Corporate Governance:  
A Brief Review of the Literature

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# Abstract

At first, this article briefly describes the subject of corporate governance, why it is essential, and why product market competition is not enough for it. Moreover, it discusses agency problems which corporate governance deals with them. Then I explain how financing without governance can occur and whether these mechanisms is sufficient. After this I review two major approach to corporate governance, legal protection and large investors, both in theory and empirical studies.

# Introduction

The subject of corporate governance is of enormous practical importance. Corporate governance deals with mechanisms through which investors assure themselves of getting a return on their investments in corporations. Given the vast discretion of managers, how do financiers control managers? The managers or entrepreneurs who run the firm might abscond with the money or invest in destructive projects. How do suppliers of capital get managers to return some of the profits to them?

In perspective, corporate governance literature deals with the principal-agent problem that stems from the separation of ownership and control, or the separation of financing and management of firms, in theory and practice. The agency problem here refers to difficulties that financiers have in ascertaining that their funds are not expropriated or wasted in destructive projects.

Also, Tirole (2001, p. 4) defines corporate governance as “the design of institutions that induce management to internalize the welfare of stakeholders.” It means that not just the welfare of shareholders matters in corporate governance but also stakeholders, such as employees, customers, suppliers, and communities, in corporate governance.

A better corporate governance environment is associated with a more developed financial system, as many studies show. Besides that, a more developed financial sector facilitates economic growth. In an influential study, Rajan and Zingalas (1998) show that more financial development has a causal effect on growth; it facilitates growth. Financial development reduces the costs of external finance to firms, and this is more crucial for industries that are technologically more dependent on external finance. This effect of corporate governance on growth through financial development raises its importance furthermore.

One might think that we should not worry about corporate governance because, in the long run, the product market competition would take care of corporate governance. After all, competition forces firms to minimize costs so they would adopt corporate governance mechanisms to raise the external capital at the lowest cost.

However, market competition is probably the most potent force toward economic efficiency; it is doubtful to be enough for corporate governance. Market competition reduces the return on capital and thus reduces the amount that managers can expropriate, but it does not prevent managers from expropriating competitive return after the capital is sunk. Hence solving this problem requires something more than the competition, as discussed in the following.

Most developed economies have solved the corporate governance problem reasonably well; hence they have assured the flows of enormous capital to firms and actual return of some of the profits to finance providers. Nevertheless, this does not mean it has been solved perfectly and cannot be improved.

Understanding corporate governance sheds light on the discussion of marginal improvements of rich economies and stimulating major institutional reforms where they need to be made.

## The Agency Problem

### Contracts and management discretion

The essence of the agency problem is separation ownership and control. The financiers and the manager sign a contract; ideally, this contract would specify what the manager does in all states of the world and how the returns are divided. However, this is technologically infeasible; hence the manager and the financiers have to allocate residual rights, i.e., the decision rights in the circumstances not foreseen by the contract.

Because financiers do not have the information and qualification to decide in these residual states, the very reason they hire managers in the first place, they cannot retain all residual rights; consequently, managers end up with substantial residual rights and, therefore, discretion to allocate funds.

Specifically, those who control a corporation, either managers or controlling shareholders (hereafter insiders), can divert corporate wealth to themselves instead of sharing it with other investors. In other words, insiders can expropriate minority shareholders or outsiders.

Expropriation can take a variety of forms. In the most straightforward instance, it can take the form of outright theft of corporate assets; in other instances, insiders sell outputs, assets, or other securities to other firms they own below market prices. Excessive compensation, diversion of corporate opportunities, installing possibly unqualified family members in managerial positions, directed equity issuance, or personal loans to insiders are other forms of expropriation. This ability of insiders to divert corporate wealth to themselves is called “private benefits of control.”

Much of the subject of corporate governance deals with limits managers put on themselves or investors put on managers to limit expropriation to reduce the ex-post misallocation and induce investors to provides more funds to firms ex-ante.

