimates of the relation between R&D intensity and levels of foreign equity ownership. The variables for the foreign ownership ranges are defined identically to those in Table 3. ADV/RV, R&DRV, and DIR/RV are expenditures on advertising, research and development, and directors' salary standardized by the replacement value of assets, respectively. *t*-Statistics are provided in parentheses.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

4.7. Long-run Vitality and Foreign Ownership

As discussed previously, the major concern of Japanese firms regarding foreign investment has been the “stability” of foreign capital. Morck and Nakamura (1999) contend that ownership by stable shareholders who rarely sell their shares and consistently support management, has been the norm in Japan until recently. Thus, we examine the association between corporate long-term vitality and foreign ownership. We use R&D intensity as a dependent variable to represent the long-run vitality of a firm and regress it against other dependent variables.

Table 10 shows the results of the OLS and 2SLS regressions without and with industry controls. We observe an interesting result at the 10–20% level of foreign ownership, where the majority of large foreign owners are institutional investors. R&D expenditures rise as the fraction of foreign ownership increases.

In the first column of Table 10, we see that the coefficient for the 10–20% range of foreign ownership is 0.37 (*t*-statistic of 2.97) and 0.30 (*t*-statistic of 2.64), respectively, for each OLS regression. With the 2SLS estimates, however, the coefficient becomes insignificant at the 10–20% range of foreign ownership. But for foreign ownership between the 20 and 40% range, the coefficients are consistently significant without an industry control, but become insignificant when industry effects are introduced. This suggests that at the 10–20% range of foreign ownership, foreign institutional investors are adding capital to firms with higher R&D intensity. At the 20–40% range of foreign ownership, foreign institutional investors are actually responsible for increased R&D intensity in several industries in Japan. These industries include chemicals, general and electric machinery, and precision equipment. Overall, the results broadly suggest that foreign institutional investors are substantially concerned with firm long-run vitality. This is contrary to the claim that foreign investors are merely short-term speculators.

At foreign ownership levels in excess of 40%, however, R&D intensity declines as the fraction of foreign ownership increases. There is one plausible explanation for this surprising result. As previously noted in Table 2, foreign investors in this ownership range are more likely to be industrial firms operating in the same industry as their Japanese targets. Those industrial owners might tend to spend less R&D in Japan, but expend more on their main R&D facility back home. The finding is broadly consistent with the view by Stulz (1988) that top managers (mostly foreigners) might not pursue value-maximization at very high concentrated foreign ownership levels. This concern has become a central argument by those policy advisers recommending against large foreign acquisitions following the Asian financial crisis. Finally, we also find a positive association between R&D

intensity and firm size in Table 10 (the last coefficient). This indicates that larger firms spend more on R&D expenditures.

5. CONCLUSION

This study establishes a strong curvilinear relation between Japanese firm value and the equity ownership of foreign investors. Firm value rises until foreign ownership reaches approximately 40%, and then it begins to decline. Our analysis using the earnings rate or the annual change in q demonstrates a similar pattern of non-linearity in the relation between foreign ownership and firm value. It appears that in Japan large foreign institutional investors invest in well-performing firms and serve as effective monitors. Our results are broadly consistent with the arguments of Pound (1988) who predicts a positive relation between firm value and institutional equity ownership. These results are also consistent with Khanna and Palepu (1999) who argue that Tobin's q is positively related to the presence of foreign institutional investors. We also find that foreign industrial firms increase their equity holdings in poorly performing Japanese firms, suggesting a rescue acquisition of equity ownership at high levels of concentrated foreign ownership. Our results remain robust even after controlling for other governance variables such as the equity ownership of main banks and the presence of foreign investors on the board of directors.

To avoid potential problems with endogeneity in our analysis of firm value and equity ownership, we use the annual changes in firm value instead of levels. We confirm that at substantial levels of foreign equity ownership, an increase in foreign ownership will lead to an increase in firm value. But there are important cross-sectional differences in these results. We show that most of the growth in firm value and the performance improvement is due to the increase in foreign ownership in non-keiretsu or independent firms. For keiretsu affiliated firms, we observe a significant negative relationship between foreign ownership and the annual change in earnings rate.

Finally, we find that an increase in foreign ownership is correlated with a rise in R&D intensity. This suggests that foreign institutional investors in Japan contribute much to a firm's long-run vitality. But at very concentrated levels of foreign ownership, an increase in foreign equity ownership is correlated with a decrease in R&D intensity. This is consistent with the managerial entrenchment hypothesis of Stulz (1988) that foreign owner-managers pursue agendas which might not be in the best interest of all shareholders. We also introduce a dummy variable to capture the presence of foreign board members. We fail to find any evidence that inferior performance is attributable to foreign board members.

NOTES

1. For additional discussions of recent trends in foreign acquisitions in Japan, see: "Barbarians at the Gate," *The Economist*, April 3rd, 1999 and "Beyond Japan's Lost Decade," *Wall Street Journal*, December 28, 2000.

2. Until recently, foreign investors in Japan have been viewed as undesirable shareholders along with racketeer shareholders or *sokaiya*, who embarrass incumbent management by blackmail. *Sokaiya* do not enhance shareholder wealth since they become quiet upon receiving their pay-off.

3. Preferred stock issues were virtually non-existent in Japan prior to 1990. There were only two companies that issued preferred stocks for the period from 1965 to 1990: Hitachi Zosen and Nippon Yakin Kogyo Corp. In April 1991, the Commercial Law was reformed and the issuing procedure for preferred stock became much simpler. Nevertheless, the issuance of preferred stock by Japanese firms other than banks remains uncommon.

4. The average (median) foreign equity ownership is 27.4% (22.0%).

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CORPORATE GOVERNANCE AND FIRMS VALUE IN EMERGING MARKETS: THE CASE OF JORDAN

Ritab Al-Khouri

ABSTRACT

This paper empirically explores the relationship between the identity and concentration of different block holders and firm value for 89 industrial and service firms listed at the Amman Stock Exchange (ASE) over the period 1998–2001. The paper examines the role of block holders (institutional investors who are not on the board of directors, the institutional investors who are on the board of directors, the ownership of the board of directors, and the financial policy of the firm, such as the capital structure) in controlling the managerial actions which leads, on average, to better firm valuation in the emerging market of Jordan. The paper employs a piecewise regression specification methodology. The results of the piecewise regression analysis indicate a positive and significant relationship between the ownership of securities above 25% by the board of directors, institutional investors on the board of directors, the institutional investors not on the board of directors and firm value. There is no significant relationship between the above-mentioned ownership and firm value for ownership below 25%. The results also indicate a significant and negative relationship between ownership by the CEO below 5% and firm value. Leverage is significantly and positively related to firm value when we relate ownership by institutional investors not on the board of directors and firm value. This might imply that creditors work

as complementary monitors of value along with institutional investors who are not on the board of directors. The paper concludes that block holders are important monitors of firm value especially if they own large amounts of securities to justify the high cost of monitoring.

1. INTRODUCTION

This paper builds on the previous literature to explore the relationship between the identity and concentration of different ownership structures (block holders) and firm value for a number of firms listed at the Amman Stock Exchange (ASE) over the period 1998–2001. The question is whether corporate governance mechanisms lead, on average, to better valuation of firms. Previous research focused on ownership structure variables such as concentration and insider holdings only. The first goal of this paper is to include other mechanisms such as the identity of outside owners in the firm (e.g. the institutional investors who are not on the board of directors), the institutional investors on the board of directors, the ownership of the board of directors, and the financial policy of the firm, such as the capital structure.

The second goal of this paper is to help clarify the relationship between corporate governance and firm value in a developing country (Jordan). Most empirical governance-related research dealt with very large firms in the U.S., which has a very active market for corporate control in comparison to those of emerging markets. The Jordanian firms however are quite smaller than those of the U.S., and the takeover mechanism in Jordan is nonexistent. In addition, since large shareholders, as institutional investors, own a large fraction of shares then households hold fewer shares. This makes the Jordanian stock market less liquid as compared to those of the developed markets. We should expect then a great role of governance by equity block holders. Contrary to the findings by Lins (2002), and Claessens et al. (2002) on a sample of emerging markets, we find that the dominant types of controlling block holders in Jordan are institutional investors. The management, however, does not seem to hold large blocks of the equity of their firms. Given the expected role of block holders to control the managerial actions, we should expect a positive relationship between firm value and block holder ownership. Therefore, since governance related mechanisms are important for economic performance and the welfare of investors, the results of this research could help us understand the characteristics of the market for corporate control in emerging economies.

This paper is the first attempt to study the importance of block holders in influencing the value of their firms in Jordan. The results of this paper might help common stockholders develop a clear understanding of firms in which they intend to invest. In addition, the results of this paper will help us judge better the validity

of the agency issue related to corporate governance when testing the prediction of the theory on firms operating in different markets and different mechanisms.

Equity holders generally depend on both internal and external monitoring mechanisms to resolve the agency problem that emerges from the separation of ownership and control. The financing policy of the firm and the takeover mechanism are considered important external methods to control managers. Block holders (holders of large stakes of equity, such as managers, institutional investors and individuals) are important for internally controlling the managerial incentives, in the belief that this will eventually lead to an increase in firm value.

Previous studies on agency issues have focused on the managers as block holders, and their influence on the perceived value of their firms. [Jensen and Meckling \(1976\)](#) argued that managers with high equity ownership in their firms would be prompted to act in their own best interest, which is aligned with that of shareholders to maximize the firm value. Hence, greater ownership served to align the interests of both managers and shareholders. [Stulz \(1988\)](#) argued, alternatively, that managerial ownership might give the manager power to guarantee his/her presence in the company and pursue non-value-maximizing activities at the expense of shareholders. Therefore, greater managerial ownership could insulate managers from external takeovers, which induced them to act for their own interest rather than that of shareholders. That was described as the entrenchment effect, whereby the firm was expected to be negatively related to management ownership.

Empirical evidence demonstrated the importance of both the alignment and the entrenchment effects of managerial ownership in the U.S. [Morck, Schleifer, and Vishney \(1988\)](#), [McConnell and Servaes \(1990, 1995\)](#), [Hermalin and Weisbach \(1991\)](#) and [Holderness, Kroszner and Sheehan \(1999\)](#) showed a nonlinear relationship between firm value and managerial ownership in the U.S., which was consistent with both the alignment incentive and the entrenchment effects of management ownership.

In addition to managerial ownership, [Leleux, Vermaelen and Bunerjee \(1995\)](#) analyzed the impact of other large block holders and their impact on firm performance in France. They found that the identity of the block holder was crucial. [Claessens, Djankov, Fan and Long \(hereafter CDFL, 2002\)](#) studied the relationship between firm value and ownership structures across eight East Asian emerging economies. They found that the cash flow rights held by the largest block holders were positively related to value. [Lins \(2002\)](#), also provided evidence of the relationship between firm value and management ownership across firms from 18 emerging markets. His results suggested that the separation of management group ownership and control had a significant negative relation to value in countries with low shareholder protection, whereas large non-management block holder had a significant positive relation. He also found that managers and their families were

dominant types of controlling block holders in the emerging markets under study, controlling two thirds of the sample firms.

This paper proceeds as follows. Section 2 reviews the literature on the ownership and firm value. Section 3 describes the link between ownership structure and firm value. Section 4 discusses our data and model. Empirical tests are presented in Section 5, and Section 6 concludes this paper.

2. REVIEW OF THE LITERATURE ON FIRM VALUE AND OWNERSHIP

Due to the separation of ownership from control, a conflict of interest between managers and owners generated what is known as “agency problem.” Managers acting for their own best interest, which is not aligned with that of the owners, might affect the value of their firms negatively. Most literature has focused on solving this problem by making managers as shareholders. If managers own a large amount of shares in their firms, then those managers as insiders, while acting for their own best interest, will have a positive effect on the perceived value of their firms. This agency theory was discussed thoroughly in the literature, starting with [Jensen and Meckling \(1976\)](#). They argued that managers with high equity ownership in their firms will be encouraged to act in the best interest of shareholders and therefore, act to maximize firm value. Therefore, higher ownership served to align the interests of both managers and shareholders.

Alternatively, insider ownership as management ownership may also destroy firm value. [Stulz \(1988\)](#) argued that higher managerial ownership could protect managers from external takeovers, which induced them to act for their own interest rather than that of equity shareholders. If managers own a large amount of stocks, this might give them more power to guarantee their presence in the company and pursue non-value maximizing activities at the expense of shareholders. This was described as the “entrenchment effect,” where a negative relationship was expected between firm value and management ownership.

Empirical evidence by [Morck, Schleifer, and Vishney \(1988\)](#), [McConnell and Servaes \(1990, 1995\)](#), [Hermalin and Weisbach \(1991\)](#) and [Holderness, Kroszner and Sheehan \(1999\)](#) demonstrated the importance of both the alignment and the entrenchment effects of managerial ownership in the U.S. These papers showed a non linear relationship between firm value and managerial ownership, which is consistent with both the alignment incentive and the entrenchment effects of management ownership.

[Morck, Shleifer, and Vishny \(1988\)](#), for example provided evidence on both the alignment of interest and the entrenchment effects. The piecewise segmentation

was used to capture the possible presence of alignment and entrenchment effects. The study found a significant increase in firm value for ownership level between 0 and 5% consistent with alignment effect. Hence, management has incentives to increase its wealth by maximizing the value of their firms. At the ownership level between 5 and 25%; the study showed a significant decrease in firm value which is attributed to the entrenchment of managers as they become isolated from market forces. At ownership levels beyond 25%, the relationship became positive but insignificant. They attributed this observation to the convergence of interest hypothesis, where the welfare of management was, once again, aligned with those of the shareholders. The paper did not control, however, for other factors such as the age of the company, dividend and the leverage, which could have yielded different results.

McConnell and Servaes (1990) have investigated the value of the firm proxied for by Tobin's q and the different equity structures, such as insider ownership (officers and directors), the square of insider ownership, individuals, blockholders, and institutional investors. They used a sample of firms from the years 1976 to 1986. Their results of piecewise regression analysis were similar to those of Morck et al. (1988), which indicated a strong curvilinear relationship between firm value and insider ownership.

Hermalin and Weisbach (1991), alternatively, attempted to measure the difference that could be observed in firm performance due to the composition of the board of directors and ownership structure. Their study sampled a total of 134 firms listed on the New York Stock Exchange for the years 1971, 1974, 1977, 1980, and 1983. They measured profitability by the average of Tobin's q and the Return on Assets (ROA). They divided ownership into three types: insiders (present and former chief executive officers), outsiders (non-employee directors), and others. Tobin's q was regressed against the ownership structures using ordinary least squares regression. In addition, the researchers used piecewise regression for insiders. Their results suggested that Tobin's q rises when ownership is less than 1%, denoting a reduction in agency cost. Meanwhile, Tobin's q decreased at ownership levels of greater than 20%, which indicated loss of value due to the increased control of insiders. When Tobin's q was replaced by ROA, similar results were noted. Finally, a relationship was not found between board composition and performance.

The paper by Hermalin and Weisbach (1991), however, neglected to control for important variables that could have had an effect on the value ownership relationship such as dividend policy and the age of the firms that were in the sample.

All the previous papers studied the relationship between ownership and firm value in the U.S. However, Stulz (1988), Leleux, Vermaelen and Bunerjee (1995),

La Porta, Lopez-de Silanes, Shleifer and Vishny (hereafter [LLSV, 1998](#)), [Morck, Nakamura, and Shivdasani \(2000\)](#), [Makhija \(2000\)](#), Claessens, Djankov, Fan and Long (hereafter [CDFL, 2002](#)), and Lins (2002) provided evidence on the relationship between firm value and ownership structure in markets other than the U.S.

The paper by [LLSV \(1998\)](#), for example, studied the relationship between firm value and large blockholders with a sample of 20 largest firms in each of 27 developed economies. They found that firm value was positively related to cash flow rights held by the largest blockholders. However, they found no evidence of the valuation effect when there was a difference in the control rights and cash flow rights held by the largest blockholders. In comparison, [CDFL \(2002\)](#) studied the relationship between firm value and ownership structures across eight East Asian emerging economies. They provided an evidence consistent with that of [LLSV \(1998\)](#) that cash flow rights held by largest blockholders were positively related to firm value. In addition, [Gorton and Schmid \(1996\)](#), found that performance improved in firms where banks held large blocks of securities. [Kaplan and Minton \(1994\)](#) found that managers in Japanese firms were more likely to be replaced based on poor performance if securities were placed in the hands of large shareholders, than in companies with small shareholders. Recently, Lins (2002), provided evidence of the relationship between firm value and management ownership with a sample of 1,448 firms from 18 emerging markets. His results suggested that the separation of management group ownership and control had a significant negative relationship to value in countries with low shareholder protection. However, large non-management blockholder had a significant positive relation. He also found that managers and their families were dominant type of controlling blockholders in the emerging markets in their study, controlling two thirds of the sample firm.

[Makhija \(2000\)](#) tested the relationship between firm value proxied for by logs of share prices and the logs of different types of ownership structure with a sample of 988 Czech firms in the year 1991. The ownership structures were made up of insiders (managers and directors) and outside blockholders (foreigners, restitution, and fund ownership). The underlying hypothesis of the study stemmed from the agency problem, where dispersed owners lacked the incentive or the motivation to take on costly monitoring actions. The study stressed the fact that foreign blockholders had maintained advantageous information, and they placed their investments in more profitable firms. The study found that share values were positively related to insiders and foreign ownership. The study's results showed negative relationship with fund holdings. [Makhija \(2000\)](#) investigated the firm value and different ownership structures for the year 1991. The paper, however, did not use a piecewise specification on the ownership data which left some of the finer results unrevealed.

However, one strand of literature suggested that managerial ownership did not affect firm value and vice versa. Agrawal and Knoeber (1996) examined the use of several apparatuses to control agency problem. Those mechanisms were insider ownership, institutional holdings, and blockholdings, outside directors, debt policy, the managerial labor market, and market controls. The researchers argued that since several mechanisms of control existed, the use of one over the other should not have had an effect on firm performance. They used a sample of 400 U.S. firms for the year 1987. Each control mechanism was tested simultaneously against the other, to find interdependence among variables. Tobin's q was used as a measure of performance, and was regressed against each control variable separately, using an ordinary least squares regression. Q was then regressed against all variables using simultaneous equations.

The results were contradictory. In the first regression, insider ownership was positively related to performance while in the second regression, which incorporated all the control mechanisms, the effect of ownership disappeared. That indicated that ownership was not a determinant of firm performance.

This paper builds on the previous research on firm value and ownership and applies the both the simple linear regression and the piecewise specification regression methodologies to test the relationship between firm value and different ownership structures. We used a sample of 89 Jordanian firms listed on the Amman Financial Market.

3. THE LINK BETWEEN OWNERSHIP STRUCTURE AND FIRM VALUE

3.1. Managerial Ownership and Firm Value

Previous literature on agency issues has focused on the managers as blockholders. If managers own large amounts of equity in their firms, this will give them an incentive to act in the best interest of owners to maximize firm value, since their interest will be aligned with that of shareholders. Therefore we hypothesize:

H1. The higher the percentage of securities owned by managers, the higher the value of their firms.

On the other hand, if managers own larger amounts of securities of their firms, this might give them power to guarantee his/her presence in the company and pursue non-value-maximizing activities at the expense of shareholders. Therefore, higher managerial ownership can insulate managers from external takeovers, which induces them to act in their own interest rather than that of equity shareholders. Therefore, our first hypothesis is:

H2. The higher the percentage ownership of equity by management, the lower their firm values.

3.2. Board of Directors and Firm Value

In addition, the theoretical framework of the agency theory is often used in finance to understand the link between the characteristics and the structure of the board of directors and firm value. Fama and Jensen (1983) proposed an important role of the board of directors as one mechanism to control and monitor managerial actions. The board of directors generally has incentives to build reputation as external expert monitors to managerial actions and to work for the best interest of the shareholders.

Given the effective monitoring role of the board of directors, and since the incentive to monitor the management is high when the board of directors hold large sum of securities in the firm, we therefore hypothesize:

H3. A positive and significant relationship is expected between the percentage of equities owned by the board of directors and firm value.

3.3. Ownership Concentration and Firm Value

The concentration of ownership can also reduce the “free rider” problem. Several findings in the literature support the role large shareholders have in corporate governance. Gorton and Schmid (1996), for example, found that performance improved in firms where banks held large blocks of securities. Alternatively, Morck, Shleifer, and Vishny (1988), McConnell and Servaes (1990, 1995), Hermalin and Weisbach (1991) and Holderness, Kroszner and Sheehan (1999) found a nonlinear relationship (inverted “U”) between ownership and companies performance, as measured by their Tobin’s q . Two hypotheses will be used to test the effect of institutional investors as block holders, whether or not they sit on the board of directors in controlling the action of management to enhance firm value. Therefore, we hypothesize:

H4. A positive and significant relationship is expected between the number of equities held by institutional investors on the board of directors (not on the board of directors) and firm value.

4. DATA AND METHODOLOGY

The population of the study consists of listed companies on the ASE. According to the ASE annual report for the year 2001, 163 companies represented the industrial, service, insurance, and financial sectors.

The sample is drawn from the industrial and service sectors over the period 1998 and 2001. A total of 89 companies are included in the sample. All insurance and financial companies are excluded from the analysis, since the calculations that are needed to determine the firm's value required the exclusion of financial firms from the banking and insurance sectors. In addition, we excluded all companies with missing data, companies that were acquired by or merged with another company, and companies that were liquidated either voluntarily or obligatorily. Finally, to avoid capturing effects that may be related to extreme financial distress, we eliminated firms with negative book equity value.

Institutional ownership on the board of directors in this paper is defined as ownership by mutual funds, banks, insurance companies and pension funds whose personnel are on the board of directors. Finally, management ownership or chief executive officers ownership is the fraction of shares owned by the management.

4.1. Variables Definition

4.1.1. Dependent Variables

4.1.1.1. *Firm value.* Tobin's q is usually defined as the market value of equity divided by replacement cost. Due to the unavailability of data for calculating the replacement costs, this study adopts the Approximate Tobin's q (AQ) following Chung and Pruitt (1994).

$$AQ_{it} = \frac{MVE_{it} + PS_{it} + DEBT_{it}}{TA_{it}}$$

where AQ_{it} = Approximate Tobin's q for the i th firm at period t . MVE_{it} = The market value of equity for the i th company at period t , calculated as the firm's year-end closing stock price times the firm's number of common stock outstanding. PS_{it} = The liquidating value of outstanding preferred stock for the i th company at period t . Jordanian firms rarely issue preferred stocks; therefore the preferred stock variable was omitted from the AQ calculation. $DEBT_{it}$ = Debt for the i th company at period t , calculated as the firm's short-term liabilities less its short-term assets, plus the book value of the firm's long-term debt. TA_{it} = Book value of total assets for the i th company at period t .

4.1.2. Independent Variables

4.1.2.1. *Ownership structure.* Ownership structure is the percentage of common stocks owned first by the board of directors, second the percentages owned by institutional investors on the board of directors, the percentage owned by institutional investors outside the board of directors, and the percentage of ownership by chief executive officers consecutively. Following the work of [Hermalin and Weisbach \(1991\)](#) this paper divides ownership into three classes: 0% to less than 5%, 5% to less than 25%, 25% and above.

The variables representing the piecewise separation are the following:

$OWN1_{it}$ = ownership between 0% to less than 5% for the i th firm at period t . $OWN1$ will represent the fraction of ownership as it is if less than 5%; Otherwise, it will equal 5% if ownership is actually 5% or greater than 5%.

$OWN5_{it}$ = ownership greater than or equal to 5% and less than 25% for the i th company at period t . If ownership is greater than or equal to 5% and less than 25%, then the fraction will be stated as it is minus 5%. If ownership is less than 5%, then $OWN5$ will equal zero. If ownership is greater than 25%, then $OWN5$ will automatically equal 20%.

$OWNGRT_{it}$ = ownership greater than or equal to 25%. If ownership is greater than or equal to 25%, then $OWNGRT$ will be stated as it is minus 25%, otherwise it will equal zero.

Where OWN here refers to the percentage ownership by different groups (BOD, institutional investors on the BOD, institutional investors not on the BOD, and the ownership by the chief executive officers).

In addition to the ownership variables, this study uses the following control variables:

4.1.2.2. *Firm size.* Larger firms will have greater amounts of assets, liabilities and owners' equity and they are more able to undertake profitable investments ([Joaquin & Khanna, 2001](#)). In addition, larger firms will be more able to find markets to their products and to attract qualified management and employees. Larger firms are more diversified and have a lower probability of default, which in turn lowers their perceived risk. In addition, firm size can be a signal for information availability. Therefore, we hypothesize a positive and significant relationship between the size of the firm and its value.

Size in this study is measured by the natural logarithm of sales. $Size_{it} = (\text{Ln}) \text{Sales}_{it}$.

4.1.2.3. *Leverage.* This paper will control for leverage to account for the possibility that creditors, acting as outside monitors, are able to add value by

decreasing agency problem (see Harvey, Lins & Roper, 2001; McConnell & Sevaes, 1995). According to Jensen (1986), management discretion over free cash flow is usually restricted when firms are financed more with debt than with equity, and when firms pay out earnings in terms of dividends rather than retain them. When management pay out dividends, this will force the firm to go more frequently to the capital market to get new equity, which consequently, will expose the firm to more monitoring by the capital market. Therefore, the more leverage the firm has, the higher the value of the firm. Leverage is measured here as: $\text{Leverage} = \text{Total Debt} / \text{Total Assets}$.

4.1.2.4. Firm age. Firms that have been established for longer periods of time can be considered reputable due to their expertise and knowledge. Older firms that are listed on the ASE can also benefit from free publicity and analytical documentation. Firm age is calculated as the number of years since establishment of the firm until the year 2001 (Kuan, Lui & Ween, 2000). The paper hypothesized a positive and significant relationship between age and firm value. Age is measured here as: AGE_{it} = Firm age for the i th company at period t .

4.1.2.5. Dividends. Following Chen and Ho (2000), this study used a dummy variable to proxy for the dividend. Institutions may demand high levels of dividends to force firms to go to the capital market for external funding, and therefore, be subject to monitoring by the external market (Easterbrook, 1984; Rozeff, 1982).

DIV_{it} = a dummy variable that equals 1 if the i th firm at period t pays dividends; otherwise it equals to zero.

4.2. Model Specification

The hypothesized relationship between firm value and ownership is expected to be positive for ownership level over 25%. This expectation is inclined with, the alignment hypothesis, which indicates that an increase in ownership will result in an increase in firm value. This hypothesized positive relationship above 25% level is due to the increase in monitoring by different blockholders, such as the ownership by the board of directors, institutional investors, and management. A negative relationship is expected for ownership below 25% ownership. This is mainly due to the lack of influence over the firm at low levels of institutional ownership. The dividend dummy variable is expected to have a significantly positive sign due to the substantial effect of the dividend policy on the perceived value of the firm. The size variable is also expected to have a positive sign due to a hypothesized positive relationship between larger firms and greater value.

This paper will test the relationship between firm value and ownership structure by different block holders to see whether their holdings affect the value of the firms positively. In other words, do blockholders control the operations of firms and work as monitors for management operations?

This study will also use a cross-sectional; time-series ordinary least squares piecewise regression. Four separate regressions will be run. First, the study will examine the hypothesized relationship between firm value, and the percentage of stock ownership by the board of directors, in addition to the control variables. Second, we will examine the hypothesized relationship between firm value, and the percentage of stock ownership by institutional investors on the board of directors. Third, we will examine the relationship between firm value and the ownership by the institutional investors not on the board of directors. Finally, we will examine the relationship between firm value and the percentage of ownership by the executive officers.

The model that is used in this study is:

$$Q_{it} = \alpha_0 + \alpha_1 \text{OWN5}_{it} + \alpha_2 \text{OWN25}_{it} + \alpha_4 \text{OWNGT25}_{it} + \alpha_5 \text{SIZE}_{it} \\ + \alpha_6 \text{D/TA}_{it} + \alpha_7 \text{Age}_{it} + \alpha_8 \text{DIV}_{it} + \alpha_{it}$$

where Q_{it} = Tobin q for the i th firm at period t . OWN5_{it} = ownership between 0% and less than 5% for the i th firm at period t . OWN25_{it} = ownership greater than or equal to 5% and less than 25% for the i th firm at period t . OWNGT25_{it} = ownership greater than or equal to 25% for the i th firm at period t . Where OWN refers to different ownership structure by either the board of directors, the institutional investors on the board of directors, the institutional investors who are not on the board of directors, and the ownership by the chief executive officers. SIZE_{it} = size of the firm for the i th firm at period t . D/TA_{it} = percent of total debt to total assets. AGE_{it} = age of the firm i at period t . DIV_{it} = dummy variable representing dividend policy for the i th firm at period t . ε_{it} = error term for i th firm at period t .

5. EMPIRICAL RESULTS

5.1. Summary Statistics

Table 1 reports the descriptive statistics for the variables used in this study. The table shows that Tobins' q , which measures the firm value, possesses the lowest variability as compared to the other variables.

Table 1. Summary Statistics.

	<i>N</i>	MIN	MAX	MEAN	STD.	Skewness
TOBIN <i>Q</i>	356	0	2.586	0.565	0.403	1.47
BOD	356	0.76	96.32	45.49	26.02	0.297
CEO	356	0.00	78.5	3.92	11.87	4.45
IBOD	356	0.00	95.05	31.4	28.57	0.72
InBOD	356	0.00	54.38	8.9	13.34	1.68
D/TA	356	0.28	135.06	35.14	21.16	0.78
SIZE	356	0.00	8.7718	6.297	1.367	−2.8
AGE	356	4.00	62.00	17.7	13.34	0.10

Note: This table contains descriptive statistics of the variables. *N* is number of observations, MIN is the minimum value, TOBIN *Q* is the proxy for firm value, BOD is the amount of stock owned by the board of directors, CEO is the amount of stocks owned by chief executive officers, IBOD is the ownership of institutional investors on the board of directors, InBOD is the ownership of institutional investors not on the board of directors, D/TA is the ratio of debt to total asset which measures the leverage, SIZE is the proxy for firm size, AGE is the proxy for firm age.

Tobin's *q*, the proxy for firm value, has an average of 0.565 and a standard deviation of 0.403. This figure constitutes a low average firm value for Jordanian service and industrial firms. The low mean value for Tobin's *q* in this study could be due to the decreasing market value of Jordanian stocks during the study period as a result of the sluggish economy and the instability in the region.

The different categories of ownership produced varying means. Ownership by the board of directors (BOD) has a mean of 45.49% of total ownership in the sample. This indicates that the BOD owns a significant amount of ownership in industrial and service companies. This high percentage raises questions concerning the value of the firm when the BOD owns a considerable number of its shares. Chief executive officers (CEO) own a small portion of stocks in industrial and service companies in Jordan with a mean value of 3.92%. This low ownership by the CEO indicates that the agency problem in Jordan is not tackled through the incentive-driven stock ownership plans. Institutional investors make up close to 40% of total ownership in the sample. Institutional investors that are on the board of directors (IBOD) own 31.4% of total shares. This point's to the fact that a significant percentage of institutional investors are in control of the companies they own. Institutional investors that are not on the board (InBOD) have a mean of 8.9%.

The size variable (SIZE), measured as the natural log of sales, has a mean of 6.297 and a standard deviation of 1.367. The distribution of the size variable was negatively skewed. The age variable (AGE) had a mean of 17.7 years with a standard deviation of 13.34.

Table 2. Correlation Matrix.

	<i>Q</i>	BOD	CEO	IBOD	InBOD	Size	Age	Div	D/TA
<i>Q</i>	1								
BOD	0.178**	1							
CEO	0.042	0.157**	1						
IBOD	0.186**	0.784**	-0.228**	1					
InBOD	0.170**	-0.369**	-0.15*	-0.264**	1				
Size	-0.057	0.040	-0.004	0.076	-0.105	1			
Age	0.001	0.105	-0.168**	0.192**	0.051	0.362**	1		
Div	0.129*	-0.04	-0.154*	0.064	0.039	0.283**	0.329**	1	
D/TA	0.012	0.041	0.048	0.049	-0.11	0.319**	0.157*	-0.108	1

Note: *Q* is the proxy for firm value (Tobin *q*), BOD is the amount of stock owned by the board of directors, CEO is the amount of stocks owned by chief executive officers, IBOD is the ownership of institutional investors at the board of directors, InBOD is the ownership of institutional investors not in the board of directors, Div is the dummy variable for dividend, D/TA is the ratio of debt to total asset which measures the leverage, SIZE is the proxy for firm size, AGE is the proxy for firm age.

* Significant at the 0.05 level.
** Significant at the 0.01 level.

5.2. Correlation Analysis

The correlation between the variables under investigation is shown in Table 2. Tobin’s *q* is positively and significantly in correlation with the percent stock ownership by the board of directors (BOD), and the percent of stock ownership by institutional investors on the board (IBOD). There is a 17.8% correlation between *Q* and the percent of stock ownership by the BOD, significant at the 5% level, while *Q* has an 18.6% positive correlation with IBOD, significant at the 5% level. *Q* has a positive correlation with the ownership segments that were greater than 25%.

Firm size is shown to be positively and significantly related to the age of the company, Dividends, and D/TA variables.

The firm’s age, represented by (AGE) shows a significant positive relationship at 16.8% with ownership of stocks by the BOD significant at the 0.05 level. In addition, there exists a positive and significant relationship between the age of the firm and the ownership of the institutional investors on the BOD of the firm (19.2%) at the 5% significant level.

5.3. Simple Regression Aanlysis

The simple regression results are presented in Table 3. Panel one shows the regression results of the relationship between firm value and the percentage of

Table 3. Simple Regressions of Firm Value (Tobin q).

Variables	1	2	3	4
Constant	0.121 (4.83)*	0.117 (5.98)*	0.0116 (5.501)*	0.119 (5.22)*
BOD	0.193 (3.197)*			
CEO		0.064 (1.04)		
IBOD			-0.192 (3.157)*	
InBOD				0.165 (2.702)*
D/TA	0.073 (1.12)	0.071 (1.08)	0.073 (1.077)	0.087 (1.33)
Div	0.196 (2.943)*	0.187 (2.75)*	0.173 (2.687)*	0.174 (2.605)*
Size	-0.125 (-1.81)**	-0.127 (-1.80)**	-0.122 (-1.76)**	-0.101 (-1.45)
Age	-0.05 (-0.74)	-0.015 (-0.215)	-0.061 (-0.905)	-0.041 (-0.62)
Adj. R^2	0.059	0.016	0.049	0.04
F Stat.	3.765	3.65	3.713	0.032
P value	0.000	0.000	0.000	0.000

Note: Column (1): Tobin's q is regressed against the BOD, Dividends, D/TA, Size, Age. Column (2): Tobin's q is regressed against the CEO, Dividends, D/TA, Size, Age. Column (3): Tobin's q is regressed against the IBOD, Dividends, D/TA, Size, Age. Column (4): Tobin's q is regressed against the InBOD, Dividends, D/TA, Size, Age.

* Significant at the 0.05 level.

** Significant at the 0.1 level.

stock owned by the board of directors, and other control variables. The variables in the model explain around 5.9% of the variation in the firm value. Results show a positive and significant relationship at the 5% level between the percent of securities owned by the board of directors and firm value. In addition, there exists a positive and significant relationship between firms that pay dividends and firm value at the 5% significance level. However, contrary to expectations, size has a negative effect on firm value at a significance level of 10%.

Panel 2 outlines the results of regressing firm value and ownership by the chief executive officers, along with other variables under study. Results indicate no significant relation between the ownership of the CEO and firm value. However, dividends are still positively and significantly related to firm value at the 5% level. The size of the firm is also significant, but negatively related to firm value, contrary to our hypothesized sign.

The regression results between firm value and the percent of securities owned by the institutional investors on the board of directors are shown in panel 3. Results indicate a positive and significant relationship between firm value and the percent of securities owned by institutional investors sitting on the board of directors. However, dividends are positively and significantly related to firm value at the 5% level, while the size variable affects the value of the firm negatively.

Table 4. Firm Value Piecewise Regression (*t* Test).

Variables	1	2	3	4
Intercept	0.298 (2.178)*	0.117 (6.66)*	0.124 (5.55)*	0.119 (4.86)*
BOD5	0.016 (0.244)			
BOD25	-0.076 (-1.032)			
BODGT25	0.241 (3.432)*			
CEO5		-0.241 (-3.161)*		
CEO25		0.0228 (1.027)		
CEOGT25		-0.027 (-0.132)		
IBOD5			-0.05 (-0.58)	
IBOD25			0.02 (0.187)	
IBODGT25			0.211 (2.68)*	
INBOD5				-0.081 (-0.971)
INBOD25				-0.019 (-0.19)
INBODGT25				0.298 (3.685)*
Div	0.199 (2.99)*	0.195 (2.928)*	0.189 (2.795)*	0.195 (2.963)*
D/TA	0.064 (0.966)	0.075 (1.16)	0.075 (1.15)	0.113 (1.74)**
SIZE	-0.11 (-1.6)	-0.141 (-2.034)*	-0.113 (-1.63)	-0.069 (-1.001)
AGE	-0.074 (-1.08)	-0.032 (-0.478)	-0.072 (-1.059)	-0.037 (-0.556)
Adj. R^2	0.051	0.052	0.048	0.076
F Stat.	3.027	3.079	3.926	4.122
P value	0.004	0.004	0.006	0.000

Note: Column (1): Tobin's q is regressed against the BOD5, BOD25, BODGT25, Dividends, D/TA, Size, Age. Column (2): Tobin's q is regressed against the CEO5, CEO25, CEOGT25, Dividends, D/TA, Size, Age. Column (3): Tobin's q is regressed against the IBOD5, IBOD25, IBODGT25, Dividends, D/TA, Size, Age. Column (4): Tobin's q is regressed against the INBOD5, INBOD25, INBODGT25, Dividends, D/TA, Size, Age.

* Significant at the 0.05 level.

** Significant at the 0.1 level.

Finally, Panel 4 shows the regression results of the relationship between firm value and the percent of securities owned by the institutional investors who are not on the board of directors. Results indicate again a positive and significant relationship between firm value and ownership of institutional investors not on the board of directors at the 5% significant level.

5.4. Piecewise Regression Analysis

The regression results of firm value against the percent of ownership by different blockholders are presented in Table 4. Panel (1) has regressed the firm value variable (TOBIN Q) against the three segments of ownership of stocks by the

board of directors of firms. The adjusted R^2 implies that 5.1% of the variation of firm value could be explained through the model. The results show a positive (0.241) and significant relation at the 5% level between firm value and the percent of stocks above 25% owned by the board of directors. However, there is no significant relationship between the percent of stock ownership by the board of directors at lower than 25% level and firm value. Therefore, the incentive to control the firm's operations increases when the board of directors owns a large fraction of the shares in their firms.

Panel (2), reports the regression results between the firm value and the percentage of security ownership by the chief executive officers segmented into three ownership groups (less than 5%, between 5 and 25%, and more than 25%) and the other control variables. These variables explain around 5.2% of the variation in firm value as indicated by the adjusted R^2 . The results show a negative and significant relationship at 5% significance level between the percent of ownership by the CEO below 5% and firm value. However, there is no relationship between value and ownership by the CEO at ownership levels beyond 5%. This indicates a high agency problem between managers who own a small percentage of shares and firm value. The results also show a positive and significant relationship at the 5% level between firms that pay dividends and their values. However, the firm size is negatively related to firm value. Therefore, contrary to expectations, the larger the firm the lower its value.

Panel (3) presents the regression results between firm value and the percentage of ownership of institutional investors on the board of directors. The variables in the regression explain around 4.8% of the variation in the model. Results show a positive and significant relationship between firm value and the percent of securities above 25% owned by institutional investors sitting on the board of directors of firms at the 5% significant level. However, no significant relationship is detected between firm value and ownership below 25%. Also, a positive and significant relation at the 5% level is found between firms that pay dividends and their value.

Finally, panel (4) outlines the regression results between firm value and ownership of institutional investors not on the board of directors, segmented into three groups. Results show a positive and significant relationship between firm value and ownership above 25% by institutional investors not on the board of directors at significant level of 5%. Again we find a positive and significant at the 5% level between firms that pay dividends and firm value. Also, we note a positive and significant relation between firm value and leverage. This positive relationship between leverage and firm value and institutional investors owning large amount of securities, and not on the board of directors, indicates that these two groups work as complementary outside monitors of the management actions.

6. SUMMARY AND CONCLUSIONS

This study examines the relationship between the identity and concentration of different ownership structures (block holders) and firm value for 89 industrial and service firms listed on the Amman Stock Exchange (ASE) over the period 1998–2001. The question is whether corporate governance mechanisms lead, on average, to better valuation of firms. This paper includes other mechanisms compared to previous research on corporate governance, such as the identity of outside owners in the firm (e.g. the institutional investors who are not on the board of directors), the institutional investors on the board of directors, the ownership of the board of directors, and the financial policy of the firms as the capital structure. Also, this paper helps clarify the relationship between corporate governance and the value of small firms in an emerging market (Jordan).

The results of our simple regression show a significant and positive relationship between the ownership of the board of directors and firm value. Also, the paper found a positive and significant relationship between firm value and ownership by institutional investors whether or not they are on the board of directors. However, there is no significant relationship between ownership by management and firm value. This implies that the ownership by the board of directors or by institutional investors add value to firms. However, ownership by management has no bearing in increasing firm value, so solving agency problem due to separation of ownership and control might not be efficient in the Jordanian firms. As we noted previously, the ownership by management is not this large as compared to the ownership by institutional investors. Therefore, this small ownership in general might not give management incentives to add value for security holders. In addition, size and dividends have a significant effect on firm value.

The results of the piecewise regression analysis indicate a positive and significant relationship between the ownership of securities above 25% by the board of directors, institutional investors on the board of directors, the institutional investors not on the board of directors and firm value. There is no significant relationship between the above-mentioned ownership and firm value for ownership below 25%. Since monitoring actions is costly, dispersed owners lack the incentive or the motivation to take on costly monitoring actions, except if they hold a large blocks of securities which would justify the cost of monitoring.

The results also indicate a significant and negative relationship between ownership by the CEO below 5% and firm value. Therefore, it seems that low ownership by management does not give management incentives to work for the interest of shareholders. Dividends are still positively and significantly related to firm value. Leverage is significantly and positively related to firm value when we relate ownership by institutional investors not on the board of directors and firm

value. This might imply that creditors work as complementary monitors of value along with institutional investors who are not on the board of directors.

The paper concludes that blockholders are important monitors of firm value especially if they own large amounts of securities to justify the high cost of monitoring.

Agency problem incurred by the separation of the capital providers (shareholders and lenders) and management justifies the need for corporate governance activities. To insure the efficiency of capital allocation in the economy, and hence improve its growth potential, and the wealth of corporate owners, it is important to enforce the contracts between capital providers and management. There are relatively few studies about corporate governance in Jordan. A more comprehensive study is needed to understand the practice of corporate governance in small economies where legal protection is not well understood. Also, future research should look into the role of the Board of Directors and the effectiveness of the Board of Directors in terms of performing their roles required and expected by the shareholders.

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REFORMS IN CORPORATE GOVERNANCE IN ASIA AFTER THE FINANCIAL CRISIS[☆]

Helen Cabalu

ABSTRACT

Reforms in corporate governance in selected Asian countries were introduced after the financial crisis of 1997–1998. After the financial collapse, several crisis-affected economies overhauled their corporate governance, strengthening market forces, implementing tougher regulations and focusing on transparency in decision-making and accountability. Since then, a commitment to improving corporate governance has grown as governments recognised the need to protect investors' interests, reduce systemic market risks, maintain financial stability and enhance investors' confidence to encourage the return of capital to the region through better accountability and transparency. The incentive for corporations to follow best practice is to boost their corporate performance and attract investment. Effective corporate governance is also recognised as essential for economic growth. Governments are realising that good governance of corporations is a source of competitive advantage and critical to economic and social progress.

Since the financial crisis, corporate governance has become a key policy issue in most of Asia. Progress in reforming corporate governance, however, has been uneven across Asia. This paper documents that progress.

[☆]This paper is a revised version of Cabalu (2003).

INTRODUCTION

Weak corporate governance has been recognised as one of the major sources of East Asia's vulnerabilities to the financial crisis of 1997–1998. Many corporations in the five crisis-affected economies of Indonesia, Korea, Malaysia, Philippines and Thailand suffered from over-capacity, poor quality of investments and excessive diversification and exposure to debt brought about by decisions of ineffective board of directors, weak internal controls, poor audits, lack of adequate disclosure and weak legal and administrative systems (Capulong et al., 2000). The corporate failures and excesses were often the result of incompetence, fraud and misuse of power. The business environment was largely relationship-based where close links among firms, their banks and the government have developed through ownership, family ties and political deal making. Perverse connections between lenders and borrowers led to insider and poor quality lending. Not only did firms rely heavily on related parties for finance but also for inputs and distribution. The relationship-based system protected both firms and banks from market discipline, undermining the need to develop adequate corporate governance mechanisms.

Since the financial crisis, corporate governance has become a key policy issue in most of Asia. A commitment to improving corporate governance has grown as governments recognise the need to protect investors' interests, reduce systemic market risks, maintain financial stability and enhance investors' confidence to encourage the return of capital to the region through better accountability and transparency. The incentive for corporations to follow best practice is to boost their corporate performance and attract investment. Effective corporate governance is also recognised as essential for economic growth. Governments are realising that good governance of corporations is a source of competitive advantage and critical to economic and social progress (Economic Analytical Unit, 2002).

Stronger market forces, tougher regulations and a move towards rules based system are gradually transforming the business environment in Asia. The new focus on transparency in decision-making and accountability has emerged to prevent future abuses. Progress in reforming corporate governance, however, has been uneven across the five crisis-affected economies. Although a number of measures to strengthen and modernise the regulatory framework for a rules based corporate sector have been in place well before the crisis, implementation has been weak. Poor compliance and enforcement due to weak courts, lack of well-trained and resourced regulators, powerful vested interests and lack of political will have hindered corporate reform in some economies.

After the crisis, more recent reforms in the broad areas of corporate ownership structure, shareholder participation and protection, creditor protection, transparency and disclosure, and bankruptcy procedures have taken place. The following is a survey of recent developments in these major areas of corporate governance reform.

CORPORATE OWNERSHIP STRUCTURE

Ownership structure is an important area of corporate governance. It determines the nature of the agency problem, that is, whether the dominant conflict is between managers and shareholders, or between controlling and minority shareholders. The interests of those who manage the company can differ from those who supply the company with external finance. The principal-agent problem grows out of separation of ownership and control. One aspect of corporate ownership structure is the degree of ownership concentration, which determines the distribution of power between its managers and shareholders. Ownership concentration is not necessarily bad. When ownership is concentrated, large shareholders are good for corporate governance as they could play an important role in monitoring management. Indeed, in Asia where corporate ownership is concentrated, corporate management is usually in the hands of controlling shareholders. The problem with ownership concentration is when it is combined with weak outside shareholder protection laws, an uncompetitive financial system, and opportunities for malfeasance and corruption by big powerful (insider) shareholders that the cost of failures becomes high (Prowse, 1998).

Another aspect of corporate ownership structure is its composition. It determines who the shareholders are and who among them control the company. A shareholder can be an individual, a family, a bank, a holding company, an institutional investor, or a non-financial corporation. Depending on who the significant shareholder is, the involvement in the company's management could vary. For instance, a family would be more likely to get interested in control and profits than an institutional investor who would probably be only interested in profits (Capulong et al., 2000).

Research conducted by Claessens, Djankov and Lang (2000) investigates the separation of ownership and control in selected Asian countries. Their key findings indicated that the control of a single shareholder was prevalent in more than two-thirds of firms and the separation of management from ownership control was rare, giving the owners excessive power to pursue their own interests at the expense of minority shareholders, creditors and other stakeholders. While concentration of ownership and extensive family control characterised corporate ownership in most Asian countries, it is particularly severe in Indonesia, Philippines and Thailand. A

small number of families control a significant share of corporate assets with 16.6% in Indonesia and 17.1% in the Philippines, of the total value of listed corporate assets could be traced to the ultimate control of a single family. In Indonesia, the Philippines and Thailand, the largest ten families controlled up to 50% of market capitalisation while the largest ten families in Korea controlled about one-third of the corporate sector. Control was enhanced through dual-class shares, pyramid structures, and cross-holdings among firms.

While ownership concentration in Asia is not unique to the region, it raises the possibility of increased risk taking. The high concentration and family-based ownership is a typical sign of weak corporate governance. It has led to governance structures that enabled the dominant shareholding families to make key decisions on their own. Appointments of board members are almost entirely decided upon by those families in control of the firms. This has led to conflicts of interests between dominant family shareholders/managers and minority shareholders. It has reduced the effectiveness of shareholder protection, as presumably the dominant and politically powerful shareholders will not be a source of pressure for improvements in disclosure and governance for fear that these may erode their control and benefits. It has also resulted in the expropriation of non-controlling (outside) shareholders by the controlling shareholders. In some countries, controlling shareholders have frequently utilised inter-firm transactions as a means to divert resources from one held firm to another to increase their welfare at the expense of outside shareholders. Diversion of money by a dominant shareholder could also take the form of paying himself special dividends and engaging in excessively risky projects at the expense of minority shareholders' investments.

