Topic 9 Solutions: International Corporate Governance

1. **The majority of major corporations are franchised as public corporations. Discuss the key strength and weakness of the 'public corporation'. When do you think the public corporation as an organizational form is unsuitable?**

The key strength of the public corporation lies in that it allows for efficient risk sharing among investors. As a result, the public corporation may raise a large sum of capital at a relatively low cost. The main weakness of the public corporation stems from the conflicts of interest between managers and shareholders (and bondholders and shareholders).

2. **The public corporation is owned by multitude of shareholders but managed by professional managers. Managers can take self-interested actions at the expense of shareholders. Discuss the conditions under which the so-called agency problem arises.**

The agency problem arises when managers have control rights but insignificant cash flow rights. This wedge between control and cash flow rights motivates managers to engage in self-dealings at the expense of shareholders.

3. **Studies show that the legal protection of shareholder rights varies a great deal across countries. Discuss the possible reasons why the English common law tradition provides the strongest and the French civil law tradition the weakest protection of investors.**

In civil law countries, the state historically has played an active role in regulating economic activities and has been less protective of property rights. In England, control of the court passed from the crown to the parliament and property owners in seventeenth century. English common law thus became more protective of property owners, and this protection was extended to investors over time.

4. **Discuss different ways that dominant investors use to establish and maintain the control of the company with relatively small investments.**

Dominant investors may use: (i) shares with superior voting rights – family of the founder may have a class of security that has higher votes, (ii) pyramidal ownership structure – *Keiretsu* in Japan, *Chaebol* in Korea, and (iii) inter-firm cross-holdings.

5. Many companies grant stocks or stock options to the managers. Discuss the benefits and possible costs of using this kind of incentive compensation scheme.

Stock options can be useful for aligning the interests of managers with those of shareholders and reduce the wedge between managerial control rights and cash flow rights. But at the same time, stock options may induce managers to distort investment decisions and manipulate financial statements so that they can maximize their benefits in the short run.

6. It has been shown that foreign companies listed in the U.S. stock exchanges are valued more than those from the same countries that are not listed in the U.S. Explain the reasons why U.S.-listed foreign firms are valued more than those which are not. Also explain why not every foreign firm wants to list stocks in the United States.

Foreign companies domiciled in countries with weak investor protection can bond themselves credibly to better investor protection by listing their stocks on U.S. exchanges that are known to provide strong investor protection. Managers of some companies may not wish to list shares in U.S. exchanges, subjecting themselves to stringent disclosure and monitoring, for fear of losing their control rights and private benefits.

7. Define corporate governance. How is it relevant to investors?

When ownership and control of corporations are not aligned there is potential for conflicts of interest between owners and managers. Corporate governance is a set of mechanisms designed to minimize the loss in value that results from the separation of ownership and control. In other words, it is a set of mechanisms either voluntarily adopted by the company or forced upon the company by providers of capital to ensure that providers of capital receive an appropriate return on their invested funds. For equity investors, corporate governance mechanisms act as a safeguard to ensure that management are doing what they are supposed to – maximize the value of the firm for shareholders.

8. Explain the different internal corporate governance mechanisms available to companies.

The three main internal corporate governance mechanisms are the board of directors, executive compensation and ownership structure. The effectiveness of the monitoring provided by the board of directors depends on the board size, board independence, board committees and the separation of the positions of Chairman and CEO. Executive compensation is a tool used to tie the interests of top executives to those of shareholders. This is usually achieved through stock ownership and stock options. Ownership structure can also impact on the propensity of management to expropriate funds. If a controlling shareholder has power over both the board of directors and management then they are more likely to act in their own interest than that of all shareholders. This is most likely in family-controlled companies and least likely when an outside blockholder is present.

9. What external mechanisms also play a part in corporate governance?

External mechanisms include the strength of the takeover market and the legal system. The takeover market acts as a ‘court of last resort’ to discipline corporate managers who have been underperforming. The legal system provides a base level of protection to investors, but this can vary substantially across countries. In general, those countries with English common law origins provide better protection to investors.

10. The 1998 study “Law and Finance” by La Porta, Lopes-de-Silanes, Shleifer, and Vishny measures the ownership concentration of firms in many countries around the world. They show that the top three shareholders of the typical U.S. firm own 12% of the firm’s equity, while the top three shareholders of the typical Mexican firm owns 67% of the firm’s equity. What explanation do these authors advocate for this large difference in ownership concentration between these two countries? ***Past Exam Question***

Large shareholders may need to own more capital to “exercise control rights” to minimize the risk of being expropriated by managers especially if the legal protection provided is weak (– diffuseness in ownership would allow managers to divert more of the firm’s resources to serve their interests).

Furthermore, dispersed shareholders would only purchase stock at a sufficiently large discount to account for the high risk of expropriation by managers.

Large concentration is viewed as a "substitute" mechanism to ensure that managers act in shareholders' interest.

11. The table below contains some data for two countries, Italy and the United Kingdom. The 1998 study "Law and Finance" by La Porta, Lopes-de-Silanes, Shleifer, and Vishny has an explanation for why we observe differences across these two countries in the three measures below (labeled 1, 2, 3). Describe the basic idea behind the "Law and Finance" view and the author's explanation for the differences in these three measures. ***(Past Exam Question)***

	Italy	UK
Legal Origin	French civil law	English common law
Shareholder rights index	1 (low)	5 (high)
(1) Average ownership of the 3 largest shareholders	58%	19%
(2) Market capitalization of the stock market/GDP	71%	248%
(3) Number of listed stocks	247	2,292

** Students need to read the academic paper to answer this question. **