## Evidence on agency costs

Empirically, the private benefits of control have been investigated in several contexts. A considerable amount of research has documented the prevalence of this self-serving managerial behavior. Most of these studies are event studies based on the idea that if the stock price falls after an announcement of managers’ actions, this must serve managers’ interests rather than shareholders’ interests.

However, in some circumstances, this inference is not justified, but such event studies are reasonably compelling. Such event studies have become the most common empirical methodology in corporate governance and finance.

For example, Bae et al. (2002) find that in Korean business groups (Chaebols), substantial tunneling occurs. They find that on average when a business group firm makes an acquisition, its stock price falls, and the value of other firms in the group increases. It means that controlling shareholder tunnel firm resources to increase his wealth. Furthermore, the concentrated ownership by owner-managers in chaebol bidders and rescue mergers by chaebol bidders are negatively related to bidder announcement returns but are positively related to announcement returns of the value-weighted portfolio of other firms in the same group. The fact that a chaebol bidder loses its value but other firms in the same chaebol rise in value suggests a wealth transfer from the bidding firm to the other firms in the same group. They also find that the mean market value change of insider holdings in chaebol bidders around the time of the merger announcement is -105 million won, but that in other member firms, it is 614 million won. All these findings support the tunneling view for business groups.

In a study in China, Jiang, Lee, and Yue (2010) find that during 1996–2006, controlling shareholders borrowed tens of billions of RMB, usually interest-free and almost never paid back, from hundreds of Chinese listed companies. They also find a higher implied discount rate in the valuations of earnings of firms that have large amounts of intercorporate loans.

Insiders have a strong incentive to hold excessive amounts of cash for their private benefits, as Jensen’s (1986) free cash flow hypothesis suggests for managers. Cash provides more expropriation opportunities to insiders because it can be conveniently transformed into private benefits.

As an indirect evidence of this agency problem, Chen et al. (2012) find that firms hold extensively lower amounts of cash after the split share structure reform. The split share structure reform took place in China in 2005 that allowed previously non-tradable shares held by controlling shareholders to be freely tradeable on the exchanges. This reform aligned the incentives of controlling shareholders more in line with those of minority shareholders. Consequently, the reform reduced the incentives of insiders to expropriate firm resources; hence they significantly reduced firms’ cash holdings; especially, this effect is more pronounced in firms which governance arrangements were weakest before the reform.

# Financing without governance

The previous arguments raise the question of why financiers invest when both the theory and evidence suggest the vast discretion of managers about the funds, often to the point of being able to expropriate much of it?

There are two general explanations: first, the idea of managers’ reputation, and second, the idea that investors are gullible and get taken. Both of these approaches have the common feature of investors do not get any rights, just the hope that they would make money in the future.

The reputation building argument is that managers payback investors because they want to raise external finance in the future in the capital market; and in order to convince future investors, they have to build a reputation.

However, pure reputational stories run into a backward recursion problem. At a point in time, for the manager, when the future benefits of raising funds are less than the costs of paying promised payments, the manager rationally default. Moreover, because investors know that such a time will be reached in the future, they would not finance the firm in the first place. Hence there is no possibility of external finance.

An alternative explanation is that investors get excited about companies and finance them without thinking much about getting their money back simply because of excessive optimism and short-term share price appreciation.

As the evidence suggests, managers can expropriate only limited wealth, and the securities have some underlying value, so the explanations for this have to go beyond investors’ optimism.

# Investor legal protection

The principal reason that financiers invest in firms is that they receive control rights in exchange. The most important rights investors have is the right to vote on most important corporate issues like board election, firm liquidation, or acquisitions. When investor rights are extensive and well-enforced by regulators, they are willing to finance firms; in contrast, when the legal system does not protect outsiders, the external finance would break down.

All outsiders, large or small, shareholders or creditors need to have their rights protected. Much evidence suggests that the level of investor protection provided by the legal system has significant economic consequences. Much of the difference in corporate governance systems worldwide stems from the legal obligations of managers to financiers and how courts interpret and enforce these laws. Variations in law and its enforcement are crucial to understanding why firms in some countries raise more external funds than the others.