Korea

In Korea, the *chaebols* – large diverse conglomerates, dominated the corporate sector and operated in nearly all sectors prior to the crisis. They were mostly owned and managed by families using cross-ownership and pyramid structures and received favourable bank treatment.¹ It was quite common in Korea that minority shareholders had to take intolerable risks as the firm in which they held shares made loan guarantees to other firms controlled by the same family, or lent money directly to them at below market interest rates. Other episodes of expropriation were abundant where *chaebol* owners acted in ways that were inconsistent with the maximisation of firm value by investing in big projects whose prospects of return did not justify the investment but were ways to transfer wealth. Equity participation by connected firms frequently resulted in similar expropriation where outright transfer of wealth occurs from participating firms to an insolvent firm issuing new

equities. This has led many large corporations to insolvency or bankruptcy costing lending institutions and taxpayers a substantial amount of damage (Nam et al., 1999).

When the Korean government announced its “Big Deal” initiatives in 1998, it disclosed an extensive economic reform program highlighted by bold restructuring of Korea’s *chaebols*. It aimed to reduce the *chaebols*’ market power and excessive sectoral diversification by forcing them to focus their business operations on a small number of core industries. The program also aimed to reduce *chaebol*’s strong reliance on debt financing, to improve transparency in decision-making, and to enhance the accountability of controlling shareholders and managers. The specific initiatives included (Economic Analytical Unit, 2002; Woo-Cumings, 2001):

- Requiring the largest *chaebol* to undertake voluntary workouts including converting debt to equity and selling non-core subsidiaries and other assets to disperse *chaebol* ownership;
- Banning cross-guarantees of loans of *chaebol* group of companies;
- Removing incentives for *chaebol* to retain non-core businesses;
- Exempting or reducing taxes on asset transactions, encouraging merger and acquisition activity, assets sales and business asset swaps;
- Introducing new listing rules for holding companies, assisting restructuring; and
- Starting a corporate restructuring fund and easing requirements for public offerings.

The “Big Deal” measures were particularly applied to the five largest *chaebols* including Hyundai, Samsung, Daewoo, LG and SK.² Several laws related to *chaebol* restructuring such as the Commercial Law and the Securities Exchange Law were also revised in 1998.

Considerable progress has now been achieved in *chaebol* reform. The four largest *chaebols* cut their total number of subsidiaries from 232 in 1997 to 137 in 1999 (*Korea Times*, 2000). Apart from a reduced number of subsidiaries and elimination of cross debt guarantees among *chaebols*, debt-equity ratios have fallen from their excessively high levels. For instance, from an average of 700% debt-equity ratio before the reform, Hyundai and LG cut their debt-equity ratios to 181 and 184.2%, respectively and Samsung and SK registered debt-equity ratios of 161 and 166.3% in 2000. The conglomerates have either been broken up or sold like the Daewoo Group, which once had 37 subsidiaries in diverse industries, or forced to focus on their core competencies by divesting collateral business lines like the Samsung, LG and SK Groups. The Hyundai Group has been separated with its components on the international auction block. Overall, 16 out of the top 30 conglomerates of 1997 are no longer in the list in 2002 (Ministry of Finance and Economy, 2002).

Indonesia

In Indonesia, it is very common to find control by families or by limited number of shareholders in the corporate sector. The highly concentrated and family based ownership resulted in a governance structure where corporate decisions were made by controlling families. In many instances, these controlling families had political connections that allowed their companies to enjoy special privileges, particularly in gaining easy access to credit. There is no separation of ownership and control. In 2001, around 67% of publicly listed companies were family-controlled while only 7% was widely held. Ownership concentration in Indonesia is highest in the region. It is demonstrated by the fact that the top five largest shareholders controlled between 57 and 65% of company shares. Indonesia has the largest number of companies owned by a single family. In terms of capitalisation, the top family controlled 17% of total market capitalisation while the top 15 families controlled 62% of the market. Concentration of corporate control has been enhanced by cross-shareholdings, which is allowed by Indonesian law without restrictions (Kurniawan & Idriantoro, 2000).

As in other countries in Asia, Indonesian conglomerates range widely in size, scope, importance, and nature and degree of political connections. Chinese Indonesians assumed a dominant position in the highly concentrated ownership structures. It was generally known that some 15 families, 14 of them Chinese Indonesians were predominant. They controlled 61% of all publicly listed companies, while other families only controlled another 5.4% (Claessens et al., 1999).

Each conglomerate controlled at least one bank, which financed company investments with little autonomous decision-making or objective investment project analysis. Virtually all banks have made “connected loans” to sister companies far in excess of the legal limits, which have caused a number of insolvencies particularly during the Asian crisis. The failure of one company led rapidly to failure of the bank it owned and other affiliates. These were taken over by the government’s Indonesian Bank Restructuring Agency (Patrick, 2001).

Many corporations in Indonesia are now under government ownership, though some are still operated by former family owners. Recent commitments by the government to privatise the large state-owned enterprises have been delayed because of vested interest opposition and hence the privatisation program has not yet made much progress.

Malaysia

Corporate ownership in Malaysia is distributed among outside investors, families and the government. Hence, unlike the other crisis-affected economies,

concentration of ownership is not as pronounced. Malaysia's top ten families controlled only around 25% of market capitalisation while the government held 35%. Recent moves to sell substantial government equity in listed companies suggest that the government is reducing its role in the corporate sector. Foreign fund managers were an active group in shareholding, far more active than domestic fund managers. They were reported to account for almost 50% of the turnover of the blue chip companies during the 1990s. Domestic institutional investors have emerged as a significant force in the equity market, with *Perbadanan Nasional Berhad* (PNB) and the Employees Provident Fund (EPF) as the most important. Foreign fund managers and domestic institutional investors have opted to play a passive role in corporate governance (Thillainathan, 1999).

Philippines

In the Philippines, family ownership dominates. Large shareholders that dominate ownership are families whose wealth dates back to the country's colonial past, early industrialists and ethnic Chinese immigrants and entrepreneurs, and professionals from the middle class. Large shareholders managed their investments through corporate group structures, which would commonly include a commercial bank, other financial institutions like insurance and finance companies. Large shareholders either directly owned these banks or controlled them through companies they owned. Once banks became part of a corporate group, member companies of the group accessed loans at favourable interest rates and terms. The corporate culture promoted sweet deals to well-connected people and other misuses of capital.

The average ownership of the largest shareholder in the Philippines was 40.8% of the market value of non-financial companies and 27.2% of the financial sector in 1997. The largest five shareholders owned about 65.3% of the non-financial sector and 59.2% of the financial sector in the same year (Saldaña, 1999).

Publicly listed companies are not widely held by public investors. Most of them are part of family business groups that went public to raise capital. Public listing rules required public issuance of only 10–20% of outstanding shares. Hence, ownership by large shareholders (mostly families) of publicly listed companies is very common. Many companies listed in the Philippine Stock Exchange have issued only the minimum number of shares needed to gain public listing. By limiting the ownership shares issued to public investors, controlling shareholders reduce minority shareholders to passive roles in corporate governance. Concentration of ownership at these high levels demonstrates that publicly listed Philippine companies are not truly publicly owned (de Ocampo, 2000).

Thailand

As in most Asian countries, ownership of Thai corporations is concentrated. The average size of equity share of the top five largest shareholders was 56% of total outstanding shares in 1998. This implies that the control of an average Thai company is typically in the hands of a few persons (founders or their associates). The management of most large Thai corporations listed on the Stock Exchange of Thailand has been predominantly family-run as pioneered by Chinese merchants. Many of these families have built their empires and prospered in many sectors, particularly in banking, finance and securities, agro-industry, and telecommunications. Around 62% of all publicly listed companies in Thailand are family controlled. Although some of the businesses have become publicly listed companies, their founders managed to keep a controlling share within their family. The Public Company Act of 1992 allowed ownership and control of these companies to remain with the founding families even as they became increasingly dependent on non-family resources. It has also been a practice of Thai corporate founding families to set up holding companies to own shares in affiliated companies or subsidiaries. Through these holding companies, founding families maintained effective control of entire groups, including those that are publicly listed (Limpaphayom, 2000).

The emerging post-crisis Thai corporate sector is one that is less family dominated. It has experienced more government and foreign ownership. For instance, the government has become the largest equity owner in the banking industry subsequent to the nationalisation of commercial banks. Significant increase in foreign shareholding has also occurred in many sectors such as banking, finance and securities, insurance, and public utility services.

Despite many family owned corporations still hanging on to non-core assets with high leveraging and low cash flows, several other families have made early progress in restoring their companies through voluntary restructuring, have listed their companies and sought external managers and directors.

SHAREHOLDER PARTICIPATION AND PROTECTION

Shareholder participation and protection is crucial in corporate governance because expropriation of minority shareholders and creditors by the controlling shareholders occurs so often. When outside investors finance firms, they face a risk that the returns on their investments will never materialise because controlling shareholders or managers expropriate them. A major concern for minority shareholders is how they can effectively monitor management so that managers

will act in the shareholders' best interest. In general, expropriation is related to the agency problem. A conflict of interest occurs when controlling shareholders use the profits of the firm to their own benefit rather than return the money to the minority shareholders and other investors.

A sound corporate governance framework requires that shareholders actively participate in and exert influence on corporate decision-making, and are protected from exploitation by company insiders. Reforms in the area of shareholder protection have focused mainly on strengthening the system of the board of directors and minority shareholders' rights. These have involved amending listing rules and corporate laws and introducing voluntary codes of corporate governance.

A number of mechanisms exist for shareholder participation and protection. When shareholders and other investors finance firms, they become entitled to certain rights or powers that are generally protected through the enforcement of corporate laws and other legislation. The most important are the system of board of directors, shareholder participation through voting in meetings, legal protection of minority shareholder rights, and transparency and disclosure requirements.

Shareholders have the right to elect their representatives on the board of directors of a company who assume responsibility of monitoring, directing and appointing the firm's managers. Boards are expected to draft corporate policy, approve strategic plans, authorise major transactions and the sale of additional securities, and declare dividends. They are also expected to hire, advise, compensate and, if necessary, remove management, subject to the approval of shareholders. Boards should be independent of management and shareholders for them to be effective in resolving conflicts in situations where the interests of shareholders and management diverge (Choe, 1998).

Basic shareholders' rights, usually captured in company laws, should allow for active participation and influence on corporate strategic decision-making (e.g. decisions concerning corporate changes such as amendments to the articles of incorporation and decisions on mergers and dissolutions, among others). Shareholders should have the right to participate and vote in annual and special general meetings, share in the residual profits of the company, obtain relevant company information on a regular basis and convey or transfer shares. Rules in some countries allow proxy voting by mail, which makes it easier for minority shareholders to exercise their voting rights while others allow cumulative voting, which makes it easier for a group of minority shareholders to elect at least one director of their choice. Allowing cumulative voting strengthens the position of minority shareholders under concentrated ownership structures. Other rights include provision for outsider representation on the board, anti-dilution provisions, limits on self-dealing or insider trading by controlling shareholders, and takeover rules limiting the power that controlling shareholders can appropriate (Johnson & Shleifer, 2001).

Timely and accurate disclosure and transparency on all matters material to company performance, ownership, and governance relating to other issues are keys to effective shareholder control and protection. The benefits that emanate from effective monitoring, disclosure of information and transparency meant that capital providers were able to protect themselves from the opportunistic behaviour of managers.

Financial information should be independently audited and prepared following internationally acceptable standards. The quality of transparency and disclosure depends on accounting and auditing standards and the financial reporting system adopted. Before the Asian crisis, corporate transparency and disclosure were generally weak in most crisis-affected countries. After the crisis, important measures have been introduced to improve them. Many countries have introduced changes in accounting and auditing rules to move towards international standards, particularly with those issued by the International Accounting Standards Committee.

Korea

Simple diversion of money by a dominant shareholder from a firm under his control was not uncommon in Asia. In Korea, minority shareholders had to take intolerable risks as the firm in which they held shares made loan guarantees to other firms controlled by the same owner, or lent money directly to them.

A number of amendments to Korea's laws and regulations to increase the accountability of management and controlling shareholders, and strengthen the rights of minority shareholders were implemented in 1998. These changes included (Chopra et al., 2001; Korea Stock Exchange, 2002):

- The Korean Stock Exchange (KSE) required that all publicly traded companies had at least one outside board director; by the end of 1999, a quarter of their boards should be outside directors. Moreover, for listed companies and financial institutions with the assets of KRW 2 trillion or more, there must be at least three outside directors and they must account for at least half of the total board members. It is also recommended that listed companies appoint outside auditors.
- The Commercial Code and Securities and Exchange Act were reformed to lower the threshold for exercising rights to file suit, make proposals at a general shareholders' meeting, inspect company's financial accounts, and request the dismissal of directors or internal auditors. The previous requirement of 1% ownership to bring a derivative suit was eased to 0.01% and the 1% ownership to request the dismissal of a director or auditor for an illegal act was relaxed to 0.5%. The minimum ownership required to examine corporate books has been reduced from 3 to 1%.

- The shareholder proposal scheme entitled a shareholder of a listed company with a stake of 1% or more of total voting shares to exercise the right to submit agenda items for the shareholder meetings.
- As part of an effort to encourage institutional investors to play an active role in monitoring corporate management, restrictions in voting rights for institutional investors were removed.
- A limited form of cumulative voting for the selection of directors was introduced.

In 1999, the Code of Best Practice for Corporate Governance required listed companies to prepare financial statements that were audited in accordance with international standards and to bring financial disclosure standards in line with best practice.

More recently, the Corporate Restructuring Promotion Law is enforcing transparency for the big groups. It introduced a number of measures strengthening accounting rules and audit oversight. These included:

- Combined financial statements that net out intra-group transactions were required for the top 30 *chaebols*;
- In addition to annual and semi-annual reports, listed companies were required to release quarterly reports and establish audit committees composed of outside directors, shareholders, and creditors' representatives within the board of directors; and
- Legal changes have been made so that domestic accounting practices conform to international standards.

At the start of 2002, Korea introduced revised listing regulations, which provided for stricter compliance and stronger delisting criteria and introduced a penalty system for non-compliance with regulations ([Korea Stock Exchange, 2001](#)). Hence in March 2002, ten companies were delisted from the Korea Stock Exchange for accounting irregularities. In June 2002, the Korea Corporate Governance Service was established to conduct research and analyse trends of corporate governance in Korea and overseas, make policy recommendations and provide consultancy services on corporate governance.

Indonesia

In the case of Indonesia, most disclosure requirements have tightened and accounting standards have improved after the crisis, although from a low base. In 1999, a code for good governance was introduced, which guided subsequent reforms. All companies were required to provide annual reports with audited and

annotated financial statements and consolidated reporting has become mandatory. In order to improve the quality of reporting, a “Guidelines for the Financial Reporting Systems of Listed Companies” was jointly prepared by the Indonesian Institute of Accountants, the Indonesian Issuers Association and the Faculty of Economics of the University of Indonesia.

By 2001, the Jakarta Stock Exchange (JSX) has tightened listing rules especially disclosure and liquidity rules. It required listed companies to form audit committees, appoint independent directors comprising at least 20% of the board and strengthen the company secretary’s function. The JSX required listed companies to disclose information concerning company performance in an accurate and timely manner through the publication of periodical and non-periodical reports but at the same time tightening the rules and regulations governing the disclosure of information. These reports should enable interested parties to review listed companies’ performance objectively to protect themselves from undertaking excessive risks ([Jakarta Stock Exchange, 2001a, b](#)). Major initiatives have been taken to harmonise Indonesia’s Financial Accounting standards with International Accounting Standards. By the end of 2001, 247 listed companies have appointed independent directors and 168 have established audit committees.

To encourage listed companies to conform to the Code of Good Governance, the JSX implemented a pilot program of monitoring and reviews of listed companies’ level of compliance with the principles of good corporate governance. These efforts combined with routine education and development programs have improved the overall level of compliance that by end of 2001, 73% of total listed companies in the JSX were fully compliant with the principles of good corporate governance, from 65% in 2000.

Malaysia

Malaysia was well advanced in its corporate regulatory environment. Even before the crisis in 1997, listed companies were already required to appoint independent directors to their boards and establish audit committees. Listed companies were subjected to a disclosure based regulatory regime where authorities were allowed to regulate securities offerings by assessing the investment merits and pricing of the offering. Its accounting standards were among the highest in Asia and were generally consistent with international accounting standards ([Kuala Lumpur Stock Exchange, 2001a, b](#)). After the crisis, Malaysia has maintained significantly higher standards in corporate governance and at the same time has developed more sophisticated and adequate legal systems to protect shareholders’

and creditors' rights than the rest of the countries in the region. In 2000, through the Malaysian Code on Corporate Governance, authorities have set out principles and best practices for companies to follow in an effort to maintain high standards of corporate governance. The Code set out principles guiding (PricewaterhouseCoopers, 2000):

- The composition of the board of directors to include a balance of executive and non-executive directors; appointments to the board and re-election of all directors; and directors' remuneration to be linked to corporate and individual performance; and
- Listed companies to include in their annual reports a full disclosure of information relating to the extent of compliance with principles of good governance and the state of internal control.

The Kuala Lumpur Stock Exchange in 2001 implemented new listing requirements that strengthened provisions in areas relating to disclosure, financial reporting and enforcement through the following (Kuala Lumpur Stock Exchange, 2001):

- Enhancing the definition of independent director and strengthening the composition of the board of directors;
- Requiring directors to attend a prescribed minimum number of board meetings;
- Enhancing the composition of the audit committee, its functions, rights and authority;
- Express statement of directors rights;
- Imposition of obligations on directors.

Philippines

The Securities and Exchange Commission (SEC) enforces regulations on conduct and disclosure according the Philippines' US-based Corporation Code. Publicly listed companies have to meet conduct and disclosure requirements. Basic rights of shareholders are adequately protected. Shareholders are entitled to a one share-one vote rule, with proxy voting legally allowed and practiced. The Corporation code required an annual general shareholders meeting to confirm decisions made by management. A shareholder can discuss concerns during the meeting without any required minimum shareholdings for such privilege. Major transactions made by the company such as amendment of articles, bonded indebtedness, sale of major corporate assets, investments in other companies, and mergers required approval by two-thirds majority vote of shareholders (Saldaña, 1999).

In 2000, authorities initiated several useful reforms including the new Securities Regulation Code, which provided protection to minority shareholders through

mandatory tender offers and prohibition of insider trading. In 2001, the SEC reinforced this with initiatives promoting transparency and improved regulatory environment through a new framework based on international standards. Financial reporting was tightened requiring companies to provide annual reports with balance sheets and profit and loss statements to the SEC. New rules on shareholder representation, board structure and legal actions against erring directors were imposed ([Securities and Exchange Commission, 2001](#)).

In April 2002, the SEC approved the Code of Corporate Governance which required listed companies to draft their respective manuals on good corporate governance based on the principles of the Code. Under the Code, a company's board of directors was held responsible for adhering to fairness, accountability and transparency in overseeing the operations of the company. Board members who do not attend meetings regularly and do not disclose the extent of their business interests may be suspended from the board. Board members and top management were also required to undergo a regular performance evaluation. The Code required listed companies to form four board committees which would oversee audit and compliance, nomination, compensation and risk management and to rotate their external auditors or handling partners every five years ([Philippine Daily Inquirer, 2002](#)).

Board members number between 7 and 11 representing the largest shareholders of a company. The board of directors is not explicitly mandated by the Corporation Code to consider the interest of minority shareholders. However, the Code prohibits the removal of a director without reason only if minority shareholders shall lose their representation on the board as a result of such action. A shareholder can file derivative suits against directors, but this process is costly and ineffective as conflicts take a very long time to resolve. Independent directors are not acceptable for most companies because family members and close associates who dominate ownership prefer to discuss business issues within the family.

In general, the legal framework for shareholder rights is adequate. However, in practice, shareholder protection is undermined by the dominance of large shareholders in corporations even for major decisions involving two-thirds vote. There is very little deterrent on management regarding conflict of interest and insider trading because the Corporation Code only required special approval by two-thirds vote, which can be done by large shareholders due to dominant control. Insider trading regulations are poorly enforced.

Thailand

The Public Limited Company Act 1978 regulated Thai publicly listed companies. However, some rules and regulations of this law were perceived to be too

restrictive and were discouraging companies from going public. There were concerns that the provisions regarding criminal prosecution and penalties of directors and management were harsh and inappropriate. It disallowed cumulative voting. The law also prohibited the largest shareholders, as a group, from holding more than 50% of total outstanding shares and other shareholders from holding more than 10% of outstanding shares individually. Hence, in 1992, this law was amended as the Public Company Act of 1992 and promoted the development of public companies. It relaxed the contentious provisions of its predecessor. Cumulative voting was made optional, the limit on shareholdings by the largest shareholders was increased to 70% of total outstanding shares and lighter penalties for management misconduct were imposed. However, the new legislation removed a number of provisions that would have kept public companies prudent and diligent in their operations and this may have contributed to the 1997 financial crisis.

The protection of minority shareholders was inadequate under the Public Company Act of 1992. The minimum share required to exercise some of the shareholders rights were too high. For example, the right to call emergency shareholders meeting requires 20% of total eligible votes, which is 10% in other countries. There are also regulatory loopholes. For instance, in case the required quorum is not met in shareholders meetings, decisions are made and recorded regardless. Minutes of shareholders meetings are often drafted prior to the meeting and can take up to one year to get disseminated. Thus, small shareholders are minimally involved in corporate decision making and inadequately informed of corporate decisions (Lipaphayom, 2000).

The Securities and Exchange Commission of Thailand (SET) requires that at least two directors be independent directors. However, in the Thai context, “independent” is interpreted only as being non-executive, which would only exclude insiders (i.e. management and employees) but could include anyone with personal ties with certain insiders. Hence, independent directors can come from friends and family of controlling shareholders who would not oppose management. A more serious issue is the accountability of the directors with the current rules and regulation. It would be very difficult to prove misconduct on the part of a director because much is subject to interpretation.

In the area of transparency and disclosure, accounting in Thailand is notorious for its creativity and imagination. Most companies maintain two accounts: one for management, another for the authorities. The major weakness in Thai accounting was in the method used to value assets. Rules are unclear regarding the methods by which assets can be valued and accountants can manipulate the numbers to make financial reports look good. Poor accounting standard can be attributed to insufficient regulatory supervision and light penalties in case of negligence or violations. Auditing is also poor and suffers from potential conflict of interest.

Auditors often develop a good business relationship with its clients and thus unwilling to report potential anomalies.

Since 1997, the Thai government has implemented new measures to protect shareholders' rights and interests, including the upgrade of accounting and audit standards which required listed companies to establish audit committees and to appoint independent directors to company boards. The May 2000 Accountancy Law made company management, not the auditor or accountant, responsible for legal behaviour. More importantly, in 2001, the Thai Securities and Exchange Commission amended the Public Limited Company Act which provided mechanisms for adequate protection of minority shareholders, transparency and disclosure. For instance, mechanisms to prevent directors from making use of companies' opportunities for their own benefit and to ensure that minority shareholders can exercise their rights in making decisions for the company have been put in place. Many disclosure standards now match best practice. Companies were required to provide shareholders with sufficient and timely information before shareholders' meetings, facilitate shareholders' rights to call for meetings, and by providing proxy. A number of corporate governance initiatives are planned for 2002: to introduce a "governance rating" which will rate listed companies on the basis of transparency, fairness, accountability and responsibility of companies and directors and to create an independent association of minority shareholders to act as a representative of minority shareholders in meetings and monitor business operations of listed companies ([Securities and Exchange Commission, 2002](#)).

CREDITOR MONITORING AND PROTECTION

Creditors have some control rights in companies and hence are also important players in corporate governance. A major mechanism to protect creditors interests is the implementation of effective bankruptcy or insolvency procedures. These procedures provide means by which creditors can settle their claims against an insolvent company in an orderly manner. They also provide a forum for debt restructuring and an opportunity for the insolvent company to reorganise. The laws governing corporate insolvency are usually contained in bankruptcy laws or company laws.

Before the crisis, bankruptcy regimes were generally weak in most affected countries, and some were out-of-date. They were biased towards borrowers and did not provide sufficient protection for creditors. Following the Asian financial crisis, many of the affected countries began to reform their corporate insolvency, restructuring and debt recovery laws and procedures. Significant progress has so far been made, although significant implementation problems persist.

Three broad strategic approaches exist for corporate restructuring that could lead to more efficient bankruptcy procedures: centralised, decentralised and London. Governments play a major role in centralised approaches where its strategies prove more effective with small debts, simple corporate structures and high levels of shareholders' confidence in governments. On the other hand, the decentralised approach requires relevant shareholders to reach voluntary restructuring arrangements. This approach is more effective with large debts and complex corporate structures. An intermediate strategic approach, the London approach, is when creditor financial institutions and indebted firms worked closely with a government institutions outside formal judicial processes. It involves full information sharing between all parties; collective decision-making among creditors; standardised and binding agreements between creditors and debtors particularly in honouring restructuring agreements; clear timetables for resolution and penalties for broken agreements. This approach requires strong confidence in the official mediating institutions (Haley, 2000).

All the crisis-affected countries followed broadly the London approach. All the countries developed new out-of-court systems to restructure large corporations' debt such as the Jakarta initiative in Indonesia, corporate debt restructuring committees in Korea and Malaysia, and Thailand's corporate debt restructuring advisory committee.

Korea

Before the financial crisis, Korea had a formal liquidation and bankruptcy procedure. This procedure was furthered enhanced after the crisis. Banks and non-bank financial institutions have been taken over and recapitalised by the government, reorganised under government supervision and liquidated. A number of purchases and mergers has occurred prompted by injections of government capital. A portion of bank assets have been shifted to the Korea Asset Management Corporation (KAMCO), which, at the end of 2002, had resolved 57% of the face value of non-performing loans purchased from financial institutions since 1997. In October 2000, through the Law on Corporate Restructuring Investment Company, Korea has established a range of corporate restructuring vehicles (CRVs) that can acquire non-performing loans, distressed assets and assist in the restructuring and recovery process. The distressed debtor then dealt with the CRV to formulate a workout process. A workout process involved debt/equity conversions, term extensions, deferred payment of principal or interest, reduction of interest rates, waiver of indebtedness, provision of new credits, sale of non-core businesses and new equity issues. This process was introduced through the "Big

Deal” measures. The Agreement Among Creditor Financial Institutions on the Establishment of CRVs strengthened this process in February 2001. In September 2001, the Corporate Restructuring Promotion Law was implemented. It provided a framework by which creditors of a distressed debtor that owed 75% of the debt owed to financial institutions could grant a moratorium to the debtor to allow it to prepare a Memorandum of Understanding for their restructuring. This would streamline the resolution of creditor disputes (Ministry of Finance and Economy, 2001).

Indonesia

After the crisis, the government raised creditor protection by amending its bankruptcy laws, establishing a new commercial court and introducing an out-of-court framework for restructuring non-performing loans. In January 1998, the Indonesian government established the Indonesian Bank Restructuring Authority (IBRA) to restructure troubled banks while the Indonesian Debt Restructuring Agency (IDRA) was established to restructure foreign debt in July. This allowed debtors and creditors to insure themselves against exchange risks, once rescheduling agreements were reached. In August 1998, the Indonesian government introduced a substantially revised bankruptcy law that modernised the legal infrastructure for bankruptcy and established a Special Commercial Court that facilitated the rapid resolution of commercial disputes. The revisions to the bankruptcy law included the following (Iskander et al., 1999):

- Procedural rules designed to ensure that bankruptcy proceedings were efficient and transparent;
- Provisions that allow for the appointment of receivers and administrators from the private sector to administer the estates of debtors;
- Greater protection of debtors’ assets; and
- Limitations on the ability of secured creditors to foreclose on collateral during proceedings.

Subsequently, in 1999, a law against corruption, collusion and nepotism was adopted. In 2000, the Jakarta Initiative Taskforce (JITF) was created to assist in workout procedures and restructuring mainly for out-of-court corporate settlements. The JITF is an independent government agency whose mandate was to facilitate active corporate restructuring and accelerate the approvals required for restructuring plans. As of December 2002, the JITF had worked out about \$18.9 billion out of the total \$29 billion in corporate debt that it had been tasked to restructure.

Despite the comprehensive legal and institutional framework, the progress of corporate restructuring seems slow. The IDRA has registered little debt with 80 bankruptcy cases despite almost half of Indonesian corporations experienced insolvency while IBRA has disposed only about 20% of the total assets under its management at the end of 2002. Much of the restructuring has focused on debt-to-equity swaps, loan extensions and debt discounts rather than asset sales.

Malaysia

Even before the financial crisis, Malaysian bankruptcy laws were sound by international standards and corporations carried less debt than companies in other East Asian countries. With reforms being introduced since the crisis, the resolution of non-performing loans was facilitated. In 1998, the government established Danaharta, an asset management corporation, as a pre-emptive measure to purchase non-performing loans from banking institutions. Danaharta could also acquire the assets and liabilities of a company in financial difficulty, if requested. In September 2002, Danaharta announced that it had dealt with its entire portfolio of non-performing loans projecting an expected recovery rate of 57%. The Malaysian government also established the Corporate Debt Restructuring Committee (CDRC) to assist creditors and debtors to agree on restructuring and workout programs. As at the end of July 2001, the CDRC was involved in the restructure of 46 applications involving debts of over RM26 billion, representing about 40% of the total value of debts referred to the CDRC. In August 2002, the CDRC ceased operation after successfully completing the restructure of all the debts it accepted (Ariff et al., 2001; Asian Development Bank, 2003).

Philippines

Unlike the other crisis-affected countries, the Philippines did not establish an asset management corporation relying instead on banks to work out their own non-performing loans. In 2002, however, due to the rising level of non-performing loans which was about 17% of the total assets of the banking system, the Government proposed a bill for the creation of a specially designed asset management corporation or special purpose vehicles. The proposed bill was signed in early 2003 and laid out a framework for debt relief and recovery measures to financially distressed enterprises and offers four modes of rehabilitation: pre-negotiated rehabilitation, fast-track rehabilitation, court-supervised rehabilitation, and dissolution-liquidation. The Securities and Exchange Commission, *Bangko Sentral ng Pilipinas*, Department of Justice, Capital Markets Development Council

and the Insurance Commission favourable endorsed the law ([Asian Development Bank, 2003](#); [Committee Affairs Department, 2002](#)).

Thailand

The bankruptcy system in Thailand prior to the crisis was weak. It made it difficult for creditors to obtain payment against bankrupt borrowers. Debtors used different ways to stall the bankruptcy process, including procedural disputes, which could cause a delay by at least a year. Actual bankruptcy proceedings took more than five years to complete, on average.

Thailand introduced a number of legislative reforms to its insolvency laws and practice following the financial crisis which strengthened creditor rights. These reforms included:

- Enactment of new corporate reorganisation procedure in 1998; establishment of a specialised bankruptcy court in 1999;
- Establishment of the Corporate Debt Restructuring Advisory Committee which facilitated formal out-of-court debt workouts; and
- Introduction of taxation and other incentives to promote restructuring and investment.

In September 2001, Thailand established the Thai Asset Management Corporation which managed and restructured non-performing loans transferred to it by state and some commercial banks. To date restructuring has often involved only debt rescheduling with long grace periods and lower interest rates. There are only very few cases of thorough corporate restructuring involving write-offs on banks and forcing companies to shed non-core assets ([Economic Analytical Unit, 2002](#)).

CONCLUSION

Stronger market forces and tougher regulations are gradually transforming the business environment in East Asia. Company financial reporting, accounting and auditing standards provide for adequate transparency and disclosure. For instance, many of Thailand's disclosure standards are close to matching best practice with 95% of auditing standards and 90% of accounting standards complying with international standards. Tougher bankruptcy laws and listing rules have started to protect minority shareholders' and creditors' rights. Hence, in March 2002, ten companies were delisted from the Korea Stock Exchange for accounting irregularities, the Jakarta Stock Exchange exposed and sanctioned 40 companies for non-compliance while the Kuala Lumpur Stock Exchange had a total of 481 investigations against

listed companies for breaches of listing requirements. The *chaebols*' market power has been reduced with some broken up and sold while the others were forced to focus on their core competencies by divesting collateral business lines. Based on experience in other countries, corporate governance improved when the extent of disclosure increased, the power of large inside shareholders was curbed, and an adequate number of outside shareholders was present.

While considerable progress has been made in the ongoing process of corporate governance reform in the five crisis-affected countries, gaps to achieve best practice remain. Despite sound and comprehensive laws and regulations, weak implementation and enforcement have hindered progress due to weak courts, lack of experienced personnel, powerful vested interests and lack of political will.

There is no single model of good corporate governance. Differences in corporate governance among countries depend on their respective economic, institutional and legal structures, and cultures. However, to remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices to meet challenging demands and face new opportunities. Similarly, governments have the responsibility for creating an effective regulatory framework that provides for flexibility to allow markets to function effectively and respond to expectations of shareholders. There should be a strong commitment in increasing transparency in the judicial system and regulatory bodies by building the necessary institutional capacity.

NOTES

1. A *chaebol* is characterised as a group of large corporate groups operating in diverse and mostly unrelated industries, usually under the ownership and control of a single family. The success of *chaebols* has highly depended on the strong support of the state by channelling cheap credit to them, coordinating investment and export strategies and controlling wages.

2. Restructuring of the 6th to the 64th largest *chaebols* was carried out through a program referred to as "Workout." The top five *chaebols* were given a different treatment from other smaller *chaebols* since their business activities involved key sectors and are linked to hundreds of subcontractors; thus, their economic influence was even greater than their size would suggest. The five largest *chaebols* were a target of more extensive reforms than the other conglomerates.

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CHINA'S INSTITUTIONAL ENVIRONMENT AND CORPORATE GOVERNANCE

Jean Jinghan Chen

ABSTRACT

This paper demonstrates that the agency problems within China's state-owned enterprises (SOE) constitute the characteristics of corporate governance. It argues that the current corporatisation of SOEs in China has not improved the performance of the corporatised SOEs because it has failed to address the critical issue of corporate governance. For China, a neo-corporatist approach of corporate governance with a two-tier board structure may have advantages over a neo-liberal approach with a single board. However, the key issue is not to adopt a fixed set of governance models to copy, but to develop its institutional environment that lead to effective corporate governance.

1. INTRODUCTION

One of the most important aspects of Chinese economic reforms has been the reform of state-owned enterprises (SOEs). Unlike most former centrally planned economies, China has tried to avoid privatising SOEs and instead sought to reform them through piecemeal measures, such as by increasing managers' decision-making autonomy, introducing financial incentives, and bringing in performance

contracts between the government and SOEs (Naughton, 1995; Shirley & Xu, 2001). These reform measures resulted in improved productivity of SOEs; SOEs accounted for most of the extraordinary growth of Chinese industry during the 1980s and the early 1990s (Groves et al., 1994; Jefferson & Rwaski, 1999; Li, 1997; Zhuang & Xu, 1996). However, the performance of SOEs has since steadily deteriorated. Much literature on Chinese SOEs, reports that productivity is growing, yet profitability is declining, and the number of loss-making SOEs is increasing (Cao, Qian & Weingast, 1999; Cook, Yao & Zhuang, 2000; Jefferson & Singh, 1999; Lin & Zhu, 2001; McKinnon, 1994; Nolan, 1995; Sachs & Woo, 1997).

Faced with mounting losses in the state sector, in the mid-1990s, the Chinese government began to shift the focus of SOE reform to privatisation of small SOEs and corporatisation of larger ones (Cao, Qian & Weingast, 1999; Chen & Wills, 2002; Lin & Zhu, 2001; Zhu, 1999). Research has shown that it is not realistic to entirely privatise all SOEs considering the important roles they have played in the national economy and the social responsibilities they have undertaken (Chen & Wills, 2002; Cook, Yao & Zhuang, 2000; Jefferson & Singh, 1999; Liu, 2000). Corporatisation is hoped to be an achievable and effective way to improve the performance of large SOEs. The corporatisation strategy aims to turn SOEs from public sole proprietorships controlled by industry-specific government agencies at various administrative level into shareholding companies that are, at least in theory, independent in decision-making and diverse in ownership by share issuing.

The existing empirical literature on the relationship between ownership effect and firms' performance in China is not always conclusive given the short history of China's stock market and data constraints. Some studies document a linear relationship between ownership concentration and firms' performance (Chen & Gong, 2000; Gul & Zhao, 2000; Xu & Wang, 1999). However, research using larger data sources suggests that the performance of SOEs has not been improved by share issue corporatisation (Hovey, Li & Naughton, 2002; Wang, Xu & Zhu, 2001). Wang, Xu and Zhu (2001) argued that the effects of public listing on performance are not significantly affected by the percentage of shares held by the state or by large top shareholders. Hovey, Li and Naughton (2002) reported that ownership concentration does not affect listed firms' performance but ownership structure sometimes matters. Overall, most research findings seem to suggest that ownership is not a major factor in improving firms' performance in the current process of share issue corporatisation. The overall poor effects of share issue corporatisation as experienced by Chinese firms imply that share issue corporatisation does not work as a way to reform SOEs; the corporate governance structure has not functioned effectively.

There is growing interest in the study of corporate governance of Chinese SOEs. Most of the research is limited to the issue of which Western model of corporate

governance Chinese firms should adopt (Tam, 2000), and, at the firm level, issues such as corporate board structure, CEO terms and compensation (Tam, 1995; Wen, Rwegasira & Bilderbeek, 2002; Xu & Wang, 1999). However, there is a lack of comprehensive comparison at the macro-level to illustrate the important elements constituting effective corporate governance, and the essential institutional conditions China needs to develop in order to establish effective governance mechanisms. This paper attempts to fill this void. The research hypotheses are set as:

- (1) The current share issue corporatisation does not work as a way to reform SOEs since it fails to address the critical issue of corporate governance.
- (2) Improving China's institutional environment is the pre-requisite for creating effective corporate governance.

The remainder of this paper is organised into four sections. Section 2 discusses the fundamental reasons for the poor performance of Chinese SOEs before corporatisation. Section 3 reviews the development of Chinese corporatisation and China's stock markets. Section 4 reveals the effectiveness of current corporatisation programme. Section 5 investigates the current corporate governance status in China as compared with the Western modules of corporate governance. Section 6 studies the institutional requirements for an effective governance mechanism and suggests what China needs to do to meet these requirements. Section 7 concludes with implications of the findings.

2. PRE-CORPORATISATION: SOES' INEFFICIENCY AND THE CORPORATE GOVERNANCE

Most literature on the reforms of Chinese SOEs reported the notable SOE efficiency problems – declining profitability and increasing loss making (Cook, Yao & Zhuang, 2000; Jefferson & Singh, 1999; McKinnon, 1994; Nolan, 1995; Sachs & Woo, 1997; Zhu, 1999). SOEs' low efficiencies and the increasing losses were often attributed to excessive welfare burdens (Broadman, 1996; Hu, 1996; World Bank Country Study, 1997), increasing competition (Jefferson & Rawski, 1994), and, more importantly, the built-in agency problems associated with public ownership in a centrally planned economy (Chen & Wills, 2002; Qian, 1996). As the Chinese economy has become increasingly market oriented, it is natural to expect that the artificial profit for SOEs as guaranteed by the planning system in the past would decline owing to the increasing competition. Since the late 1990s, measures have been taken to socialise SOEs' welfare burdens by privatising housing and medical benefits and laying off redundant workers. However, these measures have not necessarily improved the intrinsic efficiency of SOEs, but acted at the expense of

the workers and the society without being accompanied by measures addressing SOEs' agency problem. The size of the pie has not increased; it has only been redistributed. Moreover, the effort to "break the iron ice bowl" has backfired because it has caused tremendous uncertainty among workers about their future job security and hence has greatly depressed consumption demand. This has further weakened the profitability of SOEs. China still lacks a social security system to deal with these social burdens. It put the SOEs' accounting costs more in line with the real society's economic costs.

Both theory and empirical evidence have suggested the most important reason for the increasing loss in pre-corporatised SOEs was the agency problems (Chen & Wills, 2002; Qian, 1996). The agency problems with SOEs were twofold: on the part of enterprise managers on the one hand, and on the part of government bureaucrats on the other hand. SOEs, in principle, were owned by the state, but control rights were divided or shared between government bureaucrats and enterprise managers. Although bureaucrats were supposed to act as owners, they were not legally entitled to be the residual claimants as owners of private enterprises would normally be. It was this lack of real owners combined with an inadequate governance structure that distinguished a traditional SOE from a Western-style public corporation and made the agency problems with SOEs far more serious.

Red tape, soft budget constraints, and corruption were all manifestations of the agency problem on the part of bureaucrats. A particularly serious agency problem with the bureaucrats was in their choice of managers. Personal connections, seniority, political loyalty, and factors other than management ability were often the criteria used for the promotion of SOE managers.

The agency problems in SOEs resulted in a monitoring problem, managerial slack and a lack of competent managers. In the absence of owners and of managers who possessed the authority and faced the incentives to monitor the input of key factors of production, and lack of reward systems for their hard work, opportunistic behaviour motivated managers, workers, and public officials to take more from the enterprise than they gave. The result was persistent losses and a corporate governance structure characterised by insiders' control, soft budget constraints, managerial slack and lack of competent managers. This was the fundamental reason for SOE's inefficiency.

3. CHINA'S CORPORATISATION AND THE DEVELOPMENT OF STOCK MARKETS

The more difficult and more fundamental task for reforming SOEs is to address the agency problems. The question, therefore, is: can corporatisation effectively

deal with the agency problems associated with public ownership resulting from a centrally planned economy?

3.1. China's Corporatisation Programme

The central goal of corporatisation is to establish a system in China, through share issue privatisation, featuring corporate governance structures that separate the government from enterprises. It is hoped that corporatisation will transform an SOE into a modern-form corporation that features both significant state and significant non-state institutional shareholders in addition to small individual shareholders. The separation is deemed necessary both for enterprises to achieve full autonomy in structural and operational decisions and for government to limit its liabilities to the enterprises, hence hardening the budget constraints. It is also hoped that corporatisation will improve managerial incentives by installing shareholders with incentives and abilities to monitor the managers. Public listing of SOEs in the domestic stock exchanges is a key measure of corporatisation. Indeed, the vast majority of China's publicly listed companies are formerly SOEs, mostly large and better-performing ones (Lin & Zhu, 2001).

Share issue privatisation has been one of the major forms of privatising SOEs around the world since the 1980s with many successful cases in developed countries (Megginson & Netter, 2001). Evidence from developed countries also indicates that corporate governance has a significant impact on the performance of public listed firms (Jensen & Meckling, 1976; Shleifer & Vishny, 1986, 1997). The objective of such an action in China is also expected to introduce elements of corporate governance that facilitate improvements in firm's performance. However, it should be noted that China's case is different from those in developed countries. It is not the market, nor the motivation to obtain private benefits that determines the presence of blockholders. Ownership structures are largely determined by government. At listing, a significant proportion of shares are held back by government (state-owned), and a large proportion of shares are transferred to state-owned investment trusts and asset management companies (legal persons owned). The distinction between state and legal person shareholders is in many cases superficial. The state and legal persons owned shares account for about 70% of the total share issuance (China Securities Regulatory Commission web site). Institution share holding according to the Western definition is rare. Therefore, it is hard to see what the transfer from the state to legal persons would have done for the potential monitoring effect. The public listed shares are dispersed and minorities have little legal protection. Whether a company can make an IPO is still determined largely by an administrative process rather than the market process seen in developed

economies. When an SOE wants to go public, it must seek permission from the local government or/and its affiliated central government ministries, which receive an IPO quota from the China Securities Regulatory Commission.

3.2. The Development of China's Stock Markets and the Institutions

As a result of China's corporatisation drive, two capital markets, Shanghai Stock Exchange and Shenzhen Stock Exchange, began to emerge in the early 1990s and have developed rapidly since the late 1990s. [Table 1](#) outlines the development of China's stock markets. At the end of 2000, 1088 firms were listed on the two stock exchanges, with a total market capitalisation close to 5 trillion yuan (about US\$0.6 trillion), or 54% of China's GDP. The stock market has also become an increasingly important means of raising capital for China's SOEs, resulting in more than 480 billion yuan new equity issuance in 2000 alone. However, at present, China's capital markets are immature and have not been properly regulated. This is reflected by scandals of insider-dealing and large capital gains in secondary capital markets ([Chen, 2004](#); [He, 1998](#)).

China's legal and institutional framework has become increasingly incompatible with a modern market economy. Establishing the rule of law has been largely ignored or deliberately avoided. Despite the passage of numerous commercial laws, their enforcement is still lacking. The judicial system is insufficiently independent of the Party and the government. China's company law lacks specific rules governing the corporatisation of SOEs, the transfer of state assets and, particularly, rules clarifying the autonomous rights of companies, which would prevent arbitrary administrative interventions ([World Bank, 1997](#)). It is also ambiguous about the debtholders' rights. There are no specific rules about what debtholders can do in the case of default by a company. It is seriously flawed in giving shareholders and government agencies too much power in bankruptcy procedures. The law stipulates that liquidation teams be composed of "relevant" shareholders, government agencies and professionals. Debtholders are not given any control rights in liquidation.

China's accounting system and auditing system are also under reform. Since 1998, Chinese listed companies are required to reconcile accounting earnings from Chinese Generally Accepted Accounting Standards (GAAP) to international accounting standards (IAS). This regulation is the most comprehensive effort so far at harmonising Chinese GAAP to IAS. However, developing the accounting system is more than introducing good accounting standards. Harmonisation of accounting standards may not necessarily lead to harmonised accounting practices and comparable financial reports. Chen et al. reported that the Chinese

Table 1. Development of China's Stock Market.

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total number of listed firms	53	183	291	323	530	745	851	949	1088
Capital raised (billion yuan)	9.4	31.4	13.8	11.9	34.1	93.4	79.5	100	142.8
Market capitalisation (billion yuan)	104.8	353.1	369.1	347.4	984.2	1752.9	1950.6	2647.1	4809.1
Market capitalisation/GDP (%)	3.9	10.2	7.9	5.9	14.5	23.4	24.9	32.3	54.0
Number of investors (million)	2.2	7.8	10.6	12.4	23.1	33.3	39.1	44.8	58.0
Total book value of assets (billion yuan)	48.1	182.1	330.9	429.5	635.2	966.1	1240.8	1610.7	1796.0
State share as a percent of total shares	41.4	49.1	43.3	38.8	35.4	31.5	34.3	36.1	38.9
Legal person shares as a percent of total shares	27.9	23.1	23.5	25.0	28.4	32.7	30.4	27.7	24.5

Source: China Securities Regulatory Commission, *China Securities and Futures Statistics*, China Finance and Economic Publishing House, Beijing, 1999, and CSRC's Official web site <http://www.csrc.gov.cn/CSRCSite/deptlistcom/stadata.htm>.

government's efforts have not eliminated the gap between Chinese and IAS earnings despite harmonised accounting standards because of the lack of adequate supporting infrastructure manifested in excessive earnings management, preparers' low professionalism and low quality auditing (Chen et al., 2002). Furthermore, agency problems between the accountants and the listed firms prevail due to the lack of monitoring systems. This may tempt companies to falsify statements of capital, budgets, costs, and profits.

4. HAS CORPORATISATION IMPROVED CORPORATE GOVERNANCE?

It is hard to see that the corporatisation programme, so far, has tackled the agency problems with the former SOEs. It is hoped that through corporatisation, SOEs will finally be separated from the government. But, in the meantime, the government still retains a majority shareholding in the large SOEs. However, unless the state only keeps a passive ownership, it is not clear how the government can be truly separated from enterprises. If the state indeed withdraws its control over corporatised enterprises, currently, there is no mechanism in place to prevent enterprise managers from abusing their newly acquired power. In fact, many managers of corporatised SOEs tend to use their new independence to pursue reckless operations or engage in self-seeking activities (He, 1998). For example, the CEO of one of the largest department stores in Zhejiang Province caused huge losses to the company by "blindly providing credit guarantees" without the consent of the board of directors due to the lack of monitoring and supervision (Beijing Youth Daily, December 13, 1997). Neither the employees as shareholders nor the board of directors had the ability or motivation to exercise any control over major business decisions and to monitor the chairman and the CEO of the company. A more serious misbehaviour by managers of corporatised SOEs is asset stripping, which for many is the quickest way to get rich. He (1988) provided several detailed cases that illustrate vividly some of the methods used by managers to divert state assets into their own pockets. In addition, if corporatised SOEs are not performing, the government will still bail them out, while in developed countries they will go into bankruptcy.

Managerial autonomy in the listed SOEs has not really been fulfilled. This problem is manifested in the fact that government bodies are still using their power as the "owners" of enterprises to interfere with operational decisions, typically through their control over investment, finance, and personnel decisions and through making regulations. Many shareholding companies still operate like traditional SOEs, and their management teams are appointed by the government and often

composed of government officials and the same senior managers from the pre-corporatised SOEs (He, 1998).

From the above analysis, it can be seen that corporatisation of SOEs in China so far has not effectively dealt with the built-in agency problems associated with public ownership resulting from a centrally planned economy, but in some cases, is even worsening those problems. There are two problems with the corporate governance structure in corporatised SOEs. On the one hand, managerial autonomy has not really been fulfilled; on the other hand, there is a lack of effective monitoring of management due to the fact that the state is still the major stakeholder, and there is little legal protection for small individual shareholders; and there are few independent institutional shareholders. The private property rights and property rights markets for these minorities have not been established.

China's corporatisation scheme is apparently modelled on the Western-style public corporations. But what has been overlooked and poorly understood is the fact that in the West, the emergence of public corporations, characterised by the separation of ownership and control, is a result of an endogenous, evolutionary process based on voluntary exchanges of private property rights in pursuit of gains from specialisation (Fama & Jensen, 1983). In such a process, various governance mechanisms have been developed to safeguard owners' interests from managerial infringement. They include laws against self-dealing activities as well as economic mechanisms such as managerial stock options, independent auditing, bankruptcy, and the market for corporate control (Hart, 1995; Shleifer & Vishny, 1997). Moreover, in even the largest corporations, there are normally shareholders that hold significant ownership stakes and hence have both the ability and incentives to exercise effective control rights and monitor the management.

Further, these governance mechanisms need to be supported by a well-functioning financial market and a sound legal system. Managerial stock options require stock prices to reflect firms' true performance. An excessively speculative market will not serve this purpose. Capital markets are essential for the emergence of nonbanking financial intermediaries that are often needed to increase blockholding. The absence of a well-functioning capital market will also limit the effectiveness of corporate take-overs as a viable governance mechanism. In the mean time, the legal rights of investors and managers should be protected, and self-dealing activities must be effectively prosecuted. The governance function of bankruptcy requires that, on the one hand, debt payment and the transfer of control rights upon bankruptcy be strictly enforced by law, and on the other hand, capital markets are developed so that firms have more choices in the means of financing.

Empirical evidence of Chinese SOEs suggests that the market and institutional conditions in China are very different from those in Western economies. The current conditions need to be improved to meet the requirements for establishing

effective corporate governance in the listed firms. Wang, Xu and Zhu (2001) investigated the effect of public listing on performance and suggested that ownership was not a major factor in improving firms' performance in the current process of share issue corporatisation due to the fact that the corporate governance of listed companies is not effective. Wen, Rwegasira and Bilderbeek (2002) provided evidence on the relationship between the capital structure of Chinese listed firms and their corporate governance structure. The result shows that only the board composition and the CEO tenure affected the firms' capital structure decisions rather than the board size and the fixed compensations of CEOs. This suggests that the corporate governance processes in Chinese listed firms are only partly working in the manner that might have been so far assumed on the basis of Western models. Chen (2004) studied the determinants of the capital structure of Chinese listed firms and found that none of the capital structure models derived from the Western settings provided convincing explanations for the financing decisions of the Chinese firms. This is attributed to the fact that the fundamental institutional assumptions underpinning the Western models of financial markets and banking sector are not valid in China, and corporate governance of either listed firms or banks is still inefficient. The effects of costs of financial distress are, therefore, not significant, which shows that the Chinese environment still keeps some features of a centrally planned economy. The study suggests that establishing efficient corporate governance systems and improving the institutional environment to protect debt-holders' rights and small individual shareholders' interest are crucial for the success of corporatisation in China.

In short, the current share issue corporatisation has not improved the corporatised SOEs' performance because the critical issue of corporate governance has not been addressed. Establishing effective corporate governance of SOEs is the key issue for the success of reform of SOEs.

5. LESSONS DRAWN FROM ESTABLISHED CORPORATE GOVERNANCE MODELS AND THE CHINESE EXPERIENCE OF CORPORATE GOVERNANCE

In developed economies, two broad types of governance structure can be distinguished (Shleifer & Vishny, 1997). One is the "insider" or "neo-corporatist model," such as the Japanese-Germanic model, that relies on large institutional stakeholders such as banks for effective governance. The other is the "outsider" or "neo-liberal model," such as the Anglo-American model, that relies on capital market discipline and the legal system. One should not advocate that China should try to copy micro-level corporate governance models from Western countries,

whether neo-liberal or neo-corporatist. Nevertheless, it is argued that for former SOEs a neo-corporatist approach to the structure and composition of the board of directors, with a two-tier board structure, may have advantages over a neo-liberal approach with a single board, particularly when external monitoring devices, such as the stock market, are not well developed.

Under the two-tier structure, the upper (supervisory or oversight) board consists entirely of non-executive directors, with a non-executive chairman. The lower (management or executive) board is composed entirely of executive directors and is chaired by the chief executive, who also attends meetings of the supervisory board but without any voting rights. The supervisory board is concerned with strategy and stakeholder interests. It appoints (and can dismiss) the chief executive, but cannot interfere in the operational management.

The existence of a supervisory board would provide an opportunity for representatives of local and national government and of state-owned investment trusts, as well as those of large private shareholders or groups of shareholders, to play a role in monitoring, without having the right to interfere in operational matters. This two-tier structure would thus provide a basis for managerial autonomy, as well as for monitoring by stakeholders.

The two-tier board system of corporate governance, which is common in the European countries, is highly appreciated by the Chinese and is regarded as a means of enhancing internal unity and performance of the company. China has adopted this system since 1994 for publicly listed companies. However, the Chinese practice is somewhat different from those found in Europe. For example, in Germany, supervisory board members include representatives of banks, which provide share capital as well as loans to companies. For reasons explained above, banks cannot currently play this role in China. Moreover, in Germany, government representatives on supervisory boards play a secondary role in monitoring to that of private shareholders. In the current situation in China, private shareholders are not in a position to play the primary role in monitoring.

5.1. Shareholders' Meeting

Compared with the function of the shareholders' meeting in the European countries, the shareholders' meeting in China has a wider range of powers. The shareholders' meeting has the power of passing resolutions on mergers, division, dissolution and liquidation, electing and removing directors and supervisors, and amending the articles of association of the company. Beyond that, the shareholders' meeting also has the decision-making powers on a range of financial matters, such as deciding policies on the business operation and investment plan of the

company; reviewing and approving the annual financial budget, the final accounts, and the plan of profits distribution; and deciding on the increase or reduction of the registered capital of the company and the issuance of debentures by the company.

There are two types of shareholders' meetings: regular meetings (general meeting) and interim meetings (special or extraordinary meeting). The regular meeting is held once a year. It reviews and approves the annual financial budget and accounts and decides the plan of profit distribution and recovery losses. An interim meeting must be held if the following events occur: the number of directors is insufficient to comply with the law; the company's net accumulated losses have reached one-third of its total paid-up capital; it is requested by the board of directors or the supervisory board.

The principle of one share, one vote is included in the 1994 Chinese Company Law. Regarding the voting rights attached to different shares, there were different practices in Western countries. The Chinese remain silent on whether companies can issue non-voting shares or preferential shares and leave room for issuing special kinds of shares, if necessary. However, one of the legislative defects in China is that it fails to stipulate the quorum of shareholders at shareholders' meetings and the minimum holdings of shareholders. Therefore, theoretically, a shareholders' meeting can be held with any number of shareholders holding only one share. The state, even if being a minority shareholding, can still take part in the shareholders' meeting and get involved in decision-making process.

5.2. Supervisory Board

China adopted the Japanese model of setting up supervisory boards for publicly listed companies. Both the members of the supervisory board and those of the executive board are appointed by the shareholders' meeting. Both of the boards are obliged to submit their reports to the shareholders' meeting for review and approval. A supervisory board should have no less than three members. Among them there should be an appropriate proportion of employee representatives who are elected by the employees of the company rather than the shareholders' meeting. The supervisory board has the powers of supervising the work of the directors and the manager and proposing the holding of interim shareholders' meetings. However, there is a lack of supplying provisions for implementing the powers and duties. There are no provisions concerning rules of procedure, rules of voting, and rules of proposing and holding meetings of the supervisory board. Moreover, the supervisory board usually consists of quite a few government appointees. Therefore, the supervisory function of the supervisory board in terms of monitoring

management and reducing agency costs is very limited. The Company Law gives supervisory powers to supervisors, but does not prescribe how to exercise the power, or the liabilities of supervisors in case of breach of duty. In a country like China where awareness of shareholders' rights is not well developed among the general public, it is even more important to provide a means of enhancing the supervisory capacity of the supervisory board.

5.3. Board of Executive Directors

It is worth noting that the board of executive directors of a Chinese company is an organ of decision-making for day-to-day business operations, but not an organ for carrying out daily business operations. The manager of the company who is normally appointed by the central government carries out the tasks of daily business management. The board of executive directors together with the manager comprise the managerial capacity of the company. This characteristic distinguishes the board of directors of a Chinese company from that in the European systems where the board of directors is the management organ of a company. Moreover, the board of directors has fewer powers in a Chinese company than it has in the European systems. For example, in Germany, the management board has power over all matters regarding business operations. The shareholders' meeting can deal with those matters only if the management board requests it to do so. In comparison, the board of directors in China only has the power of formulating business and investment plans. The power of approving the plans is in the hands of the shareholders' meeting due to the lack of supervising capacity of the supervisory board. The main task of the board of directors is to implement resolutions passed at the shareholders' meeting. Considering the fact that the government is the major shareholder of the company, the two-tier board system in China clearly shows the government's intervention in day-to-day business operations. Furthermore, the Company Law states that the executive directors and the manager have the duty of upholding the interests of the company, but fails to address the directors' fiduciary duties, the duty of care or the business judgement rule. The absence of such provisions causes some inconvenience in practice (Zhang, 1998).

It should be clear, therefore, that the micro-level adoption of a two-tier board structure in China by itself is no kind of panacea for the macro-level problems discussed above. In fact, discussing the implementation of such a structure serves to highlight issues such as the impotence of the banks, the paucity of private shareholders and the risk of inappropriate appointments of top managers, based on politics or cronyism. But as the macro-level institutional strengthening takes place, a truly effective two-tier board structure is expected to emerge and would

be a more appropriate structure to benefit from them at the micro-level, than a unitary board structure. The key condition for success would be the appointment and remuneration of the chief executive and other executive directors on the basis of competence and performance. Moreover, there must be mechanisms preventing the possibility of conspiracy between the supervisory board and the managing board. For example, like in Germany, there should be a law that forbids managerial functions to be delegated upwards to the supervisory board. The board of executive directors should be given more powers over business operations to facilitate the separation of the government from the day-to-day business management.

6. INSTITUTIONAL REQUIREMENTS FOR ESTABLISHING EFFECTIVE CORPORATE GOVERNANCE

No governance structure is universally applicable. It is difficult either to prescribe what type of governance structure China should adopt or to predict what will actually emerge in China. What is common in countries that have more or less effective corporate governance is that they all have a system of effective institutions, in particular, a system of private property rights, and a relatively well-functioning financial market. For China, therefore, the most important issue is not to find a fixed set of governance models from which to copy, but to develop institutions that are conducive to effective corporate governance and enforce some basic rules of the market game. This section provides suggestions of what China needs to do to develop institutions that are conducive to effective corporate governance.

6.1. Establishing an Effective Monitoring System

It can be seen from the above analysis that the current corporatisation of SOEs has not served the purpose of diversifying the state ownership, because the state is still involved in running business entities. The ownership is still concentrated state ownership. The institutional stakeholders so far are mainly government agencies, not real institutional investors as in the Western context.

Government's role in governance of corporatised SOEs must be limited. The government should act as an unbiased referee and regulator and should not interfere in day-to-day affairs of corporatised companies. However, only when the rule of law is established can the government be truly separated from enterprises.

It is critical for China to establish and, more importantly, enforce workable and efficient bankruptcy rules. This means that opening up of the country's financial

sector is required for the success of China's SOE reform and China's entry to the WTO. The government must gradually withdraw its control over the financial sector, otherwise, bankruptcy, even if enforced, may not be very efficient.

China should encourage non-state institutional and international investors to become important players in its national market. Corporatisation in China has created many individual shareholders; most of them are inexperienced first-time buyers who do not have adequate knowledge about the stock market. Currently, they are left unprotected from expropriation by the large state shareholders. A real diversified ownership has an important advantage over concentrated state ownership. That is, no individual shareholder has the dominant control power and hence all are prevented from abusing the power to reap private gains, but each shareholder has a stake that is significant enough for it to have both the incentive and the ability to monitor the firm's performance. Independent institutional investors would serve this purpose. The participation of independent large investors will promote information transparency, production efficiency, and also bring liquidity to the market and sophistication to the business. They are also important players in the monitoring system. These large independent investors should be able to hold large stakes in corporatised firms and be able to exert meaningful influence on enterprise managers.

However, in order for both independent institutional investors and individual shareholders to be real players in the market and participate in firm's governance, the current securities law and enforcement need to include rules to protect their interests in the firm. The securities law needs to clarify and define rights and responsibilities of firm's claim-holders, in particular, independent institutional investors and small individual shareholders, such as their rights in liquidation, their voting rights, and frequency and degree of information disclosure available for them. The judicial system also needs to be independent and competent.

An effective monitoring system relies on the motivation of managers of the business. To motivate the managers of both state-owned shareholding institutional investors and corporatised SOEs, there is a need to tie their compensation to their performance. Currently, most Chinese managers are provided with little contractual, personal incentive. This makes corruption both inevitable and acceptable. It is more efficient to change managerial incentives from implicit or illegal benefits to explicit and legal forms of compensation.

An independent legal system is also crucial for effective corporate governance. It would help to deter misbehaviour by business managers, shareholders, and government officials. Specifically, managers should be required by law to fulfil their fiduciary duty to shareholders. At the same time, enforcement of anti-graft law should be strengthened to punish managerial corruption and self-dealing activities in business transactions. No governance system will work if business

and bureaucracy lack a minimum degree of cleanness. If anti-graft law is strictly enforced, monitoring should be much improved.

6.2. Regulating Capital Markets

The capital market is playing an increasingly important role in the corporatisation of China's SOEs. At present, China's financial sectors are still under the strong grip of the state; there is significant amount of bad debt. The bond market has not developed because of lack of creditor protection and control rights in the event of default. Therefore, domestic bank loans are unsustainable. Capital markets are winning the present in financing corporatisation of SOEs.

Stock exchanges should set clear initial, ongoing listing requirements. The government should mandate additional disclosure and other rules by setting independent regulatory bodies, which are separated from business operations. China Securities Regulatory Committee is expected to serve this purpose. It is designed to protect the public and competitors, by regulating share pricing, service levels for utilities and transporting firms, but its role has yet to be enforced. Meanwhile enforcement of antitrust rules will promote competition and discourage collusion.

6.3. Establishing and Enforcing Supporting Institutions

A governance system also involves legal regulatory features. A clean and independent auditing and accounting system is important for effective corporate governance. It is important for domestic shareholders, essential for foreign shareholders, and perhaps most important (and difficult) for banks. Without reliable corporate information, effective internal governance, market discipline and law enforcement would be impossible to achieve. Developing the accounting system, however, is more than introducing good accounting standards. There must be mechanisms to ensure adequate incentives and discipline so that the standards will be implemented in practice. There is also a need for training accounting and auditing professionals.

7. CONCLUSION

This paper has argued that the current corporatisation of SOEs in China by share issuing does not work as a way to improve firms' performance because it has not effectively dealt with the agency problems associated with public ownership

resulting from a centrally planned economy. Therefore, it falls short in addressing the critical issue of corporate governance. The creation of an effective corporate governance structure, in turn, requires the development of markets and institutions. China should learn lessons from the corporate governance systems in developed countries, particular the European systems, to develop its own truly functioning and effective corporate governance.

China's capital markets are still immature and the institutions are incomplete. However, they cannot develop without solving key corporate governance problems. The Chinese government must realise the economic payoff from effective corporate governance. To sustain the economic growth China has experienced, China must develop large and efficient capital markets. This is because domestic bank loans are unsustainable as a result of lack or unenforceability of creditor's rights; they can no longer offer a real alternative to capital markets. Foreign banks' participation in supplying capital for domestic firms is still very restricted and has not played a significant role. Capital markets provide an alternative corporate funding tool. They can also provide a mechanism for cleaning up problem loans. Large stock markets can promote bond markets, thus promoting the importance of corporate governance. Efficient stock markets are important for corporate control and as a compensation tool for corporate managers. Though it is still debatable, efficient capital markets may have decisive competitive advantages over bank or government financing in technological development, developing entrepreneurial growth and venture capital. Foreign direct investment, in particular, has been very important in China's economic development. Foreign capital is better channelled to the country through the capital market than through banks, because the former offers more efficient allocation of risks and rewards. But this requires the capital markets to be based on an effective property rights and corporate governance regime.

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LEGAL ISSUES OF ENFORCEMENT FOR CORPORATE GOVERNANCE IN VIETNAM: CONSTRAINTS AND RECOMMENDATIONS

Bui Trong Dan

ABSTRACT

The aim of this article is to describe and analyze the legal issues of enforcement for corporate governance in Vietnam, focusing primarily on constraints that are faced by companies. And subsequent recommendations to Vietnam's policy makers are raised. In support of working out a legal framework on enforcement of corporate governance, the article has initially focused on assessment of the enforcement for corporate governance in Vietnam. The theoretical framework is that of OECD Principles of Corporate Governance (April 1999, Paris). Furthermore, this article briefly raises some relevant impacts by corporate governance enforcement on compliance with best standards of corporate governance. The article also addresses current impediments on enforcement of corporate governance. It is concluded that enforcement of corporate governance requires making the legal framework perfect to assist inspectors with enforcement of corporate governance; and improvements on the legal framework to enhance the capacity of implementing officials is a need.

1. INTRODUCTION

The development and implementation of corporate governance in transition economies such as Vietnam has been the subject of many researches. Many people think that the implementation of the code of best practice of corporate governance will bring about profits, market-share and development for the enterprise. However, it is difficult to describe clearly and correctly the benefits of implementing best practice of corporate governance with only the concepts of profits, market-share and development. The strong and rapid development of companies in Asia during the 1980s and 1990s showed that companies in this region still earn profits even super-profits and developed to conglomerates without applying any kind of good Corporate Governance as defined and commonly accepted. However, the recent economic and financial crisis proved that due to the lack of methods of good corporate governance, these companies developed on an unstable background, suffering from risks. And in the longer term, these companies may easily collapse when the volatility of the commodities and financial markets arises. Therefore, implementing a good corporate governance does not mean to help companies gain more profits or fast development but to help them to gain stable profits and development, building the adaptability and preventing the poor results in terms of not only the market, but also the social and political risks. In short, as repeated by economists, good corporate governance is to increase the present value of the company.

The article defines the role of enforcement in ensuring good standards of corporate governance and barriers that exist to enforce the legal framework. The article will modestly present an analytical framework that enables the author to suggest that improvements to the legislation enhance the ability of enforcement officials.

2. ENFORCEMENT OF CORPORATE GOVERNANCE IN VIETNAM'S LEGISLATION

Enforcement of Corporate Governance refers to the fact that the State takes necessary measures by means of its functional agencies to enforce corporate managers to comply with the legislation on Corporate Governance, to handle violations and to ensure compliance with OECD's Best Practice of Corporate Governance.

2.1. Rights of Minority Shareholders

The issue to the most efficient way for protecting the rights of minority shareholders has not been yet resolved in Vietnam. The experience in practicing and protecting

the rights of minority shareholders is also insufficient. It is due to the insufficiency of a proper legal framework in Enforcement of Corporate Governance.

The rights of shareholders to control the governance of companies and to prevent possible mismanagement are protected by the existing legal framework. The rights should be enhanced by the enforcement of coming regulation, revised Decree 48/1998/ND-CP. Suggestions for legal provisions allowing voting by mail, cumulative voting and the like are also under discussion.

At the same time, there is still a number of organizational and bureaucratic obstacles for full exercising of the rights of minority shareholders: participation in shareholders general meetings, participation in managerial bodies, receipt of dividends, etc. This environment and the underdeveloped institutional framework, which is still failing to define clearly relations between owners and managers, creates substantial difficulties in protecting the rights of shareholders and at the same time is not ensuring the required degree of managerial freedom.

2.2. State Legislation

By means of the legislation, the state sets out regulations on Corporate Governance (such as those who participate in Corporate Governance, contents of Corporate Governance, rights and responsibilities of corporate managers). At the same time, the state also uses its functional agencies (namely state administration line agencies: Inspection bodies, Procuratorate, courts) to take necessary measures (administrative, civil, criminal) for enforcing compliance with legal regulations on Corporate Governance.

Administrative measures are now given priority to take mainly through examination, inspection and surveillance on compliance with Corporate Governance. By corporate examination, inspection and surveillance, the state's functional agencies shall find out non-compliance or wrong compliance with the legislation on Corporate Governance and then requires corporate managers to comply with the legislation, to handle shortcomings and problems in Corporate Governance. Corporate managers, who are found to violate the legislation on Corporate Governance, shall be subject to punishment. In special cases, if violations are serious, they shall be subject to administrative or criminal sanctions. In some cases, the court also will be the agency to involve in Enforcement of Corporate Governance such as handling complaints on Corporate Governance and dealing with corporate bankruptcy.

In Vietnam, enforcement is still weak. Legal dissemination and surveillance on compliance are not properly carried out. Inspection apparatus are organized into line inspection agencies on the basis of Civil Law, Administrative Law,

but there is no shortage of inadequate and overlapping functions, causing a great deal of inconvenience for companies and many difficulties in complying with the legislation. It, therefore, is necessary to review functions, duties, and competence of agencies for inspection, examination and enforcement. At the same time, simplifying and rationalizing the system of by-laws is necessary to facilitate enforcement and compliance.

3. MEASURES ON ENFORCEMENT OF CORPORATE GOVERNANCE IN VIETNAM'S LEGISLATION

At present, Vietnam does not have complete corporate legislation applied to all types of businesses. The reality shows that in addition to general regulations, Vietnam also sets out particular regulations to govern each type of business. Therefore, there still exist differences in regulations on corporate governance and Enforcement of Corporate Governance for each type of business. To facilitate the study, I have analyzed Enforcement of Corporate Governance applied to each type of business.

3.1. For Joint Stock Companies

A joint stock company is set up, regulated and operates under the Enterprise Law (dated 12th June 1999). The organizational structure of a joint stock company consists of General Shareholder Meeting, Board of Directors, Director/Chief of Executive; an Internal Control Board is required in joint stock companies having more than 11 shareholders. The state agencies that take the responsibility of enforcing Corporate Governance are state administration line agencies, inspection bodies, and law protection agencies.

Enforcement of Corporate Governance in joint stock companies covers following contents:

- (a) Enforcing corporate managers (Board of Directors, Director/Chief of Executive, other managers) to observe their obligations in Corporate Governance such as working for the interests of shareholders and the company in an honest manner; not taking advantage of their positions for their own benefits; publicly disclosing the company's financial performance and taking necessary steps to handle financial problems if the company copes with; observing the legislation . . .
- (b) Providing regulations for cases in which corporate establishment and management are not allowed; Forcing those who belong to the prohibited

- category or do not satisfy the requirements on Corporate Governance out of their office;
- (c) In order to secure Corporate Governance and minimum participation by shareholders in joint stock companies, the law requires a joint stock company to have at least 3 members; and founding shareholders to hold at least 20% of the company's popular shares for a period of 3 years since the date of receiving its business license so as to make founding shareholders' responsibilities closely associated with the company;
 - (d) The court has a right to abolish the decision of general shareholder meeting in case such decision violates the law/the company's charter; or proceedings and procedures of convening general shareholder meetings are not subject to the law/the company's charter (if there is a petition);
 - (e) All joint stock companies with more than 11 shareholders are required to set up an internal control board and chief of this board shall be a shareholder in order to monitor the company's financial performance and business operation, and to ensure the company's activities to comply with the legislation;
 - (f) Joint stock Companies' financial performance shall be strictly subject to the legislation; financial statements shall have to be made accurately and honestly. Joint stock companies' annual financial statements shall be submitted to the Tax Authority and Business Registration Authority and be disclosed to all shareholders;
 - (g) Upon carrying out some finance related activities (share redemption, dividend payment), joint stock companies shall have to meet certain requirements (especially requirements on debt and financial obligation settlement). In case there are violations, necessary measures to settle them should be taken;
 - (h) The company's civil and economic contracts that are of high value or related to corporate managers are required to have approval from general shareholder meeting or board of directors;
 - (i) In special cases, if the company is unable to facilitate due debts (after necessary measures are taken), the court shall declare the company bankrupt. Individuals who have serious breaches of the legislation shall be subject to punishment, administrative or criminal sanctions.

3.2. For Limited Liability Companies

The Limited Liability Company has been set up, regulated and operating in accordance with Law on Enterprise (dated 12th June 1999). The limited liability company consists of 2 types: A limited liability company that has one member and a limited liability company that has 2–50 members.

(a) For a limited liability company that has 2 to 50 members:

The organizational structure of a limited liability company with 2–50 members comprises board of members, chairperson of board of members, director/chief executive officer; for a company that has more than 11 members, an internal control board is required. State agencies that are responsible for enforcing Corporate Governance in a limited liability company are the state administration line agencies, Inspection bodies, and law protection agencies.

Enforcement of Corporate Governance in the limited liability company that has 2–50 members covers the following:

- Enforcing corporate managers (director/chief executive officer) to perform their obligations in Corporate Governance such as: working for the interests of the company and its members in a honest manner; not taking advantage of their position for their own benefits; publicly disclosing the company's financial performance and taking action to settle financial problems if the company copes with; observing the legislation . . .
- To protect their interests, members have a right to take Director/Chief Executive Officer to court if Director/Chief Executive Officer does not perform their obligations, damaging members' interests.
- To secure the company's financial position, members are required to make due sufficient contributions of their capital. To make a reduction of the company's chartered capital and distribution of its profits shall meet certain requirements (especially requirements on the secured settlement of its debts and financial obligations). In case there are violations, settlement measures should be taken.
- Important decisions on finance or on contracts with the value of more than 50% of the company' total assets . . . shall be made by Board of Members.
- The company's financial performance shall be subject to the legislation; financial statements shall be accurate and faithful. The company's annual financial report shall be dispatched to Tax Authority and Business Registration Authority.
- In special cases, if the company is unable to honor its due debts (after necessary measures are taken), the court shall declare the company bankrupt. Individuals who have breaches of the legislation shall be subject to punishment, administrative or criminal sanctions.

(b) For a limited liability company that has one member:

The company has been set up by an organization that has a legal status (the company owner). The owner of the company shall be the one who will decide the most important matters in the company such as enactment of the company's charter, the company's organizational structure, appointment of the company's managers etc.

The limited liability company that has one member can choose one out of two models of management: Board of Directors Model (including Board of Directors and Chief executive officer) or Company Chairman Model (including Chairman and Chief executive officer). State agencies that are responsible for enforcing Corporate Governance are: State Administration Line agencies, Inspection agencies, law protection agencies.

Enforcement of Corporate Governance in a one-member limited liability company is mainly aimed at the company's owner. The current applicable law provides that the company's owner shall observe the following obligations:

- Making sufficient contribution of his capital as committed.
- The owner is not allowed to withdraw his capital directly during the company's performance.
- The owner who wishes to draw the company's profits shall meet compulsory requirements of which the company's remaining assets after profits have been drawn shall still be sufficient to honor debts and other obligations that come due.

3.3. For State Owned Enterprises

State owned enterprises are set up and regulated by the State. Regulatory structure in large state enterprises (General Corporation, large-scale independent state owned enterprises) comprises Board of Directors, Supervisory Boards and Chief executive officer/Director and supporting divisions. For small-scale state enterprises, regulatory structure consists of a Director and his supporting divisions. The state agencies that enforce Corporate Governance in State owned enterprises are the Government, state administration line agencies, inspection bodies, and law protection agencies.

Enforcement of Corporate Governance in State owned enterprises covers the following contents:

- State functional agencies conduct examination and inspection on compliance with the legislation, guidelines, policies, and regimes of the state in the enterprises. If there are shortcomings, they are required to be amended and corrected. Corporate managers are obliged to observe all decisions of state functional agencies.
- Corporate managers shall use and multiply the state's given capital in an efficient and safe manner; conduct the business performance in accordance with the legislation, the regime and regulations on managing capital, assets, funds; on accounting, book keeping, auditing; and be responsible for the accuracy, legitimacy of the enterprise's financial activities.

- State owned enterprises shall perform the reporting to the corporate owner; publicly disclose their annual financial statements and other material information on corporate performance.
- Corporate managers shall monitor, examine the use of the enterprise' paid-in capital in other enterprises.

3.4. For Listed Institutions

The major agency that is responsible for enforcing Corporate Governance in institutions on the securities market is State Securities Commission (SSC).

Institutions that wish to take part in the securities market (securities business, issuance and listing) shall meet all legal requirements and be licensed by the SSC.

Institutions that wish to issue or list securities shall meet certain requirements as stated in the legislation (excluding government bonds); such as having minimum registered capital (that is 10 billion Vietnamese dong at the present time); having been profit-making in their business performance in 2 latest consecutive years; having members of board of directors and director/chief executive officer with experiences in business management; having a sufficient number of shareholders as required and having minimum equity capital held by these shareholders (current regulations state that 20% of the issuers' or listed institutions' equity are held by more than 100 investors outside those listed institutions/issuers; if the equity is more than 100 billion VND, minimum percentage requirement shall be 15%).

In their performance, those institutions shall observe rules and regulations on securities and securities market and be subject to inspection and surveillance by the SSC.

Listed institutions shall publicly make periodical or irregular disclosure of their material information as prescribed in the legislation.

Breaches in securities and securities market shall be subject to administrative sanctions (warning, fine, license withdrawal); in case breaches are serious, criminal sanctions can be imposed).

4. SOME OBSTACLES IN ENFORCEMENT FOR CORPORATE GOVERNANCE

Current applicable legislation only sets out general provisions on corporate managers' responsibilities rather than clear-defined responsibilities taken by the board of directors, the board of management and other concerned parties; no regulation on forms of enforcement, handling agencies and specific dealing for

breaches caused by the above system of corporate governance (units in Corporate Governance system) is in place.

Regulations on responsibilities taken by state agencies that are in charge of enforcing Corporate Governance (such as state administration line agencies, State General Inspector, Procuratorate, Investigation bodies, courts) as well as scope of inspection, investigation are not clearly defined, still overlapped or ambiguous.

The proceedings, procedures on Enforcement of Corporate Governance are not provided in an elaborate and full way (compliance with accounting – auditing regime; reporting and information disclosure regime; supervisory agency for financial statements in order to ensure accuracy; responsibilities taken by board of directors, board of management . . . before the law of verifying the accuracy for financial statements).

Rather substantial authority is given to inspectors such as rights of requesting for documents, questioning, inquiring transferring documentation dossiers to investigators . . . but violators have a right to “keep silent and refuse to give answers” so enforcement results still have little effect. In addition, violations handling requires coordination from many functional authorities so the process is always slow and sometimes not efficient.

5. MEASURES FOR IMPROVING THE LEGISLATION TO ASSIST ENFORCEMENT OFFICIALS

The aim of this section is to give some measures that are needed to overcome the obstacles mentioned in the earlier section. The number of enforcement officials of corporate governance is small and does not have sufficient knowledge of applicable laws and regulations as well as experience of investigating. Furthermore, the authority of these enforcement officials is still limited (the measures such as license revoking, compensation forcing, and property seizing . . . *require for the coordination form many functional agencies so they are not carried out timely*).

Standardization of the titles of those officials who undertake the implementation of the laws at each level and at the enforcement level should be specified in laws, paying attention to professional knowledge and code of conducts. In Civil and Criminal Laws, inspectors should be given more authority in their investigation, prosecution, and lawsuit. Inspection Law on Financial Institutions (Enterprises) should be promulgated so that enforcement officials can be empowered at a modest degree that adequately allows them to be fully capable of carrying out their functions. At the same time, the rights and responsibilities of the officials at every level should be clarified.

Conducting training and education courses to heighten knowledge on laws and administration *of the implementing as well as enforcement officials of corporate governance*. All of the officials shall have to reach a specified level of professional knowledge through training courses on laws and corporate governance.

There should be a competent, independent institution for financial inspection, and able to monitor sectors in the financial system (finance, banking, securities, insurance).

6. ENHANCEMENT FOR EXTERNAL CONTROL

In order to enhance legal observance and to ensure compliance with best standards – besides internal control – it is necessary to rationalize and intensify external control outside the company with a focus on following issues:

6.1. Making Perfect Rules and Regulations on the Financial System.

This is one of the most important and urgent factors required to strengthen the financial system. Legal documents should be complete and thus lay a strict foundation for best and highly efficient enforcement.

One important issue in completing regulations, rules, is to make legal documents consistent with one another. A serious problem that exists in Vietnam's current legal framework is the overlap or even contradiction among various legal documents. This causes many difficulties in activities for companies and banks. A great deal of time is required to iron out these difficulties if we really want to build up a complete legal framework.

In addition, legal enforcement also should be enhanced to ensure compliance with legal documents. Studies on Asian financial and monetary crisis indicate that in most of the affected countries, a complete legal framework to govern the operation of the securities market appear to be adequate on paper, but the application of this framework is quite different in reality. The real problem is compliance, enforcement, and how to enhance regulations and rules to facilitate them. Recently, progress has been made in some countries. For example, the Philippines has already simplified prosecution of insider trading cases; Malaysia has set out strict standards of disclosure for corporate acquisition. Thanks to these measures, capital markets in those countries have recorded considerable growth.

Moreover, to enhance enforcement, personnel's professional capability in the inspection and legal industry should be improved and synchronous and harmonious

coordination should be carried out among agencies such as the courts, and police, in order to bring into full play the strength in inspecting and handling legal violations.

To enhance the mechanism for legal compliance, improvements should be made in the following:

- State administration agency (State General Inspector, law protecting agencies).
- Independent auditors.
- Credit rating agencies.
- Professional associations.
- Developing the market for corporate control.

6.2. Enhancement for Market Competition

Market competition puts pressure on corporate managers to work for the interests of shareholders, as otherwise they will be forced out of business. Therefore, it provides indirect protection for shareholders and creditors. In a perfect competitive world, market discipline could be an adequate guarantee that managers will act in investors' interests. However, most companies do not operate in such a world with major reasons: some companies enjoy their monopoly power; informational problems may prevent market forces from monitoring corporate performance and overseeing the allocation of the financial resources in an efficient manner; there are governmental interventions such as directed credits, implicit and explicit guarantees, and state ownership. These problems affect the role of market forces in encouraging managers to work for the highest interests of shareholders and the company. In this regard, measures for promoting market competition can improve corporate governance in the financial and corporate sector.

It is noted here that healthy competition are promoted, competition within the legal framework by means of the company's innovation, capacity and reputation is encouraged rather than unhealthy competition, making a blockade and violating legal regulations.

To build up a healthy competitive world, the government should review all rules and business and production development policies in order to limit subsidies, guarantees; to eliminate implicit and explicit back-up and other unreasonable forms of protection. In Vietnam, the government adopts the policy of building up a healthy competition climate – a level playground for all firms, in all economic sectors, but this excellent policy is not well implemented. In reality, state owned firms are favorably treated. Some solutions to this issue are: priority should be given to improving the infrastructure for efficient conduct of business of all scales and organizational modes; reduction of graft and corruption should be made; SOE

equitization should be intensified and ownership structure should be diversified; administrative procedures should be simplified and foreign investment should be encouraged. In addition, the scale and business line of large corporations should be taken into account. If possible, those corporations can be rationalized and restructured to improve their business efficiency and to make the competition climate healthy, because regional countries' experiences and even Vietnam's, indicate that practices of organizing firms into large industry groups could limit the extent of competition, leading to internal capital markets and cross subsidies and weak business efficiency.

6.3. Developing the Market for Corporate Control

Many economists believe that the market for corporate control is a key factor in corporate governance. Two basic forms of ownership transfer are merger and takeover. Developing the market for merger and takeover helps improve corporate governance because it is an instrument to regulate listed institutions in centrally organized markets. Lessons drawn from regional countries' experiences are: governments should review their Enterprise Laws. If necessary, governments should formulate takeover laws in which internationally accepted practices should be applied to encourage and open the market for corporate control activities. At the same time, domestic and international regulations should be aligned. The laws should prescribe the protection of minority shareholders in the process of liberalizing corporate takeovers and acquisitions. For example, Philippines' Law requires an investor, who wants to acquire a firm, to make a tender offer to all minority shareholders at a price equal to its offer to major shareholders. In addition, terms of the offer with major shareholders should be disclosed to a certain extent to all minority shareholders.

In Vietnam, Market for Corporate Control is a quite new concept. Degree 48/1998/ND-CP already sets out some regulations on this. However, they are just initial regulations, a great deal of time and substantial effort is required to formulate a detailed and reasonable legal document governing takeovers and acquisitions for listed public firms.

6.4. Reforming Bankruptcy and Insolvency Procedures

The aim of reforming bankruptcy and insolvency procedures is to enhance creditors' role in enforcing firms and corporate managers to comply with rules and regulations; to protect the interests of lenders and to facilitate the corporate debt-rescheduling process.

In general, laws on bankruptcy and insolvency are in place in most regional countries. But the Asian financial and monetary crisis revealed many fundamental weaknesses in those countries' laws on this issue. A series of reform measures have been taken so far, but there is still no shortage of existing problems. For example, in immediate response to the crisis, some countries have changed insolvency, bankruptcy processes in favor of debtors and at the expense of creditors – especially the secured creditors. This can encourage planned defaulting and to a certain extent, can be the reason for the slow process in corporate debt restructuring. What should governments and policy-making agencies do? They should review and adjust legal documents governing insolvency, bankruptcy and set forward severe and strict measures to make compliance effective. These changes and adjustments can be:

- Review the legal documents on securities and securities market, law on bankruptcy in order to ensure that creditors are able to execute their claim to collateral assets, move away obstacles, and simplify the procedures of executing these claims;
- Review the regulations on insolvency and bankruptcy and if necessary, amend them to create the consistency between legal documents;
- Simplify the procedures of applying for bankruptcy and liquidation or restructure of company;
- Simplify the procedures of liquidation of the companies, which cannot survive any longer and have to declare bankrupt;
- Preventing the case when creditors abuse restructuring of bad debts under the supervision of court or government bodies.

7. CONCLUSION

Enforcement of Corporate Governance has an impact on corporate managers, forcing them to strictly comply with legal regulations on Corporate Governance (intentional non-compliance shall be subject to administrative, criminal sanctions as stated in the legislation) so compliance with best standards of Corporate Governance shall be secured and corporate performance shall be conducted in a safe and more efficient way. Enforcement for Corporate Governance, therefore, is one of key ingredients leading to best compliance with Corporate Governance standards.

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THE IMPACT OF REGULATORY CHANGE ON INSIDER TRADING PROFITABILITY: SOME EARLY EVIDENCE FROM NEW ZEALAND

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ABSTRACT

This paper adds to the scant literature on the tightening of regulations and its impact on the profitability of insider trades by examining the effects of the recent enactment of the Securities Market Amendment Act 2002 in New Zealand. We investigate the abnormal returns around the date of insider transactions both before and after the introduction of this Act. We find that the number of insider transactions decreased just prior to the introduction of the Act; further we observe a marked reduction in the profitability of directors. However, the difference between the pre and post-change returns lacks statistical significance.

1. INTRODUCTION

Insider trading remains a contentious issue in the finance and law literature as it has both harmful and beneficial impacts on the market. While the quick dispersal of the information that an insider uses to trade on improves the informational efficiency

and resource allocation of the market, the possibility of trading against a better informed party reduces participation in the market by outside investors with flow on effects for the economy as a whole. In practise, countries have tended to allow some insider trading as a necessary evil. This is achieved by implementing laws that allow the most beneficial insider trading and prohibit the most harmful. According to [Bhattacharya and Daouk \(2002\)](#), insider trading has been regulated in over 80% of countries with a capital market. However, even legal trading can be damaging as insiders expropriate trading gains at the expense of uninformed outsiders. This raises questions about the efficacy of insider trading regulations allowing some trading given insider share dealings have been shown to be profitable regardless of legal structure. Studies have failed to detect that the tightening of the laws governing insider transactions has had a positive effect on legal insider trading profitability.

The profitability of insider trading has been almost uniformly established. Starting with [Lorie and Neiderhoffer \(1968\)](#), numerous papers have examined insider trading profitability. In the U.S. studies such as [Jaffe \(1974a\)](#), [Finnerty \(1976\)](#), [Seyhun \(1986, 1998\)](#), [Rozeff and Zaman \(1988\)](#) and [Lakonishok and Lee \(2001\)](#) have all found that insiders earn significantly higher returns following their purchases and avoided losses following their sales. These papers have been supported in a variety of other markets including Canada ([Baesel & Stein, 1979](#)), Spain ([Del Brio, Miguel & Perote, 2002](#)), Poland ([Wisniewski & Bohl, 2005](#)), New Zealand ([Etebari, Tourani-Rad & Gilbert, 2004](#)) and the U.K. ([Friederich, Gregory, Matatko & Tonks, 2002](#); [Pope, Morris & Peel, 1990](#)). Only scant contrary evidence exists to suggest insiders cannot trade profitably, based predominantly on [Eckbo and Smith \(1998\)](#) who examined the Oslo Stock Exchange. These papers cover a broad cross-section of markets, sample periods and regulatory regimes, yet in virtually every study insiders have been able to earn positive abnormal returns.

These studies also provide some indirect evidence on the effectiveness of the tightening of regulations on insider trading profitability. In the U.S., various papers have examined this issue over a long period of time, providing almost continual coverage from the early 1960s through to the 1990s, encompassing several periods of marked changes in the laws, including increased sanctions and an increase in the will to prosecute by the Securities Exchange Commission (SEC). Despite the laws being strengthened on several occasions [Lakonishok and Lee \(2001\)](#), one of the most recent U.S. studies, still found insiders trade before price increases and sell prior to price decreases resulting in significant returns. Their results suggest that the changes in the laws have achieved little to make legal insider trading unprofitable.

Several papers have specifically examined the impact of regulatory changes on insider trading profitability. [Jaffe \(1974b\)](#) was the first to explore this issue in

the U.S. by calculating cumulative abnormal returns earned by insiders over the period 1962–1968. The study focused on the profits earned and volume traded before and after several court cases which were argued as having a major impact on the enforcement of insider trading. The Cady, Roberts decision, the Texas Gulf Sulphur indictment and Texas Gulf Sulphur decision, were argued as evidence of a new will to prosecute as well as extending the definition of insider. However, these decisions, neither individually nor cumulatively, were found to have a significant impact on the profitability or the volume traded.

The findings of Jaffe (1974b) are supported by Seyhun (1992) who examined the profitability of insider trading around major changes in the insider trading laws that occurred in the U.S. in the 1980s. The early years of the 1980s in particular saw a much higher expected cost of insider trading due to rapid incremental increases in the potential penalties and greater vigilance by the SEC. Despite these massive changes to enforcement, Seyhun (1992) found that insider trading actually became more lucrative between the period prior to 1980 and that following 1984, accompanied by a dramatic increase in the volume traded. The paper did however find that court rulings impacted on insider trading in terms of dissuading insiders from trading before earnings announcements and takeovers. The author concluded that the involvement of the courts gave insiders too much certainty as to what was and was not covered by the laws. This allowed them to trade more profitably on legal information, avoiding the increased sanctions and vigilance.

In both studies the focus of the change in regulations was the tightening of the enforcement regime. In Jaffe (1974b) this was an increase in the possibility of prosecution and a broadening in the definition of who was covered, whereas Seyhun (1992) tested the effect of improvements in enforcement involving both higher sanctions and the greater possibility of prosecution. However, both studies examined this impact on enforcement against the profitability of legal insider trading rather than illegal trading, an aspect that is more likely to be affected by improvements in enforcement. This is borne out to a degree by Seyhun (1992) who notes that the law changes were not aimed at legal insider trading. This raises the question of whether regulatory changes targeted specifically at legal insider trading will have more effect on reducing the profits earned by insiders than has been evidenced to date in the U.S.

The New Zealand market provides a prime opportunity to examine this issue due to the recent enactment of the Securities Market Amendment Act 2002. This act was introduced to address weaknesses in the previous regulations governing both legal and illegal insider trading. In particular, two key deficiencies were addressed by the new laws. The first was the perceived weakness in the enforcement regime. Under the previous rules, enforcement was the domain of the company in which the trading occurred or the other party to a trade against an insider. This meant

that insider trading cases could only be pursued by those with little access to the information required to make a case. The weakness in this system was compounded by allowing the other party to the trade to only pursue a case for the value of the loss they as an individual suffered. This meant taking a case was extremely uneconomical given the loss would often be far less than the expected cost of the prosecution. As a consequence, in the 14 years that the old rules operated there was not a single successful prosecution of an insider trading suit.

The other weakness addressed was the disclosure regime. Under the old rules only substantial shareholders, those with more than 5% of the voting stock, were required to disclose within five working days. Directors were not required to divulge details of their trade until the annual report was published, a delay of 9–10 months on average (Etebari et al., 2004). Executives, those Seyhun (1998) states have the best access to information and therefore could earn the largest profits, were not required to disclose at all, provided they did not fall in either the director or substantial shareholder categories. This delay in disclosure in New Zealand resulted in ongoing opportunities to profit by insiders who could continue to trade for a prolonged period of time before the market could observe their information and adjust the price to remove this information asymmetry. Huddart, Hughes and Levine (2001) argue that delays in disclosure could theoretically allow insiders to earn significantly higher profits. This was supported empirically by Etebari et al. (2004) who examined the profitability of delayed versus immediate disclosures in New Zealand prior to the introduction of the new laws. They found those able to delay their disclosures earned significantly greater returns than those required to disclose immediately. It was argued that the new laws being introduced at the time could therefore result in a reduction in profitability of directors transactions.

This paper builds on the findings of Etebari et al. (2004) by examining whether the prediction of a decrease in the profitability of directors has held true following the introduction of the new laws. The amendment of the regulations in New Zealand provides a good opportunity to add to the literature on the impact of regulations by examining changes that are targeted at the profits of legal insider trading. This is in contrast to the works of Jaffe (1974b) and Seyhun (1992) who examined law changes whose effects were primarily aimed at illegal insider trading. If the laws in New Zealand have had the effect expected we should observe a strong reduction in the profits of insiders between transactions that occurred prior to the introduction of the new laws and those that were undertaken following the changes.

We employ a sample of 1,489 transactions conducted between January 1996 and December 2003 in companies listed on the New Zealand Exchange. The profitability of these transactions were tested using a market adjusted model. The abnormal returns for various event windows within the test period of –50, 50 days

around the trade were examined. The transactions were separated, based on when the trade occurred, into one of three sub-samples, the pre-change, change and post-change. The difference between the pre and post-change groups was then tested to observe whether the law changes had been effective in reducing the abnormal returns of insiders. The results show that there were fewer trades in the period immediately prior to and following the new act's introduction. Further, there is some evidence, albeit not statistically significant, indicating a reduction in the profitability of insider trading.

The rest of the paper is structured as follows. Section 2 discusses the sample and methodology employed in this paper. Section 3 provides the empirical findings and their discussion and Section 4 concludes.

2. SAMPLE AND METHODOLOGY

To examine the impact of changes in regulations on the profitability of insider trades we employed a sample of 89 companies that had been listed on the New Zealand Exchange (NZX) between January 1996 and December 2003. For each company we collected information on all disclosed directors transactions that occurred over the sample period. We examined only directors' transactions as the rules applying to substantial shareholders remained unchanged. Under both the old and new laws they were required to disclose in a timely fashion. Further, executives were not subjected to mandatory disclosure requirements under the old law making the profitability of their trading before the changes impossible to gauge. Directors, by contrast, are affected by the recent regulatory changes and their gains can be examined in both periods making their transactions suitable for establishing the impact of the new regime. Directors' transactions, prior to the introduction of the new laws, were collected from the company annual reports, the only place they were disclosed, while after the law change we obtained information on the trades from the disclosures filed with the New Zealand Exchange. Information on the insider's position within the firm was taken from the annual report while market capitalisation and price information was gathered from Thompson Financials DataStream database.

To examine the impact of the law changes on the profitability of insider trading we use an event study methodology. We calculate the profitability of insider trading in three periods, the pre change period covering transactions that occurred between January 1996 and December 2001, the post change period encompassing transactions that occurred between December 2002 and December 2003 and the change period, transactions that occurred between January 2002 and November 2002. We separate out the change period to isolate any potential bias caused by

Table 1. Transaction Breakdown and Summary Statistics.

Number of Transactions Per Year	Aggregate	Purchases	Sales
Panel A: Transactions by year			
1996	244	114	130
1997	213	124	89
1998	246	154	92
1999	222	126	96
2000	217	124	93
2001	126	75	51
Change period	75	56	19
Post period	146	93	53
Total	1489	866	623
Panel B: Transactions by position			
Pre change period			
Managing Director	205	130	75
Chairman	173	85	88
Director	890	502	388
Change period			
Managing Director	10	6	4
Chairman	8	5	3
Director	57	45	12
Post change period			
Managing Director	18	10	8
Chairman	20	14	6
Director	108	69	39

Note: The Pre Change spans January 1996 to December 2001. The Change Period spans from January 2002 until November 2002. Post Change spans December 2002 until December 2003.

the passage of the Securities Market Amendment Bill 2002 through the legislative process.

Table 1 gives a breakdown of the insider transactions, the sample consists of 1,489 transactions (866 purchases and 623 sales). Unlike studies from the U.S. and U.K., we find fewer sales than purchases, largely due to the fact that there is limited use of stock and options in New Zealand as a form of managerial compensation. The breakdown of transactions by years in Panel A also shows that prior to 2001 there were typically in excess of 200 director trades a year. In the years since 2001 this has decreased markedly with the numbers finally picking up again in the post period. This could be a reaction to the proposed introduction of the new insider trading laws. One possible explanation is that insiders may have voluntarily reduced their number of trades due to uncertainty regarding the impact

of the new laws. In particular insiders may have been concerned about the new laws being applied retroactively as has been the case in the recent Transrail case (New Zealand Herald, Oct. 18, 2004). With the new laws in place insiders would be more certain about the impact of the act allowing them to resume speculative trading, although the numbers are still lower than observed prior to 2001. This could be due to either less information driven trading as a result of the new Act or some residual uncertainty about the effect of the changes with insiders continuing to play it safe. Whether this is a permanent change remains to be seen.

As shown in Panel B, when the trades are broken down by the insiders position within the company, it can be seen that directors typically undertake the most trades followed by managing directors and chairmen who have similar levels of trading. In percentage terms the largest reduction in trading has occurred in the managing directors sub-sample who have gone from an average of 34 trades per year in the pre-change period to 18 in the post-change period, a reduction of nearly half. Chairmen have experienced a smaller reduction in trades followed by directors who reduced the number of their transactions least. This is in line with the information hierarchy proposed by [Seyhun \(1998\)](#) and tentatively suggests that in the short run at least there has been a greater reduction in the number of trades by those with the greatest access to information, although a larger sample over a long period is needed to fully ascertain this.

We calculate the profitability of the transactions using a market adjusted return in the form:

$$AR_{i,t} = R_{i,t} - R_{m,t} \quad (1)$$

Where R_i is the return of company i and R_m is the return on the NZSE40 capital index. This index represents 98% of the market capitalisation of the NZX making it a suitable proxy for the market portfolio. We calculate the profitability over various event windows within the test period $-50, 50$ by calculating cumulative abnormal returns (CARs) in the form:

$$CAR(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_t \quad (2)$$

The CARs were then aggregated for all trades. Sales transaction CARs are multiplied by -1 in the process of aggregation to account for the fact that a decrease in returns following the sale represents the loss avoided by the insider. This measure of the profitability of sales is used in all testing.

We calculate the significance of the returns using a bootstrap methodology which was introduced by [Efron \(1979\)](#) and applied in the context of event studies by

Foster, Olsen and Shelvin (1984) and Wisniewski and Bohl (2004). The procedure is relatively robust to the problems of non-normality, heteroscedasticity and time dependence of security returns as it avoids many distributional assumptions of parametric tests (Kramer, 2001). This testing was conducted by randomly selecting a replacement firm-date pair from the entire population of companies and dates to match each of the insider purchases and sales from our initial sample. The cumulative abnormal returns following each of these random events were then computed for the respective event windows and aggregated. This process was repeated 2,000 times to develop the distribution. The null is rejected at the α percent level if the abnormal return from the insider trading sample exceeds $(1-\alpha) \times 2,000$ simulated values from the empirical distribution.

The significance of the difference between the profitability in the pre and post change periods was calculated using the formula:

$$t = \frac{(\text{ACAR}_1 - \text{ACAR}_s)}{\sqrt{S_1^2/n + S_2^2/m}} \quad (3)$$

where $S_1 = \sqrt{n} \times \sigma_{\text{AR}_1}$, $S_2 = \sqrt{m} \times \sigma_{\text{AR}_2}$ and ACAR is the average cumulative average returns for each sample.

3. RESULTS

Table 2 reports the sample cross-correlations between the variables employed in this paper. The results show a significantly negative relationship between market value, MV, and the number of deals made by managing directors, MD. This implies that managing directors are less likely to trade in larger companies. This is consistent with the idea that larger companies are the subject of greater scrutiny resulting in less information asymmetry and therefore opportunities to profit.

The theoretical model of Huddart et al. (2001) predicts that the requirement to disclose in a timely fashion should have a significant effect on the profitability of insider trades. The literature has shown almost uniformly that insider trading is profitable, while studies specifically examining the effect of changes in insider trading laws on profitability have found little impact. Jaffe (1974b) and Seyhun (1992) both concluded that tighter regulations had at best a minimal impact on disclosed insider trading.

The results in Table 3 provide evidence on the profitability in both the pre and post-change periods in New Zealand. As can be seen in Panel A, the aggregate sample provides evidence that the regulatory changes have had an impact on insider trading profitability, but the effect is not strong. Pre-change insiders experience significant cumulative abnormal returns within five days of their trade, eventually

Table 2. Sample Cross Correlations.

	Change	MV	MD	CH
Post	−0.0750 (0.1156)	0.0138 (0.6453)	−0.0314 (0.3628)	0.0048 (0.8710)
Change		0.0200 (0.5158)	−0.0118 (0.6986)	−0.0326 (0.3490)
MV			−0.1188 (0.0553)	−0.0123 (0.6876)
MD				0.1689 (0.0310)

Note: *p*-values are reported in the parentheses. Post is a dummy variable that equals 1 for the months December 2002–December 2003. Change is a dummy variable that equals 1 for the months between January 2002 and November 2002. MV is the natural logarithm of the market capitalisation. MD is a dummy variable that equals 1 when a transaction is undertaken by a managing director or CEO. CH is a dummy variable that equals 1 when a transaction is undertaken by the Chairman of the board of directors.

earning a premium of 2.72% above the market over the first 50 days. The results for post-change show that insiders earn 0.7% less over the 0, 50 day window and that the significance of the CARs occurs much later. The delayed significance of post-change trades may indicate a change in the trading behaviour of insiders, may be increasing the delay between their trades and upcoming disclosures to avoid increased scrutiny by regulators. This could account for the delayed significance observed in Table 3 and the sharp jump in CARs in Fig. 1 that occurs 15–20 days following the transaction. The post-change CARs increase at a slower rate than those for pre-change trades until around Day 20 at which point the rate of increase appears to be similar. Insiders still earn a statistically significant return of 2.01% over the market in the first 50 days. The post-change patterns can also be observed in the change period where insiders earn similar CARs. This suggests there has been some pre-emption of the effects of the new laws.

Another point of interest is the change in the timing of insider trades in relation to the pre-trade price performance of the stocks. The greatest difference in returns is over the −50, 50 day event window where pre-change insider transactions earn 1.22% while post-change trades make −0.29%. As can be seen in Fig. 1 this is a result of insiders in the post-change sample trading after a much greater drop in the CAR. In fact at Day 0, post-change trade companies have suffered twice the decrease in price, approximately 2.5% versus 1.3%. This suggests that insiders have switched to a more long-term contrarian investment strategy based on price movements caused by market misvaluation which has the advantage of reducing the risk of a prosecution for insider trading.

Table 3. Insider CARs and Average Volume.

Windows	CARs			<i>t</i> -Stat Difference
	Pre-Change	Change	Post-Change	
Panel A: Aggregate sample CARs				
0, 1	0.0024	0.0097*	−0.0034	0.4179
0, 5	0.0048*	−0.0007	0.0003	0.3173
0, 10	0.0074*	0.0059	0.0004	0.5044
0, 20	0.0139***	0.0006	0.0093**	0.3311
0, 50	0.0272***	0.0200**	0.0201**	0.5122
−50, 50	0.0122*	−0.0134	−0.0029	1.0777
Panel B: Purchase sample CARs				
0, 1	0.0028	0.0107*	−0.0051	0.4224
0, 5	0.0044	−0.0041	−0.0062	0.5773
0, 10	0.0059	0.0046	−0.0082	0.7643
0, 20	0.0132**	−0.0088	0.0025	0.5784
0, 50	0.0271***	0.0155**	0.0151*	0.6472
−50, 50	0.0294***	−0.0160	−0.0212	2.7314***
Panel C: Sale sample CARs				
0, 1	0.0022	0.0066	−0.0004	0.1248
0, 5	0.0054	0.0094	0.0119	−0.3051
0, 10	0.0099	0.0097	0.0155	−0.2646
0, 20	0.0155*	0.0285*	0.0213**	−0.2719
0, 50	0.0293**	0.0332	0.0288*	0.0218
−50, 50	−0.0080	−0.0056	0.0292**	−1.7466*

Note: Abnormal returns were calculated using the market adjusted model. The significance level was assessed using the bootstrap methodology employing 2000 iterations. *Pre Change* includes the 1268 transactions (717 purchases and 551 sales) that occurred between January 1996 and December 2001. *Change* includes the 79 transactions (56 purchases and 19 sales) that occurred between January 2002 and November 2002. *Post Change* includes the 146 transactions (93 purchases and 53 sales) that occurred between December 2002 and December 2003. Sales transaction CARs were multiplied by −1 before aggregation.

* Significant at 10%.

** Significant at 5%.

*** Significant at 1%.

While the CARs for the aggregate sub-sample show a decrease of 0.7% in the change and post-change trades and there appears to be evidence of a change in the behaviour of insiders, the *t*-stats of the difference between the pre and post-change periods are insignificant. None of the event windows demonstrate a significant reduction in CARs despite the large decrease in CARs apparent over many of the event windows. The results therefore suggest that while there has been a reduction in the profitability it is not prominent, providing limited support for the belief that

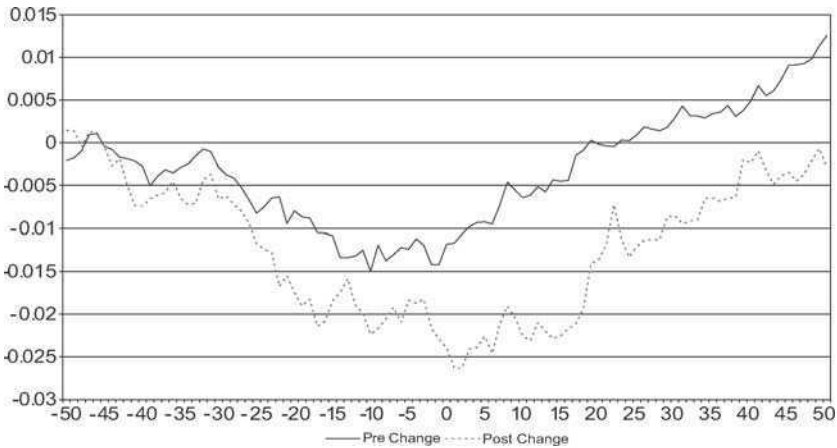


Fig. 1. -50, 50 Day CARs for the Aggregate Sample. *Note:* The vertical axis represents the cumulative abnormal returns based on a market adjusted model. Sales transaction CARs were multiplied by -1 before aggregation. The pre-change sample contains 1,268 transactions that occurred prior to January 2001. The post-change sample contains 146 transactions that occurred after 1 December 2002.

the regulatory change has had a statistically significant impact on the abnormal returns earned by insiders.

Panels B and C report the results where the sample is separated into purchases and sales. Not all sales are information driven transactions as insiders may sell for diversification or liquidity needs. As the new regime should affect information driven transactions most, we separate out the sample to see whether there is a difference in the impact of the new laws. The results in Panel B report the CARs for the purchase sub-sample. In the pre-change period insiders expropriate abnormal returns of 2.71%. The change and post-change transactions earn significant returns for the 0, 50 day event window of just 1.55% and 1.51% respectively, a reduction of about 1.2%. These large decreases appear to be largely responsible for the aggregate sample results, supporting the idea that the changes would have the greatest impact on information driven trades.

Figure 2 also reveals similar patterns in timing to those for the aggregate sample. Again there is a significant difference in the pre-trade CARs with the pre-change transactions showing no signs of significant movement prior to the trade. Post-change on the other hand experience a steady decrease in CAR over the 50 days prior to the trade. This presents even stronger evidence of insiders switching to relying on mispricing in the share price to profit. Figure 2 also shows why there is such a long delay in the CARs becoming significant as the CARs do not start

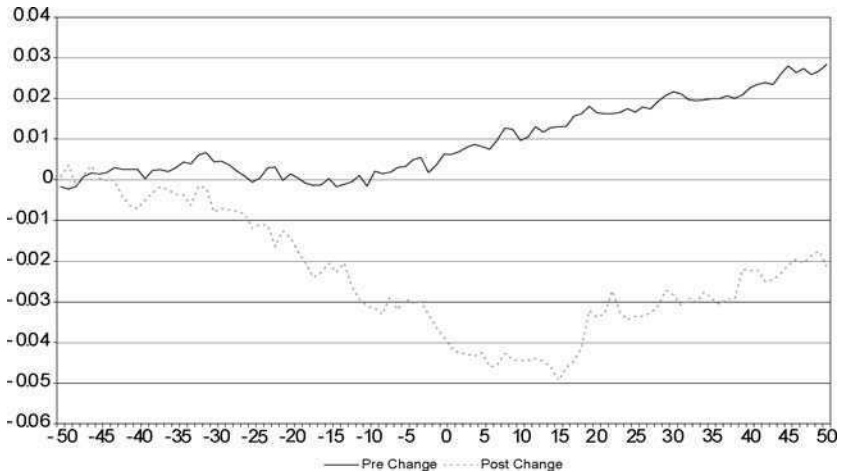


Fig. 2. –50, 50 Day CARs for the Purchase Sample. *Note:* The vertical axis represents the cumulative abnormal returns based on a market adjusted model. The pre-change sample contains 717 transactions that occurred prior to January 2001. The post-change sample contains 93 transactions that occurred after 1 December 2002.

to increase for approximately 15 days following the trade. This further reinforces the pattern observed for the aggregate sample where the significance appeared dependent on a sharp increase in the returns around day 15.

Despite the reduction in CARs of over 1% and the very different patterns in the CARs both before and after the trade, the t -stat of the difference is still insignificant. Only in the –50, 50 time period is the difference great enough to produce large t -stats, caused largely by insiders switching to a more contrarian style of investing. As with the aggregate sample the evidence suggests that although insiders display evidence of better timing and their trades earn smaller CARs, the difference in returns are insignificantly different.

Panel C reports the results for the sales sub-sample. Unlike the aggregate and purchase samples there is little evidence of an improvement following the introduction of the new law for sales. The pre and post change results are very similar at 2.93% and 2.88% respectively which is supported by low t -stats of the difference. The returns also become significant at the same point, during the 0, 20 event window. Only the –50, 50 event window is significantly different although in this case it is the pre-change which demonstrates superior timing. [Figure 3](#) shows the two samples are comparable up until about 20 days prior to the trade. While the pre-change CARs continue to decrease, they start to increase for the post-change. The insignificant impact of the regulatory changes on sales however

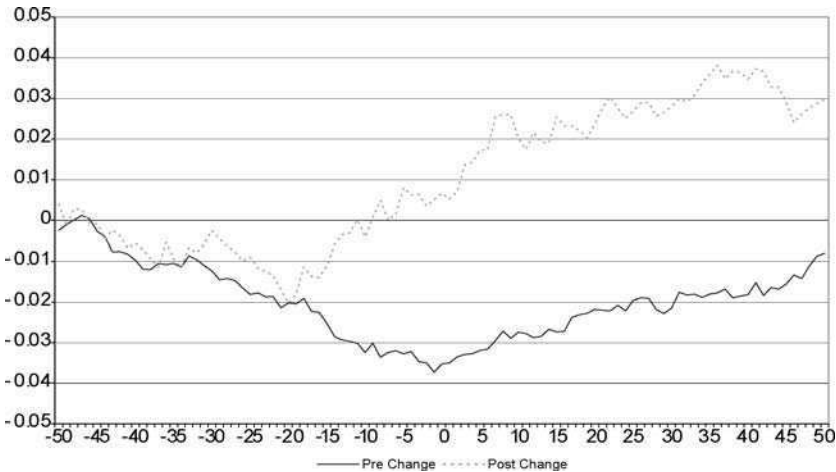


Fig. 3. -50, 50 Day CARs for the Sales Sample. *Note:* The vertical axis represents the cumulative abnormal returns based on a market adjusted model. All transactions CARs were multiplied by -1. The pre-change sample contains 551 transactions that occurred prior to January 2001. The post-change sample contains 53 transactions that occurred after 1 December 2002.

is likely a result of the fact that most of the sales are not information driven transactions. As explained in [Lakonishok and Lee \(2001\)](#) insiders can sell for a number of reasons including liquidity needs and diversification. [Tourani-Rad and Gilbert \(2004\)](#) also found that only a very small number of sales were timed to take advantage of bad news announcements although sales were still profitable. It may be that the high number of non-informational trades has allowed insiders to camouflage information driven trades more successfully than purchases.

We also check the impact of the regime change on insider profitability by employing regression analysis. [Table 4](#) presents the results of the regressions of the 0, 50 day CARs against a number of explanatory variables. Models 1, 4 and 7 regress insiders profits against a dummy that equals 1 for those transactions that occur in the post-change period. Models 2, 5 and 8 add to the previous models a dummy for transactions that occur during the change period while Models 3, 6 and 9 add in three dependent variables; the firm size, MV, and two dummies for the insiders position within the company, MD and CH. Numerous studies have found that insiders in larger companies earn smaller profits, largely due to the heightened media attentions and coverage which reduces the information asymmetry in those firms. [Lakonishok and Lee \(2001\)](#) and [Seyhun \(1998\)](#) have also found that the position of insiders can have a large impact on the profitability of their transactions

Table 4. Regression Model Results.

	Aggregate Sample			Purchase Sample			Sales Sample		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
Constant	0.0268*** (0.0045)	0.0276*** (0.0047)	0.0728*** (0.0161)	0.0260*** (0.0058)	0.0271*** (0.0062)	0.0652*** (0.0216)	0.0278*** (0.0071)	0.0283*** (0.0072)	0.0844*** (0.0247)
Post	−0.0067 (0.0088)	−0.0076 (0.0089)	−0.0059 (0.0087)	−0.0109 (0.0104)	−0.0120 (0.0106)	−0.0091 (0.0103)	−0.0010 (0.0159)	−0.0005 (0.0159)	−0.0044 (0.0163)
Change		−0.0077 (0.0116)	−0.0053 (0.0116)		−0.0116 (0.0142)	−0.0114 (0.0142)		0.0049 (0.0194)	0.0104 (0.0209)
MV			−0.0087*** (0.0025)			−0.0069** (0.0032)			−0.0115*** (0.0042)
MD			0.0162 (0.0140)			0.0012 (0.0164)			0.0407 (0.0258)
CH			0.0268*** (0.0102)			0.0227 (0.0145)			0.0283*** (0.0146)
Observations	1489	1489	1489	866	866	866	623	623	623
R ²	0.02%	0.02%	1.99%	0.05%	0.08%	1.12%	0.00%	0.02%	3.89%

Note: Standard errors are reported in parentheses. *Post* is a dummy variable that equals 1 for the months December 2002–December 2003. *Change* is a dummy variable that equals 1 for the months between January 2002 and November 2002. *MV* is the natural logarithm of the market capitalisation. *MD* is a dummy variable that equals 1 when a transaction is undertaken by a managing director or CEO. *CH* is a dummy variable that equals 1 when a transaction is undertaken by the Chairman of the board of directors.

** Significant at 5%.

*** Significant at 1%.

with managing directors and chairmen earning higher profits due to better access to information.

The results again suggest that the law changes have reduced the profitability of insider trading but have failed to have the significant impact expected. In all models the relationship between the profits earned by insiders and the *Post* variable is negative but insignificant. This supports the results in Table 3 which found reductions, albeit small ones in the case of sales, in the CARs of insiders following the introduction of the new act. It is also interesting to note that the *Change* variable is also negative in the aggregate and purchase sample models suggesting that the slight effect on insider profitability occurred prior to the law change. As expected, the regressions results show a significantly negative relationship between insiders profits and MV. Only trades by chairmen, CH, are important in terms of insiders position and only for the aggregate and sales sub-samples although it is close to being significant for the purchase sample. The results therefore suggest that the profits expropriated by insiders are smaller in large companies, likely due to less information asymmetry, and that chairmen are better at timing their sales than other insiders.

The results show that the new act has had some impact but that the effects have been smaller than expected. The difference in CARs, while reasonably large in economic terms for the aggregate (0.7%) and purchase sub-samples (1.2%), are insignificantly different between the pre and post-change periods. The purchase and aggregate trades also suggest a change in the trading patterns of insiders with the transactions appearing to be based on a more contrarian investment strategy. Further, the significance occurs much later, suggesting insiders are trading earlier to avoid regulatory scrutiny. The sales CARs are almost identical in both the pre and post-change periods with only the pre-trade returns causing any difference in the samples. These results are fully supported by the regressions which show insignificant negative relationships between the 0, 50 CARs and the *Post* dummy. While the results suggest only a marginal impact on profitability, they are in line with Jaffe (1974b) and Seyhun (1992) who both found little or no positive effect from tightened insider trading laws.

4. CONCLUSIONS

While the debate on the merits of insider trading is ongoing, the vast majority of countries have chosen to impose restrictions in the hope of maximising the benefits of insider trading and minimising the harm from it. The most visible aspect of insider trading, the profitability of the trades, has been well researched and almost universally established. However the impact of regulations on the expropriated

profits has only been the subject of minimal research restricted almost solely to the U.S. The scant evidence on this topic, in addition to other anecdotal findings, suggests that regulations do not reduce the profitability of insider trades. [Seyhun \(1992\)](#) even concluded that the tighter enforcement regime of the 1980s increased the abnormal returns accruing to insiders. This paper seeks to add to the literature by focusing on the experiences of a market with different legal structure. Further, the law changes considered are likely to more directly impact on legal rather than illegal insider trading, as was the case in [Seyhun \(1992\)](#) and [Jaffe \(1974b\)](#).

We examined the impact that the recently enacted Securities Market Amendment Act 2002 has had on the profitability of directors' trades in companies listed on the New Zealand Exchange. Transactions were separated into three samples; pre-change which included transactions between January 1996 and December 2001, change which contained trades between January 2002 and November 2002 and the post-change sample which encompassed share dealings between December 2002 and December 2003. A market adjusted model with various test periods was employed to calculate the profitability of each sample which were then compared to determine the effect of the new laws. A decrease in director share dealings in the period prior to the introduction of the act was observed with a small increase following its enactment. The results also showed that CARs were smaller for the change and post-change aggregate sample although this was largely driven by an economically significant decrease of over 1% in purchase sample CARs. The sales however showed no evidence of a decrease and the differences were statistically insignificant. Further, the regressions showed a negative but statistically insignificant relationship between the (0, 50) day CARs and the transactions occurring in the post change period.

The results therefore suggest that the new laws have had only a marginal impact on the profitability of insider trades. It is possible that an examination of a longer event period or a sample with more transactions post-change may find a more marked decrease in profitability although this will require more time to pass before such testing can be conducted. It is also possible that the full impact of the changes in the laws has yet to be established. [Bhattacharya and Daouk \(2002\)](#) found that it took the first enforcement of insider trading laws before a reduction in the cost of capital was experienced. This may prove to be the case in New Zealand, with the market requiring a demonstration of the political will and ability to enforce the new rules before the full effect of the changes are experienced. It should also be noted that while this paper has found that the new laws have had only a marginal impact on profitability, the new regime is likely to have effects on other areas in addition to abnormal returns. It may be that the new laws have had a larger impact on illegal insider trading, as shown by those factors, than it had on disclosed share dealings.

Moreover, the new regulations can have an impact on market structure elements such as liquidity, bid-ask spreads and the cost of capital as has been established in a recent paper by the authors (Gilbert et al., 2004).

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CORPORATE GOVERNANCE MECHANISMS IN ACTION: THE CASE OF AIR CANADA

Sean M. Hennessey

ABSTRACT

The resolution of conflicts between shareholders and managers, at minimal cost, is the goal of corporate governance. In 1999, an intriguing series of events occurred that dramatically reshaped the Canadian airline industry. This clinical study considers these events in relation to four corporate governance mechanisms. The results of this clinical study suggest that these four mechanisms may not be sufficient to control a management team that is committed to a course of action and to retaining their positions. In practice, corporate governance can be severely limited, even when the majority of board members are outside directors. In addition, institutional shareholders may not be the disciplining force that theory and logic suggests. Overall, the results imply that managerial entrenchment is a powerful motivating force that may be impossible to counter even for a large, poorly performing corporation that is subject to a very attractive takeover offer.

1. INTRODUCTION

Finance theory suggests that for publicly-traded companies, market and shareholder initiated actions will encourage superior performance. That is

the purpose of corporate governance. For managers who are not creating shareholder wealth, who are behaving in their own interests, or who are simply incompetent, shareholder and market mechanisms serve to check the inefficiency and penalize the outcome. These actions include decreases in compensation (through salary, bonus, or decreased value of options), reputation costs (poor corporate performance reflected on senior management), increased shareholder monitoring, and, ultimately, replacing current management either through firing or a corporate takeover.

This clinical study considers four approaches to corporate governance by examining the series of events affecting Air Canada in 1999. Air Canada (hereafter AC), the 12th largest airline in the world, is the dominant domestic and international airline operating in Canada. In 2000, AC directly served 188 destinations worldwide generating sales of \$9.3 billion. (In this paper all dollar amounts are in Canadian dollars.) The company's two classes of common shares (voting and non-voting) are widely held and actively traded on the Toronto Stock Exchange. Although 80% of the outstanding shares are held by institutional investors, by law no individual can hold or control more than 10% of the voting shares.

In late 1999, AC completed two major corporate transactions in response to a series of actions that began with friendly merger discussions with its major competitor. First, the company repurchased over 36% of their outstanding common shares, an action taken to avoid a hostile takeover. Second, AC bought and merged Canadian Airlines, once their main competitor, with their own operation. The net result was a complete restructuring of the Canadian airline industry.

The purpose of this clinical study is to consider whether the actions taken by the company's management, board, shareholders, and the market are consistent with the effective governance of the company. Numerous corporate governance issues arise when a poorly performing company engages in merger discussions with their main competitor, that evolves into a hostile takeover attempt by an unforeseen acquirer. The defeat of the takeover offer, concluding with the acquisition of the major competitor, enhances the opportunity to study the actual practice of corporate governance. Important questions considered are: Does the board act on behalf of shareholders? and Can the actions of the market and shareholders discipline corporate management?

A surprising aspect of this case is the lack of direct shareholder involvement in the attempted takeover of a large, widely-held Canadian company. The actions taken and statements made by the federal government and public opinion had a much larger impact on the affair than did the actions of both individual and

institutional shareholders. AC's board of directors appeared to put management's interest ahead of shareholders'. This is an unexpected outcome given that the takeover of an underperforming company was the key issue. The results of this clinical study, however, tend to support the widely accepted view that incumbent management often act in their own interest at the expense of shareholders (e.g. DeAngelo & DeAngelo, 2000; Jensen, 1986; Jensen & Meckling, 1976; Morck et al., 1988). The long-run maximization of firm value did not appear to be AC's governing objective.

AC had a long history of financial underperformance, questionable management decisions, and a woeful record of creating value. Yet, the shareholders and board allowed management to freely operate. During the 1990s, AC aggressively pursued a strategy of driving Canadian Airlines out of business, regardless of the cost. In the nine years to 1999, the company lost an average of \$36 million per year while shareholders saw their investment in AC decline by an average of 7.9% per year. Yet, in this period, AC invested over \$5 billion in capital assets while debt grew to almost \$3 billion and interest and lease costs approached \$900 million per year.

During 1999, the company successfully resisted a takeover offer that valued the company's voting (non-voting) shares at 2.7 (3.2) times the average market price in the 100-day pre-takeover period. The company then engaged in a very costly share repurchase program, financed mostly by debt, that resulted in a partial takeover of AC. Since 1999, the company lost huge sums of money and eventually filed for bankruptcy protection in April 2003. The company's shares are now worthless. Yet, the senior management responsible is still in place. This outcome with the long history of poor performance is inconsistent with the concepts of corporate governance, maximizing firm value, and the disciplining role of the market.

This study adds to the growing list of clinical studies that fully explore the impact a series of events have on a single company (e.g., the regular contributions published in JFE since 1989). In Canada, this is arguably the most prominent, interesting, and nastiest takeover battle to date. There are no previous Canadian clinical studies focusing on corporate governance issues and the evolution of the affair, with its numerous maneuvers, makes it intriguing even by American standards.

The paper is organized as follows. Section 2 provides an overview of corporate governance issues. Section 3 details the history and operating and share price performance of the three companies involved. The history of the AC affair over 11 months in 1999 are presented in Section 4 while Section 5 discusses the four major corporate governance mechanisms as they relate to AC. Section 6 concludes the paper.

2. OVERVIEW OF CORPORATE GOVERNANCE ISSUES

Theoretically, the principal financial goal of a public company is to maximize the long-run total value of the firm. For the modern corporation, however, the separation of ownership and control creates an agency problem.

Professional managers act as agents for the principals (common shareholders) in running the corporation.¹ The decisions made and actions taken by management impact shareholders and other stakeholders, but also the wealth, tenure, and reputation of management. Consequently, the senior managers of a company may pursue their own goals for personal gain. The resolution of the conflicts between the shareholders and managers, at minimal cost, is the goal of corporate governance.

Corporate governance is the set of actions and procedures that ensure a company is soundly managed so all investors receive a return on their investment that is reasonable given the risks involved. In many public companies, ownership is fragmented across many shareholders allowing management with no or a very small ownership position full control of the company (the residual right of control). In such cases, there can be significant agency problems and corporate governance is vital to ensure management's actions serve investors, not management. The objective of corporate governance is to ensure acceptable performance.

There are four approaches to corporate governance, four mechanisms that shareholders rely upon to ensure managers do not act in their own self-interest at the expense of investors. These are: 1) the board of directors who monitor management, 2) management compensation plan, including options, 3) the mechanism of the market that both evaluates management's performance (through the market price of the common shares) and allows individual shareholders to become holders of large voting blocks of shares concentrating ownership and control, and 4) takeovers.² Each of these mechanisms are considered below.

An obvious form of corporate governance is the board of directors who monitor management on behalf of shareholders. Boards, a regulatory phenomenon, are prevalent around the world and across organization type. The board's role is to directly represent shareholders' interests to management and ensure that management acts in the owners' best interests. This implies the maximization of firm value, not of management's income or tenure in their jobs. If a company's financial performance is poor, the ultimate power of the board (shareholders) is to replace underperforming managers. [Hermalin and Weisbach \(2003\)](#) review the literature concerning the effectiveness of boards.

A second component of corporate governance is management compensation plans. To align the interests of shareholders and management, tying compensation to the value of the company's common shares is often used ([Jensen & Meckling,](#)

1976). Stock options are a part of the compensation paid to the managers of many public companies. Theoretically, the greater the overlap between ownership and control, the lower the conflict between owners and managers. Too little ownership may lead to inefficient use of a company's free cash flow, or outright theft; too much, to management entrenchment and empire-building. Jensen and Warner (1988) suggest that there is some optimal level of ownership by management that fully aligns the interest of shareholders and managers. Both managers and shareholders have incentives to avoid management ownership stakes that do not align the interests of the two parties.

Third, the stock market provides a forum for corporate governance. When investors can freely trade their shares in efficiently-operated markets, the mechanism of market pricing allows shareholders to "vote" on management actions thereby minimizing agency costs and ensuring acceptable performance. If a company's financial performance is poor, shareholder "voting" in the stock market will result in the common share price declining, leading the board to question the poor performance of the company. In addition, stock options provided to managers will lose value or become worthless. This should lead to changes, either with the strategic direction of the company, the tactics the company is using to meet their goals, or with senior management.

In addition, institutional investors own the majority of the common shares of many companies. These professional managers, who hold large blocks of shares, would be expected to actively monitor a company's performance. Poor financial results, leading to declining share values, may provoke these institutional investors to gain control of a company's board and replace under-performing managers. In some cases, an institutional investor may hold a significant interest (between 5% and 10%) in a company for a long period of time. These "relational investors" are expected to play an important role in ensuring acceptable firm performance.

Fourth, a potent form of corporate governance is takeovers. Underperforming companies often attract the interest of others who feel they can run the company more efficiently and profitably, usually with a new management team. Shareholders benefit since the takeover price is generally at a significant premium to the market price prior to the takeover.

Theoretically, these four forms of corporate governance should ensure management maximizes shareholder value; there seems to be significant forces in place to ensure this occurs. But beginning with Adam Smith in 1776, expanded upon by Berle and Means (1932), and formalized by Jensen and Meckling (1976), an extensive literature has developed noting both the virtues and defects in the corporate governance process. Shleifer and Vishny (1997) and Denis and McConnell (2002) provide excellent reviews. There are a number of conclusions

that can be drawn from the literature as it relates to the four approaches to corporate governance.

First, while it seems the board of directors *should* afford excellent protection for shareholders, whether this occurs is still an open question. Recent antidotal evidence suggests that the boards of companies around the world have done a poor job of creating and protecting firm value. Boards often include the very managers the board supposedly monitors. While these inside directors may be a minority on the board, their positions in and knowledge of the company afford them powerful voices on the board. Furthermore, the outside (non-management) board members are often selected by and are sympathetic (some suggest beholden) to management. Obviously, this combination may result in the board being loyal to management, not shareholders, and thus an ineffective corporate governance mechanism. Much more work needs to be done on modeling the relation of the board, its membership, and actions to shareholder value.

Second, making managers owners attempts to mitigate the problems associated with the managers having the residual right of control of a company, but this approach shows mixed results. [Berle and Means \(1932\)](#) suggest management's ownership position is too small to act as an incentive. It is good financial planning for management to have no or a very small equity position in their employer. For diversification purposes, it makes sense to separate human wealth from financial wealth. So, the incentives put in place to encourage managers to become owners work against managers' self-interest to maintain a diversified portfolio of total wealth. A second problem with this approach is if management is convinced (or bribed) to assume a significant ownership stake in the company, an opposite incentive is created: develop a big enough stake to effectively control the company and become entrenched. Perhaps this approach to corporate governance is doomed to failure due to the conflicts in positions of managers and shareholders.

The evidence concerning this issue is mixed. [Jensen and Murphy \(1990\)](#) suggest that there is little relation between pay (salary, bonuses, and options) and company performance while [Yermack \(1997\)](#) and [Carter and Lynch \(2001\)](#) find that self-dealing often governs the awarding of options. Also, [Jensen and Murphy \(1990\)](#), [Cho \(1998\)](#), and [Demsetz and Villalonga \(2001\)](#) report that firm performance is not influenced by managerial ownership. Jensen's free cash flow theory contends that managers of companies with access to large cash reserves (either internal or external through unused borrowing capacity) are more likely to undertake low-benefit or even value-destroying transactions. [Morck et al. \(1990\)](#) hypothesize that poor corporate performance is associated with bad managers making decisions that meet managerial objectives, not the objective of maximizing shareholder value.

On the other hand, [Jensen and Meckling \(1976\)](#) contend that management's actions are "screened" from owners and tying management's compensation to the value of common shares controls managers' incentive to act in their own interests. [Shleifer and Vishny \(1989\)](#) argue that in the absence of significant ownership stakes, corporate governance does not work; managers undertake wealth-destroying activities to pursue their own goals to the detriment of shareholders. [Morck et al. \(1988\)](#), [McConnell and Servaes \(1990\)](#), and [Hermalin and Weisbach \(1991\)](#) report that firm performance is positively associated with managerial ownership. Also, [Bhagat et al. \(1999\)](#) find that boards are more likely to replace a poorly performing CEO when the board members hold a significant investment in the company.

Third, while the market recognizes good and bad company performance in share price, the mechanism of pricing itself is ill-suited to corporate governance. Falling share prices, on their own, do not discipline managers; shareholders and others must act. For companies with holders of large blocks of shares or those where institutional shareholders own the majority of shares, there seem to be major incentives to act. A shareholder with a large block of shares (a minority position of between 10 and 20%) is not subject to the free-rider problem and has significant incentive to monitor management's performance and act when performance lags.

Indeed, [Bethel et al. \(1998\)](#) report that purchases of large blocks of shares by activist investors lead to superior firm and share price performance. [Shleifer and Vishny \(1986\)](#) consider large shareholders "monitors" who can discipline managers and, if necessary, facilitate the replacement of poorly performing management through the voting of their shares. [Jarrell and Poulsen \(1987\)](#) and [Brickley et al. \(1988\)](#) report that institutional ownership is associated with a higher probability of dissidents winning proxy contests and with lower adoption of antitakeover proposals that often result in declining share prices. [Allen et al. \(2000\)](#) show that institutional investors reduce agency costs particularly for firms that pay high dividends. On the other hand, [Black \(1998\)](#), in a review of the limited literature concerning institutional investors, reports that institutional activism has little bearing on firm performance or actions.

This may be due to the fact that few institutional investors hold more than 10% of a company's common shares due to reporting requirements once this threshold is reached. It seems that when a group of institutional shareholders each hold a sizeable but minor stake in the company (1–5%), there is little benefit in terms of superior company performance. This may be due to the free-rider problem that reduces the incentives to act in anticipation that another party will do it.

Fourth, there is little question that takeovers address corporate governance problems ([Jensen, 1986, 1993](#); [Martin & McConnell, 1991](#); [Mikkelsen & Partch, 1997](#)). But, takeovers are an extreme, and expensive, corporate governance

mechanism that requires access to large amounts of capital and are open to political interference. In addition, they can create agency issues for the bidding firm's shareholders when empire-building is the motivation and the acquirer overpays (Shleifer & Vishny, 1997). Recent research and observation indicates that many takeovers over the past few years have not been successful due to overpayment. Moeller et al. (2005) report that acquiring firm shareholders lost \$120 per \$1,000 spent on takeovers for a total loss of \$240 billion during the stock market bubble of 1998 to 2001. The tremendous destruction of shareholder wealth was due to the overestimation of expected synergy gains.

This clinical study explores the issue of corporate governance for one Canadian company, Air Canada, during a period of intense control activity in 1999. This activity was motivated by a long period of company under-performance following the privatization of the company by the Canadian government in 1988. The study illustrates the four corporate governance mechanisms and how all failed to discipline the management of a company that was clearly underperforming on any measure. Superior performance often follows the privatization of a company (Megginson et al., 1994). This paper illustrates, however, that this may not occur if the privatization is not total. Real and/or perceived government association seems to severely retard the development of an effective corporate governance system.

This paper adds to the growing body of clinical studies that consider key theoretical and empirical issues from an individual company perspective. Multi-firm studies are one way to explore decisions or events. Clinical studies can raise new questions and provide in-depth analysis of interesting theoretical questions and extend empirical knowledge.

3. HISTORY AND OPERATING AND SHARE PRICE PERFORMANCE OF THE COMPANIES INVOLVED

AC, the dominant airline company in Canada, was formed in 1937 by the Canadian government as the national airline. Setting a precedent in the airline industry that was to be repeated, the national routes were given to AC over an alternative bid from a Winnipeg-based, private-sector airline operating in the Canadian west. The decision highlighted the federal government's position that the government should be involved in the operation of certain industries. As C.D. Howe, the Transport Minister at the time, stated: "With a private company chosen by competitive tender, it would be difficult to protect the *government* in the matter of a safe and adequate service."

AC then operated as a Crown Corporation, solely owned by the government, for the next 51 years. In October 1988, the federal government partially privatized

the airline selling 43% or 30.8 million common shares for \$8.00 per share. The government retained the remaining 57% of the company. The AC Public Participation Act authorizing the IPO, included a clause that limited one person or organization from owning or controlling more than 10% of AC's voting shares. In July 1989 the government's remaining interest was sold for \$12 per share. The company has since operated as a fully publicly-owned corporation.

While AC was based, by law, in Montreal, it maintained close ties to Ottawa, the country's capital. To some, the company was operated more like a subsidiary of the government than a publicly-traded company. While AC was profitable in some years, this may have had more to do with the favorable position the public company inherited (fleet, routes, financing, etc.) than with it being run like a profit-focused, shareholder-driven company. AC had two classes of common shares: the original voting shares and a non-voting "A" share that began trading in May 1995. Both classes were widely held and traded in Canada on the Toronto Stock Exchange. The "A" shares also traded on the NASDAQ exchange in the US but in very low volumes.

Until 2000, AC's major competitor was Canadian Airlines (formally PWA), an amalgam of five different airlines, that traced its start back to a bush plane operation in 1945. Based in the west, in the city of Calgary, Canadian Airlines (hereafter, CDN) and the predecessor airlines, felt they were more entrepreneurial operations than their central Canadian competitor. CDN was often critical of the favorable treatment they felt the government gave AC. This underdog image, part of the corporate culture, affected many of the company's decisions.

Throughout the 1990s, the Canadian airline industry was extremely competitive and even though the two airlines controlled, at minimum, 80% of the air travel market in Canada, both struggled. Between 1990 and 1993, AC and CDN each lost over a staggering \$1 billion on operations. Over the four-year period from 1995 to 1998, AC's average operating margin was a little over one-half of the 8% average recorded by the major US airlines while CDN's was negative. Had the two airlines achieved the 8% recorded by the US airlines, combined operating profits would have been over \$1.7 billion greater than the actual results.

Table 1 provides a summary of the financial results reported by the two airlines from 1990 through 1998. Over the nine years, AC had a cumulative loss of \$9.89 per share losing money in five of the years. CDN lost money in eight of the nine years with a cumulative loss of \$448.45 per share. For the two companies combined, the return on assets was negative in seven years and averaged a woeful -2.9% over the period. Losses for the industry totaled \$1.9 billion. Over the period, employment in the industry declined by 10%. Table 1 also indicates the substantial amount of capital that was invested in the industry during the 1990s and the industry's reliance on debt financing. AC's debt ratio averaged 81.1% over the nine years

Table 1. Summary Financial Results for the Canadian Airline Industry: 1990–1998 (in Millions).

	1990	1991	1992	1993	1994	1995	1996	1997	1998	Avg ^a
Panel A: Air Canada										
Operating revenue	\$3,899	\$3,485	\$3,501	\$3,598	\$4,024	\$4,507	\$4,880	\$5,572	\$5,932	\$4,378
Operating income	(\$11)	(\$200)	(\$197)	\$1	\$244	\$275	\$215	\$368	\$144	\$93
Operating margin	−0.28%	−5.74%	−5.63%	0.03%	6.06%	6.10%	4.41%	6.60%	2.43%	1.55%
Net income (loss)	(\$74)	(\$218)	(\$454)	(\$326)	\$129	\$62	\$149	\$427	(\$16)	(\$36)
Earnings per share	(\$1.01)	(\$2.94)	(\$6.13)	(\$4.23)	\$0.97	\$0.36	\$0.82	\$2.37	(\$0.10)	(\$9.89)
Profit margin	−1.90%	−6.26%	−12.97%	−9.06%	3.21%	1.38%	3.05%	7.66%	−0.27%	−1.68%
Total assets	\$4,579	\$4,921	\$4,810	\$5,039	\$4,997	\$5,397	\$5,441	\$5,991	\$6,422	\$5,289
Total long-term debt	\$2,194	\$2,970	\$3,330	\$3,435	\$3,340	\$2,813	\$3,033	\$2,940	\$2,917	\$2,997
Total shareholders equity	\$988	\$770	\$316	\$230	\$365	\$662	\$799	\$1,234	\$1,457	\$758
Total capital expenditures	\$673	\$993	\$598	\$395	\$410	\$326	\$607	\$439	\$730	\$575
Net investment cash flows	(\$583)	(\$829)	\$287	\$126	\$69	(\$263)	(\$166)	\$95	(\$640)	(\$212)
Capital structure										
Debt	69.89%	79.69%	91.45%	93.96%	90.30%	84.18%	80.31%	70.93%	69.12%	81.09%
Equity	30.11%	20.31%	8.55%	6.04%	9.70%	15.82%	19.69%	29.07%	30.08%	18.82%
Panel B: Cdn Airlines										
Operating revenue	\$2,745.6	\$2,871.5	\$2,737.2	\$2,785.4	\$2,964.7	\$3,136.5	\$3,096.4	\$3,077.5	\$3,171.3	\$2,954.0
Operating income	\$156.5	\$48.8	(\$108.7)	(\$64.9)	\$55.0	(\$26.7)	(\$94.1)	\$97.1	(\$21.8)	\$4.6
Operating margin	5.70%	1.70%	−3.97%	−2.33%	1.86%	−0.85%	−3.04%	3.16%	−0.69%	0.17%
Net income (loss)	(\$18.6)	(\$165.7)	(\$547.3)	(\$295.8)	(\$53.7)	(\$194.7)	(\$187.1)	\$5.4	(\$137.6)	(\$177.2)
Earnings per share ^b	(\$12.00)	(\$73.20)	(\$227.40)	(\$122.60)	(\$1.39)	(\$4.67)	(\$4.23)	\$0.09	(\$3.05)	(\$448.45)
Profit margin	−0.68%	−5.77%	−19.99%	−10.62%	−1.81%	−6.21%	−6.04%	0.18%	−4.34%	−6.14%
Total assets	\$2,964.4	\$2,811.1	\$2,461.9	\$2,265.4	\$2,335.9	\$2,233.6	\$1,866.7	\$1,911.2	\$2,098.6	\$2,327.6
Total long-term debt	\$1,552.4	\$1,543.1	\$1,684.9	\$1,566.1	\$1,115.1	\$1,018.9	\$841.0	\$826.8	\$1,008.0	\$1,239.6
Total shareholders equity	\$562.0	\$527.4	\$25.0	(\$266.8)	\$282.0	\$134.0	(\$28.6)	(\$23.2)	(\$159.8)	\$116.9
Total return on assets for both companies	−1.23%	−4.96%	−13.77%	−8.51%	1.03%	−1.74%	−0.52%	5.47%	−1.80%	−2.89%

^aFor EPS, the total over the nine years is provided. For all other items, the average over the period is provided.

^bEPS is adjusted for the 1 for 20 common share consolidation that occurred on May 4, 1995.

while CDN ended 1998 with negative equity of \$160 million. By the end of 1998, total long-term debt for the two companies approached \$4 billion, a suffocating amount given the level of operating income.

While both companies experienced financial problems during the 1990s, CDN's were much worse. CDN completed three major financial restructurings that included debt restructurings and a 1 for 20 common share consolidation. In 1992, the company received a controversial equity investment from American Airlines (AMR) that resulted in a 25% voting interest (the maximum foreign ownership allowed under federal law) but 34% economic interest, and also received financing from all employee groups and from the federal and two provincial governments. These miserable operational results seemed to be due to four factors.

First, by global standards, Canada has a small, widely-dispersed population. The vast majority of the population span the continent-wide Canada, US border. In Canada, there were roughly 15 million people per major carrier. In the US, the ratio was 55 million while in Germany it was 82 million people.

Second, this competitive disadvantage was compounded by fierce competition. CDN's ongoing strategy was to be a national carrier, regardless of the cost. AC and CDN competed for the same business and leisure travel market. In many markets, an AC flight was preceded or followed by a CDN flight within 15 minutes. CDN could have considered focusing on their international and western-based routes but their stated goal was to be in all markets as their competition. This turned out to be a very costly strategy. Compounding this was AC's strategy of trying to drive CDN out of business. For example, in 1999 AC increased capacity and then launched nine seat sales. It seemed that AC was willing to sacrifice short-term profits for the long-term goal of sole control of the industry.

Third, AC and CDN together carried only one-third of the passengers travelling from Canada to destinations outside North America. There was more incentive to connect their international passengers to their respective foreign carrier allies rather than to each other. Fourth, the federal government's involvement with the industry compounded the problems with both airlines. Supporting CDN while it was hemorrhaging cash only delayed the inevitable. Not fully exposing AC to market forces impeded the company's ability to become a customer-driver and shareholder-focused company. All involved, however, likely believed that they were following the correct path.

Onex Corporation, a diversified investment company formed in 1985, was the Canadian version of a leveraged buyout company. Onex's founder and CEO, Gerald Schwartz, had worked with Henry Kravis and Michael Milken in New York and decided to bring the skills learned back to Canada. Onex's strategy was to buy large, controlling ownership positions in leading but undervalued companies and grow company value. Onex was very successful. In the 14 years to 1998, Onex

acquired about 60 companies increasing the value of the invested capital by an average of 34% per year. In only one case did Onex fail to increase the value of an acquired company. As of June 30, 1999 Onex was one of the largest companies in Canada with controlling interests in 13 companies, assets of \$11 billion, and 58,000 employees. Over the most recent four quarters, sales and profits were \$11.4 billion and \$314 million, respectively. Since 1994, assets and sales grew at average annual rates of 51.4 and 61.3%. Schwartz was considered a patient investor who built shareholder value; he had been called the Warren Buffet of Canada.

The stock prices of the three companies reflected their respective operational results. The price of AC's voting shares was very erratic, opening the 1990s at over \$13 per share, falling to \$2.20 in January 1993, then rising to roughly \$15 in late 1997, before plummeting to \$6.00 in early 1999. For CDN, the stock price reflected the lengthy series of financial problems during the 1990s. On a post-consolidation basis, CDN opened trading at over \$400 a share in 1988. The stock price then systematically declined throughout the 1990s to less than \$2.00 by the end of 1998. Onex's share price opened the 1990s at a split-adjusted \$3.50, declined to the \$1.20 range in late 1990, fluctuated between these values for almost six years, but then increased to \$11.00 by the end of 1998.

Figure 1 displays the results of investing \$1,000 in AC (the voting shares), CDN, Onex, and TSE 300 Index at the beginning of 1990 and holding through



Fig. 1. Results of Investing \$1,000 in AC, CDN, Onex, and the TSE 300 from 1990 to 1998.

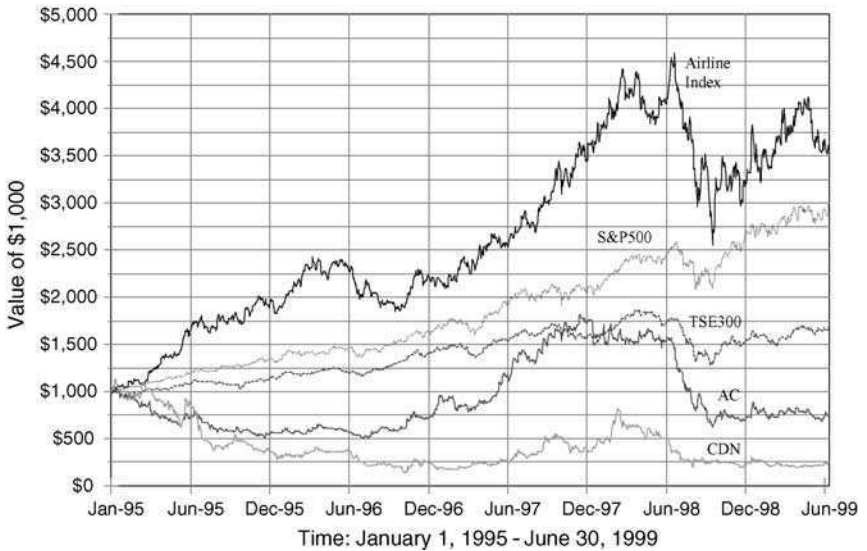


Fig. 2. Results of Investing \$1,000 in AC, CDN, TSE 300, S&P 500 and S&P Airline Indexes.

1998. The results are dramatic. An investor would have \$478, \$6.91, \$3,026, and \$1,634 respectively resulting in average yearly returns of -7.9 , -42.5 , 13.1 , and 5.6% . Figure 2 provides the results of investing \$1,000 in AC (the voting shares), CDN, the TSE 300 Index, the S&P 500 Index, and the S&P Airlines Index at the beginning of 1995 and holding through to June 30, 1999. The results are even more telling. Over the 4.5 years, investors would have lost \$260 and \$787 on AC and CDN, but made \$675 on the TSE 300 and \$1,990 on the S&P 500. For the Airline Index the return was \$2,608. Average yearly returns were -6.5 , -29.1 , 12.1 , 27.6 , and 33% , respectively. The latter half of the 1990s was a very good period for US equities, in general, but even better for US airlines.

The significant difference in the performance of the Canadian and US airlines apparent in Fig. 2 indicates that the Canadian airline problems were home-grown. One analyst reviewing the performance of the Canadian airlines stated: “US airlines are set on creating shareholder value. Profit means all to them, whereas here we’re more in survival mode.” A union leader commenting on the industry declared: “What business person in their right mind would sell their product for less than it costs? The war between the two airlines is a sibling rivalry.” With this history, the Canadian airline industry was ripe for restructuring. In 1999 this occurred and the chain of events dramatically reshaped the industry.

4. HISTORY OF THE AIR CANADA, CANADIAN, ONEX TAKEOVER BATTLE

In 1999, AC, CDN, and Onex engaged in a lengthy series of merger discussions that eventually failed but later evolved into a hotly contested and nasty takeover battle between AC and Onex. The control of the Canadian airline industry was the key issue in the battle, and the outcome would dramatically reshape the industry. Over the previous decade it had been made abundantly clear to all participants and observers of the industry that the current situation of two national carriers and a number of small regional carriers was not working and could never work given the population and geography of the country. A major restructuring was required. This section of the paper provides a history of this fascinating affair.

This may be the most widely reported business related story in Canadian history. For example, in the 1999 versions of the CBCA Business and Fulltext Reference Databases, 1,854 news stories are listed where both AC and CDN are discussed in the report. The level of interest transcended the business world and the impact of the takeover and merger on shareholders. The federal government was closely involved in the affair for several reasons. First, AC had been a Crown corporation for most of its existence so the government had a long history of close involvement in the industry. Second, the government had provided financial assistance to CDN a number of times during the 1990s. No politician wanted to be blamed if CDN failed. Finally, it was a government Order that established the process whereby the government would evaluate proposals to restructure the airline industry. Also, any deal required cabinet approval.

The public was involved. Many felt that a monopoly would be the result of an industry restructuring. The past decade had made it clear that the country could not support a hostile duopoly, two highly competitive national carriers operating hub-and-spokes airlines. As the affair evolved, this became a concern. Major issues were airline prices after the merger, the fate of regional services, job losses, and control of the merged airline. In making the bid, Onex briefly referred to the control issue, but they likely never believed it would become *the* issue associated with their bid.

AC and some of their unions (who were trying to protect jobs) mounted a very successful public relations campaign that focused on this concern. Critical media coverage further fueled the debate. The media played a prominent role in questioning the motives of the Onex bid, thus indirectly supporting AC's position. By the end of the affair, Onex was not only fighting AC, but also public opinion that came to believe the Onex bid would lead to an American company controlling the Canadian airline industry. This turned out to be the issue that Onex could never address to the satisfaction of many Canadians.

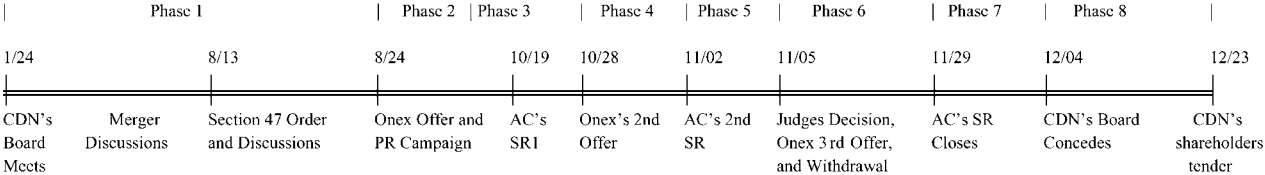


Fig. 3. Total Study Period and Major Phases Identified by Event.

Figure 3 illustrates the total time period considered and the major events that occurred in this period. All of the major events occur in an 11 month window from January 24, when CDN's board of directors met to discuss the company's financial options, through to December 23, the closing date of AC's offer to CDN's shareholders. The total period is divided into eight phases corresponding to major events. Figure 3 provides the dates and details. The phases are identified by the event when, in all cases except the first, the information was released to the market. Note that the Figure is not drawn to scale. Some of the phases are quite long, others only a matter of a few trading days.

Announcement dates for the many events associated with this case were taken from three sources. First, where a company issued an offer or management circular, the date on this document was used. Often the information in the documents was not widely circulated until the following day. Second, the three companies involved issued numerous press releases throughout the period and these were secondary sources of announcement dates. Finally, where neither of the previous documents was available, the date provided in one of the two major Canadian daily newspapers (*National Post* or *Globe and Mail*) was used. Numerous other company documents were also used including annual reports, annual information forms, and proxy circulars.³ Figures 4 and 5 illustrate the share price patterns for AC's voting (V) and non-voting (NV) shares over the total period.

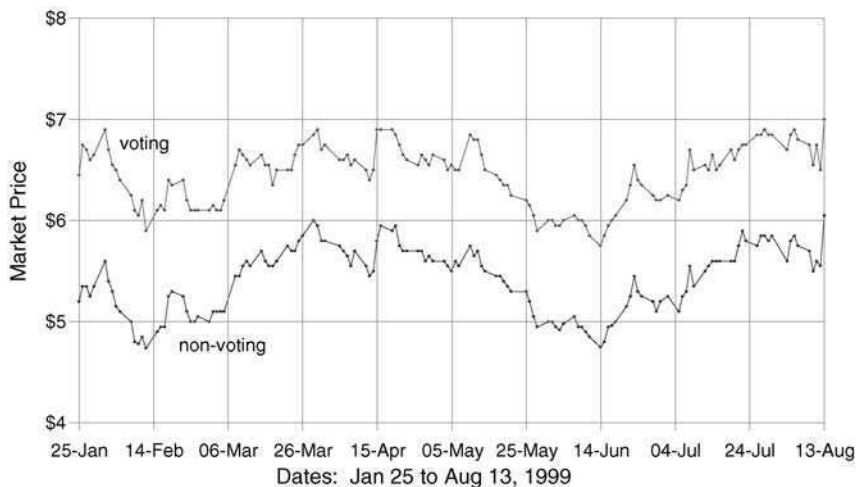


Fig. 4. Closing Market Prices on Air Canada's Two Share Classes: January 25 to August 13.

4.1. Phase 1 (January 24–August 23): Discussions Between AC and CDN, and the Section 47 Order

On January 24, CDN's board of directors held a meeting where the company's tenuous financial position was discussed. The Board realized that more financing, on its own, would not solve the over-capacity problem of the Canadian airline industry. Consequently, the Board directed senior management to begin discussions with various third parties, including AC and AMR, regarding an alliance or merger. On February 4, the CEOs of AC, CDN, and AMR secretly met and discussed the possibility of a merger. They agreed that senior representatives of the three companies should meet to further explore the idea of a merger. Beginning on February 11, and continuing for the next six weeks, the managers and their legal and financial advisors met numerous times to discuss the structure of a merger agreement. These talks were very secretive and the first public indication that they were taking place was reported on the newswires on March 23. The March 23 news reports, however, dismissed the idea of a merger and focused on route swaps between the two airlines.

On March 25, CDN and AMR made a joint merger proposal that was rejected by AC the next day. On April 14, AC made a counter-offer to CDN and AMR; an offer that was not made public and not reported in the press. The offer was not equitable and would have not been considered a serious bid. As expected, CDN and AMR quickly rejected the AC offer and negotiations ceased. On June 23, AC made a formal offer to buy CDN's international routes, an offer that had been made at least twice in the past. CDN and its principal owner AMR felt that the company would not be "financially viable" if these routes were sold. Rather than respond negatively to the offer, however, CDN attempted to put some public pressure on AC to negotiate a comprehensive merger.

On June 29 at CDN's annual meeting, CDN's CEO called on AC to discuss a reduction in "destructive competition" on domestic routes. CDN wanted to share those routes that could not support the services of both carriers. An industry analyst commented: "It looks like CDN is raising the white flag but why would AC want to help CDN, especially if it senses CDN is on the ropes? Milton is a take-no-prisoners kind of guy, he's got to think, 'oh, this is interesting, let me fine tune the sights on my rifle.' I don't think there's a cooperative bone in his body because to what end, it doesn't make any sense." As expected, on July 23 AC's offer expired and negotiations ceased.

Three weeks later, on August 13, the federal government, at CDN's request, issued a Section 47 Order suspending certain provisions of the Competition Act. This allowed the airlines to hold discussions and share confidential information to arrive at a private-sector solution regarding the restructuring of the airline industry.

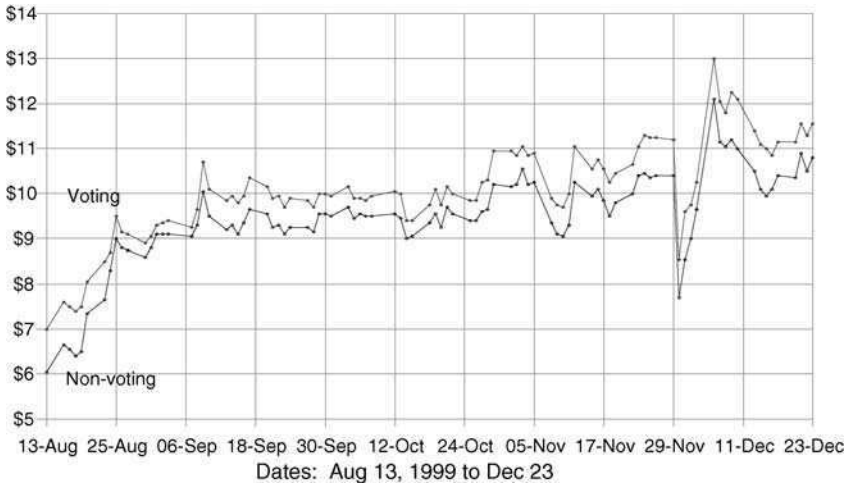


Fig. 5. Closing Market Prices on Air Canada's Two Share Classes: August 13 to December 23.

Figures 4 and 5 provide the reaction of AC's V and NV shares to the events that occurred in this period. AC's V (NV) shares opened trading on January 25 at \$6.45 (\$5.25), on August 12, the shares closed at \$6.50 (\$5.55), suggesting that little happened. The apparent lack of share price changes seems odd given the nature of the negotiations held. It could be explained, however, by the lack of media attention. While numerous discussions between various parties occurred from February through to August 13, the only media report appeared on March 23. It is surprising that only one story appeared in the press given the nature and number of people involved in the meetings.

At 3:50 EST on Friday, August 13, the TSE halted trading in ACs and CDN's shares. At 4:55 EST, the federal government announced the Section 47 Order. On August 13, AC's V (NV) shares opened at \$6.60 (\$5.60); on August 16 the shares closed trading at \$7.60 (\$6.65) after hitting highs of \$7.85 (\$7.20). In two trading days the shares moved 15.2% (18.75%) strongly suggesting the market believed AC was going to benefit from the announcement of the Section 47 Order (see Fig. 5).

4.2. Phase 2 (August 24 – October 19): Onex's Surprise Announcement and PR Campaign

On August 24, Onex, an investment company with a long history of extracting value from underperforming companies it acquired, made an announcement that

shocked AC, most in the investment community, and the federal government. Onex offered to buy AC for \$8.25 per share (both V and NV) and CDN for \$2.00 per share and then merge the two airlines. The offer was open for acceptance until November 9. Including debt, the deal was valued at \$5.7 billion.

AC's share prices significantly increased in the period before the offer (see Fig. 5). Perhaps information regarding Onex's forthcoming surprise offer was leaked to the market, the market expected an offer (although no serious bidder was mentioned in the financial press), or the market expected AC to be the principal beneficiary of the Section 47 Order. Regardless of the reason, over the eight trading days following the Section 47 Order, the V (NV) shares increased by 35.7% (50%). Obviously the market was anticipating a very positive event for AC, in general, but for the NV shareholders, in particular. In addition, by August 25, both shares were trading for more than Onex's offer price.

The Onex offer was the result of two sets of secret meetings between Onex, CDN, and AMR. In early 1999, while CDN and AMR were negotiating with AC, they also approached Onex concerning a possible investment in CDN. In April, Onex rejected CDN's overtures suggesting that the airline industry was structurally unsound and required major restructuring to be viable. By early May, with the AC talks in limbo, the three companies began discussing a merger of AC and CDN; a transaction that Onex believed would lead to long-term profitability for the industry. The August announcement was the cumulation of these negotiations.

As expected, CDN and AMR, quickly backed the offer. In making the offer Gerald Schwartz, CEO of Onex stated: "We are pleased to be able to put forward a plan that addresses industry and government objectives, provides a substantial working capital infusion and, at the same time, offers clear benefits for Canadian travellers and communities, attractive opportunities for employees and shareholders of AC and CDN, and excellent long-term value for Onex shareholders. We feel strongly that this is the right private sector solution: comprehensive, long-term, sustainable and requiring no government or taxpayer money. As the Government has acknowledged, the status quo is clearly not sustainable. We hope to enter into discussions with AC's board of directors and we expect that, once it has had an opportunity to fully review the benefits of the proposal, it will recommend acceptance by AC shareholders."

Canadian Business magazine described the announcement as the: "sucker punch of the year, and nobody felt it more than [AC's newly appointed CEO Robert] Milton." (October 8, 1999, p. 37). Milton had been appointed CEO only in August, the third American in a row to hold the job. At this point, the "private-sector solution" to the airline industry's woes became a heavyweight fight between Milton and Gerald Schwartz, Onex's CEO. The public relations battle started on August

24 but really heated up in September. By October, it would become brutal and very personal.

Prior to August 24, AC was “confident and cocky,” feeling they were the “only horse in the race.” Since AC was truly shocked at the Onex bid, their first focus was defense; it took the company a few weeks to muster a counterattack. AC’s statement on the 24th contended that the bid “was below market value, had little merit and favored CDN.” Onex suggested that the takeovers and merger were needed since AC had failed to create shareholder value and Onex would correct this. Schwartz added: “An AC shareholder could have put his money in a tin can, buried it in the backyard and 11 years later had more money than he did by investing in AC stock.” (*Canadian Business*, October 8, 1999, p. 38).

On August 31, AC made two defensive announcements. First, the company announced a shareholder rights plan or “poison pill.” Under this plan, if more than 10% of the common shares were acquired by an unfriendly purchaser, AC would issue one right for each share outstanding. The company also started to search for a “white knight.” Second, a special shareholders meeting was called for January 7, 2000 (two months after the Onex bid expired) to consider the rights plan and the Onex proposal. Onex’s reaction to the second tactic was immediate; on the 31st they applied to the courts for an order requiring AC hold the special shareholders meeting on a timely basis and prior to the expiry date.

In the period after the bid, both sides tried to convince the federal government, the labour unions, the media, AC’s shareholders, and the public that their plan was best for the industry, workers, shareholders, and the country. After the bid was announced, the federal government attempted to act impartial. A spokesperson for the Department of Transport said: “I can give you absolute assurance that the Onex deal is not sanctioned by the government. The government has no official opinion on the bid. It’s a market-driven solution. The Minister’s made it clear that’s what he wants. It’s up to the shareholders of AC and CDN.” The truth of this was suspect given that any transaction would have to be approved by the federal cabinet and the government would have to lift the AC 10% ownership rule for the Onex bid to proceed. In truth, government support to any plan was vital. It was very clear, however, the government wanted a solution that resulted in CDN’s survival, in some form. Onex’s proposal provided this.

In addition, in some circles it was felt that Onex’s strong connections to the governing Liberal party meant the government favored Onex. At one time, Schwartz had been the chief fund-raiser for the Liberals and had worked on the party’s 1997 federal re-election campaign. Also, a number of people closely associated with CDN and AMR were prominent Liberals. Others insisted that AC, with its 51-year history as a government-owned Crown Corporation, its past history

of receiving favorable government decisions, and strong Liberal connections, was supported by government.

The fate of the 39,000 employees of both airlines was also a divisive issue. CDN workers fully supported their company and the Onex bid. One stated: "AC is the dragon. We've slain the dragon. All we are waiting for now is to put the head in the guillotine." AC's unions presented a mixed picture. The pilots came out early and strongly against the deal with one union leader stating: "This deal is repugnant to AC pilots. Making AC employees pay for the mismanagement of CDN. It's very, very sensitive right now."

Three of the other unions were split by the bid since they represented members at both airlines. It was clear, however, that a merged airline would not require all of the workers and there was a marked divide between the employees at the two airlines. It was expected that AC's workforce would suffer the majority of the job losses since layoffs are based on seniority and AC had more junior staff. This feeling of rift was well described by a CDN employee: "We definitely have a culture clash, east coast versus west coast. We used to have pep rallies where we shouted better dead than red (AC's company colors). AC has tried for years to put us out of business so don't look to the CDN workers for sympathy."

Two of the AC unions also focused on the issue of who would control the merged airline. With AMR involved, it was argued, the American company would assume control. To union members this would mean head office jobs would be lost to Americans, to nationalistic Canadians it would mean the country would lose control of the vital airline industry, an issue that dated back to 1937 when the government awarded the national routes to AC. AC quickly recognized the power of this argument and it became a key part of the strategy used to fight the Onex takeover bid. The argument was ironic, however, for three reasons.

First, under the Onex bid, AMR ownership position (and economic interest) would decline from 25% (34%) of CDN to 14.9% of the merged airline. Public shareholders would hold 52.2%. AC contended, however, that Onex and AMR would jointly own 57% of the merged airline. Second, AMR had publicly stated that it would not increase its equity interest but intended to divest its holdings in the merged airline when market conditions were appropriate. Third, while the CEOs of CDN, Onex, and even AMR were Canadians, AC's three most recent CEOs were Americans. Yet AC would very successfully target Schwartz personally with an intense PR campaign. AC accused him of being "the face" for AMR.

On September 7, Onex mailed its offer to the shareholders of both companies. The offer disclosed that on June 15 Onex had begun purchasing AC's V and NV shares and by August 20 held almost 8.2 million or 4.3% of the total number of shares outstanding. Of these shares, 54.8% were NV shares. On September 20, AC

responded to the Onex bid claiming it was illegal since it violated the regulation that limited ownership of the company by any one party to 10% of the V shares. The company recommended shareholders reject the offer and announced they were commencing legal action to have the Onex bid declared void.

On September 28, the decision in the Onex court case requiring AC hold the special shareholders meeting on November 8 was released in favour of Onex. Also on September 28, the federal Transport Minister held a press conference concerning the Onex plan and its impact on five public policy issues. The Minister made the government's position clear stating: "The market alone will not decide what is in the best interest of Canadians."

Schwartz became the face of the Onex bid. He appeared before politicians, editorial boards, and, almost daily, in the media. He was widely interviewed on TV, radio, newspapers, and even Internet chatrooms. In his public appearances to sell the Onex bid to the public, however, Schwartz was deemed as "stiff" and some felt he was not convincing. Both sides were also using separate Websites and extensive newspaper and even radio advertising to sell their story to the public. It was common to see double-page ads in the national newspapers in support of either AC or Onex. At AC, union members were wearing, and distributing to passengers, anti-Onex lapel buttons and stickers. Both sides spent millions to market their message and the contest took on the aura of a political campaign, not a takeover.

By the second week of October, the Onex bid was in trouble and it appeared they were losing the public relations war. On October 8, AC released a management circular that strongly recommended against the Onex offer. To counter the AC campaign, on October 8, Onex publicly announced a number of "Commitments to Canadians," concerning the five public policy issues raised by the Transport Minister in the September 28 press conference. The key issues addressed by Onex included company control, fares for air travel, seat sales, employment assurances, and service to smaller communities. The company described these as "ironclad commitments," providing strong guarantees of compliance.

On October 13, Onex released a circular seeking shareholder support for their offer. In the document, Onex suggested that AC, in their October 8 circular, threatened to take away shareholders' rights to vote at the special meeting if Onex's offer was accepted. Onex claimed AC's management was intimidating and disenfranchising shareholders and trying to entrench management.

By October 14, AC was convinced they had won the brutal public relations war. In the Liberal caucus meeting on October 13, MPs peppered the Transport Minister with questions and concerns about the Onex bid. The MPs decided to hold their own review of the Onex bid, and indicated that they would not be held to the November 8 deadline set by Onex. The MPs did not want to be rushed and the

leadership seemed to be backing away from Oxex. At AC, a spokesperson stated: “The Onex bid doesn’t have the support of our shareholders. We’re pleased there seems to be support from a number of places,” referring to the outcry from some politicians, media, and the public to the Onex bid.

While the first statement was questionable, since 80% of AC’s shares were held by institutions and these shareholders were more secretive regarding their voting intentions and should not be swayed by emotional arguments, the latter statement was very true. By October 14, analysts were suggesting the Onex bid: “is not going to go anywhere. These are very smart business guys at Onex, but business interests alone don’t always dictate what happens. I don’t think Schwartz knew it was going to be this rough. If it gets too ugly or messy, they’ll walk away.” In two weeks, there had been a dramatic change in the tone of the public relations battle and this change was impacting AC’s share prices.

4.3. Phase 3 (October 19–28): AC’s Share Repurchase Plan

On October 19, AC finally announced their long expected proposal to counter the Onex bid. AC offered to repurchase 35% of their common shares, both the V and NV, at \$12 per share and to buy CDN for \$2.00 per share. The offer also stated that AC and CDN would not be merged but operated as separate companies with CDN becoming a subsidiary of AC. Robert Milton, AC’s CEO, said: “It’s a made-in-Canada solution to the problems affecting the airline industry. It’s absolutely the best for this country. No AC employee will face job loss.” Two offers were now outstanding, a takeover and a share repurchase (SR). Both offers treated V and NV shareholders identically, yet the NV shares were still trading for substantially less than the V (see Fig. 5).

To finance the SR and takeover, AC turned to their business partners. United Airlines and Lufthansa, two of AC’s partners in the airline marketing group Star Alliance, provided \$732.4 million of financing to keep AC in the Star Alliance network. The Onex bid would shift AC, and the billions of dollars of connector fares, from the Star Alliance network to the AMR-led One-World alliance. The financial support was provided after AC extended its membership in Star Alliance for a further 10-year period. In addition, the airlines would each receive a 3.5% ownership position in AC. The Canadian Imperial Bank of Commerce (CIBC) provided \$200 million of financing after AC extended the Bank’s exclusive VISA AC air points program for a further eight years. In addition, the Bank received 4.7 million warrants that upon conversion would provide a 3% ownership interest in AC. Both of these agreements, others type of “poison-pills,” were designed to “repel” the Onex bid.

4.4. Phases 4 and 5 (October 28 – November 5): The Revised Offers and Court Decision

Not seeing any increase in public support for their bid, and with time running out, Onex tried to sway shareholders with the long-awaited increase in their offer. On October 28, Onex increased their offer for AC by over 57% to \$13.00 per share and accused AC of selling out the airline to the Star Alliance partners. The market reaction to the announcement was, again, surprising.

On October 26, the V (NV) shares closed at \$9.85 (\$9.40). The closes on October 29 at \$10.95 (\$10.20) were only modestly higher (11.2 and 8.5%). This is a very muted response to a 57.6% increase in the takeover offer, seemingly, a very positive announcement. Again, the smaller reaction for the NV shares seems irrational given that the higher offer price applied to both the V and NV shares. This market response should have suggested to Onex that their bid was in trouble, or that investors were confused by the two competing offers. Given that 80% of AC's shareholders were institutional investors, however, the merits of a partial share repurchase and a total takeover should not have been difficult to analyze. The lack of market "excitement" concerning the revised offer should have been a warning to Onex.

On November 2, AC responded with a revised Issuer Bid. The company offered to repurchase a total of 68,750,000 common shares, both V and NV, representing 36.4% of the outstanding shares for \$16 per share. The offer was open for acceptance until 5:00 pm EST on November 29, 1999 unless withdrawn or extended and was not conditional on the outcome of the Onex bid. Milton suggested AC had been "trying to set the record straight, to talk the truth."

While November 8 was the date of the special meeting of AC's shareholders that had been called by Onex, November 5 was the date that a court ruling was due on AC's case that Onex's bid contravened the AC Act that limited individual ownership to 10% of the company's V common shares. Onex worked all day and night on the 4th preparing a revised offer in anticipation of a favorable court ruling. At the unusual time of 7:00 am, the company announced they were willing to increase their offer to \$17.50 per AC share, over double their original offer. Later that morning, AC's board recommended shareholders reject the offer and awaited the court ruling that was due at 3:00 pm.

In a decision viewed surprising by most people involved in the process, a Quebec Superior Court judge ruled that the Onex bid was illegal since it violated the AC ownership rule. AC announced that the court ruling would not affect their Issuer Bid. Onex attempted one last time to have the government change the ownership rule but the government was well aware of the public mood and refused. Later that day Onex withdrew their offer. Like many hard-fought competitive events, the end

came quickly. The intense public relations campaign led to an emotional, “I can’t lose” bidding war and at the end Robert Milton was the CEO left standing. The airline war was over.

The market reaction to the resolution of the affair was as expected given the outcome. The share prices started to decline on November 1 and continued to decline for the next three trading days. Surprisingly, there was almost no reaction on Friday, November 5, the day that all of the activity took place. Given that the court ruling was released at 3:00 pm, market participants had almost a full hour to trade on the decision. That this did not occur leads an observer to question what traders were doing that Friday afternoon in early November. By Wednesday, November 10, the market prices of the V (NV) shares had declined to \$9.70 (\$9.05) (see Fig. 5).

4.5. Phases 6, 7, and 8 (November 9 – December 23): AC’s SR Closes and CDN Concedes

On November 29, the V and NV shares ended the day trading at \$11.20 and \$10.40 respectively. On November 30, the day after the Issuer Bid closed, AC’s shares closed trading at \$8.55 for the V and \$7.70 for the NV. The shares were trading at lower prices than on August 24, the day of the first Onex offer. AC repurchased 41,670,000 V shares and 27,080,000 NV “A” shares costing the company \$1.1 billion.

CDN released a Directors’ Circular on November 28 indicating that while AC’s offer of \$2.00 per share was fair financially, the Board would not recommend acceptance. Rather the company would continue to pursue alternative financial arrangements in an attempt to remain a separate company. Unable to find investors, on Saturday, December 4 CDN accepted the inevitable and conceded, recommending shareholders accept AC’s offer.

With AC’s victory in the great airline dogfight almost assured, AC’s V shares opened trading on Monday, December 6 at \$11.20 and closed at \$13, up \$2.75 or 26.8% on the day. The NV shares opened at \$10.40 and closed at \$12.10, up \$2.45 or 25.4%, essentially offsetting the earlier declines. Over 9.5 million shares of both series were traded. But, between December 7 and 20, the shares drifted down.

On December 21, the federal government approved AC’s actions to restructure the Canadian airline industry. The final act in the affair occurred on December 23, the closing date of AC’s offer to CDN’s shareholders. AC announced that all of the conditions associated with the offer were met including an agreement with AMR and the tendering of over 50% of CDN’s common shares.⁴

Robert Milton concluded the saga stating: “We have an opportunity now to build on the success and histories of two great Canadian airline franchises of which Canadians can be truly proud ... for shareholders this means greater opportunities to benefit as we grow.” AC’s shares closed the day at \$11.55 and \$10.80 respectively. Given that AC finally got what it had been seeking throughout the 1990s (apparent control of the Canadian airline industry), it is not clear why the share price would decline so sharply over the previous five trading days to a level well below the second Onex offer and the \$12 AC’s shareholders paid in July 1989 for the secondary issue of 57% of the company’s shares.

This act formally concluded one of the more intriguing but nastiest takeover battles and one of the bitterest corporate rivalries in the country. It also meant that after a protracted series of events, AC eventually achieved its original goal: the (almost) complete control of the Canadian airline industry – but at a much higher cost than originally expected. The two transactions (the SR and takeover of CDN) cost AC about \$1.2 billion and were financed by \$705 million of debt, preferred share, and lease financing, and by \$485 million of cash. The transactions had a major impact on the company’s capital structure with common equity falling from 30.1% of capital in the 1998 fiscal year to 13.1% of capital in 1999.

5. DISCUSSION OF THE FOUR CORPORATE GOVERNANCE MECHANISMS

5.1. Actions of AC’s Board

AC’s lengthy and costly history of trying to drive CDN out of business, the company’s long history of poor financial results, AC’s long-term underperformance relative to US airlines and the TSE 300 Index (itself a significant underperformer to the US market, see Fig. 2), and the stated objectives of AC’s various CEOs of becoming a large international airline are consistent with the managerial objectives hypothesis (Morck et al., 1990). In 1992 AC had the opportunity to merge with CDN at little financial or political cost. In September 1992, AC offered to acquire CDN (then PWA) for about \$200 million. After rejecting three earlier offers, CDN finally accepted AC’s fourth offer. About one month later, AC inexplicitly withdrew the previously accepted offer. Rather than negotiate a “peaceful surrender” and give CDN a way out, instead, it seemed, AC’s management wanted to “crush” CDN.

In 1995, Canada and the US signed the Open Skies agreement that deregulated transborder air travel. In response, AC raised \$500 million in equity financing to significantly expand the airline even though the company’s passenger load factor had declined throughout the 1990s. The move was viewed as a way to step-up

pressure on CDN; blow the company out of the skies and then strip it for the best parts (the international airline routes) at very low cost. The plan did not work and between 1996 and 1998 the Canadian airline industry lost money at a time when oil prices and interest rates were both low; a period when US airlines earned very high profits (see Fig. 2). CDN's ability to stay afloat, against numerous obstacles and tremendous cash flow pressures must have been an ongoing frustration for AC's management.

These decisions were surprising since in AC's 1992 annual report, the CEO discussed the advantages of a merger between AC and CDN and suggested that the continuation of the status quo would lead to the two companies seeking international partners on less than favourable terms. While the merger eventually occurred, the delay of seven years led to both large losses for the industry and the large international presence in the industry. AC's decisions seemed to result in all of the worst outcomes. These actions do, however, support Morck's et al. (1990) view that poor corporate performance is due to poor decisions by bad managers. The events also support Bruner's (1999) value-destroying path dependence hypothesis. Bruner suggests that decisions managers made in the past constrain choices in the present. Managers get on a path, a way of thinking about a solution to a problem, that is difficult to get off. In AC's case, the path transcended CEOs. Three different CEOs all thought driving CDN out of business was the best solution to their problems and a way to achieve the goal of becoming a large international airline.

On the cover of their 1999 annual report, after the victory over Onex, the only words are: "A true global franchise." On the inside front cover the following statement is found: "The takeover bid defeated, AC's proposal for kick starting a long-awaited industry restructuring prevailed. . . . Many years from now, we may look back on the events of 1999 for precipitating a rational, market-driven competitive environment, one in which AC gained the freedom to become Canada's truly global airline."

While AC's long-sought goal had been achieved, the path was followed at great cost to shareholders. It seemed the board agreed with management's path as they did not intervene to change the company's direction. AC's financial and market performance over the 1992–1998 period suggested that the strategy was not working. A comparison of AC's performance to that of the U.S. airline industry in general (see Fig. 2) further highlights the underperformance. The board's apparent lack of action suggests that shareholders' interests were not their primary concern.

AC's corporate governance structure appeared to provide an environment where management was directed and their actions scrutinized. As written in various AC documents: "the board represents shareholder interests by providing strategic direction to management and reviewing the business of AC, like its strategic and business plans and major capital acquisitions." Throughout the 1990s, the vast

majority of the board members were unrelated to the company as were the members of the five permanent board committees. The committees and full board met on a regular basis throughout the year.

This structure seemed to provide sufficient opportunity for the board members to hold AC's management responsible for their decisions and the company's subpar performance. The ongoing underperformance of the company suggests that this did not occur. After a hugely disappointing 1998 fiscal year, the chairman of the board, in his report to shareholders, wrote: "Your board of directors is strongly supportive of the program formulated . . . to bring about balanced change to lift the airline to higher levels of profitability." Based on AC's financial results during 1990, as presented in [Table 1](#), this is a surprisingly supportive statement for a group that represents shareholders.⁵

Management's proposal and the board's support and later adoption of a number of antitakeover amendments in response to the Onex takeover offer raises questions concerning the board's motives in agreeing to proposals that entrenched management. It is not clear who represented shareholders in these discussions. This evidence suggests that AC's governance structure and compensation plans did not encourage its management to act for the benefit of shareholders but rather in their own interests. Overall, AC's operational, financial, and market performance portray a company that was "out of control," lacking any type of supervision or accountability. It seemed senior management could do whatever they wanted in pursuit of the long sought goal of "becoming a global player." It appears the board raised few concerns.

For example, the boards support of the share repurchase raises questions. The net effect of the repurchase was a partial takeover of AC to "repel" the total takeover of the company by Onex. The Star Alliance members and the CIBC gained a 10% interest in AC while the company (on behalf of the remaining common shareholders) acquired the other 26.4%. The 10% stake was acquired indirectly. AC sold contract extensions and the 10% ownership stake for \$932.4 million that was then used to finance the repurchase.

[Spencer et al. \(1998\)](#) contend that partial takeovers are cheap ways for acquiring companies to gain either total or partial managerial control. This seems to have occurred in this case. The financing provided by the Star Alliance partners and the CIBC was conditional on very beneficial contract extensions that tied AC to these companies, preventing AC from evaluating alternative, perhaps more profitable, contracts. The deals contained covenants that prohibited AC from considering other airline alliance proposals or violating the existing alliance, from selling planes, routes, or airline slots or gates, and from paying dividends or other distributions, if common equity fell below a slated value. The deal tied AC and any acquirer to these partners for an extended period of time. It would

be reasonable for AC's shareholders to expect that valuable company assets (the contract extensions) would be managed to increase company value, not entrench management. The repurchase, leading to the partial takeover, seems to have resulted in AC's partners gaining some control over AC's managerial decisions at the expense of shareholders.

There is little evidence that the SR was meant to create value for the public shareholders. Rather it seemed this transaction was associated with board supported management entrenchment. During 1999, the full board held 42 meetings, a very high number given that historically it was usual for the board to meet about 12 times per year. A special six-member ad hoc committee of the board formed to review the Onex offer met another 19 times. Over a three-month period, the full or partial board discussed the Onex takeover offer close to 50 times.

That not one of Onex's three offers was viewed as beneficial to shareholders is shocking given AC's history of destroying value. Onex's final offer of \$17.50 per share was rejected by the board in less than four hours yet this offer provided V (NV) shareholders with a 170% (220%) premium over the average market price in the 100-day pre-takeover period. It would be legitimate for shareholders to question the actions and motives of AC's board.

Following Onex's initial offer of \$8.25 per AC share on August 24, a number of analysts suggested that the offer was low. Others, however, noted that the offer price was 26.9% (48.6%) higher than the market price for the V (NV) shares on August 12, one day before the Section 47 order was issued. Analysts who thought the offer was low believed that a low double-digits offer would have to be seriously considered, especially given the company's miserable history of creating shareholder value. An institutional investor stated: "Everybody is sitting back waiting for the other shoe to drop. My guess is there's not a lot of shareholder pressure to take this bid. My guess is \$8.25 allows the directors of AC a little wiggle room. A price of \$9 and change gives them significantly less wiggle room. Double-digits, I think there would be immense pressure on directors from shareholders."

That pressure was not applied is almost inconceivable. It seems that shareholders and their representatives, the board, were mute while AC's management and the federal government controlled the debate. The actions (or lack thereof) of AC's board appear to provide support for *Adam Smith's (1776)* view, that directors are negligent and profuse, not as vigilant with other people's money as with their own.

5.2. Compensation of Management and Board

Management and board compensation also portray a company lacking effective governance and management accountability. Compensation bore little relation to

the company's operating results. Over the 1990s, while shareholders suffered large declines in wealth, management enjoyed high levels of compensation. Table 2 reports the compensation paid to the AC's CEO and the next four most highly compensated managers since 1993, the first year publicly-traded companies in Canada were required to report this data. All compensation including salary, bonuses, other payments, and the value stock options is provided. The results are enlightening.

While shareholders saw the value of their investment in AC decline by over 50% during the 1990s, senior managers of the company experienced significant increases in compensation. In 1993, the top five managers earned a total of almost \$2.5 million. By 1999, the top five managers split over \$7.2 million. The 1999 payment excludes the almost \$7.7 million AC paid to the retiring CEO and Senior Executive V-P. Also, since these two executives retired on September 1, the salary of their replacements is artificially depressed. The board was quite generous to the senior managers of an underperforming company.⁶

Compensation paid to the directors presents a similar picture. In 1989, the total compensation received by the 14 members of the board of directors was \$62,100 based on a fee of \$300 per board or board committee meeting attended, an average of \$4,435 per board member. The board members held 103,000 shares of AC, 0.14% of the shares outstanding. In 1996, AC had 14 members on their board, 11 of these were unrelated members. In total the directors owned 136,692 shares (by exercising options, the retiring CEO owned 46% of these shares) amounting to 0.09% of the shares outstanding. Board members received a retainer of \$15,000 per year and the five unrelated chairs of the board committees an additional \$3,000. Members received \$700 for each meeting attended. During 1996, the full board met 12 times and the five committees met an average of seven times. So an unrelated board member attending all meeting and being the chair of one committee could receive \$31,300 in compensation, a significant increase from 1989.

By 1998, the 13 board members owned fewer AC shares, 51,832, 0.03% of the shares outstanding while the retainer increased to \$25,000 per year with an additional \$4,000 for chairs of the board committees. Meeting fees increased to \$1,000 per meeting attended. During 1998, the full board met 14 times and the five committees averaged five meetings. So an unrelated board member attending all meeting and being the chair of one committee could receive \$48,000 in compensation, another large increase.

In 1999, the 13 directors owned 73,623 shares, 0.04% of the shares outstanding while the retainer had increased to \$37,000 per year with an additional \$4,000 for chairs of the board committees. Meeting fees remained at \$1,000 per meeting attended. During 1999, the full board met 42 times and the six committees averaged

Table 2. Total Payments Made to AC's CEO and the Four Other Most Highly Compensated Managers.^a

	1993	1994	1995	1996 ^b	1997	1998	1999 ^c
Annual compensation ^d	\$1,813,319	\$2,563,709	\$2,406,059	\$2,596,938	\$3,320,231	\$2,293,445	\$3,064,783
Value of options exercised ^e		340,879	319,277	19,910	305,054	317,701	197,847
Value of all in-the-money options ^f	\$639,189	1,816,076	\$196,971	405,773	\$5,716,579	279,489	\$3,964,703
Total	\$2,452,508	\$4,720,664	\$2,922,307	\$3,022,621	\$9,341,864	\$2,890,635	\$7,227,333

^aIn Canada public companies are only required to report compensation information for the CEO and the four other most highly compensated managers. This requirement became effective for the 1993 fiscal year.

^bThis excludes payments made to the retiring CEO who received \$2,164,543 in salary and bonus, \$82,560 from exercising options, and \$384,792 in unexercised in-the-money options for a total of \$2,631,895.

^cThis excludes payments made to the retiring CEO and Senior Executive V-P who received \$3,889,407 in salary, bonuses, and other compensation, \$1,518,341 from exercising options, and \$2,255,017 in unexercised in-the-money options for a total of \$7,662,765. The two executives retired on September 1, therefore, the total compensation shown for 1999 is artificially depressed. In the 2000 fiscal year, the total compensation paid to the top five managers was over \$3.7 million with the CEO receiving over \$1.6 million.

^dAnnual compensation includes the total of salary, bonuses, and all other compensation.

^eValue of options exercised during the fiscal year.

^fValue of all exercisable and unexercisable in-the-money options.

eight meetings. So an unrelated board member attending all meeting and being the chair of one committee could receive \$91,000 in compensation. During the 1990s, the directors did quite well with average pay per unrelated director increasing by 19.5 times and little exposure to the declining share price of the company. The dichotomy between [Table 2](#) and the data above for directors and [Figs 1 and 2](#) is striking.

Compensation arrangements are meant to align the interests of managers and shareholders. But, [Core et al. \(1999\)](#) find that higher compensation levels are associated with poor corporate governance, entrenched management, and poor financial results thus exacerbating agency conflicts. William M. Mercer, a Canadian consulting firm, reports little correlation between CEO pay and company performance as measured by revenue and earnings growth or shareholder return. The National Post (May 22, 2001, C1, C6) describe compensation committees in Canada as “a close-knit fraternity of perhaps 100 peripatetic directors each serving on between five and 15 boards. It’s still a fairly closed network, you might call it stacking the deck.”

Board memberships are lucrative and membership is tied to the ability to work with the CEO. The CEO likely serves on other company’s boards. It’s a system where it is in everyone’s interest to keep CEO pay levels rising. An institutional investor complains: “There is an element of people helping each other to get cookies out of the jar.” Charlie Munger, Warren Buffet’s partner, concludes: “As for the corporate consultants who advise companies on salary, all I can say is that prostitution would be a step up for them.” These findings paint a disturbing picture for shareholders: entrenched management, controlling board appointed compensation committees, enriching themselves by transferring wealth from shareholders.

5.3. Market Pricing, Institutional Shareholders, and Takeovers

One of the most surprising findings of this clinical study is the lack of corporate governance provided by the market and shareholders throughout the affair. It is clear from [Table 1](#) and [Figs 1 and 2](#) that AC’s performance badly lagged the overall market and the US airline industry. AC and their investors both lost billions during the 1990s. Institutional investors controlled 80% of the shares, yet little happened. Why didn’t the company’s poor performance, on almost any measure, unite shareholders to seek changes? Shareholders elect directors, yet nothing was done on this front. The lack of shareholder support for Onex’s very high second and third offers seems odd. [Shleifer and Vishny \(1986\)](#) report that large shareholders play an active role in corporate governance. But in this case

large shareholders seemed to be indifferent and impartial observers to the events affecting the company.

Takeovers are the ultimate form of corporate governance. Underperforming companies should attract takeover interest if the reason for the poor performance is bad management. Shareholders must evaluate the takeover offer in light of the company's performance and ultimate worth, and decide on the fairness of the offer price. As stated earlier, Onex's first offer was considered low, but the second and third offers were much higher than AC's share price in the 100-day pre-takeover period. In hostile takeovers, the target company usually resists, but the ultimate decision on the offer rests with the shareholders. The lack of action, or indication of preference, from AC's institutional investors is puzzling.

They did not object to the 10% share ownership, antitakeover law. In the US, institutional shareholders generally oppose such laws and encourage companies to opt out of the law. This did not occur. In fact, AC introduced at least three additional poison pills as the situation evolved. AC's management wanted to protect their positions, and institutional shareholders acquiesced. [Jarrell and Poulsen \(1987\)](#) report that when companies adopt antitakeover provisions, the level of institutional ownership declines. For AC, institutional ownership actually increased from 70% in 1990 to 80% in 1998.

The evidence in this paper suggests there is little value provided by institutional voice, a puzzling finding given the mandate of institutional investors. It is also directly opposite to that reported by [Bruner \(1999\)](#) who illustrates that activism by institutional investors in Sweden to the merger of Volvo and Renault stopped the destruction of shareholder wealth and redirected the firm. Bruner reports that seven actions by financial institutions, "jawboning" or institutional voice, prompted corporate changes and a halt to declining shareholder value. In contrast, the complete lack of institutional voice and a disregard for shareholder value in this clinical study is a striking finding.

For example, it is surprising that "sophisticated" institutional shareholders allowed the share repurchase (SR) to proceed. The SR resulted in a partial takeover and was a questionable allocation of AC's scarce financial resources. If institutional investors were proactive in supporting Onex's offer, all of the V (NV) shares, not just 36.4%, would have been purchased at a price that was 2.7 (3.2) times the market price prevailing on August 12, one day before the Section 47 Order was issued. In addition, management would have been disciplined for the many years of inferior results.

One reason managers repurchase shares is as a defense in the event of a takeover offer. [Vermaelen \(1984\)](#) finds that as takeover activity increases, so too does the number of SRs. This may be because both takeovers and repurchases signal undervaluation. It may also be that a SR made in response to a takeover is

management's way to avoid a takeover and secure their jobs.⁷ Vermaelen (1984) concludes that SRs provide positive and significant managerial benefits through the prevention of takeovers and the increased value of management's stock options. SRs also increase the company's debt ratio and reduce the amount of free cash reducing the attractiveness of a takeover (Dittmar, 2000).

Dann and DeAngelo (1988), Denis (1990), and Nohel and Tarhan (1998) report a decline in share prices for companies that announce a SR in response to a takeover offer. Dann and DeAngelo (1988) also report that the takeover was unsuccessful in all cases where the target repurchased shares. Jarrell and Poulsen (1987) report negative stock price reaction to antitakeover proposals. These results suggest that a SR used as a takeover defense is not in best interest of shareholders implying that managers and the shareholders' representatives, the board, do not successfully resolve agency issues.

For AC, there is little doubt that the SR was used to prevent the Onex takeover bid. The premium associated with the first SR offer of \$12.00 was 21.8% (27.3%) for the V (NV) shares based on the average share price over the ten trading days prior to the announcement period. In the three-day announcement period, the CAR was 3.17% (1.64%) for the V (NV) shares. While the premium was comparable to that reported in the literature, the CAR was much lower. This reaction may imply that the market had already anticipated the offer or did not believe that the defensive tactic would work. This reaction is consistent with the market believing that the takeover would proceed at a slightly higher price than originally offered.

AC's second SR offer for \$16.00 on November 2 was greeted with a very muted market response. The premium, based on the average share price over the ten trading days prior to the announcement period, was 58.5% (67.3%) for the V (NV) shares. The CAR during the three-day announcement period was 1.24% (3.74%) for the V (NV) shares. The lack of market response to an unconditional SR with such a large premium is surprising and implies that the market believed that the Onex bid would not be successful and that the AC shares not repurchased would decline after the SR. If this were the case, however, why didn't shareholders, particularly institutional shareholders, aggressively push the board to negotiate with Onex for a higher bid. The share price reaction to a SR offer carrying such a large premium seems irrational given that a takeover offer at a higher price than the current market price was also available.

Between November 2 and 5, the date of the court decision, the V (NV) traded in a very narrow range (see Fig. 5) averaging \$10.90 (\$10.30). Consider the implication of these market prices. It is clear that all shareholders would tender all of their shares to AC's SR, assuming the takeover offer was defeated and given the large premium associated with the SR. AC would then purchase 36.4% of the shares tendered. The

post-repurchase share price implied by the above market prices is \$7.98 for the V shares, \$7.04 for the NV.⁸ For AC, this means that not only was the repurchase price greater than the implied post-repurchase market price, a result consistent with that reported in the literature, but also that the implied post-repurchase market price was *less than* the market price prior to the SR offer. For AC, the SR was a blunt and very expensive measure to block the Onex takeover offer.

In addition, the implied post-repurchase share prices are less than Onex's original offer price of \$8.25 and much less than the two later offers of \$13.00 and \$17.50 that were outstanding during the trading period following AC's second SR offer. Even though the Onex offer was still available for acceptance, the market had already priced in the defeat of the offer and a return to market prices that had been in effect around the Section 47 Order. This pricing and acceptance of defeat is absurd given that AC's shareholders had four trading days to influence the board's recommendation.

For an independent board that is theoretically committed to creating shareholder value, the implied post-repurchase share prices should have been a strong signal to negotiate with Onex. Instead, the board supported management, and shareholders went along. It was remarkable that AC's management was able to convince the board and shareholders: 1) that repurchasing shares at a price double the implied post-repurchase share price was a good use of resources, and 2) to reject a serious takeover offer at an attractive price. It also raises the question of why sophisticated institutional shareholders would accept such a salesjob when there was time to negotiate a better deal with a committed acquirer.

Stulz (1988) and Harris and Raviv (1988) hypothesize that for target firms that defeat tender offers, greater increases in leverage will be observed than for offers that are successful or that are not strongly opposed. For target firms, increasing leverage and decreasing free cash reduces potential gains to bidding firms. The defensive strategy utilized by AC resulted in both outcomes. While theoretically, this should have reduced the likelihood of the takeover offer proceeding, it eventually took a court decision for AC to win the takeover battle. From Onex's perspective, the direct cost of the takeover increased while potential gains seemed to decline, yet Onex decided to proceed. Emotions and reputational issues may have resulted in the offer proceeding, when financially it was no longer a positive NPV project.

6. CONCLUSION

The centerpiece explanation for the results of this clinical study is managerial entrenchment. Morck et al. (1988) suggest that when managers hold little equity

in the firm and shareholders are too dispersed or uninterested to enforce value maximization, corporate assets may be deployed to benefit managers rather than shareholders. This explanation seems to fit the data in this clinical study extremely well. The results may also imply that Canadians can be swayed by nationalistic arguments and when fear of foreign control of an essential industry is raised, or that value maximization is not the primary goal of Canadian investors or board members.

Regardless of the reason, the outcome of the events affecting AC in 1999 is unexpected based on the four corporate governance mechanisms. It would be expected that the board, who represents shareholders, and institutional investors, who are responsible for managing clients' funds, would have acted to ensure a better outcome occurred for their principals. The pricing of AC's shares around the second SR offer should have been a signal for these two groups to act. A surprising outcome of this clinical study is that they did not.

It could also be argued that by attaching the 10% ownership limit to the privatization, the government destined AC to below-market, substandard results. By limiting the markets' ability to counter agency costs, AC's management never feared the disciplinary role of the market and continued to make poor decisions leading to inferior operating and market performance. In such cases, the company's internal corporate governance procedures must be very effective.

Jensen (1993) argues, however, that internal governance systems have limited effectiveness. Mikkelsen and Partch (1997) report that internal systems are less potent in disciplining management in an inactive market for corporate control. As it turned out, there was never a market for the control of AC given the government imposed, court supported 10% ownership limit. The net effect of the ownership limit was to entrench the senior management team that had a long record of destroying company and shareholder wealth.

While the company failed to create shareholder value, the government's timing in selling AC was exceptional. The first block of shares in AC were sold on October 13, 1988 at \$8.00 per share. Between then and August 12, 1999, AC's V shares closed above \$8.00 only 1,011 of the 2,726 trading days in the period. The larger second block of shares were sold on July 6, 1989 at \$12.00. Between then and August 12, the shares closed above \$12.00 only 337 of 2,541 trading days.

If the money raised by the government from the share issues were invested in one-month Government of Canada t-bills and rolled over each month, those funds would be worth \$1.46 billion on August 12, 1999. As of August 12, 1999, the market value of AC was \$1.17 billion and this value reflects the over \$5 billion the company invested in assets over the ten years since 1989. This remarkable record of futility highlights the agency issue, in general, and the corporate governance problems with AC, in particular.

With the takeover of CDN, AC finally had what they long wanted: almost complete control of the Canadian airline industry and the claim to be “Canada’s truly global airline.” AC’s share of the Canadian airline market was over 90%. The company could operate as a loosely regulated monopoly. Their long-followed strategy seemed to be working, but it all ended in failure. In the four years 2000 to 2003, AC lost almost \$4.1 billion or \$34.06 per share. AC finished 2003 with \$11 billion of debt and -\$4.1 billion of equity. The company entered bankruptcy protection in April 2003 and for 18 months tried to cement a deal that would allow them to emerge from protection. And, AC’s common shareholders continued to pay the price for management’s poor performance. By May 2004, AC’s market value was less than \$100 million. By the time the company exited bankruptcy protection in October 2004, the common shares were worthless.

While some of AC’s problems were due to external factors, WestJet, their main Canadian competitor, was performing remarkably well. WestJet had been able to grow their market share from less than 5% in 1999 to 24% in 2004. Since 1999, the company reported increasing sales and total profits of \$179.3 million or \$2.50 per share. By May 2004, the company had reported 29 consecutive profitable quarters and their market value was \$1.4 billion. The market was sending another strong message to AC. After seemingly winning it all, AC was again losing to a small western-based airline.

NOTES

1. Agency theory analyzes the conflicts between the principals and agents. A selection of papers from the extensive literature that considers agency issues include [Berle and Means \(1932\)](#), [Coase \(1937\)](#) [Donaldson \(1963\)](#), [Alchian and Demsetz \(1972\)](#), [Jensen and Meckling \(1976\)](#), [Harris and Raviv \(1979\)](#), [Fama \(1980\)](#), [Fama and Jensen \(1983a, b\)](#), [Jensen \(1986\)](#), and [Shleifer and Vishny \(1997\)](#).

2. A fifth mechanism is the legal and regulatory systems as discussed in [La Porta et al. \(1999, 2000\)](#). Since this clinical study considers only a single company in one country, this form of corporate governance is not considered.

3. A complete record of circulars and offers is available on the System for Electronic Document Analysis and Retrieval (SEDAR) website at www.sedar.com. Press releases are available on the Canada NewsWire website at www.newswire.ca.

4. On January 4, 2000, AC purchased the 82% of the CDN shares outstanding that had been tendered to the offer.

5. It could be argued that the board performed their duties at least in part since during the 1990s the CEO was replaced three times. The circumstances of the replacements, however, tend to dismiss this explanation. In 1992 Hollis Harris, former COO of Delta Airlines and CEO of Continental Air was hired to bring professional airline management to the

company. With him came his longstanding number 2, Lamar Durrett. In 1996 Harris retired, as planned, becoming chairman of the board for three months before leaving the company with compensation of over \$2.6 million in pay and stock options. As planned, Durrett then became CEO retiring in 1999 with payments of \$4.84 million in compensation and options. Milton, a senior AC manager since 1992 then became CEO. While CEOs changed, the thinking in senior management did not. The only surprise in the appointments was that all three CEOs were from Georgia.

6. The lower level of compensation in 1998 was due to two factors. First, the company did not pay managers bonuses. Second, AC's stock price declined by over 57% during 1998 thus reducing the value of outstanding options.

7. Kamma et al. (1992) and Lie and McConnell (1998) report that 15 to 20% of SR are in response to a hostile takeover bid. DeAngelo et al. (2000) report that SRs were of marginal economic significance until the 1980s; the increase was associated with the upsurge in corporate restructuring and takeovers.

8. The following formula was used to calculate the post-repurchase share prices where P_{PR} is the implied post-repurchase share price, P_O is the current share price, and n is the number of shares tendered:

$$P_{PR} = \frac{(P_O \times n) - (\$16 \times 0.364 \times n)}{n \times (1 - 0.364)}$$

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FURTHER EVIDENCE ON INSTITUTIONAL OWNERSHIP AND CORPORATE VALUE

William W. Jennings

ABSTRACT

Whether institutional investors monitor corporations and improve firm value is a key question for corporate governance and investment management. I find little empirical support for the hypothesis that institutions undertake monitoring that increases firm quality and valuation. Granger causation tests show that while quality firms do attract institutional investment, institutions do not monitor and firm value subsequently declines. Instead, institutional incentives are critical; some institutions with strong incentives to monitor do, indeed, monitor. Institutions with concentrated portfolios successfully monitor while institutions with a larger percentage stake do not. Pensions and endowments are better monitors than insurers, banks and mutual funds.

1. INTRODUCTION

The question of institutional monitoring is of central importance to corporate finance. In their literature survey, [Shleifer and Vishny \(1997\)](#) accord large ownership blocks the key instrument of corporate governance. Concentrated control rights facilitate coordination across investors and encourage particular large investors to undertake costly governance actions including monitoring, resorting to

the courts and attempting takeovers. Without institutional monitoring, the classic corporate finance issue of ownership-control separation is much more problematic.

Recent research has documented widespread activist monitoring by institutional investors. Studies investigating institutional watch-list targeting of poor-performing firms find improvements in profitability and share price (Nesbit, 1994; Opler & Sokobin, 1997; Smith, 1996; Strickland, Wiles & Zenner, 1996). Institutions also act to maximize value in control situations like takeovers and proxy votes (Agrawal & Mandelker, 1990; Bhagat & Jefferies, 1991; Brickley, Lease & Smith, 1988; Denis & Serrano, 1996; Kang & Shidasani, 1995; Pound, 1988). Finally, McConnell and Servaes (1990) find a positive contemporaneous association between firm value and 1986 institutional ownership.

An increasingly popular interpretation is that institutions discipline corporate managers to increase firm value. While unsurprising in light of the aforementioned research, this belief in institutional monitoring is incompatible with the evidence documenting poor institutional investment performance relative to the market. Since shareholder monitoring implies oversight of corporate management to increase firm value, pervasive institutional monitoring cannot coexist with institutional underperformance. This incongruity between two bodies of academic literature suggests revisiting whether firm value varies with the degree of institutional ownership.

Before continuing, one must be precise about terminology; by “monitoring,” I mean shareholder oversight of management to increase firm value. Monitoring involves effort, influence and results. Effort entails proclivity to gather information and to affect company management. After effort, the potential monitor must attempt to influence corporate managers’ behavior and must succeed. In this paper, monitoring requires a positive outcome – I consider only *effective* monitoring. Although the focus here is on explicit activist monitoring, the evidence presented here also applies to instances of implicit monitoring; that is, where the mere presence and implicit oversight of institutional investors constrains corporate decision-making.

By reviewing this definition of monitoring, one can see why institutions might be monitors. First, institutions are key information gatherers, or information intermediaries, and, as such, are able to publicly evaluate and discipline management. Institutional scale makes them particularly efficient information gatherers since the cost of acquiring valuable information likely has a large fixed component and this fixed cost can be amortized over the large number of shares held (Merton, 1987). Second, institutions’ size makes them viable influencers. Corporate executives will be more responsive to large shareholders; they will also likely be more responsive to entities interested in business-oriented monitoring rather than social-policy monitoring or gaining direct control (Gillan & Starks,

1999; Karpoff et al., 1996). Finally, institutions monitor indirectly through the market – insofar as institutional trading affects prices, it serves a disciplining function because stock price reactions to major managerial decisions are widely tracked in the financial press.

The difficulty in reconciling institutional underperformance and institutional monitoring is not the only reason to expect institutions are ineffective monitors. First, institutions are characterized as myopic owners who “vote with their feet” in response to unfavorable short-term results. Relatedly, diversification and liquidity requirements encourage small positions, which hinder monitoring. Historically, institutions have not generally participated in corporate governance and now may have a cultural bias against participation. Fourth, populist opposition, given voice through politics, may hinder institutional monitoring. American history is rife with examples of political opposition to concentration of financial power; certainly statutory and regulatory hurdles exist. Even where they do not prohibit monitoring *de jure*, they may raise monitoring costs prohibitively. Fifth, institutions suffer from a range of agency problems including free-rider problems, lack of incentives, loyalties displaced to management, ambiguous benefits and a bank-run problem. The gains from activism go to the institution’s beneficiaries while any losses may induce personal liability of the fiduciary. Sixth, conglomerates, analogous to institutions in many respects but suffering from fewer of these hindrances to monitoring, ultimately proved a failed experiment. Finally, institutional investors may lack sufficient expertise. If they lack expertise in their primary role, there is little reason to expect aptitude in an ancillary role.

Does firm quality vary with the degree of institutional ownership? My results strongly reject the hypothesis that institutions undertake monitoring which affects firm quality and valuation.

Unlike other studies, I examine the time series to detect causal relationships. Institutional monitoring requires that institutional investment Granger-cause higher firm quality and valuation. The specific hypothesis is that increases in institutional own show quality improvements attract institutions but institutions subsequently preside over a quality decline.

The causal evidence of attraction to quality, a firm attribute, suggests considering differences in institutional type (e.g. banks vs. pensions). In selecting stocks, banks like different firm attributes than other institutions (Del Guercio, 1995). Further, incentives for and barriers to monitoring differ in numerous dimensions (diversification regulations, liquidity demands, degree of management co-option, etc.) across institutional type. While developing unambiguous by-type expectations is difficult, I show it is reasonable to expect pensions, endowments and insurers to be more prone to monitor than banks and mutual funds. Analyzing the by-type relationship in the proper time-series causation framework provides

estimates consistent with these expectations. Importantly, the causation framework reverses some anomalous results from those obtained in simple contemporaneous regressions.

Finding such strong evidence that some institutions are better able to monitor than others but faced with the difficulty in drawing clear implications across institutional types, I next focus on specific institutional characteristics (e.g. high vs. low turnover). Selected appropriately, characteristics are more directly related to monitoring incentives than institutional type is. Specifically, I expect monitoring by institutions with a large fraction of a firm, large dollar positions, long holding periods, large portfolios, or a large portion of their portfolio concentrated in a firm. The results are striking; many probable monitors do not. However, institutions with more concentrated portfolios, large portfolios and large dollar investments are better monitors. Again, the causation framework offers insights beyond a contemporaneous regression. Measuring the importance of specific institutional incentives to monitor, particularly institutional focus, is a key finding for corporate governance.

The causal framework is a contribution of this paper. Examining institutional monitoring virtually requires allowing for causation. Investigating a non-causal contemporaneous relation might be appropriate for relatively *static* potential monitors like director-owners (Morck et al., 1988), insiders and 5% blockholders (McConnell & Servaes, 1990), 20% and majority blockholders (Holderness & Sheehan, 1988), or investment analysts (Chung & Jo, 1996). However, the nature and level of institutional ownership is much more *dynamic*. While the other potential monitors likely have a relatively stable association with the monitored firm, this is not likely the case with institutions.

Consider an institution where activist monitoring is an explicit policy. Its portfolio could include firms with a range of valuations. Some of the investments are in low quality companies – newly acquired in anticipation that they will potentially benefit from institutional monitoring. Others will be medium quality firms beginning to respond to monitoring. The remainder of the portfolio could include high quality firms with no further potential gain to monitoring and now awaiting disposition. Cross-sectionally this is a muddle – no relation exists on average. The time-series, however, can reveal the positive impact of monitoring. If monitoring is effective, the transition from low to high quality will follow the increase in total institutional ownership attributable to the monitoring institution's acquisition of shares. I use Granger-causation tests to discern whether this temporal precedence exists.

Causation tests have another advantage in the context of monitoring – they control for endogeneity. The monitoring literature in general and this paper specifically relies on Tobin's q as a measure of firm quality. However, market-to-book ratios

(of which q is a permutation) are also a measure of investment style; portfolios characterized by low market-to-book follow a “value” investment style while high market-to-book follow a “growth” style. Institutions’ choice of whether to pursue a value or growth style is a decision unrelated to the question of whether to monitor. Thus, contemporaneous association suffers from serious endogeneity problems. I use a bi-directional systems-of-equations approach to causation that avoids the endogeneity issue.

In addition to the compelling result that only a subset of institutions overcomes the barriers to monitoring, this study has several valuable distinctions from other research. I use more comprehensive data than prior research; prior studies have relied on limited time-series and cross-sections of data. The data used here is the most comprehensive available that focuses on institutional ownership. It contains a time series which allows me to both investigate causation and ensure the stability of the results. Unlike most other studies, the data is not limited to a particular subset of institutions. I examine over 20,000 firm-years; prior research has been limited to a maximum of about 1100 firms in two or three years. Unlike other research, I exclude potentially confounding insider ownership data. Finally, the data is comprehensive in another dimension – by including all firms and not just focusing on control events or the worst performers, one gains insight into institutions’ on-going monitoring efforts. This study avoids a problem with watch-list research where activist institutions’ monitoring gets credit for corporate recoveries but not the preceding declines. It also avoids the selection-biases in watch-list research that management at the worst performing firms has the least viable objection to institutional monitoring. By including all firms, not just the worst performers, I avoid another problem with these malady studies – the targeted worst performers may be unresponsive to the informal on-going institutional monitoring which many commentators espouse as a corporate governance cure (e.g. [Jacobs, 1991](#); [Monks, 1996](#)). In this respect, these watch-list studies are similar to the other public-pressure studies that examine institutional activism in proxy contests, proxy proposals, *etc.* Here, I examine institutions’ ability to monitor top, median and worst firms through both formal and informal measures.

In sum, this paper advances the literature in several dimensions. Recognizing the difficulty in reconciling institutional underperformance with institutional monitoring is an intellectual contribution. Examining the relationship between institutional ownership and quality in a causation framework is a major methodological contribution. Analyzing institutional type and, more significantly, institutional characteristics represents a further enhancement over prior work.

Section 2 provides additional background and discusses prior research. Section 3 presents the primary empirical results. Sections 4 and 5 consider specific institutional incentives to monitor, and Section 6 concludes.

2. MOTIVATION AND PRIOR RESEARCH

The introduction discussed reasons institutions would and would not be associated with monitoring. Since the prior research has developed the pro-monitoring arguments well and since they are perhaps more intuitive, I do not discuss them further. Instead, I develop the non-monitoring explanations.

2.1. Arguments Against Institutional Monitoring

First, institutions are characterized as myopic owners who sell in response to unfavorable short-term results. Certainly, there is evidence of institutional positive-feedback trading, window-dressing and high turnover (Lakonishok et al., 1991). Some executives argue that this myopia makes them peripheral shareholders unentitled to a voice in corporate governance; short-term shareholders are likened to (voteless) optionholders – focused on short-term price moves – and, accordingly, entitled to no voice in corporate governance. Since a key ingredient in effective monitoring is gaining influence with management, a short-term focus will hinder institutional activism. Further, a short time horizon reduces incentives to monitor since it reduces the period over which to amortize start-up costs.

Second, diversification and liquidity are key reasons individuals use institutions to invest. Liquidity needs reinforce the need to diversify, so both diversification and liquidity encourage small position sizes. This makes monitoring difficult as the relatively fixed monitoring costs are spread over fewer shares held. Institutions may choose to avoid the excess risk of non-diversification (Demsetz & Lehn, 1985). Bhidé (1993) argues American public policy promotes portfolio fragmentation in order to enhance liquidity but does so at the expense of corporate governance.

Third, history has a range of examples of Americans' disinclination to tolerate centralized influence by financial entities. Opposition to supra-state financial entities was so strong that the Continental Congress rechartered its central bank as a state bank in Pennsylvania. Populist dislike of strong banks encouraged the veto of the renewal of the second Bank of the United States. When conditions again necessitated a new national bank in 1913, a decentralized Federal Reserve System diffused its power. That America's politics discourage concentrated power is unsurprising since the Constitution enshrines non-proportional representation in the Senate, which facilitates populist opposition to centralization of financial power.

More recently, a broad range of regulations applying to specific types of institutions limit their monitoring ability. I discuss them in Section 4; here I discuss government-imposed restrictions that affect all institutions. Many restrictions relate to coordinated action by investors. If institutions jointly seek to affect

management when they jointly own more than 5% of the firm, they become a “control group” subject to SEC 13(d) filing requirements. If an institution seeks to coordinate action with other institutions concerning a specific firm, the act of soliciting cooperation can be interpreted as a proxy solicitation subject to SEC 14(a) regulations. According to the legislative sponsor of the proxy rules, they are intended to protect the “legitimate buyer” who buys “strictly for investment purposes and with *absolutely no interest in affecting management policy*” (quoted in Black, 1990, p. 564). In addition to the SEC, the FTC also has the right to regulate large investments if greater than 10% of the target company. Finally, some states have enacted draconian anti-takeover laws that restrict the voting power and trading opportunities of groups that control more than 20% of a firm (Szewczyk & Tsetsekos, 1992).

Fifth, several agency problems hinder institutional monitoring. A free-rider problem arises when monitors incur the full costs of monitoring for only a pro rata share of gains from monitoring. Effective monitoring is non-excludable – it benefits all shareholders. If monitoring is costly and lowers returns, institutions have an incentive not to contribute to (collective) monitoring activity when they compete on returns.

Assets under management drive institutional compensation. Since monitoring requires effort that will be essentially uncompensated, institutional managers will be disinclined to monitor. Instead, they will focus on increasing assets under management. Past returns largely determine cash inflows (Sirri & Tufano, 1993). If monitoring raises returns immediately, managers would choose to do so, but if the monitoring-return relationship is delayed or ambiguous, managers may not monitor since even slight monitoring costs may be sufficient to drop returns off the high-profile best-returns tables.

Institutional managers may try to increase assets by favoring corporate managers. Armstrong World Industries, the focus of Pennsylvania’s draconian antitakeover statute, moved its 401(k) plan from Vanguard to Fidelity after the latter dropped its opposition to the antitakeover law. So institutional managers may have their loyalties displaced from their beneficiaries to corporate management. Brickley, Lease and Smith (1988, 1994), Pound (1988), and Heard and Sherman (1987) advance this commercial pressure hypothesis that institutions with ties to a firm will face management pressure for support. Van Nuys’ (1993) notes that currying management favor can affect behavior of unaffiliated institutions that want to build a future relationship.

The conflict between institutional investment and management need not be so clear-cut. By not monitoring, institutions may avoid management ire and retain access to information flow about the corporation. Most fiduciaries have an incentive to be informed (or appear to be informed).

If an institution approaches another to suggest the need for joint monitoring action, this may alert the second institutional investor to a previously unnoticed problem at the firm. To the extent that one institution's monitoring efforts highlight problems at a firm, that institution lowers the stock price and hurts itself. Selling out may be easier and less costly.

Sixth, conglomerates are like institutional investors but with fewer hindrances to monitoring. Conglomerates potentially experience less myopia, weaker diversification needs, weaker liquidity needs, fewer legal constraints and fewer agency problems than institutions. Yet even here, monitoring seems ineffectual – conglomerates discredit indicates they were ultimately unsuccessful at monitoring.¹

Finally and importantly, institutional investors may lack sufficient expertise at monitoring corporate management. They may lack expertise at any of the three stages of monitoring I discussed above – effort, influence and results. They may lack the ability to identify good monitoring candidates, may lack the credibility or negotiation skill necessary to get management's ear, and may lack useful value-enhancing advice or the skill to get management to commit to their own value-enhancing actions. If institutional managers lack expertise in their primary investment management role and systematically underperform the market, one should not expect aptitude in a role ancillary to their primary duty.

2.2. Tobin's q and Prior Evidence

If one is to examine the association between institutional investment and firm quality, a metric is required. Tobin's q is frequently a proxy for firm quality (Chung & Jo, 1996; Holderness & Sheehan, 1988; Lang, Stulz & Walking, 1989; Lang & Stulz, 1994; McConnell & Servaes, 1990; Morck, Shleifer & Vishny, 1988). Tobin's q is the ratio of the marginal product of capital to the required yield on equity; more mundanely, q is the ratio of the market value of the firm to the replacement cost of the firm's existing assets. It is high when intangible assets raise market values above the cost of physical assets. Because these intangibles include goodwill, extraordinary growth prospects, monopoly power, managerial expertise and intellectual property, Tobin's q is a good measure of firm quality and managerial performance.

In their survey of corporate governance literature, Shleifer and Vishny (1997) emphasize ownership concentration as the more important of two primary means of overcoming agency problems arising from the separation of ownership and control. Several papers examine the association between significant investors and firm valuation. These studies explicitly assume that monitoring by significant investors

will produce higher Tobin's q . Morck et al. (1988) find a relationship between Tobin's q and *director ownership*; firm value rises then falls then rises again as director ownership increases. While the up-segments are consistent with Jensen and Meckling's convergent interests hypothesis, Morck et al. believe the down-segment related to moderately high director ownership encouraging managerial entrenchment. McConnell and Servaes (1990) examine the simultaneous effects of blockholders, insiders and institutional owners; they find a concave relationship between *insider ownership* and q , no discernible relationship for 5% *blockholders* and a positive relationship for *institutional owners*. Holderness and Sheehan (1988) find no significant difference in q between firms with majority shareholders and firms with no shareholder owning more than 20%. Chung and Jo (1996) find a positive relationship between *analyst following* and q (relevant since O'Brien & Bhushan (1990) show a positive association between analysts and institutions). In summary, the bulk of this evidence either documents or suggests a positive relation between institutions and Tobin's q .

Note all the previously mentioned studies focus on the long-term steady-state association between firm value and various potential monitors. Other studies examine institutional activity in control situations like takeovers and proxy votes. Bhagat and Jefferies (1991) find nonpositive correlation between institutional ownership and the probability a company will propose antitakeover amendments to its corporate charter. Jarrell and Poulson (1987) find negative abnormal returns at firms proposing antitakeover amendments, but Agrawal and Mandelker (1990) find this effect disappears in companies with high institutional ownership. Brickley, Lease and Smith (1988) show institutional owners vote more actively on antitakeover amendments than other shareholders. Pound (1988) finds the probability that management will prevail in a proxy contest increases as institutional ownership increases. Denis and Serrano (1996) find blockholders increase management turnover in firms that perform poorly after rebuffing a takeover attempt. Kang and Shidasani (1995) show non-routine executive turnover with outsider succession is higher in Japan for firms with large shareholders and with main-bank affiliations; this suggests institutional censuring. The evidence from control votes is generally indicative of institutional monitoring.

A third area of research focuses on coordinated institutional activity against a subset of worst performing firms. Opler and Sokobin (1997) document significant profitability and share price improvements in the pension industry's Council of Institutional Investors' watch-list. Nesbit (1994) and Smith (1996) both found small price improvements in firms targeted by the giant CalPERS pension fund. Strickland, Wiles and Zenner (1996) find collective action by small shareholders is effective in enhancing corporate value at poor performing firms. While Wahal (1996) examines several large activist pensions and finds little evidence supporting

effectiveness of their monitoring efforts, the bulk of the evidence from coordinated institutional activity against worst-performers bolsters the idea that institutions enhance shareholder value through their monitoring efforts.

There is also anecdotal evidence of growing institutional activism. The New York State Retirement System annually meets with management of many of the 30 worst performing of their 900 portfolio stocks. CalPERS' publicizes its annual harangue of 10 poor performing firms; in 1997, they released an exhaustive blueprint of how they want corporate boards structured. Campbell Soup publicly committed to activist monitoring – becoming the first corporate pension fund to do so. Berkshire Hathaway's Warren Buffet stepped in to serve as non-executive chairman when one portfolio company, Salomon, was caught bid-rigging in 1990. The fact that the growing institutional participation in corporate governance coincided with another large secular trend – large-scale corporate restructurings (including some cases in the 1990s (IBM, Chrysler, GM) where institutions were key restructuring proponents) – suggests institutions influence corporate value-maximization efforts. That is, institutions monitor.

3. INSTITUTIONAL OWNERSHIP AND FIRM VALUE

My results strongly contradict the preponderance of the prior evidence that institutions are effective monitors of corporate managers. I reject institutional monitoring using Granger-style causation tests that show that while higher quality firms do attract institutional investment, institutions do not monitor and firm value subsequently declines. Additionally, my regression results document a negative and significant contemporaneous association between institutional ownership and firm value.

3.1. Data

Data includes all firm-years in the three-way intersection of the CRSP, CompuStat and Spectrum databases. Market data is from CRSP's daily Master and NMS files. Annual accounting data is from CompuStat's Active and Research companies on the Primary-Supplementary-Tertiary and Full Coverage Industrial files. Institutional ownership data comes from the Spectrum files; these files, from CDA Investment Technologies, contain institutional ownership information extracted from SEC 13(f) filings. Institutions with trading discretion over more than \$100 million are required to file quarterly reports. These filings, mandated under the 1975 revision to the Securities Exchange Acts, collectively represent "a

central depository of historical and current data about (institutional) investment activities,” (Loss & Seligman, 1990, p. 2324) and “have become the single most important source of information available to the public about the holdings of major institutional investors” (Heard & Sherman, 1987, pp. 68, 69). Unlike the vagaries of alternative data sources (e.g. see McConnell & Servaes, 1990; Peles, 1992), CDA is the data-tabulator of 13(f) information for the SEC, and they emphatically claim that Spectrum is comprehensive and complete. For each firm and each quarter, Spectrum provides each institution’s holdings. I attempt a careful matching of firms to avoid errors or omissions (Chan, Jegadeesh & Lakonishok, 1995). The final sample includes approximately 20,000 firm-years in the era 1982–1991.²

Ideally, the time period for measuring changes in institutional ownership and firm quality ought to match firms’ and institutions’ response time to each other and the exogenous causal variables. Because firm quality does not change overnight and because effective monitoring may require time for a relationship between institutional and corporate managers to develop, I use annual increments. Using shorter intervals would increase the noisiness of Tobin’s q as a quality measure.³ An annual horizon is more likely to capture institutions’ association with real, secular quality changes rather than their impact following short-horizon information events. Annual horizons allow institutional trading impact to dissipate (Chan & Lakonishok, 1995); to the extent that any residual institutional trading impact, it biases results in favor of monitoring. However, using very long horizons blurs the distinction between changes and levels and reduces the ability to distinguish causal and spurious contemporaneous association, so annual horizons seem best.

I measure each firm’s year-end q using the current “best practice” in academic research. Here

$$q = \frac{MV(\text{common}) + MV(\text{preferred}) + MV(\text{debt})}{RV(\text{inventory}) + RV(\text{PP\&E}) + BV(\text{otherassets})} \quad (1)$$

where $MV(\text{common})$ indicates the market value operator, $BV(\text{otherassets})$ indicates book value, $RV(\text{inventory})$ indicates replacement value and “PP&E” is property, plant and equipment. CRSP is used for the common stock market value. I compute market value of debt using the Perfect and Wiles (1994) version of the method of Lindenberg and Ross (“L&R,” 1981) where the current long-term debt of the firm is re-valued using the change in AA long-term interest rates from time of issuance to the valuation date. I use the L&R method to compute market value of preferred stock where preferred dividends are capitalized as a perpetuity using year-end AA preferred yields. Where available, I use CompuStat’s values for LIFO Reserve to adjust inventories to replacement values; generally accepted accounting principles (GAAP) requires footnote disclosure of this difference between FIFO and LIFO inventory values. Finally, I use the method of Lewellen

and Badrinath (1997) to adjust property, plant and equipment to replacement values; they convincingly show their method of inflating past capital expenditures gives more accurate estimates than L&R.

3.2. Preliminary (Contemporaneous) Results

In all contemporaneous models, the dependent variable is $\ln(q)$.⁴ The institutional ownership variable is simply number of shares held by all institutions divided by total shares outstanding.

Along with the level of institutional ownership, I include additional independent variables. These control variables are traditional explanatory factors for cross-sectional variation in Tobin's q . Given the size and flux of the Tobin's q literature, there is no uniform specification of these additional explanatory factors; however, a review of prior work reveals consistent factor themes. I use these themes to motivate a specification below – alternate specifications of these factors are generally suppressed, but some are examined as a robustness check. Summary statistics are in Table 1.

Since economic earnings generate the cash that ultimately flows to shareholders, firm profitability has a significant impact on valuation. Chung and Jo (1996) and Yermack (1996) find it associated with higher q . I measure profitability as return on assets and compute it as operating income before depreciation over total assets.

Firm value also depends on future growth and investment opportunities (Gordon, 1962; Smith & Watts, 1992; Williams, 1938). These growth opportunities reflect

Table 1. Summary Statistics.

Statistic	Mean	Standard Deviation	5th Percentile	Median	95th Percentile
Tobin's q	1.317	1.539	0.232	0.956	3.248
CapX/Sales	0.213	9.404	0.007	0.051	0.352
Profitability	0.131	0.124	−0.003	0.135	0.296
Size (in \$million)	768	2.814	13	126	3.236
Leverage	0.228	0.182	0.000	0.204	0.554
Institutional ownership	0.298	0.202	0.023	0.269	0.661

Note: The sample consists of all firms in the intersection of the CRSP, CompuStat and Spectrum databases for the years 1982–1991. The sample has 19,359 firm-year observations. CapX/Sales is normalized capital expenditures and reflects future growth opportunities and intangible assets. Profitability is measured by return on assets. Size is the logarithm of capitalization. Leverage is the debt-to-assets ratio. Institutional ownership is the number of shares held by institutional investors divided by total shares outstanding.

an intangible asset that high quality firms have developed. From a range of possible specifications of growth and investment opportunities, I choose capital expenditures normalized by sales (Yermack, 1996). Note that unlike alternate metrics for intangible growth prospects, capital expenditures is a standard financial statement line item reported by almost every firm (91% of firm-years in my sample).⁵ More future growth and investment opportunities should be associated with higher measured firm quality.

I control for firm capitalization with the logarithm of year-end equity market value. Institutions concentrate their investments in larger companies, so including size avoids having the level of institutional ownership gain spurious significance by serving as a size proxy. The strong correlation between institutional investment and firm size (O'Brien & Bhushan, 1990) underscores the importance of using control variables to reduce the risk of model misspecification due to missing variables.⁶

Financial leverage can also affect firm quality and valuation. In studies examining ownership structure and Tobin's q , Morck et al. (1988) and McConnell and Servaes (1990) both include the ratio of debt to total assets as an independent explanatory variable. (Lang, Ofek & Stulz (1996) document the complexities of the leverage-quality relationship.) I control for leverage using the debt-to-assets ratio. Institutional investment in a stock may interact with financial leverage or some other risk measure since some institutions are subject to prudent-investment restrictions.

I examine the contemporaneous relationship first because it lays the groundwork for the causal analysis. It is simpler and more directly related to the prior literature. Table 2 presents regression coefficient estimates of the association between Tobin's q and the percent of shares outstanding held by institutional investors under several specifications. The estimated coefficient for institutional ownership is consistently negative and strongly statistically significant.

The Simple Model uses OLS and is included as a preliminary baseline. All coefficient estimates are significant and signed as expected – normalized capital expenditures, profitability and capitalization are positive. The observed sign of the coefficient for size measures is not consistent across the Tobin's q literature; however, it is also positive in specifications most similar to mine (e.g. Yermack, 1996). Leverage's coefficient is negative (Morck et al., 1988). Note that parameter coefficients in the Simple Model are consistent with (unreported) estimates from an even simpler model that includes the control variables but excludes a measure of institutional ownership. The coefficient of determination for the Simple Model (6.2%) is notably larger than in the simpler sans-institutions model (4.3%).

These results strongly contradict the preponderance of the prior evidence. Contemporaneous regression results document an unambiguous significant negative association between institutional ownership and firm quality.

Table 2. Contemporaneous Relationship Regressions.

Model	Simple	Classic	Fixed Effects	Time Series Aggregation
Intercept	Unique	By year & industry	By firm	Unique each period
CapX/Sales	0.003 (6.46)	0.003 (6.42)	0.0004 (1.99)	0.160 (3.75)
Profitability	0.569 (16.25)	0.473 (14.74)	0.428 (15.38)	0.824 (3.04)
Size	0.052 (16.95)	0.091 (29.45)	0.407 (83.09)	0.045 (6.88)
Leverage	−0.502 (−21.53)	−0.381 (−16.80)	0.041 (1.97)	−0.548 (−4.90)
Institutional Ownership	−0.512 (−19.88)	−0.697 (−27.76)	−0.871 (−41.87)	−0.461 (−10.73)
R ²	0.062	0.27	0.89	nmf

Note: Regression coefficient estimates of the association between Tobin’s q and the percent of shares outstanding held by institutional investors. The sample consists of all firms in the intersection of the CRSP, CompuStat and Spectrum databases for the years 1982–1991. The sample has 19,359 firm-year observations. In all models, the dependent variable is the natural logarithm of an estimate of Tobin’s q . The Simple Model presents ordinary least squares estimates. The Classic Model includes 2 independent series of indicator (dummy) variables – for each year and for each industry (based on 2-digit CompuStat SIC codes). The Fixed Effects Model assigns a unique intercept to each firm. Time Series Aggregation regressions are based loosely on the methods of Fama and MacBeth (1973); this Model involves separate simple ordinary least squares regressions each period then computes observation-weighted means and t -statistics based on the distribution of the by-period parameter estimates. Parenthetical values are t -statistics.

CapX/Sales is normalized capital expenditures and reflects future growth opportunities and intangible assets. Profitability is measured by return on assets. Size is the logarithm of capitalization. Leverage is the debt-to-assets ratio. Institutional ownership is the number of shares held by institutional investors divided by total shares outstanding. Parenthetical values are t -statistics.

3.3. Causation and the Endogenous Relationship

Heretofore in this paper, the premise has been that institutional investors’ monitoring activity affects firm quality. Conversely, firm quality may attract institutional ownership. The prudence literature (e.g. Aggawaral & Rao, 1990; Badrinath et al., 1989, 1995, 1996; Del Guercio, 1996) supports this view, but any investor might prefer to invest in high-quality firms. Such bi-directional causation mandates examining the time series to see beyond the endogenous contemporaneous relationship. I estimate Granger causation models. Panel A of Table 3 shows that quality improvements attract institutions, but institutions subsequently preside over a valuation decline. The panel presents regression estimates of the association between changes in institutional ownership and changes in abnormal Tobin’s q . Abnormal Tobin’s q is the residual from the regression of Tobin’s q on the control variables used in the Table 2

Table 3. Causation Regressions for Abnormal q .

Panel A – Unconditional Change-Granger Causation Result	
Attract?: $\Delta \%IO_t = 0.021 + 0.011 \Delta \ln Q_{t-1}^*$	$\begin{matrix} (29.64) & (4.36) \end{matrix}$
Monitor?: $\Delta \ln Q_t^* = -0.022_{(-8.26)} - 0.240_{(-7.20)} \Delta \%IO_{t-1}$	
Panel B – Conditional Change-Granger Causation Result	
Attract?: $\Delta \%IO_t = 0.048 + 0.014 \Delta \ln Q_{t-1}^* - 0.078 \%IO_{t-1}$	$\begin{matrix} (33.62) & (5.02) & (-21.28) \end{matrix}$
Monitor?: $\Delta \ln Q_t^* = -0.028_{(-10.98)} - 0.158_{(-4.97)} \Delta \%IO_{t-1} - 0.147 \ln Q_{t-1}^*_{(-33.14)}$	
Panel C – Autocorrelation-corrected Change-Granger Causation Result	
Attract?: $\Delta \%IO_t = 0.024 + 0.010 \Delta \ln Q_{t-1}^* - 0.091 \Delta \%IO_{t-1}$	$\begin{matrix} (31.23) & (3.73) & (-9.53) \end{matrix}$
Monitor?: $\Delta \ln Q_t^* = -0.022_{(-8.26)} - 0.216_{(-6.52)} \Delta \%IO_{t-1} - 0.158 \Delta \ln Q_{t-1}^*_{(-17.06)}$	
Panel D – Combination Conditional and Autocorrelation-corrected Change-Granger Causation Result	
Attract?: $\Delta \%IO_t = 0.048 + 0.011 \Delta \ln Q_{t-1}^* - 0.059 \%IO_{t-1} - 0.074 \Delta \%IO_{t-1}$	$\begin{matrix} (34.16) & (4.13) & (-6.25) & (-20.06) \end{matrix}$
Monitor?: $\Delta \ln Q_t^* = -0.038_{(-15.15)} - 0.147_{(-4.77)} \Delta \%IO_{t-1} - 0.135 \ln Q_{t-1}^*_{(-14.89)} - 0.131 \Delta \ln Q_{t-1}^*_{(-29.38)}$	

Note: Regression estimates of the causal relationship between Tobin’s q and the percent of shares outstanding held by institutional investors. Below, $Q_t^* \equiv$ Abnormal Tobin’s q and $\%IO \equiv$ percentage Institutional Ownership. Abnormal Tobin’s q is the residual from the regression of Tobin’s q , as computed using the current “best practices” in academic research (as described in the text; these methods approximate those of [Lewellen & Badrinath, 1997](#)), on the control variables used in [Table 2](#) – normalized capital expenditures, profitability, capitalization and leverage. Obviously, institutional ownership is excluded from this unreported, first stage regression. percentage Institutional Ownership is the number of shares held by institutional investors divided by total shares outstanding at year’s end. Each pair of equations is estimated jointly using Zellner’s JGLS methodology. The Δ operator indicates changes over the relevant period. Parenthetical values are t -statistics.

contemporaneous regressions – normalized capital expenditures, profitability, capitalization and leverage. Residuals focus the analysis on the impact of institutions after accommodating other explanatory factors; obviously, institutional ownership is excluded from this first stage regression. Estimates are calculated using joint generalized least squares (JGLS; i.e. [Zellner’s \(1962\)](#) seemingly unrelated regressions approach). JGLS allows better estimation of the parameter coefficients by incorporating cross-correlations between the error terms of each pair of equations; JGLS is a systems-of-equations approach that accommodates the endogeneity problem.

Lagged changes in abnormal q are associated with subsequent increases in institutional ownership (γ_A is positive in Eq. (2)). I interpret this result as quality

improvements attracting institutional investment. Lagged changes in institutional ownership are associated with subsequent declines in quality (γ_M is negative in Eq. (3)). I interpret this result as institutions owning firms that experience quality and valuation declines. This signifies that institutions are ineffective as monitors of corporate management.

$$\Delta IO_{it} = \alpha_A + \gamma_A \Delta q_{i,t-1} + u_{Ait} \quad (2)$$

$$\Delta q_{it} = \alpha_M + \gamma_M \Delta IO_{i,t-1} + u_{Mit} \quad (3)$$

The change-Granger approach to causation offers advantages over a traditional Granger-causation test. It better accommodates two known errors-in-variables problems with this type of data. First, calculated q is a noisy values correlated with an immeasurable “true quality.” The mismeasurement is due to the computation method and is likely long-lived and relatively stable, so differencing the data will diminish the error. Second, the level of institutional ownership is also noisy. Because Spectrum relies on SEC 13(f) filing, my percent institutional ownership variable excludes: (i) small institutions not required to file; (ii) the tiniest holdings by large filing institutions; and (iii) foreign and other exempt institutions. Further, with the data aggregated from literally thousands of sources, systematic and random recording errors will arise. The differencing approach to causation will mitigate the effect of most of these errors. By reducing both errors, the power of my test increases. Further, [Perfect and Wiles \(1994\)](#) find changes in q are less susceptible to the idiosyncrasies of how q is computed than are levels of q .

3.4. Robustness

The causal relation result is robust. First, traditional Granger-causation tests (using levels rather than changes) also support the absence of institutional monitoring. Second, the results hold for a conditional version of the unconditional regressions given in Eqs (2) and (3); the conditional test adds lagged levels of the left-hand side variable.

$$\Delta IO_{it} = \alpha_A + \gamma_A \Delta q_{i,t-1} + \lambda_A IO_{i,t-1} + u_{Ait} \quad (4)$$

$$\Delta q_{it} = \alpha_M + \gamma_M \Delta IO_{i,t-1} + \lambda_M q_{i,t-1} + u_{Mit} \quad (5)$$

The conditional version assures that significant values for γ_A and γ_M in the unconditional regressions are not simply reflecting a spurious association between the lagged independent variable and lagged values of the left-hand side variable

(which are known to be related from Table 2); these results are presented in Panel B of Table 3. The sign and significance of the conditional results are unchanged – quality still attracts institutions, and institutions still preside over a subsequent value decline.

Further, the time-series behavior of Tobin's q and the level of institutional ownership are not responsible for the causation results. First, the relation between q and institutional investment is not a spurious association of two upward-trending variables; indeed, the long bull market did not inflate q – assets-in-place also rose. Further, Dickie-Fuller tau-statistics unambiguously reject the null hypothesis of a unit root for both series.⁷ Second, ARMA effects do not change the association between q and institutional ownership. Box and Jenkins (1976) heuristic procedures using correlograms of both a subset of individual firms and aggregate values do not suggest any significant ARIMA components. Overfitting tests also reject the presence of ARMA components. However, the time series is short, so statistical power is low.⁸ Because the AR(1) model was the best recommended of the overfitted models considered and because AR(1) is particularly problematic for my interpretation of the change-Granger tests, I re-examine those causation tests in a way that accommodates first-order autoregression. Here, the change-Granger tests are conditional on lagged *changes* in the left-hand side variable.

$$\Delta IO_{it} = \alpha_A + \gamma_A \Delta q_{i,t-1} + \lambda_A \Delta IO_{i,t-1} + u_{Ait} \quad (6)$$

$$\Delta q_{it} = \alpha_M + \gamma_M \Delta IO_{i,t-1} + \lambda_M \Delta q_{i,t-1} + u_{Mit} \quad (7)$$

Autocorrelation will result in significant values of λ_A and λ_M . The results presented in Panel C of Table 3 do find autocorrelation, but the sign and significance of the γ parameters remains unchanged. Reversion (or persistence) of q is not driving the result; again, the attraction and non-monitoring results hold.

Note further that these causation results hold when industry fixed-effects are included (the single intercept of an ordinary least squares regression is replaced with an intercept unique to each industry). Doing so absorbs industry-specific variations not captured by the independent variables (Mundlak, 1961). Hausman and Taylor (1981) state that the fixed-effects framework represents a common, unbiased method of controlling for omitted variables in a panel data set. Allowing by-industry variation reflects the plausible hypothesis of variation in firm valuation across industry sectors; it also accommodates industry-selection trends by institutions.

The foregoing results, across the three primary specifications, hold whether abnormal q or raw q is used; see Table 4 for estimates with raw q (recall abnormal q is the residual from regressing q on the control variables). This means the

Table 4. Causation Regressions for Ordinary q .**Panel A – Unconditional Change-Granger Causation Result**

$$\text{Attract?}: \Delta \%IO_t = 0.021 + 0.002 \Delta \ln Q_{t-1}$$

(31.28) (2.67)

$$\text{Monitor?}: \Delta \ln Q_t = -0.053 - 0.373 \Delta \%IO_{t-1}$$

(-8.80) (-4.97)

Panel B – Conditional Change-Granger Causation Result

$$\text{Attract?}: \Delta \%IO_t = 0.047 + 0.003 \Delta \ln Q_{t-1} - 0.077 \%IO_{t-1}$$

(35.53) (3.88) (-22.52)

$$\text{Monitor?}: \Delta \ln Q_t = 0.235 - 0.139 \Delta \%IO_{t-1} - 0.240 \ln Q_{t-1}$$

(-30.12) (-2.04) (-51.90)

Panel C – Autocorrelation-corrected Change-Granger Causation Result

$$\text{Attract?}: \Delta \%IO_t = 0.023 + 0.002 \Delta \ln Q_{t-1} - 0.088 \Delta \%IO_{t-1}$$

(32.72) (1.88) (-9.71)

$$\text{Monitor?}: \Delta \ln Q_t^* = -0.060 - 0.354 \Delta \%IO_{t-1} - 0.144 \ln Q_{t-1}^*$$

(-10.03) (-4.76) (-19.05)

Note: Regression estimates of the causal relationship between Tobin's q and the percent of shares outstanding held by institutional investors. Below, $Q_t \equiv$ Tobin's q and $\%IO \equiv$ percentage Institutional Ownership. percentage Institutional Ownership is the number of shares held by institutional investors divided by total shares outstanding at year's end. Each pair of equations is estimated jointly using Zellner's JGLS methodology. The Δ operator indicates changes over the relevant period. Parenthetical values are t -statistics.

non-monitoring findings are more robust because they do not require incorporation of specific control variables.

Substantially similar implications may be drawn from a model that combines the features of the conditional and autocorrelation-corrected models – that is, both lagged changes and levels of the independent variable. See Panel D of [Table 3](#).

Because the causal models rely heavily on changes in the variables of interest, it is possible that no-change observations ($\Delta z = 0$) may be influential and could drive inferences. Inspection of the firm-level time series of Tobin's q and percentage institutional ownership should mitigate concerns – both series are almost universally dynamic. As a robustness check, the conditional causal model is estimated without zero-change observations. Results are qualitatively identical to the full-sample results.

As noted in [Section 3.1](#), annual data is preferable for analyzing monitoring, but quarterly analysis allows a richer characterization of the time-series relationship between institutional ownership and q . It also affords more data. Quarterly analysis (available upon request) supports the conclusion that that quality firms attract institutions but institutions do not monitor and firm value declines.

The contemporaneous relationship is also robust. In [Table 2](#), the Classic model includes indicator variables for each year and industry in lieu of the Simple

Model's single intercept. It is classic in the sense that most of the relevant literature uses such indicators. Allowing for intertemporal and by-industry variation reflects the plausible hypothesis of variation in firm quality across these dimensions; it also accommodates intertemporal and industry-selection trends by institutions (see Hirsh & Seaks, 1993; Morck et al., 1988). As would be expected, the model R^2 rises dramatically; the value, 27%, is similar to other studies. Parameter values and significance levels are similar to those in the Simple Model. Again, institutional ownership is negatively and significantly associated with firm quality.

Two additional models are included in Table 2 as further contemporaneous robustness checks. First, I estimate a Fixed Effects Model where an intercept unique to each firm replaces the single OLS intercept. As with the JGLS fixed effects approach, this absorbs firm-specific variations not captured by the independent variables. Institutional ownership is negatively and significantly associated with firm quality.⁹ Second, I conduct Time Series Aggregation regressions based loosely on the methods of Fama and MacBeth (1973). This approach addresses concerns about time-series *vs.* cross-sectional effects. While the Classic Model allows the intercept to vary by year, this approach allows all parameters to vary by year. Specifically, I compute a separate Simple Model cross-sectional regression each year. I then compute mean coefficient values and *t*-statistics using the time-series of the coefficient estimates. Since there are more observations later, variance changes over time; to control for this heteroskedasticity, I weight the mean results and *t*-statistics by number of observations. As before, the parameter estimates all retain their signs and all remain significant. These Time-Series Aggregation results are particularly incriminating against claims that the Classic Model results are due to simultaneous secular trends – increasing institutional ownership and increasing stock prices. In fact, Tobin's *q* has not enjoyed anything like a monotonic rise over the sample period. While the market has risen dramatically in this era (affecting *q*'s numerator), so too have total asset values (the denominator).

The contemporaneous results are robust to other methodological variations that accommodate different potential statistical problems. First, the parameter coefficients in the contemporaneous Simple Model retain their sign and significance when each control variable is excluded in turn, so, the relation between institutional ownership and quality is not due to spurious, or non-linear, correlation between the level of institutional ownership and a control variable. As noted, the relationship is robust to numerous alternate specifications of control variables. Third, influential observations or outliers are not responsible for the results. To test for robustness to extreme observations, I trim the extreme 10% of each year's observations for Tobin's *q*, institutional ownership and the control variables; these trimmed results are qualitatively the same as the results in Table 2.¹⁰ Fourth, my results are robust to including various measures of liquidity as additional control variables.

Consistent with the Amihud and Mendelson (1988) argument that illiquid stocks have lower valuations, [Capozza and Seguin \(1998\)](#) find that capital market liquidity significantly affects q in their single-industry sample. In my (all-industries) sample, liquidity does not affect my conclusions; the relation between institutional ownership and q stays negative despite the addition of liquidity variables like return variance, volume, inverse price or bid-ask spread. Fifth, non-parametric tests confirm the negative relation between institutional ownership and q .¹¹ Finally, note that the negative contemporaneous relation holds in the univariate case.

3.5. *Economic Significance*

The impact of institutional ownership is significant, both econometrically and economically: First, the semi-log specification means a 25% increase in the percent of a firm held by institutional investors is associated, *ceteris paribus*, with a 17% decline in q . In dollar terms, a 5% increase in the level of institutional ownership is associated with a \$35 million decline in value for a firm with my sample's mean of \$768 million.¹² Second, Tobin's q is leptokurtic, so it assumes "off-peak" values for smaller changes in institutional ownership than if it were distributed normally. Third, to assure the effect of institutional ownership has market-wide significance, I re-estimate the three change-Granger models using capitalization-weighted least squares. This value weighting produces the same result as equal weighting – evidence of institutional attraction but no support for institutional monitoring. Also, value-weighting the contemporaneous Classic Model produces the same result as equal-weighting – the estimated coefficient for the level of institutional investment remains negative and strongly significant. Finally, I assure there are no non-linearities that affect economic significance.¹³

3.6. *Relation to Prior Research*

Sections 1 and 2 note several distinctions from prior research. The change-Granger framework is a methodological advance for institutional monitoring research.¹⁴ The extensions in Sections 4 and 5 of analyzing institutional type and, more significantly, institutional characteristics represents a further enhancement over prior work. In order to gain insight into institutions' on-going monitoring efforts, this study, by design, uses data that is comprehensive – across firms and time. This helps avoid misattribution, time-series problems and selection-biases that affected prior work.

Because [McConnell and Servaes \(1990\)](#) is the seminal work relating firm valuation and institutional owners for a broad sample of firms, I address it directly.

Note first that McConnell and Servaes is only concerned with the contemporaneous relationship between institutional ownership and firm value – not the causal one.

Many researchers citing [McConnell and Servaes \(1990\)](#) choose to ignore the fact that McConnell and Servaes find a positive relation between Tobin's q and institutional ownership but *no relation* for 5% blockholders. Because most such blockholders could simply be larger institutional investors, this substantially weakens the institutional monitoring protagonists' case. McConnell and Servaes are simply documenting a non-linearity in institutional ownership; interestingly the institutions one might expect to be effective monitors are not – while smaller institutions are.

McConnell and Servaes use poor-quality data. While they examine both 1976 and 1986 data, their results for institutional ownership in 1976 are less relevant since they document in their Note 3 that their data source, Value Line, limited coverage of institutions to only investment companies in 1976 but subsequently covered all institutional investors. Further, the footnote suggests some ambiguity on the part of Value Line as to what the data actually represents. [Kole \(1995\)](#) reports Value Line does not provide an ownership measure that is consistent across firms. [Anderson and Lee \(1997\)](#) also show Value Line is a relatively poor data source for ownership research. I use more comprehensive data than prior works which relied on limited time series (1 or 2 years) and cross-sections (500–1000 firms) of data. In contrast, I have an extensive time series and a broader intra-year sample.

[McConnell and Servaes \(1990\)](#) jointly test institutional and insider ownership data. While reasonable for examining the *partial* impact of the two groups or considering monitoring in general, joint tests do not address institutional monitoring directly. Insiders and institutions have different incentives to monitor; [Van Nuys \(1993\)](#) notes institutional investors' opposition to antitakeover charter amendments increases as managerial holdings rise. I exclude potentially confounding insider ownership data.

While the results already documented are at odds with McConnell and Servaes, I am able to replicate results consistent with them. My evidence suggests their parameter estimates may be sample- and/or specification-dependent.

If I follow McConnell and Servaes and segregate 5% blockholders from other institutional owners as well as restrict my sample to NYSE-AmEx firms in 1986 and use their model specifications, I also find the association between Tobin's q and institutional ownership is positive. However, expanding the sample reverses the results – producing results consistent with my [Table 2](#). This is true both with and without their set of control variables (regressions comparable to their models 2.4 and 1.7). See Models 1–4 of [Table 5](#).

Also note that if one adds a profitability measure to their set of control variables, their result again reverses; see Model 5 of [Table 5](#). This suggests an

Table 5. Relation to Prior Research.

Model	1	2	3	4	5
NYSE & AmEx	Yes	Yes	Yes	Yes	Yes
Nasdaq	No	Yes	No	Yes	No
Era	1986	Full Sample	1986	Full Sample	1986
Intercept	Unique	Unique	Unique	Unique	Unique
Control Variables	No	No	M&S Base Controls	M&S Base Controls	M&S Base Controls + ROA
Institutional Ownership	0.187 (1.53)	−0.038 (−0.76)	0.454 (2.06)	−0.400 (−4.25)	−0.070 (−0.36)
Blockholder Ownership	−1.532 (−2.46)	−1.513 (−9.60)	−2.182 (−2.66)	−2.441 (−6.74)	−1.869 (−2.67)
Blockholder Ownership ²	1.476 (1.06)	1.419 (4.20)	4.551 (2.38)	3.376 (3.76)	3.391 (2.07)
Obs	1129	17588	249	4129	249

Note: Regression coefficient estimates of the association between Tobin's q and the percent of shares outstanding held by institutional investors under the [McConnell and Servaes \(1990\)](#) specifications and sample restrictions. Control variables include their specifications of advertising expenditure, R&D expenditure and debt. In Model 5, ROA is return on assets. Institutional ownership is the number of shares held by institutional investors divided by total shares outstanding. In this table only, however, it excludes holdings by 5% blockholders, which are included separately. Parenthetical values are t -statistics.

omitted-variable bias. Profitability and firm quality are positively associated. It is also plausible that institutional owners are attracted by greater profitability; in my sample, I find a significant positive correlation between institutional ownership and return on assets as well as a significant positive correlation between return on assets and Tobin's q . Others researchers include profitability measures; see Yermack (1996) and Chung and Jo (1996).

4. BY-TYPE VARIATION

Institutions are not a monolithic body. The incentives, culture and regulations governing banks, insurance companies, mutual funds, investment advisors, pensions and endowments vary widely. Here I discuss each in turn. The legislative and regulatory review is based in part on several mammoth law review articles – each over eighty pages long. As Black (1990) notes, the length is part of the message (also see Coffee, 1991; Roe, 1990). The range of regulatory and statutory barriers to institutional monitoring is large and the cumulative effect larger still.

4.1. The Influence of Institutional Type

Banks have long been limited from owning stock. The National Bank Act of 1863 precluded control of industrial corporations; in 1892, the Supreme Court ruled banks could not own any stock. The Glass-Steagall Act of 1933 separated banks from their underwriting subsidiaries. The Bank Holding Company Act of 1956 limits its namesake entities to holding less than 5% of a company's voting stock. Bank trust departments are also constrained with respect to stock ownership. First, prudence standards encourage extreme diversification at the level of the individual trust. Trust law in the sample period is such that trustees are liable for money lost of each investment; winners cannot be netted against losers. Prudence requirements do affect investment selection; empirically, prudence-constrained investors prefer low market-to-book stocks (Del Guercio, 1996). Second, OCC regulations limit investments in a firm to 10% of the bank's aggregate trust investments. Third, trust clients may select banks as investment managers for stability not excitement; a noisy, activist posture may be the antithesis of what trust clients want. Banks' large debt portfolios could aid monitoring except firewalls separate lending and trust activity; any shared monitoring activity would be strictly informal. Further, prudence requirements might limit banks' trust investments to the larger, more established corporations than the typical spectrum of lending customers, so co-monitoring opportunities would be reduced. Finally, banks' corporate borrowers

are their key customers and may dislike activist monitors.¹⁵ I expect banks to be attracted to nominally prudent, low q stocks and to be disinclined to monitor.

While not fiduciaries like most other institutions (Van Nuys, 1993), insurance companies also face serious restrictions on stock ownership. Both life and property insurers are substantially subject to New York rules (58 and 82%, respectively); other states have comparable restrictions, so New York regulations are a norm. Position constraints limit insurers' monitoring ability. Life insurers are limited to 20% of assets in stock with no more than 2% in one stock; property insurers cannot control another company. Further, equity control of a corporation automatically subordinates (in bankruptcy) even nominally senior debt; since most insurance assets are debt, this discourages control. Finally, corporate insurees may dislike activist monitoring and take their insurance business to a less vociferous insurer (again, see Brickley, Lease & Smith, 1988, 1994; Van Nuys, 1993). How will insurers, forced to invest primarily in non-equities, invest their equity allocation? The conservatism of the bulk of the portfolio could carry over to stocks; alternatively, a very aggressive equity posture would adjust the portfolio risk to where it would be absent regulation. Given the growing market among constrained-to-debt investors for debt products with enhanced, equity-like features, I speculate that insurer's equity allocation will be aggressively invested in high q , growth companies. Because they have a longer investment horizon and are subject to fewer barriers than mutual funds and banks, I expect insurers to be attracted to higher q companies and to be somewhat better monitors.

The 1934 Senate Pecora Report sought to separate *investment-oriented* mutual funds from *management-oriented* holding companies and included strongly worded language that Congress must "prevent the diversion of these (mutual funds) from their normal channels of diversified investment to the abnormal avenues of control of industry." Pecora led to the Investment Company Act of 1940, which requires diversified mutual funds to limit 75% of their portfolio to positions smaller than 5% of assets. The Pecora Report asserts that concentrated financial control serves no productive function but rather perverts the use of the controlled companies and is detrimental to the public welfare. Tax law also limits mutual funds since failure to meet IRS provisions eliminates their ability to pass income through untaxed; half of the portfolio must be in positions of less than 5% of the fund and 10% of the owned firm. When an investment bank or its affiliate manages a mutual fund, 5% ownership precludes the bank from doing business with the corporation. When Peter Lynch joined W. R. Grace's board, Fidelity felt compelled to have all of its funds divest Grace in keeping with the spirit of the 1940 Act seeking complete separation of mutual fund management and corporate governance. Fund compensation arrangements, based largely on assets managed, create an anti-monitoring agency problem. Monitoring entails costs that

affect performance; performance drives inflows (and thus assets); there are huge rewards to top performers (Chevalier & Ellison, 1999; Hendricks et al., 1993; Sirri & Tufano, 1993). Any monitoring costs could drop returns out of the top performers. Additionally, growth in 401(k) investing increases corporate influence over mutual funds. Open-ended mutual funds embrace investor liquidity by design – more than any other institution – so one expects small positions and little monitoring for the reasons noted in the introduction. Indeed, funds' liquidity requirements may make corporate management loath to begin discourse with them. While there have been limited announcements of investment company activism (e.g. "Fidelity is freeing its funds to be assertive investors" [*New York Times*, 12/5/89]), the barriers to mutual fund monitoring are high. Are funds attracted to high market-to-book stocks? While there are multitudes of mutual fund investment styles, the industry has been accused of "style-drift." There are strong incentives for mutual funds to drift toward high q growth stocks. Window-dressing and managerial labor market concerns induce investment in stocks that give the appearance of investment skill; these are high q stocks. I expect mutual funds to be attracted to high q companies but unable to effectively monitor because of the many regulatory and structural hurdles.

The investment advisor category primarily consists of registered investment advisor (RIA) fiduciaries who direct others' investments. RIA clients include wealthy individuals, trusts, public and private pensions, endowments, etc. (To the extent the portfolios managed by RIAs reflect these investors, see the descriptions of the other categories.) Investment advisors are more likely to be hired for a specific investment style than other institutions; deviations are more quickly detected and punished (given the greater sophistication of their clients and those clients' greater ability to hire pension consultants and other monitors). These pension consultants and a quarterly analysis horizon may lead to a myopic perspective for investment advisors; myopia discourages monitoring. The investment advisor category in Spectrum also includes investment banks that cannot conduct lucrative underwriting for firms where they control more than 5% of the stock. I expect investment advisors to have a greater range of investment styles (i.e. be attracted to a range of q); for the reasons outlined above and the reasons relating to RIA clients like pensions and endowments, I expect them to be ineffective as monitors.

For pensions, ERISA virtually requires diversification and subjects managers to the "prudent expert" standard. With respect to portfolio management, the prudent expert rule is essentially behavior dictated by modern finance texts. With respect to monitoring or exercising corporate governance, Roe (1990), Coffee (1991) and Black (1990) raise the prospect of requiring expertise of pension managers rather than a lower "sound business judgment" standard. Faced with this ill-defined standard, pension managers may demure from attempting management monitoring

(rather than face personal liability). There are also cultural barriers to monitoring; senior corporate managers probably dislike institutional monitoring and likely view unfavorably their pension-administering subordinates' monitoring activities. To the extent that public pensions are not subject to this constraint, they will be more likely to monitor (public pensions are unique among all institutional owners in this respect). Department of Labor (DoL) regulations require voting of proxies in the interests of the pension plan beneficiaries (Albert, 1994); anomalously, DoL explicitly discourages pensions from initiating proxy proposals.

Endowments are unique in that they have an infinite horizon and the goal of preserving purchasing power is usually very explicit. Beneficiaries (universities and grant recipients) may expect a smooth or non-decreasing payout; further, many make payouts of 5% of assets (Kennedy, 1996). The focus on preserving purchasing power and smoothing payouts may encourage investing in value-oriented, low q stocks. Endowments may be disinclined to monitor since they need the goodwill of wealthy individuals and corporate donors; such donors likely view shareholder activism unfavorably. Often universities have on-going links with companies (e.g. Rochester-Kodak & Emory-Coca-Cola) and are unlikely to be critical of management. Further, donors are likely well-represented in the endowments' own governance structure. Gift terms may mandate holding a stock indefinitely, so both monitoring and selling poor performers are not possible. Finally, there may be little financial incentive for endowment managers to monitor; John Neff managed the University of Pennsylvania's endowment *pro bono*.

Indexing's relationship to q and monitoring is considered under pensions and endowments since these investors seem especially prone to index. The same points would apply to an index mutual fund or bank trust. As indexing grows, demand for index stocks becomes motivated by a powerful factor other than relative investment worth. So, index membership might reasonably be included as a factor attracting institutions. Index membership and monitoring are a more complex association. Both the high visibility of index members and the long-term orientation of index investment suggest more monitoring. Monitoring may seem the only way to enhance returns in an indexed portfolio. However, low expenses and transaction costs are a key motivation for indexing; with index mutual funds charging less than twenty basis points in expenses (and non-retail index pools cheaper), there is little room for costly monitoring. Indeed expense levels drive competition among index funds, so no monitoring seems the equilibrium outcome. If institutions are passively selecting stocks, their formulaic approach to investment also draws criticism; executives could view passive institutions as other than "real" shareholders who bought after research led to an informed position on a company's plans and prospects. Indexers' passivity makes them seem peripheral shareholders less entitled to a voice in corporate governance.

As with investment advisors, I expect pensions, endowments and foundations to have a greater range of investment styles (more dispersion in q). Although there are barriers to monitoring, pensions at least have two major factors encouraging monitoring. First, ERISA requires some activism. Second, public pension funds, uniquely among institutions, are not even indirectly answerable to corporate management.

Incentives for and barriers to monitoring across institutional type differ over a number of dimensions – prudence requirements, concentration regulations, management co-option, liquidity demands, *etc.* Developing clear-cut implications is difficult; however, some reasonable priors are possible. The well-documented impact of banks' prudence requirements strongly suggests attraction to low q stocks. Pension and endowments, and possibly insurers, have lower liquidity needs and longer investment horizons that encourage monitoring. Mutual funds certainly have many reasons to be associated with non-monitoring but the strength of those reasons is difficult to gauge except to say that investment advisors are less susceptible to them. One plausible *a priori* ranking of which institutional types will be associated with effective monitoring is banks (lowest), mutual funds, investment advisors, insurers, and pensions and endowments (highest).

4.2. Results for Institutional Types

Causation results do detect by-type differences in institutional behavior. They suggest mutual funds and independent investment advisors drive the no-monitoring relationship noted in Section 3. The specific procedure taken is to partition the percent of outstanding shares held by all institutions into percents of outstanding shares held by each of the five institutional types – banks, insurers, mutual funds, investment advisors and pensions/endowments. I then address the endogenous nature of the association between institutional ownership by different types of institutions and Tobin's q by conducting JGLS regressions of the attraction and monitoring coefficients from Eqs (4) and (5). Separate pairs of this conditional version of the change-Granger tests are estimated for each of the five institutional types; results are in Table 6.

There is little empirical support for broad institutional monitoring – even after controlling for how different Tobin's q may influence institutional investment. The attraction parameter estimates, γ_A , indicate that mutual funds, investment advisors and (surprisingly) banks are attracted to higher Tobin's q . There is no statistically significant association between lagged changes in q and current changes in holdings by insurers, pensions and endowments (this can be interpreted as insurers, pensions and endowments being least subject to style drift). The

Table 6. Causal Relations and Institutional Type.

	Parameter Estimate – Attraction	Parameter Estimate – Monitoring
Banks	0.005 (4.35)	–0.041 (–0.65)
Insurers	–0.001 (–0.99)	0.009 (0.08)
Mutual Funds	0.005 (6.28)	–0.441 (–4.21)
Investment Advisors	0.005 (2.87)	–0.234 (–5.20)
Pensions & Endowments	–0.0003 (–0.34)	0.287 (2.44)

Note: Regression coefficient estimates of the causal association between abnormal Tobin's q and the percent of shares outstanding held by different types of institutional investors. Abnormal Tobin's q is the residual from the regression of Tobin's q on the control variables used in Table 2 – normalized capital expenditures, profitability, capitalization and leverage.

$$\Delta IO_{it} = \alpha_A + \gamma_A \Delta q_{i,t-1} + \lambda_A IO_{i,t-1} + u_{Ait}$$

$$\Delta q_{it} = \alpha_M + \gamma_M \Delta IO_{i,t-1} + \lambda_M q_{i,t-1} + u_{Mit}$$

The Attraction parameter estimate, γ_A , is from a regression of changes in institutional ownership (by a specific type of institution) on lagged changes in abnormal Tobin's q ; the Monitoring parameter estimate, γ_M , is from a regression of changes in abnormal Tobin's q on lagged changes in institutional ownership (by a specific type of institution). Each Attraction-Monitoring pair is from a separate pair of multivariate regressions estimated using JGLS; each equation includes lagged levels of the dependent variable. Parenthetical values are t -statistics.

monitoring parameter estimates, γ_M , are negative or indistinguishable from zero for most institutions – banks, insurers, mutual funds and independent investment advisors. This suggests most institutions do not monitor; however, pensions and endowments do Granger-cause increases in Tobin's q . This suggests that pensions and endowments, hypothesized to be the institutional type most likely to monitor, do so.

In summary, the causation results suggest value-increasing monitoring is restricted to a subset of institutions – only pensions and endowments monitor; banks, insurers, mutual funds and investment advisors do not. Note further that an F -test on the contemporaneous regression results (available upon request) support the conclusion of by-type differences in institutional behavior. The finding in the causal regressions that pensions and endowments are effective monitors of corporate managers reverses the most surprising contemporaneous by-type result. The contemporaneous regressions' indictment of pensions as non-monitors was surprising in light of well-documented activism by several pensions. This reversal in the causal test underscores the importance of separating the attraction and monitoring effects with a Granger-causation system of equations.

5. CHARACTERISTICS ENCOURAGING MONITORING

I next consider the institutional characteristics that encourage monitoring. By “characteristics,” I mean distinctions at the level of the institutional investor. Both the strong evidence that monitoring ability differs across institutional types and the laundry list of barriers to monitoring for institutions of all types collectively and each type individually motivate this inquiry into institutional characteristics. Some institutions may have sufficiently strong incentives to overcome these barriers and monitor; this focus on characteristics is an attempt to segregate the monitoring-prone institutions. By focusing on individual characteristics, I avoid some difficulties in developing hypotheses and drawing clean inferences.

5.1. *The Influence of Institutional Characteristics*

The characteristics affecting the likelihood of monitoring are based in part on the presumption of relatively fixed and non-trivial costs of monitoring. In some respects the fixed costs of monitoring are comparable to analysts’ information set-up costs (Merton, 1987). Monitoring costs include costs of information gathering, filing proxies, meeting with firm management, *etc.*¹⁶ Whether or not an institutional investor undertakes monitoring depends on cost-benefit analysis where the institutional owner’s benefit – (probability of monitoring success) \times (percent ownership) \times (corporate benefit) – must exceed its cost. Given the costs of monitoring a particular firm are largely fixed, one can see the central importance of the *fractional ownership of the firm* by an institution.

If monitoring entails set-up costs to begin gathering firm-specific information or begin building a relationship with corporate management, then the *expected holding period* of the investment will affect propensity to monitor. Institutions with longer expected holding periods would amortize this start-up cost over the longer horizon. This effect is akin to the Amihud and Mendelson (1986) liquidity-clientele effect where long-term investors amortize an initial illiquidity cost.

The *size of the portfolio* affects monitoring other ways. First, corporate managers may be more responsive to monitoring pressure of a large institutional investor than a small one. In addition to the greater credibility and prestige of a big institution, larger institutions have a more plausible implicit threat of increasing their stake. Second, larger institutions may experience economies of scale in monitoring. Economies might arise from prior or contemporaneous monitoring experience, experience with similar companies and more monitoring skills already available cheaply in-house.

As noted, institutions suffer from free-rider incentive problems where each relies upon other institutions to undertake monitoring. The *largest institutional owner* has the strongest incentives to monitor and to avoid free-riding. If sufficiently large relative to other institutions, it has a natural leadership position. So examining the stake size of the largest institutional owner looks at institutional monitoring with potentially less free-riding. Additionally, examining the *difference between the two largest institutions* captures the strength of the incentive to avoid free-riding.

Given potential free-rider problems I also consider another subset of institutions less likely to succumb. Rather than focus on a particular institutions' investment relative to the firm I consider the particular institutions' investment relative to its own portfolio. Specifically, I expect institutions with a *large percent of their portfolio* invested in a stock to be most inclined to monitor. In addition to the percent of the portfolio allocated to a stock, the *dollar size of the position* is important since a larger portfolio can afford a larger monitoring staff than a small one. A \$100 million position may merit monitoring whether an entire portfolio or only a small component.

Corporate management's responsiveness strongly affects the probability of successful monitoring. Certain institutional characteristics discussed above will have a double impact since they affect *corporate responsiveness* by raising the institution's likelihood of influence. Characteristics affecting corporate responsiveness include larger share of the firm held, longer expected holding period and portfolio size. Larger institutions also carry an implicit threat of increasing their stake. Further, institutions known for monitoring-style or relational investing may find corporate management more responsive to their advances.

Note that some of the pro- and anti-monitoring influences discussed in Section 2.1 are either ignored or subsumed into other factors. The by-type distinctions are ignored here; given sufficiently large investments, institutions will overcome most hurdles to monitoring. Institutional myopia is covered by the expected holding period. Institutional proclivity for diversification and liquidity are considered in the size measures.

5.2. Calculations and Results for Institutional Characteristics

Analyzing institutional characteristics' impact on a firm is a difficult iterative process requiring calculating company characteristics, accumulating portfolio properties with respect to the characteristics, computing cross-sectional breakpoints, then accumulating values for each company held by portfolios with certain characteristics. Table 7 presents JGLS regression estimates of the attraction and monitoring coefficients from the causation Eqs (4) and (5). Separate pairs

Table 7. Causal Relations and Institutional Characteristics.

Short Name	Variable of Interest	Parameter Estimate – Attraction	Parameter Estimate – Monitoring
Fraction of firm	Percent of the firm held by institutional owners with $\geq 3\%$ of the firm	-0.005 (-1.69)	-0.067 (-1.93)
	Percent of the firm held by institutional owners with $\geq 5\%$ of the firm	-0.005 (-1.71)	-0.041 (-1.16)
Big portfolios	Percent of the firm held by institutional owners in the top 10% when institutional portfolios are size ranked annually	-0.001 (-0.96)	0.223 (3.15)
Big positions	Percent of the firm held by institutional owners with \$100 million positions in the firm (sample restricted to ensure possible)	-0.001 (-1.01)	0.156 (3.40)
Largest shareholder	Percent of the firm held by largest institutional owner	-0.001 (-0.55)	-0.105 (-2.25)
Largest – Second	Difference in percent of the firm held by the two largest institutional shareholders	-0.0001 (-0.16)	-0.1174 (-2.45)
Long horizon	Percent of the firm held by institutional owners with turnover in the bottom 10%	0.003 (1.60)	-0.052 (-1.85)
Percent of the portfolio	Percent of the firm held by “focused” institutional owners with $\geq 3\%$ of the institutional portfolio invested in the firm	0.001 (0.53)	0.286 (4.62)

Note: Regression coefficient estimates of the conditional causal association between abnormal Tobin’s q and the percent of shares outstanding held by institutional investors with the indicated characteristics. Abnormal Tobin’s q is the residual from the regression of Tobin’s q on the control variables used in Table 2 – normalized capital expenditures, profitability, capitalization and leverage.

$$\Delta IO_{it} = \alpha_A + \gamma_A \Delta q_{i,t-1} + \lambda_A IO_{i,t-1} + u_{Ait}$$

$$\Delta q_{it} = \alpha_M + \gamma_M \Delta IO_{i,t-1} + \lambda_M q_{i,t-1} + u_{Mit}$$

The Attraction parameter estimate, γ_A , is from a regression of changes in institutional ownership (by institutions with specific characteristics) on lagged changes in abnormal Tobin’s q ; the Monitoring parameter estimate, γ_M , is from a regression of changes in abnormal Tobin’s q on lagged changes in institutional ownership (by institutions with specific characteristics). Each Attraction-Monitoring pair is from a separate pair of multivariate regressions estimated using JGLS; each equation includes lagged levels of the dependent variable. Parenthetical values are t -statistics.

of this conditional version of the change-Granger tests are estimated for each institutional characteristic. Unlike with different types of institutions, there is little reason to expect differential attraction by institutions with these different characteristics. In the discussion that follows, I ignore the attraction coefficients. They are all indistinguishable from zero.

I first consider instances where individual institutions own significant stakes in the firm. I use two levels for significant. My primary focus for significance of *fractional ownership of the firm* is the 3% level; a secondary focus is the 5% regulatory breakpoint.¹⁷ Because my interest is in the effect of fractional ownership on a company, I compute the percent of each company held by institutional shareholders owning more than three percent of the firm. Table 7 shows these shareholders are ineffective as monitors; the γ_M monitoring coefficient is insignificantly different from zero. The results hold for the percent of the firm held by 5% shareholders.

I next consider *size of the portfolio*. Each year I compute the total portfolio value for every institutional investor in the sample. I then compute the percent of the firm owned by institutional shareholders drawn from among each year's top portfolio-value decile. Regression estimates indicate these largest portfolios are effective monitors – lending credence to the prestige, credibility, plausible implicit threat and economies of scale stories.

In addition to large portfolios, I consider *large positions* in a single stock. I compute the percent of the firm owned by shareholders whose position in the firm is valued at more than \$100 million. Regression estimates indicate these largest holdings are effective monitors – lending credence to the “deputy portfolio manager for monitoring” notion that a large position in a security may merit monitoring whether an entire portfolio or only a small component.

The *largest institutional shareholder*, counter-intuitively, does not appear to respond to its stronger incentives to monitor and to avoid free-riding. The estimated coefficient for these big institutional owners is negative and statistically significant under causal, contemporaneous and univariate specifications. The coefficients are also negative and statistically significant when the difference in ownership of the top two shareholders is used.

I next examine the *expected holding period*. Because some institutions may build a reputation as long-term investors, I base this measure of long-horizon investing on the expected, rather than actual, holding period for an institutional stake in a firm. Expected holding period is reasonably inferred from an institutional portfolio's turnover level. Accordingly, I calculate portfolio turnover for each institutional investor. Because of the somewhat limited time-series, I compute turnover over the whole period. Any look-ahead bias introduced is not problematic since institutional management may be able to credibly signal to company management

their intent to hold for the long-term (with standstill agreements or choices in regulatory disclosures). I then compute the percent of the firm held by institutional shareholders who are in the bottom turnover decile. They are not effective monitors; the monitoring coefficient γ_M is statistically indistinguishable from zero.

Finally, I evaluate the effect of focused portfolios where a stock represents a significant *fraction of the portfolio*. I consider positions larger than 3% of the portfolio significant. For most institutional investment, a three percent allocation is large.¹⁸ I compute the percent of the firm held by institutional investors with more than 3% of their portfolio in a stock. [Table 7](#) presents parameter estimates that indicate these institutional portfolios are effective monitors. The coefficient is positive and strongly statistically significant.

Ownership by the largest portfolios, by individual large dollar stakes and by focused portfolios is associated with significantly higher firm quality or increases in valuation. That focus matters suggests that institution-specific incentives are critically important. Focused institutional managers may have less opportunity to shirk monitoring. It is also suggestive that investment management talent can be spread too thin by over-diversification and that there may be an optimal portfolio size ([Nanda et al., 1999](#)). The causation results suggest analyzing large and most focused institutions in future research.

Institutional ownership of large fractions of the firm, the largest position and the largest position when big relative to other institutions is not associated with effective monitoring. There is little support for any notion of a lead institutional investor akin to the monitoring lead (outside) director prescribed by corporate governance experts. Too, long-horizon institutional investors are ineffective; this suggests that management's complaint against transient shareholders are ill-informed.

6. CONCLUSION

The separation of ownership and control in large modern corporations enables agency problems to arise; dispersed ownership can allow firm management to shirk, take perqs, empire build or otherwise not maximize shareholder value ([Berle & Means, 1932](#)). Much analysis focuses on the role of managerial ownership in mitigating the problem (e.g. [Jensen & Meckling, 1976](#); [Stulz, 1988](#)). The scale of large modern corporations, however, may restrict managerial ownership, so it is worthwhile to consider whether other investors' monitoring encourages managers to act in shareholders' interest. In particular, modern corporations require collection of funds from a large number of investors who may be atomistic and unable to collect the information necessary to exercise their control rights. Institutions like banks, insurance companies, mutual funds, investment advisors,

pensions and endowments are large, active, growing and important investors in the stock market. Several arguments suggest that institutions may perform important monitoring roles, but there are also many barriers to institutional monitoring.

In this article, I attempt to characterize the association between institutional ownership and value-enhancing institutional monitoring more comprehensively than in prior research. I find there is little empirical support for the hypothesis that institutions pervasively undertake monitoring which increases firm quality, performance and valuation. In fact, I find that increases in firm valuation attract institutional investment, but quality and valuation decline subsequent to the institutional investment.

However, some anecdotal evidence and academic studies do support institutional monitoring, so I refine the focus of the study. In this stage, I focus on institutional incentives to monitor. I first consider the differences in incentives for and barriers to monitoring across different types of institutions. When the issue is framed in its proper time-series causal structure, I find that pensions and endowments alone are effective monitors. Banks, mutual funds, insurers and investment advisors are not. Next, I consider the institutional characteristics that would provide strong incentives for specific institutions to monitor. Institutions with concentrated, or more focused, portfolios are effective monitors, along with the largest institutions and large-dollar investors. Surprisingly, institutions with large percentage ownership are not associated with monitoring.

The study offers insights for corporate governance and delegated investment management. The negative causal association between institutional ownership and firm quality suggests that institutions are not a panacea for corporate governance ills. Only institutions that can overcome disincentives to monitor are relevant to resolving the shareholder-manager agency problem. Further, the relevance of specific institutional incentives suggests agency problems at the institutions themselves. Results suggesting better relative monitoring ability for institutions with focused portfolios recommend re-evaluating institutional diversification regulations and policies.

NOTES

1. Admittedly, other factors may have played a role in conglomerates' demise (e.g. lack of external capital market evaluation (Meyer, Milgrom & Roberts, 1992)). However, conglomerates and institutions share enough common features to make raising the point worthwhile.

2. Data availability precluded extending the sample period. Since much of the key corporate governance research relies on a similar time period, my results remain relevant.

3. Both book and market values used in computing Tobin's q would be noisier since quarterly statements are subject to a lower level of scrutiny than audited annual statements. In addition, the annual CompuStat tape likely has fewer errors than the quarterly one since its wider use implies greater scrutiny. Longer-horizon price changes embody less noise (Damodaran, 1993; French & Roll, 1986). Analysis of quarterly data does lead to the same conclusions on monitoring as the annual data.

4. Hirsh and Seaks (1993) recommend the semi-log specification for Tobin's q in general; my own Box-Cox maximum likelihood analysis for this particular implementation of Tobin's q confirms their results.

5. Other research (Chung & Jo, 1996; McConnell & Servaes, 1990; Morck et al., 1988) relies on values for advertising and R&D expenses to proxy for intangible assets and future growth opportunities. This is an onerous restriction – jointly requiring them eliminates 78% of my data. The common approach of using industry averages to replace missing values ignores the accountants' dictum that insignificant expenses may be aggregated. *Ipsa facto*, firms reporting advertising and R&D expenses will have larger, more significant expenses of these types. Using book value of intangibles is similarly problematic.

That said, results described below are robust to the numerous alternative specifications for intangible growth prospects including advertising and R&D expenses (normalized by sales or assets), normalized R&D expenses without advertising, normalized depreciation, normalized book intangibles, earnings-to-price ratio and return variability. In all cases, the contemporaneous regression coefficient for institutional ownership is negative and significant at the 1% level.

6. Results described below are robust to the numerous alternative measures for firm size including net sales, total assets and capitalization. The contemporaneous regression coefficient for institutional ownership is always negative and significant at the 1% level over a range of linear, quadratic, cubic and logarithmic specifications for the different measures. Using the higher-order specifications ensures that, given the high correlation between institutional ownership and firm market capitalization, including an institutional variable is not simply capturing a non-linearity in size.

7. The Dickie-Fuller (1979) tau-statistics discussed are for a traditional simple Dickie-Fuller specification where changes are regressed on lagged levels of the dependent variable. Note too that Eqs (4) and (5) are essentially Dickie-Fuller specifications augmented with additional explanatory variables. Again, unit roots are rejected.

8. Overfitting models included AR(1), MA(1) and ARMA(1,1). Aggregate correlograms were constructed using mean values of autocorrelations and partial autocorrelations and mean values of the standard errors. Parameter significance was rejected using coefficient means and means of their standard errors. The empirical distribution of the T -ratios for MA(1) effects is similar to a t -distribution. More individual AR(1) effects were significant than expected under a t -distribution, but the aggregate T -ratios still reject AR(1) effects. Though rejected, AR(1) was most plausible in the aggregate correlograms and "won" comparisons among overfitted models based on the average Akaike Information Criterion and average Schwartz Bayesian Criterion.

9. The Fixed Effects Model in Table 2 is one of a class of error-components models (ECM). It uses a least-squares dummy variables (LSDV) approach with variation across firms. Two-way fixed effects allows variation across firms and across time. Random Effects are another type of ECM; again, one-way and two-way effects are possible. As a robustness check, I estimate one-way and two-way Fixed and Random Effects models.

I use LSDV and Fuller and Battese (1974) methods with Wansbeek and Kapteyn (1989) adjustments since some firm-years are missing from the data. All specifications include the Table 2 control variables. *In all four ECMs, the association between institutional ownership and Tobin's q is negative and significant.*

10. Extreme observations are set equal to the nearest non-extreme value (Legendre, 1805). Other researchers have emphasized the importance of assuring observed values of ratios like Tobin's q and the four control variables are reasonable; for example, McConnell and Servaes (1990) exclude any $q > 6$.

11. Each period, I divide firms into two above- and below-median groups based on institutional ownership and on Tobin's q . That is, each observation is allocated to one of four (2×2) categories. The classification variables are binomially distributed, so a χ^2 -test may be used to test for association between institutional ownership and q . The χ^2 -test rejects the null hypothesis of no association between institutional ownership and q at the 1% level. Higher institutional investment is associated with lower q .

12. This is comparable to the impact of the key variable in other studies; e.g. Yermack (1996) finds that increasing board size from 15 to 16 directors is associated with a \$25 million decline in firm value for his average firm.

13. Several researchers find non-linearities in the variable of interest (Morck et al. (1988) impose breakpoints for non-linearities, McConnell and Servaes (1990) compute inflection points from linear and squared terms, and Cho (1998) uses a grid-search to find breakpoints). I compute inflection points from quadratic-in-institutions versions of the contemporaneous Simple Model and Classic Model of 0.69 and 0.74, respectively. Below these inflection points the relationship between institutional ownership and q is negative. Economic significance of the main results is assured since less than 1% of firm-year observations are in the higher, positive region.

14. Recently, others have applied 2SLS methods incorporating endogeneity, but not causation, in other monitoring contexts. See Chung and Jo (1996) for monitoring by endogenous analysts and Cho (1998) for monitoring by endogenous insiders. A contemporaneous paper, Demsetz and Villalonga (2001) most directly addresses endogeneity but focus on insider ownership and blockholders, rather than institutions.

15. Brickley, Lease and Smith (1988, 1992) find the fraction of a firm's shareholders supporting management antitakeover proxy proposals increases for firms with higher bank and insurance company holdings. Van Nuy's (1993) evidence supports Brickley, Lease and Smith but cannot statistically distinguish between the votes of institutions with and without known business relations to the proxy target.

16. As an example of the nontriviality of monitoring costs, the lead dissident in the 1989 Honeywell proxy contest reports their out-of-pocket costs at \$350,000. While small relative to their ultimate gain, it would seem large if the monitoring proved unsuccessful. See Van Nuy's (1993). She notes that while institutional investors supported dissent, they did not initiate it (a large individual shareholder did). She posits that activism will be supported by institutions but not generally spearheaded by them; instead, she expects leadership from non-institutional shareholders who are not required to justify expenditures on unsuccessful monitoring.

17. This 3% is somewhat arbitrary, but activist monitoring exists at even lower levels (Van Nuy's, 1993). I speculate that firm management in a diffusely-held corporation would generally be disparaging of monitoring attempts by shareholders with less than 1% of the firm. I also wanted to set this primary breakpoint below my secondary 5% breakpoint.

Because this 5% regulatory breakpoint is also arbitrary (though picked by regulators) and because some institutions might seek to influence management while remaining below the threshold for costly regulatory filing, I consider a lower level – picking the midpoint of the 1–5% range. It is plausible that a 3% owner can gain management’s attention.

Given this somewhat arbitrary choice, I do not examine other levels after going to the data. There are arguments for looking at 10% breakpoints (regulatory reasons again) and 20% breakpoints (GAAP reasons and the [Holderness and Sheehan \(1988\)](#) precedent). However, my primary interest is everyday, on-going monitoring further removed from these control-like positions.

18. In my sample, institutions have a mean 221 investments in different firms. Concentrated institutional investment is rare enough that it is marketed specially as with the Fidelity Fifty or Janus Twenty mutual funds. One activist monitor frequently mentioned in the popular and academic press, the LENS Fund, is highly concentrated. They normally hold only four stocks. The popular press (e.g. [Stout, 1997](#)) also highlights the association between concentration and high performance.

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THE TWO DIMENSIONS OF CORPORATE GOVERNANCE INDEPENDENCE

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ABSTRACT

The efforts to improve on the stewardship role of corporate governance have mainly emanated from external forces, such as pressure from shareholder groups, regulators, organized exchanges and courthouses. However, past research and field evidence, not the least being the Enron's scandal, have demonstrated that the independent structure of the board is far from being a guarantee to its optimum performance. Building on survey results administered to individuals with significant boardroom experience, it is argued in this paper that the quest for complete autonomy in the boardroom should be extended beyond the structural configuration to also include the psychological independence dimension.

INTRODUCTION

The debate over corporate governance independence, being fueled by the recent financial and accounting irregularities, has heated up during the past few years. Undoubtedly, this renewed scrutiny by corporate governance activists is not without justification. Many boardrooms have utterly failed the most elementary business judgment doctrine by automatically acquiescing

controversial management decisions such as unwarranted and excessive management compensation schemes, and without engaging in due diligence to avert disingenuous accounting manipulations. And while the spotlight has been on U.S. companies such as those encountered in the case of Enron, WorldCom, Adelphia Communications, Global Crossing and Tyco International, corporate governance failure is not just a U.S. phenomenon. Similar corporate debacles have occurred recently in France (with Vivendi), in Australia (with HIH), in the United Kingdom (with Polly Peck & BCCI), in Italy (with Parmalat), in South America (with Banco Bilbao Vizcaya Argentina and Venezuelan People's Bank), in Germany (with Comroad & FlowTex), in the Netherlands (with Royal Ahold), in South Korea (with SK Global) and in Japan (with Tokyo Electric Power Co. & Mitsui & Co). The prevailing practice of manipulating reported earnings by management has resulted in an increase in agency costs for the shareholders (Willis & Lightie, 2000; Xie et al., 2003; Yablon & Hill, 2000). As a result, the confidence of investors on the reliability of the corporate reporting system has badly been battered, thus producing extreme nervousness in financial markets and bringing prevailing corporate governance practices under a renewed spotlight. Furthermore, excessive management compensation packages prompted the SEC in 1992 and 1993 to adopt new sets of regulations requiring the compensation committee of the firms to disclose its compensation in tabular format, to compare their financial performance to an industry benchmark and to state whether the CEO's compensation is linked to financial market measures, accounting measures or non-financial measures (Securities & Exchange Commission, 1992, 1993).

In light of the new realities in the marketplace, the board could no longer afford to be complacent and rubber stamp management decisions. Although corporate governance is not the sole contributor of value creation to a firm, it could, at the very least, avert the downside risks associated with disingenuous management practices. Indeed, a number of companies have begun to review their current modus operandi, whereas others have formalized their corporate governance reviews into principles or guidelines. The main perceived downfall of corporate governance has mainly been attributed to agency failure inherent to the lack of independent configurational structure in the corporate governance system (Fama, 1980; Fama & Jensen, 1983; Jensen, 1993; Jensen & Meckling, 1976; Singh & Davidson, 2003). The premise behind the agency theory of the firm is that managers, by virtue of their higher knowledge of the corporation and the industry, may pursue actions that maximize their benefits to the detriment of the owners who are largely removed from the operational aspect of the firm, thus creating serious potential conflicts of interest (Mizruchi, 1983). The agency theory is firmly grounded on the accountability concept. The proponents of the agency theory, such as the public pension funds (e.g. CALPERS, TIAA-CREF), believe

that an independent corporate governance framework helps change a boardroom from a rubber-stamping entity into an effective oversight watchdog (Solomon et al., 2000). The proponents of the agency theory thus favor a critical mass of independent directors in the boardroom and the separation of the roles of CEO and Chairmanship of the board to ensure the establishment of an adequate system of checks and balances against abusive management power and control (Bainbridge, 1993; Black, 1992; Cox, 1993; Jensen & Meckling, 1976; Pozen, 1994; Rock, 1991). The requirements for independent directorship do vary from one country to the next, but typically include being an outsider to the firm; having no connection to the company besides board membership and share ownership; receiving no compensation from the company other than director remuneration or shareholder dividends; providing no services or products to the company or its subsidiaries; and not being a close relative of any officer, manager, or controlling shareholder.

In fact, the SEC and the stock exchanges have all passed resolutions to increase the autonomous power of the board as well as the independence of its audit committee. Actually, control mechanisms for an independent boardroom configuration have been put in place for quite some time now. Such regulations go back to 1972 when the SEC encouraged the establishment of audit committees for all listed companies to protect shareholders' rights. In 1973, the NYSE recommended that audit committees should consist entirely of outside directors with no personal and professional affiliation with the firm and management. And in 1976, the NYSE has required the establishment of an audit committee and the SEC approved this request in 1978. The NYSE now recommends that the boards of directors of listed companies have a majority of independent directors who will exercise independent judgment in carrying out their responsibilities so as to avoid damaging conflicts of interest. Furthermore, the NYSE has tightened its definition of the term "independent director." For example, directors will only qualify as independent if the NYSE board has determined that the director has no material relationship with the listed company (professional or personal), or that five years have passed since the director has been employed by or has been otherwise affiliated with the company. Likewise, NASDAQ has recently approved a series of corporate governance proposals such as the call for improved accountability and transparency in terms of increased boardroom independence, and stronger and more autonomous roles for the audit, compensation and nomination committees.

Although there has been a distinguished tradition in the academic and popular press of favoring an independent boardroom structure, past studies have yet to produce unequivocal results as to the superiority of a specific configuration in corporate governance (Ang et al., 1999; Burton, 2000; Dalton et al., 1998; Finkelstein & Hambrick, 1990; Klein, 1998; Rhoades et al., 2000; Schmidt, 1975; Singh et al., 2003; Zahra & Pearce, 1989). Specifically, the aforementioned

studies state that a decrease in the proportion of independent board members does not necessarily correlate with negative performance. Furthermore, recent cases, not the least being the Enron's scandal, have provided additional evidence that the independent configuration of the board of directors is not the *sine qua non* condition for its optimum performance. Enron's exemplary board of directors included only two insiders out of its 17 members. The company had earned the status of being the "Most Innovative Company" in 2001 by Fortune magazine for six years in a row. In addition, Enron placed No. 18 overall on Fortune's list of the nation's 535 "Most Admired Companies," and ranked among the top five in "Quality of Management," "Quality of Products/Services" and "Employee Talent." And yet the Enron's board was incapable or unwilling to take decisive actions against controversial management decisions (Rebeiz, 2002). As put by Patrick McGurn of Institutional Shareholder Services Inc, every step along the way Enron's board had the opportunity to take the right fork in the road, they took the wrong fork" (Washington Post, 2002). So why have many boardrooms with seemingly independent configurational structures failed in their fiduciary duty to the shareholders? It is argued in this paper that a new dimension should be extended to the independence equation, namely the psychological independence of the directors on management.

RESEARCH METHODOLOGY

The research is based predominantly on survey results administered to individuals with significant corporate governance experience. A portion of the study used the geometric mean of the stock prices of the S&P100 companies over a 10-year period to determine whether the percent independent directors impact on the market returns of the firm. Data on the participants were obtained from the SEC's EDGAR database, the Standard & Poor's Register of Corporations (Directors and Executives) and the Dun and Bradstreet reference book of corporate managements. Directors who have been serving on the boards for less than five years have been excluded from the analysis. In contacting the potential respondents, the purpose of the survey was explained, along with a request for participation. The individuals selected for the surveys were provided with a cover page of the questionnaire that explained the rationale behind the study. The subsequent pages included statements requiring their expert opinions on corporate governance issues through the selection of one of five possible choices ranging from the "strongly agree" to the "strongly disagree." For statistical interpretation purposes, the following conversion scores were used in assessing the survey responses: strongly agree = 2, agree = 1, neutral = 0, disagree = -1, strongly disagree = -2. A biographical

sketch of the respondents was then requested. The idea was to locate the most senior and knowledgeable people with the right mix of expertise to complete the questionnaire. Often, the individuals that were first contacted would forward the survey request to another individual or recommend another person who would be more knowledgeable on the subject matter. Many of the respondents have made some serious efforts to answer the questions by requesting further information and clarification. The survey respondents have an average of 12 years of experience in the boardroom. The directors' anonymity has been purposely protected to allow them to discuss freely information regarding corporate governance without the wariness of putting their companies under the spotlight. The industries that are represented in the surveys include consumer products, health care, information technology, energy, financials, materials, telecommunications, transportations, services and utilities.

CORPORATE GOVERNANCE THEORIES

The concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. Most pundits view corporate governance as a field in economics that explores how to motivate efficient management of corporations and align their interests with the shareholders via the effective utilization of incentive mechanisms, organizational designs and legislation. As corporate governance has evolved through time, many schools of thoughts have emerged in the ongoing debate as to the optimum corporate governance structures. The principal agent school of thought states that the market forces help to restrain management behavior (Hart, 1995). In other words, supporters of this view claim that managers' abuse of power can be offset by external market intervention such as hostile takeovers and loss of managerial reputation (Brickley & James, 1987; Jensen, 1986). But any external intervention may prove to be harmful and may have a negative effect on the firm's operations. Consequently, the advocates of the principal agent school of thought claim that the existence of corporate governance structures is a necessary and a preventive measure against any external interventions. Conversely, another school of thought, referred to as the myopic market view, believes that market forces place undue pressure on management to focus on short-term goals (Blair, 1995). So in order to avoid any hostile takeovers, managers are inclined to focus on short-term goals at the expense of certain long-term decisions such as research and development expenditures and capital investments. Consequently, holders of this view recommend that regulations need to be placed on corporations to ensure that governance structures are designed for the long-term benefit of the firm.

Yet another corporate governance view is the abuse of executive power school of thought. It considers that top management has abused their power to serve their own self-interests (Hutton, 1995). Holders of this view assert that in order for governance structures to function appropriately, there should be constant changes in governance in order to weaken the positions currently enjoyed by senior management. Changes include limiting the terms of the CEO to four years, requiring independent nominations of non-executive directors, and granting greater powers to non-executive directors. A more recent and broader corporate governance view is the stakeholder school of thought (Donaldson & Preston, 1995; Freeman & Evan, 1990; Freeman & Reed, 1983). It advocates a broader allegiance of the board beyond the shareholders to also include other constituencies who also have a stake in the corporation (the stakeholders) such as the employees, the customers, the suppliers and the community at large. Accordingly, the view spans beyond the conventional belief that the corporation should maximize shareholders' wealth to also include the wealth of the stakeholders as a group.

The common underlying theme of all the aforementioned views is that corporate governance deals with agency problems, the separation of ownership and control (Fama & Jensen, 1983). Owners delegate control over resources to managers who are expected to act on their behalf and to serve as their agents (Jensen & Meckling, 1976). Berle and Means have in fact highlighted the divorce between ownership and control in the early 1930s in their book "The Modern Corporation and Private Property" (Berle & Means, 1932). The transition from the entrepreneurial owner to an age of atomized ownership would come to dominate most thinking about issues of corporate governance for much of the rest of the century. The firm's board of directors is at the heart of corporate governance as shareholders have delegated authority to the board to oversee and control decisions made by upper management. Its primary mission is first and foremost to protect the best interests of the company's investors by being vested with the legal authority to approve significant decisions such as major capital expenditures and to hire, fire, and compensate top management teams. For example, most U.S. firms are incorporated under the jurisdiction of the statutes of Delaware (for tax purposes) that give the mandate and authority to the board to oversee the operations of the management and to replace it in case of non-performance. Accordingly, corporate governance sets the premises of managerial decision-making by monitoring managerial behavior and safeguarding invested capital without undermining the ability of management to operate the day-to-day business activities of the firm. In addition, it specifies the distribution of rights and responsibilities among different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs. In effect, corporate governance provides the backbones of the firm, namely the structure and framework of an integrated set of internal and

external controls designed to minimize agency costs by harmonizing and aligning the objectives of the managers (the agents) with those of the shareholders (the principals) and other stakeholders.

EVOLUTIONARY ASPECT OF THE BOARD OF DIRECTORS

The boardroom has come a long way in the last 70 years as waves of social and economical changes have metamorphosed the boardroom. The birth of shareholder rights started in the late 1920s after the famous stock market crash. By then, investors and policy makers believed that market failures were mainly due to the companies' lack of transparency. As a result, the Securities and Exchange Commission (SEC) was formed through The Securities Act of 1933 and 1934 to create public disclosure and enforcement mechanisms in order to protect investors and promote the dissemination of reliable corporate information to the marketplace. In the 1970s, socially oriented shareholder activism emerged to work for peace and social justice by organizing and filing resolutions on community economic development, global finance, environmental issues, equality issues, international issues, health, and militarism. The growing takeover market also facilitated the shareholders' rights by making inefficiently managed companies an easy prey for corporate raiders (Jensen, 1986). The major transformation, however, occurred in the past decades with the increased ownership and voting power of institutional investors and the ensuing advent of shareholder activism. Such happenings have compelled the board to move in the direction of greater structural independence. The passive ownership strategy in which disillusioned owners would just sell their stocks to voice their dissatisfaction with the operation of the firm is being replaced by more dynamic and active strategies, such as proxy fights, direct negotiation with management, public targeting of a corporation, and active lobbying to change some regulatory policies and rules. The creation in 1985 of the Council for Institutional Investors was formed to protect the financial interests of its members by providing suggestions on how to vote on performance related issues such as "poison pills," "golden parachutes," "staggered boards," "super voting shares," and excessive executive compensation. Such a collective voice provides the institutional owners with a concentration of power that they could not otherwise achieve should they decide to act independently. The shareholder activists have effectively used their concerted effort and voting power to influence corporate behavior; they also have successfully fought the SEC to initiate a flurry of regulations towards shareholders rights especially as it relates to the proxy vote. It is the institutional investors that forced the relaxation of the 1992 SEC proxy

rules, thus permitting communication among shareholders prior to the proxy vote ([Securities & Exchange Commission, 1992](#)). The institutional investors were also behind the 1997 SEC shareholder proposal amendment rule allowing shareholders to introduce their own resolutions in the proxy statement for matters dealing with issues of significant importance ([Securities & Exchange Commission, 1997](#)). If a de-facto consensus exists between public pension funds on economic performance issues, they tend however to have divergent views on social issues such as investing in tobacco, alcohol, rap music and gaming. The lack of consensus on social issues stems from the fact that these are highly politicized issues and each public pension fund is swayed by the political regime or environment under which it operates.

The transformations of the past decades have compelled the boards to move in the direction of more independent directors, a smaller board's size and more diverse representation. This trend is also true for international firms. According to the King Report in South Africa, "it is recommended that independent directors represent at least 20% of the total number of board members" ([King Report on Corporate Governance, 1994](#)). The size of the board is also an important consideration. A large board size is perceived to be ineffective because directors may "hide" in the boardroom, and therefore may not feel obligated to work and make a meaningful contribution ([Eisenberg et al., 1998](#); [Gladstein, 1984](#); [Jensen, 1993](#); [Jensen & Meckling, 1976](#); [Jewell & Reitz, 1981](#); [Lipton & Lorsch, 1992](#); [Shaw, 1981](#); [Vafeas, 2000](#); [Yermack, 1996](#)). In addition, large board sizes may face a number of barriers in reaching a consensus on important decisions, since they are more likely to develop factions and coalitions that can increase group conflict. Conversely, a smaller board seems to be a more effective device for building cohesiveness and harmony against the actions of managers that are not in the shareholders' best interests ([Jensen, 1993](#)). The increased globalization of business also calls for a diverse group of directors in terms of gender, race, religion and other cultural background ([Westphal & Milton, 2000](#)). A diverse board has the potential advantage of drawing on the multi-dimensional knowledge and experiences of its members, of inviting creativity and differing perspectives, and of providing safeguards against a myriad of complex and continually changing uncontrollable, financial, political and legal risks. The emergence of a global economy has also contributed to the transformation of the development of new corporate governance standards in many countries. The first corporate governance code of the modern era was the Cadbury Report in the United Kingdom ([Cadbury, 1992](#)). Although not yet legislated under the United Kingdom law, the London Stock Exchange has adopted The Cadbury Report for listed companies. Similar codes of best practice followed in other countries such as South Africa ([King Report on Corporate Governance, 1994](#)), the Netherlands ([Peter's Committee, 1997](#)) and France ([Vienot Report, 1999](#)). The first global set of global corporate governance principles is the

Organization for Economic Co-operation and Development, better known as the OECD Principles on Corporate Governance (OECD, 1998). The objective of the OECD is to converge corporate governance practices of diverse interests, practices and cultures into a common set of principles.

CORPORATE GOVERNANCE INDEPENDENCE

A New Set of Paradigms

The most critical issue facing today's corporations is centered on accounting irregularities, the audit process and the related issue on how a company structures and compensates its leadership, particularly vis-à-vis shareholders' rights. The increased usage of executive incentive plans is an attempt to link management performance with corporate performance. The ultimate objective is to create a mechanism that indulges into an effective laissez-faire approach while holding the managers accountable for their actions. However, the syntactic nature of earning definitions and the flexibility under GAAP rules have all contributed to an atmosphere propitious to what has been labeled "management of earnings," or the disingenuous manipulation of financial statements such as the creation of special purpose entities to hide losses and inflate revenues (as it was the case with Enron) and the exploitation of expenditure loopholes under GAAP (Dechow & Sloan, 1996; Erickson & Wang, 1999; Lim & Matolasy, 1999; Rangan, 1998; Teoh et al., 1998a; Teoh et al., 1998a, b; Wu, 1997). Consequently, the shareholders have been consistently fooled by the false impression that value has been created through legitimate means when in fact no value has been created in actuality but instead fraudulent accounting practices have artificially created value only "on paper." The ultimate result has been the unjust enrichment of the employees at the expense of the shareholders. Reformers on Wall Street and Capitol Hill are now trying to enact the most sweeping agenda of corporate-governance reforms in 70 years, especially after the scandals that have struck the financial world in the last couple of years. Public outcry is precisely the reason why the Sarbanes-Oxley Act has been passed into law in the U.S. In Germany, there is a consensus to legally implement a supervisory body for the accounting profession. The corporate turmoil also facilitated reforms in accounting standards and their convergence into a universally accepted set of procedures. As an example, the Financial Accounting Standard Board (FASB) may follow suit with the International Accounting Standards Board (IASB) and amend its previous employees stock options standards by requiring companies to expense them in their financial statements (present FASB requirements do not compel companies to expense employees' stock

options as long as they are disclosed in the form of footnotes in the financial reports).

Structural Independence

A firm's corporate board can be structured in various forms depending on its underlying purpose and context. As alluded before, there is a near consensus in the literature as to the fact that boards should be structured in such a way to mitigate conflicts of interest between the agents (the managers) and the principals (the owners) (Byrd & Hickman, 1992; Dalton et al., 1998). Holders of this view believe that it is essential for the board structure to achieve a critical mass of outside and independent directors because such structure would minimize agency costs. In effect, the advocates of the agency theory place a heavier emphasis on the monitoring and controlling role of the board – in its interaction with management – than on its counseling role (Fama & Jensen, 1983; Fleischer et al., 1988; Jensen & Meckling, 1976; Waldo, 1985; Williamson, 1985). It is notable that the unitary board models adopted in the United States, the United Kingdom, Canada, Australia and many other European and Asian countries basically conform or encourage an independent boardroom configuration. Conversely, the corporate governance system in Japan, the business network model, is by definition a dependent structure. Although it has a similar governing structure than the unitary board model, this framework is based on a web of interpersonal relationships through cross-shareholdings by affiliated companies including customers and suppliers (a practice referred to as Keiretsus). Likewise, countries that follow the two-tier board model (Germany, Austria, the Netherlands and to some extent in France) have an inherently dependent configurational structure. For instance, German boards consist of a supervisory board (Aufsichtsrat) and management board (Vorstand). The Aufsichtsrat is comprised equally of representatives of labor, appointed through the employees' trades union and representatives of capital, appointed by the shareholders. It is notable in this context that the Sarbanes-Oxley Act in the United States may be intricate for German firms because the audit committee of the Aufsichtsrat must include employee representatives, which by definition are dependent directors, a situation which would conflict with the current regulatory requirements in the United States (prior regulations exempted international firms from such a requirement). Porsche, for example, has delayed listing on the NYSE as a result of the Sarbanes-Oxley Act.

As shown in Fig. 1, there is virtually no correlation between the percent independent directors and the stock price return for the S&P100 firms.

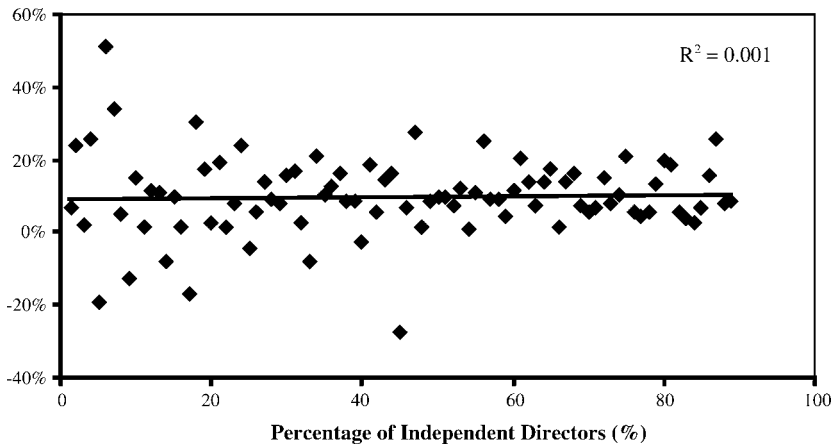


Fig. 1. Independent Directors vs. Returns on Stocks for S&P100 Firms.

The returns on the stock prices are computed using the geometric mean on the return of historical prices from January 1993 to January 2003. This finding is further reinforced by the fact that previous attempts to find a superior boardroom configuration in terms of financial performance have produced conflicting results. Some researchers have noted a positive relationship between outside director representation and firm performance (Baysinger & Butler, 1985; Ezzamel & Watson, 1993; Pearce & Zahra, 1992; Rosenstein & Wyatt, 1990; Schellenger et al., 1989). As an example, Baysinger and Butler found that firms consisting predominantly of outside board members achieved higher return on equity than firms with fewer outside board members (Baysinger & Butler, 1985). Conversely, other researchers have noted that it is instead the inside directors who were associated with firm performance (Agrawal & Knoeber, 1996; Kesner, 1987; Vance, 1964, 1978). In these studies, it is perceived that inside directors have better and faster access to key information than outside directors, as well as better ability to check key assumptions. More specifically, Kesner found a positive relationship between inside directors and the return to investors (Kesner, 1987). And a third stream of research found no relationship between board composition and firm performance (Chaganti et al., 1985; Daily & Dalton, 1992, 1993; Dalton et al., 1998; Kesner et al., 1986; Zahra & Stanton, 1988). Similarly, the effect of board leadership structure on the firm’s financial performance has also produced mixed results. In one study, it was found that firms with separate leadership structure outperformed those with the joint structure when relying on the firm financial performance such as return on equity, return on investment and profit margin (Rechner & Dalton, 1991).

Conversely, another research found that firms utilizing the joint structure achieved higher return on equity than firms employing the separate structure configuration (Donaldson & Davis, 1991). And yet, a third group of study noted no directional impact of board leadership structure on the firm performance (Berg & Smith, 1978; Boyd, 1995; Daily & Dalton, 1992, 1993, 1994; Dalton et al., 1998; Rechner & Dalton, 1989).

The above inconclusive empirical findings can be attributed to four factors. The first one being that the linkage between board composition and firm performance in large firms is long and the observations are “noisy” (Daily & Dalton, 1993; Dalton et al., 1998; Zahra & Pearce, 1989). The complexity of large firm may constrain the ability of the board to initiate changes and affect the direction of the firm (Daily & Dalton, 1992, 1993; Dalton & Kesner, 1983; Eisenhardt & Schoonhoven, 1990; Finkelstein & Hambrick, 1990; Norburn & Birley, 1988; Reinganum, 1985). The second factor for the conflicting results is attributed to noise. There are numerous variables other than differences in the board configuration that may affect the relationship between firm performance and board composition. These variables include the company’s size, its micro and macro environment, and its competitive position within the industry. The third factor for the mixed findings is attributed to the endogenous relation between the ex post firm performance and the board structure. In other words, the firm’s performance may impact on the board composition. Denis and Sarin find that poorly performing firms are more likely to add outsiders to their board (Denis et al., 1997). Furthermore, Hermalin and Weisbach find that inside directors are more likely to leave the board while outsiders are more likely to join a board after a firm has performed poorly (Hermalin & Weisbach, 1991, 1988). Finally, the fourth factor for the contradictory results is that the aforementioned analyses have ignored a crucial element in the independence equation, namely the psychological independence of the directors on the CEO. This issue is discussed subsequently.

Psychological Independence

The previous findings underscore the fact that the structural independence of the board is not the only sine qua non condition for its optimum performance. The psychological independence of the board is probably an even more pressing issue than structural independence. The survey respondents consider the self-imposed arm’s length relationship with management to be more effective in metamorphosing the boardroom into an effective watchdog than any structural configuration or piece of legislation enacted (Tables 1 and 2). Yet, and for a too long period of time, many boards have operated under unwritten and unspoken

Table 1. Survey Results.

	Strongly Agree (Frequency)	Agree (Frequency)	Neutral (Frequency)	Disagree (Frequency)	Strongly Disagree (Frequency)
Psychological independence of the board is a more effective mechanism for optimum corporate governance than regulatory reforms	10	16	10	5	4
External consultants should be hired by the board, they should be reporting to the board and they should be accountable only to the board	16	14	10	4	1
The most important issue in psychological independence is the judicious selection of new directors	20	18	5	2	0
The board should be able to meet and make major decisions without the presence of the CEO and other senior managers	13	15	8	6	3
Former CEOs should serve on the board of the company they once lead	2	4	6	15	18
CEOs should just be just limited to passive observers in corporate governance affairs, such as not serving on committees	5	11	7	16	6
The board should be able to obtain relevant information and check key assumptions through channels outside the CEO and the senior management team	9	14	13	7	2
The board should periodically engage in a self-evaluation exercise and benchmark itself against highly successful boards	8	13	17	3	4
The proxy statement should be made available for modifications before it is published in its final version	6	10	14	9	6
The board should establish a better dialogue with the shareholders through informal communication	10	11	14	7	3

Table 2. Survey Statistics.

	Average ^a	Standard Deviation ^a	Standard Error on the Mean	Computed <i>t</i> Value	<i>t</i> _{0.05}
Psychological independence of the board is a more effective mechanism for optimum corporate governance than regulatory reforms	0.51	1.22	0.18	2.78	1.68
External consultants should be hired by the board, they should be reporting to the board and they should be accountable only to the board	0.89	1.07	0.16	5.51	1.68
The most important issue in psychological independence is the judicious selection of new directors	1.24	0.83	0.13	9.95	1.68
The board should be able to meet and make major decisions without the presence of the CEO and other senior managers	0.64	1.23	0.19	3.48	1.68
Former CEOs should serve on the board of the company they once lead	-0.96	1.15	0.17	-5.52	1.68
CEOs should just be just limited to passive observers in corporate governance affairs, such as not serving on committees	-0.16	1.26	0.19	-0.82	1.68
The board should be able to obtain relevant information and check key assumptions through channels outside the CEO and the senior management team	0.47	1.12	0.17	2.76	1.68
The board should periodically engage in a self-evaluation exercise and benchmark itself against highly successful boards	0.40	1.14	0.17	2.34	1.68
The proxy statement should be made available for modifications before it is published in its final version	0.02	1.23	0.19	0.12	1.68
The board should establish a better dialogue with the shareholders through informal communication	0.40	1.19	0.18	2.22	1.68

^aThe following conversion scores were used: Strongly agree = 2; Agree = 1; Neutral = 0; Disagree = -1; Strongly disagree = -2.

norms where it is taboo to criticize the CEO within the confines of the boardroom or meet outside the presence of the CEO. According to Jay Lorsch, directors have repeatedly failed in their fiduciary duty to the shareholders by acting like “the pawns of their CEOs rather than being potentates the law intended them” (Lorsch, 1989). This deeply entrenched culture of rubber-stamping managerial decisions may have contributed to the recent corporate scandals that have reverberated across the entire market place and into the public arena.

The Enron’s scandal is particularly revealing in this respect. The psychological dependence of the board on management was probably behind the extraordinary decision by the board of waiving the Enron’s ethical code and approving an arrangement in which Enron’s executives wore two hats by serving the dual roles as employees of Enron and as general partners in off-balance sheet subsidiaries they created and controlled themselves. Inherent to the dual role of Enron’s executives (managers at Enron and partners in subsidiaries) was an egregious conflict of interest situation. The partnerships would enter into business transactions with Enron such as buying assets and receiving investment funds. The executives had access to Enron key inside information such as what assets Enron needed to sell, how badly, how fast, and who were the alternative buyers. They also had an influence on Enron personnel who were negotiating with the partnerships. Such an arrangement created an environment in which the executives’ interests would be put ahead of those of Enron’s shareholders.

When the directors are psychological dependent on the CEO, then the ensuing board faces the high probability of becoming a passive entity that makes poor decisions and is incapable or unwilling to confront management. This lack of accountability is magnified by the fact that directors will only receive valuable information to the extent the CEO is ready to share this information with them. It is very possible that directors may be subjected to information deficit, as some issues of legitimate attention may not be mentioned to them by disingenuous CEOs; or the directors may be subjected to information dependence as some important issues may be presented to them in a way that is biased in favor of senior management. The psychological dependence of the board is further compounded if the CEO’s influence also extends to the conduct of the meeting. The ultimate result may be an inoperative board that fails the standard of care and the standard of loyalty, and that is utterly unprepared to foresee opportunities or to avert crises from hitting the corporation.

The psychological dependence of the directors has another adverse effect, namely the lack of transparency between the directors and the shareholders. Important boardroom decisions are made within the confines of the boardroom and away from the public eye. Should the board be in cahoots with the management team, then these decisions are then imposed to uniformed shareholders on a

fait-accompli basis with little room to maneuver. According to one sample, at least 85% of the votes cast at the annual meetings are typically proffered before the meeting even takes place (Augustine, 1996). The shareholder proxy votes are therefore nothing more than a false illusion of control; the shareholders are left in the dark and therefore have limited influence on corporate governance decisions. Transparency of decisions is important because it provides a first line of defense against controversial and unwarranted management decisions. The more participants are involved in the decision-making process, the more information is made available to the wider constituencies and the harder it will be to engage in disingenuous manipulation schemes on a large scale basis.

Recommendations

According to the survey respondents, the most important issue in psychological independence is the judicious selection of new directors (Tables 1 and 2). The selection process is also important. New directors should be invited to join the board by the board and without undue influence from the CEO and the senior management team. A board chosen by the CEO does have one salient disadvantage: The CEO may very well elect not to bring directors who would disagree with upper management, thus creating nothing more than a rubber-stamping enterprise. Furthermore, the newly appointed directors may have a misguided sense of loyalty and indebtedness towards the CEO who extended the invitation to them at the expense of their fiduciary relationship to the shareholders. A previous study suggests that the CEO's involvement in the selection of new directors has a potentially adverse impact on the financial performance of the firm (Shivdasani & Yermack, 1998). The selection of external consultants, whether they are working for the compensation, the audit, the nominating, the executive or other committees, should also be completely dissociated from the sphere of managerial influence. The survey respondents heavily endorse the idea that external consultants should be hired by the board, they should be reporting to the board and they should be accountable only to the board (Tables 1 and 2). At the very least, such practices would enhance the image of the board from a rubber-stamping body to a legitimate, conscientious and credible entity. Equally important, external consultants should not engage in consulting activities that span beyond the realm of jurisdiction mandated by the board of directors and that might impair their independence to management.

The survey respondents strongly favor the fact that the board should be able to meet and make major decisions without the presence of the CEO and other senior managers (Tables 1 and 2). Likewise, the survey respondents do not endorse the

idea that former CEOs should serve on the board of the company they once lead for an extended period of time (Tables 1 and 2). Former CEOs could assist the board for a limited period of time to smooth the transition between leadership. But once this transition period is over, former CEOs should be totally disconnected from the board. Otherwise, conflict of interests might arise as former CEOs would try to protect their legacy. Moreover, it might put the new CEOs in an awkward situation, especially if they have to criticize decisions made under the previous leadership. Nonetheless, psychological independence does not mean that the board should act unilaterally. Actually, boardroom effectiveness is not an endeavor that rests solely on the board. Rather, it depends on the level of interaction between the board and the CEO. The directors' main source of information is the CEO who, in effect, is expected to educate the board on the important issues facing the corporation. Consistent with this view, the survey responses do not endorse the view that CEOs should be limited to just passive observers in corporate governance affairs, such as not serving on committees (Tables 1 and 2). As to the proposition that the proxy statement should be made available for modifications before it is published in its final version, there is no consensus on the matter, although a slight majority of survey respondents favor the idea. Should such an initiative take place, independent and specialized proxy advisors would carry out such a review and modification process by taking into account the fact that shareholders are a heterogeneous group of people, each with distinct preferences and expectations.

Psychological independence also entails giving the directors greater power and responsibility for monitoring the actions of senior executives. It is facilitated by giving the boardroom additional control over critical scarce resources, by increasing the board's control over important organizational decision-making procedures, and by further providing the board with motivational power to engage in due diligence. Specifically, the survey respondents endorse the following recommendations (Tables 1 and 2) in an effort to decrease the psychological dependency of the board:

- The board should be able to obtain relevant information and check key assumptions through channels outside the CEO and the senior management team.
- The board should periodically engage in a self-evaluation exercise and benchmark itself against highly successful boards.
- The board should establish a better dialogue with the shareholders, a proposition that conforms to what Lipton and Lorsch have advocated for some time now (Lipton & Lorsch, 1992). However, with the existence of the stock market and powerful telecommunication technologies, such communication should be confined to specific subjects that do not lead to intentional or unintentional

insider dealing (e.g. management compensation and the nomination of new directors).

CONCLUSIONS

The boards of many companies have failed to adequately monitor and control disingenuous management maneuverings. It is a failure that encompasses the standard of loyalty and the standard of care that the board owes to the shareholders and other stakeholders. The conventional perception for this failure is attributed to the lack of independent structural configuration of the board. Regulatory reforms have been enacted with the belief that it would help steer the boardroom in the right direction by imposing an independent structural configuration. However, past evidence clearly indicate that the structural configuration is not the only criterion for a board to adequately fulfill its oversight duties on behalf of the shareholders. Although achieving a critical mass of independent directors and encouraging a non-executive Chairman (or an independent lead director) are steps in the right direction to achieve optimum corporate governance performance, a subtler and probably more important consideration is the psychological independence of the directors on management. A psychologically independent boardroom has a greater chance of transforming itself from a reactive body into a functional (value-added) entity that maintains a healthy arm's length interaction with management while adequately fulfilling its fiduciary duty to the shareholders and other stakeholders. The result would be a proactive board that exhibits solid defense mechanisms to avert crises from ever hitting the corporation in the first place. In such a board, directors work in concert as a cohesive group and strive to improve the long-term health of the corporation such as achieving objectives, obtaining resources, asking relevant questions, making timely and sound decisions, and acting swiftly and decisively without undue influence from the management team. The achievement of psychological independence would however necessitate a radical rebalancing of corporate power and a change in attitude and culture in the boardroom.

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LEGAL FEATURES OF TRADED SECURITIES AND HIGH PRICE VOLATILITY

Nidal Rashid Sabri

ABSTRACT

This study examines laws regarding the legal features of traded shares in 25 developed and emerging economies. Included are civil and common laws in South and North America, Eastern and Western Europe, South Asia, Australia, and Middle Eastern countries. Significant changes have been implemented during the last two decades, especially those related to harmonization of corporate governance principles, best practices, and codes of conduct concerning stock trading. However, there are still significant differences among types of shares traded in world stock markets which may have different responds in case of high price volatility.

1. INTRODUCTION

Increased linkages among world stock markets have raised concerns about mounting stock price volatility. Various studies have sought to explain and find better means for coping with growing stock price volatility, including those that specifically consider adverse effects of investor overreaction, volatility transmission, financial derivatives, and laws governing the trading environment (Sabri, 2002a, b). This study examines the extent to which important differences

still exist in the legal environment across world stock markets with specific reference to rules and regulations that govern corporate governance, disclosure, and transparency.

Various international and regional organizations issue general principles, guidelines and best practice recommendations concerning corporate governance, disclosure and transparency. For example, the Organization for Economic Co-operation and Development (OCED) has issued principles of corporate governance that have been adopted by 29 OECD countries (OECD, 1999). In 2002, the International Organization of Securities Commission recommended that these general practices be followed by corporations in emerging countries (IOSCO, 2002). These OECD principles focus upon the equitable treatment of shareholders and their role in corporate governance, disclosure and transparency requirements, and responsibilities of the board of directors (OECD, 1999). The International Corporate Governance Network (ICGN) issued statements on global corporate governance principles (ICGN, 1999) and on global share voting principles (ICGN, 1998, 2000) which stated that the same voting rights should be attached to shares regardless of how much equity a shareholder holds. The Commonwealth Association for Corporate Governance has also issued guidelines and principles for the board of directors and the corporations as a whole (CACG, 1999). The changing ownership structure of world corporations has direct implications for the liquidity and stability of world stock markets. Most countries have now removed all restrictions on foreign ownership. This is also true of many emerging markets. For example, all European and Latin American emerging markets have removed almost all restrictions concerning the ownership of banks and air transportation companies (IFC, 2000). As a result, the foreign share of corporate ownership is increasing rapidly. The latest survey of FESE (2002) indicated that non-resident investors have become a driving force in European markets. Public sector ownership now ranges from 0% in the U.K. and Spain, and from 8 to 15% for European Monetary Union members. Parrino et al. (2003) report that there is generally an increase in shareholding by individual investors and a decrease in institutional investors.

A survey of global investor opinions conducted in 2002 (GCGF, 2002) found that many countries have implemented governance related reforms that have been welcomed by investors. Corporation laws have been modernized in almost all European countries during the last decade, including: Austria (1997), Germany (1997), Spain (1995), Italy (1998), Finland (1998), France (1998), Denmark (1996) (DTI, 2002). The majority of developed and emerging countries have also recommended or adopted guidelines concerning best practices for corporate governance. Sabri (2003) reported that 18 countries witnessed a change in laws governing share repurchases during the period 1995 to 2000 including Finland in 1997, Germany: 1998, India: 1999, Japan 1995, Norway: 1999, Malaysia:

1997, Singapore: 1998, South Africa: 1999, and Taiwan: 2000. Other corporate governance issues that are increasingly the focus of debate include the issue of par or no-par value shares, dual voting class shares, and bearer shares.

2. RECENT LITERATURE

Studies in financial economics point to the importance of the legal environment in corporate governance. [Denis and McConnell \(2003\)](#) argued that the legal system has a fundamental effect on the governance structure and effectiveness of companies in that country. [Johnson et al. \(2000\)](#) reported evidence that the weakness of legal institutions and the poor corporate governance had an important effect on the stock market declines in the Asian crisis in 1997. [Jordan conducted a survey \(1998\)](#) of corporate law regimes of various countries which found that there has been an increasing interdependence of domestic legal regimes. [Carati and Rad \(2000\)](#) reported that the market corporate governance (U.S. and U.K.) and group-based corporate governance (France and Germany) systems are converging in practice toward a theoretical convergence model with coexistence of an active market for corporate control and large shareholders. [Brockman and Chung \(2003\)](#) concluded that the firm's liquidity is affected by investor protection; [Shleifer and Vishny \(1997\)](#) reported that the legal protection of investor right is an essential element of corporate governance.

[Mitton \(2002\)](#) found that companies with higher disclosure quality and favorable ownership structure have provided greater protection to their minority shareholders during financial crises. Other studies consider the corporate governance effects of dual class shares in Germany ([Fatemi & Krahnen, 2000](#)), Switzerland ([Gardioli et al., 1997](#)), Sweden ([Hagelin et al., 2003](#)), Italy ([Linciano, 2003](#)), Norway ([Odegaard, 2002](#)), France ([Muus, 1998](#)), and in emerging countries ([Chung & Kim, 1999](#)). [Bailey et al. \(1999\)](#) discussed the effects of dual class shares for local (restricted) versus foreigners (unrestricted) in 11 countries and found that the premiums for unrestricted shares are positively correlated with investor demand. [Sabri \(1995b\)](#) reported that bearer share trading may destabilize stock markets during crises periods because there is no control on trading outside stock exchanges using such type of shares. [Gardioli et al. \(1997\)](#) found that the bearer share and ownership transfer regime changes are significant variables in explaining the difference between prices of dual shares.

[Lemmon and Lins \(2003\)](#) found that large separation between cash flow ownership and control rights indicates that insiders have the motivation and the ability to engage in expropriation. [Fluck \(1999\)](#) found that when shareholders are long-term oriented, then outside shares trade at a premium over their value

to management of the firm. Ehrhardt and Nowak (2000) reported evidence that separation of cash rights and voting rights by using dual-class share aims to create a controlling shareholder structure. Becht and Roell (1999) concluded that there is a high degree of concentration of shareholder voting power in Continental Europe relative to the USA and the U.K.

Finally, the FESE report (2002) found that the foreign investors have become a driving force in European corporations. One third of the capital shares of European markets now reside in the hands of nonresidents. Faccio and Lang (2002) found that the 44% of Western European corporations are now family controlled, while state control is a significant factor in various European countries. La Porta et al. (1999) found that corporations in the majority of developed economies are controlled by families or the public sector. Carati and Rad (2000) reported that institutional shareholders have become more involved in the direct monitoring of their investments.

3. LEGAL FEATURES OF TRADED SHARES

Beside the basic laws governing commerce in a specific country, two groups of laws are related to stock trading efficiency: corporate laws and securities laws. Stock exchange and securities laws govern the construction of equity indices, trading mechanisms and procedures, price determination regulations, order type, settlement, futures and options, listing and delisting requirements, disclosure and audit requirements. Corporate laws include foreign ownership restrictions, residence ownership restrictions, corporate governance laws, principles, codes and best practices, ownership structure regulations, capital maintenance requirements, disclosure requirements, and share repurchase regulations.

Table 1 presents a summary of the common features of traded shares and possible associations with market volatility.

Sabri (1995a, b) indicated that an increasing share of ownership by banks and pension funds is considered by stock market professionals to be a stabilizing force. Thus, corporate ownership structure can be a significant issue concerning the stability of prices in stock markets around the world. Institutional ownership is also thought to have a positive impact in the case of noise trading and irrational trading. Holders of nonvoting shares or shares with inferior voting rights tend to be eager sellers during periods of market instability when compared with holders of superior voting rights.

Recently, the majority of stock exchanges around the world have adopted measures to control stock market stability, including: safe-harbor rules, insider trading controls, price limits, margin requirements, circuit breakers, and trading halts. The

Table 1. Legal Features of Traded Shares.

Types of shares	Disadvantages Concerning Stock Market Stability
Bearer shares	Trading outside stock exchanges Trading outside limit prices No possibility of preventing insider trading No possibility of imposing volatility controlling measurements including trading halts on individual stocks, circuit breakers on the whole market
Non-Vote shares	Main concern is return rather than corporate control which lead to Less loyalty compared to vote shares Minority control a company No changing in management
Face (par value) to non-par value	Variation on Price determination mechanism in cross listing The mechanism of pricing no-par value during stock market crisis should be examined
Dual class shares (residence-foreigner)	Variation on Price determination mechanism Less loyalty for foreigners holders

imposition of such measures is made difficult in the case of bearer shares. Therefore, bearer share restrictions may play a role in controlling stock market volatility.

4. SURVEY METHODOLOGY AND RESULTS

To investigate the possible ramifications of corporate laws related to stock market issues in 25 countries, an email survey was sent to regulatory bodies in selected developed and emerging economies. They include countries of English origin, French origin, German origin, and Scandinavian origin. Geographic regions represented include South America, North America, Eastern Europe, Western Europe, South Asia, Australia, and the Middle East. Emails were sent using official addresses provided by the International Organization of Securities Commissions (IOSCO). [Table 2](#) shows the selected sample of countries and their reference legislation (securities laws).

Based on survey findings, it may be concluded that there are many types of shares traded in world stock markets (see [Table 3](#)). This variety of shares is different from one country to another. In some countries, such as Jordan and Palestine, there is only one type of registered common stock with one fully paid par value. There are no bearer, preferred, no-par value, or dual class voting shares for foreigners. On the other hand, there are many developed markets that trade in more than ten types

Table 2. Sample Countries and their Reference Legislation.

Countries	Reference Legislation
Australia	Corporations Act No. 50 of 2001, SCH business Rules, Australian stock exchange listing rules
Brazil	Brazilian Corporation Law No. 6406 of 1996, and No. 6853 of 1997
British Virgin Islands	The International Business companies Ordinance of 1984, British Virgin
Canada	Toronto Stock exchange company manual
China, People's R.	Company Law of the People's Republic of China of 1993, China Securities Regulatory Commission Guidelines of 1994
Colombia	No. 2640 of 1978, the commercial code, The laws 222 of 1995
Denmark	Danish Public Companies as amended to 2001, Danish securities trading Act of 2000
Egypt	Corporate law No. 159 of 1981, Capital Market Law No. 95 of 1992
France	The French Law of new economic regulations of 2001, commercial code
Germany	German corporate governance code, 2002 and Aktiengesetz; stock corporation Act
Greece	Public Limited Liability law, The securities market of the Athena stock Exchange, 2001
Italy	Italian civil code, Instruction accompanying the rules of Nuovo Meractio of 1999, Consob regulation No. 11520 of 1998
Jordan	The Jordanian Companies Law, No. 22 of 1997, The Securities Law No. 23 of 1997
Pakistan	Companies ordinance of 1985, Securities and Exchange Ordinance of 1969
Palestine	The companies law No. 12 of 1964
Poland	Poland Act of 2000, code of commercial partnership and companies, Warsaw stock exchange rules of 2003
South Africa	Companies Act No. 61 of 1973, close corporation Act No. 69 of 1984
South Korea	Commercial Act and Civil Act
State of Czech	Securities Act 591 of 1992, Commercial code No. 513 of 1991
State of Jersey	Companies (Jersey) law of 1991, Companies securities law of 1988 (State of Jersey has no stock exchange)
Sweden	NBK recommendations of 2003 (ForetagsJuridik), Companies Act No 1385 of 1975
Switzerland	The Swiss federal code of obligations, co
Taiwan	Taiwan company law as amended on 2001 Taiwan securities and exchange law as amended 2002
U.K.	Companies Act of 1985 and DTI (2002) Modernizing Company Law
USA	States' Corporate laws, Federal securities law, and Stock exchange regulations

of shares, including the Swiss stock markets, Germany, British Virgin Islands, and South Africa. These stock markets include restricted and unrestricted shares, common, preferred, bearer, registered, various voting power classes, multiple par values, and various combinations.

Table 3. Share Types Traded in Sample Countries.

Share type	Description
Certificate share	Both common and registered certificate are permitted Common Bearer shares only permitted Common registered shares only permitted Preferred bearer shares only permitted Preferred registered shares only permitted
Single to dual class share	Single common share class Dual class for voting rights Dual class for residence-non-residence Dual class for special owners
Vote-non vote share	One-share-one vote No-vote share Superior vote share (two times) Inferior vote (up to one-tenth) Special voting rights and special shareholders assemblies
Value share	Par value with no limits No-par value Stated Minimum and maximum for par value Minimum limit only for par value Par value with premium Par value with discount
Fully-partial paid	Bearer share fully paid registered fully paid registered partial paid
Type of share	Common share Preferred share Saving share Participation share

Most world stock markets deal with between five and 10 types of shares. It should be noted here that there are some stock exchanges that prohibit specific types of shares such as the superior voting rights shares on the NYSE shares, dual class shares in the Brazil stock market, or bearer shares in many countries. Most world stock markets deal with both registered and bearer shares, as shown [Table 4](#). Still, one third of the sample countries deal only with registered shares, including such important markets as the USA, Australia, Brazil, Pakistan, Palestine, Jordan, Italy, and Colombia. Few countries, such as Sweden, deal only with bearer shares. Bearer shares can include common shares, preferred shares, and/or saving shares.

The use of bearer shares is a controversial issue. Various parties support the concept and consider it a sign of stock market liberalization. Others consider

Table 4. Bearer and Registered Shares in Sample Countries.

	Registered Shares	Bearer Shares	Conditions and Explanations
Australia	Yes	No	Bearer share was prevented by the company Act of 2001
Brazil	Yes	No	Prohibited by Law 8021 of 1990, previous bearer shares should be converted to registered shares
British Virgin Islands	Yes	Yes	Registered share may be exchanged to bearer there are some restrictions on bearer shares voting
China	Yes	Yes	Registered shares issue to promoters, state, and investments institutions, bearer shares issue to other public
Colombia	Yes	No	Registered shares only
Denmark	Yes	Yes	Bearer shares may be different classes
Egypt	Yes	Yes	Bearer shares have no voting, should be fully paid
France	Yes	Yes	A company should find a way to identify the bearer shareholders, as amended by French law of 2001, disclosure of ownership every 5% up to 66%, the majority of shares should be registered
Germany	Yes	Yes	Bearer shares may be ordinary or preferred shares
Greece	Yes	Yes	The current trend to convert bearer share to registered shares
Italy	Yes	No	Only saving shares may be bearer shares
Jordan	Yes	No	Only registered shares are issued
Pakistan	Yes	No	Only registered shares are issued
Palestine	Yes	No	Only registered shares are issued
Poland	Yes	Yes	Preferred share should be registered not bearer, bearer share only for common shares and should be fully paid
South Africa	Yes	Yes	Private company should issue only registered shares
South Korea	Yes	Yes	A bearer share may be converted into a registered Has no voting right unless be deposited with the company, Issue up to 50% of total outstanding shares
State of Czech	Yes	Yes	Both registered and bearer shares may be issued by the same corporation
State of Jersey	Yes	No	Only registered shares are issued
Sweden	No	Yes	All shares are bearer shares, disclosure requirements every 5% up to 90%, restriction on foreigner shareholders removed in 1993.
Switzerland	Yes	Yes	Bearer shares may have different voting rights and may be restricted, disclosure requirements every 5% up to 66%
Taiwan, R. of China	Yes	Yes	A bearer share may be converted into a registered and has no voting right unless be deposited with the company, Issue of bearer shares up to 50%
U.K.	Yes	No	Bearer shares are permitted but are not common
USA	Yes	No	No bearer shares in all states with exception of Nevada (but it is not used even in Nevada)

bearer share as an unseemly means for tax evasion and money laundering. As a result, countries such as Brazil and Australia have moved to prevent the use of bearer shares during the last decade. On the other hand, the use of bearer shares has recently been introduced in Egypt. Countries have variable conditions for bearer shares, especially for exercising voting rights. Legislation imposes various

Table 5. Voting and No-Vote Shares in Sample Countries.

	One Share One Vote	No Vote Share ^a	Dual Class Voting	Conditions and Explanations
Australia	Yes	Yes	Yes	Dual Class shares for multi voting rights
Brazil	Yes	Yes	Yes	Dual classes of shares are admitted, but companies listed companies should have one common class
British Virgin Islands	Yes	Yes	Yes	It includes one share-one vote, no voting share, superior, inferior vote and special voting rights
Canada	Yes	Yes	Yes	Dual class for voting rights are various in Canada, superior vote, inferior vote (one-tenth)
China	Yes	No	Yes	Have three share classes A with superior voting and B with interferer voting right, and F (for foreigners)
Colombia	Yes	Yes		
Denmark	Yes	No	Yes	Dual class share for multi voting rights
Egypt	Yes	Yes	No	In case of bearer shares no voting rights
France	Yes	Yes	Yes	Preferred Shares either have no vote or have double voting rights,
Germany	Yes	Yes	Yes	Different classes of shares based on different voting rights, non-voting preferred should not exceed 50%
Greece	Yes	Yes	No	Preferred shares
Italy	Yes	Yes	Yes	No voting for saving and preferred shares, multi voting rights for dual class share
Jordan	Yes	No	No	One share one vote only, no class share, no preferred
Pakistan	Yes	Yes	No	No vote for preferred shares
Palestine	Yes	No	No	One share one vote only, no class share, no preferred
Poland	Yes	Yes	Yes	
South Africa	Yes	Yes	Yes	Dual class for multi voting rights
South Korea	Yes	Yes	Yes	Preferred share, no voting of shares should be more than 25% of outstanding shares
State of Czech	Yes	Yes	No	Preferred share
State of Jersey	Yes	Yes		Preferred share
Sweden	Yes	No	Yes	Dual class shares for voting rights A share has ten times of voting rights of B share
Switzerland	Yes	Yes	Yes	No vote or different voting rights for bearer share No vote for class of common share for foreigners
Taiwan	Yes	Yes	Yes	Dual class share for different voting rights
U.K.	Yes		Yes	Dual class vote rights shares are very limited, but permitted, superior voting is multiple voting power
USA	Yes	Yes	No	Most of Preferred shares have no voting rights

^aNo vote share mainly for either preferred shares or bearer shares.

Table 6. Par Value Status In Sample Countries.

	Par Value	No Par Value	Conditions and Explanations
Australia	No	Yes	Recently eliminated par value, a company have no par value
Brazil	Yes	Yes	Partially paid share is permitted
British Virgin Islands	Yes	No	Capital of company is the sum of par value of shares
Canada	Yes	Yes	
China	Yes	No	Par value with premium is permitted but not with discount
Colombia	Yes	No	
Danish	Yes	No	Share should have nominal value
Egypt	Yes	No	Minimum par value of LE 5 and maximum LE 1000, per value with premium is permitted
France	Yes	Yes	No-par value introduced in 1998
Germany	Yes	Yes	Recently no par value added to the par value shares
Greece	Yes	No	Nominal value should be stated
Italy	Yes	No	
Jordan	Yes	No	Minimum and maximum limits of par value, premium yes, no par value with discount
Pakistan	Yes	No	Only par value permitted
Palestine	Yes	No	Minimum and maximum limits of par value, premium yes no par value with discount
Poland	Yes	No	Minimum par value of 500 zlotys, par value with premium is permitted but not with discount
South Africa	Yes	Yes	Par value and no-par value shares are permitted
South Korea	Yes	No	Nominal value should be determined
State of Czech	Yes	No	Nominal value should be determined
State of Jersey	Yes	Yes	Both share values are permitted, partially paid is permitted
Sweden	Yes	No	Nominal value should be determined
Switzerland	Yes	No	The minimum par value reduced to 1 centime and the zero par value eliminated
Taiwan	Yes	No	Par value with premium is permitted but not with discount
U.K.	Yes	Yes	It is recommended to eliminate par value for private company, and for public company
USA	Yes	Yes	Both are used Par value and non-par vale. Par value may be with premium or discount

methods to identify bearer shareholders or to permit bearer holders to vote. In some cases, bearer shares must be deposited with a financial institution or custodian, and changes in ownership must sometimes be disclosed (as in Sweden, France, and Switzerland).

The voting right of shares traded in world stock markets varies from one country to another. In general, the one share one vote rule is maintained. However, there are many instances of non-voting shares or inferior-voting shares. No-voting rights are common for preferred, registered, bearer, or class B shares in the majority of sampled countries. Preferred shareholders are thought to sacrifice voting rights in return for higher dividend rates or other specific privileges. No-vote or inferior-vote shares are common in a few countries in which it is common to issue class B shares to keep management under the control of the minority. Superior voting shares are issued by companies in some countries to serve the same purpose. [Table 5](#) shows the voting rights of traded shares in the 25 stock markets. The no-vote share column refers to either bearer shares or to preferred shares.

Superior voting shares create a separation between the control structure of the firm and the cash flow rights accorded to common shareholders. It is a popular means for combating the loss of control due to the liberalization of stock exchange laws and growing foreign investment. It is expected that more corporations will use inferior voting shares whenever national and corporate bylaws permit. Dual classes for voting rights are traded in most leading markets, including: Sweden, Switzerland, South Korea, France, Germany, Denmark, Canada, Australia, and People's Republic of China. In some countries Class b shares with inferior voting rights have the right to elect a minority of board of Directors, while class A shares have the right to elect the majority of board of directors. Dual class share may be issue based on residence, as in Switzerland and China. Preferred shares usually have no voting rights, but there are exceptions such as Germany, British Virgin Islands, Poland, Canada, Denmark, South Korea, USA, Taiwan, Italy, and Greece.

Finally, the stated par value of shares varies in world of stock markets. Shares may be issued with nominal or face value, known as par value, or without stated par value. Minimum or maximum par values can be set by national law or according to corporation bylaws. Possibilities for par values are illustrated in [Table 6](#).

All sample countries used a stated par value per share with exception of Australia.

5. CONCLUDING REMARK

Corporate laws and corporate bylaws incorporate different regulations to characterize the classes, types and features of shares traded in world stock markets. Shares traded in world stock markets include a variety of characteristics. Examples include bearer shares compared to registered shares, a single share class compared to dual classes with respect to voting rights, par value shares compared to no-par value shares, and so on. This study argues that despite significant changes in the

laws and regulations that govern stock trading, significant differences in the classes, types and features of shares traded can represent an obstacle to the harmonization and integration of world stock markets.

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