For better explaining the role of the legal system in corporate governance and its effect on the size and breadth of the capital market, first, we explain a simple model presented by Shleifer and Wolfensohn (2002), then we summarize some empirical evidence about the role of the legal system.

## A Simple Model

### The Model setup

Shleifer and Wolfenzon (2002) introduce a simple model of an entrepreneur going public in an environment with poor shareholder protection. They examine entrepreneur decisions and market equilibrium. The implications of this simple model are consistent with several empirical studies.

Assume an entrepreneur is trying to raise external finance for a project and deciding how equity to sell and how big the project to undertake. The entrepreneur operates in an environment with limited investor protection so he can divert some of the profits after they materialize. By doing so, he risks being sued and fined. The quality of investor protection in this model is given by the probability that the entrepreneur being caught for expropriating from shareholders.

Consider a world with C countries, each one populated with J risk-neutral entrepreneur. Each (entrepreneur j from country c) differ in their initial wealth, and productivity of their projects .

We assume all countries have an identical pool of entrepreneurs. The model has two dates. At date 1, the entrepreneur chooses whether to set up a firm. Each  contribute  to the firm and invests the remainder in the market. Second, raises  from the market by selling a fraction of the ﬁrm’s cash ﬂow rights. We assume that entrepreneurs retain control of their ﬁrms regardless of the fraction of the cash ﬂow rights they sell. Each ﬁrm uses the funds committed to it to invest in the project, and the remaining in the market. The market interest rate , is determined by supply and demand for funds.

At date 2, revenue is realized as:

The entrepreneur decides to divert the fraction of of the profits. If he is caught, he is forced to return the diverted amount and pay a fine of and the entire revenue is distributed as dividends. If the entrepreneur is missed, he keeps the diverted amount, and the remaining is distributed as dividends. We assume countries differ in the level of legal protection they provide to investors. We consider the entrepreneur gets caught by the probability of . is a measure of investor protection level in country c. higher values of corresponds to better investor protection.

So, the entrepreneur’s expected payoff at date 2 is given by:

Also, we assume the fine function satisfies these conditions.

First, we take the equilibrium interest rate as given and solve the entrepreneur problem. To enlighten notation, we suppress subscripts. At date 2, E chooses the fraction to divert to maximize his payoff:

FOC:

The assumption of guarantees that SOC holds.

At date 1, the entrepreneur has to solve the following maximization problem.

s.t.

The solution to this problem is:

If g<i, the firm is not set up, and the entrepreneur supplies his entire wealth to the market.

If g=i, the entrepreneur is indifferent between I. not setting up the firm and II. setting up the firm with no outside shareholder and investing any fraction of his wealth in the project.

If g>i, the firm is set up, the entrepreneur invests all his wealth in project and sets , the optimal satisfies

And

Where and is the derivative with respect to the first argument.

And also,

### Equilibrium with Perfect Capital Mobility

First, we assume perfect capital mobility across countries, so equilibrium requires equating world demand and supply for funds. It can be shown that, in this case, an equilibrium interest rate exists. In this case, we count the model implications.

Proposition 1. For two countries, H and L, that differ in the level of investor protection, with , for country H we have

* + 1. Lower ownership concentration
    2. Larger external capital markets
    3. Larger firms

Proposition 2. It can be shown that, more firms go public in countries with better investor protection.

Proposition 3. If That is, equilibrium diversion decreases as the level of investor protection rises.

### Equilibrium with No capital mobility

For the case of no capital mobility, each country has its equilibrium interest rate that is determined by the internal supply and demand for funds. In this case, the following results can be established.

Proposition 4. Consider two countries with different levels of investor protection. The country with better investor protection has a higher market interest rate.

Compared to the results derived for the case of perfect capital mobility, capital markets with no mobility are again more extensive, and there is also more investment in countries with better investor protection, but the difference is smaller due to the effect of a higher interest rate.

An interesting corollary of proposition 4 is that:

Corollary 1. In countries with better investor protection, not only are more funds that are raised by firms, but these funds are also channeled to higher-productivity projects.

This result holds since better investor protection leads high-productivity ﬁrms to demand more funds. The increased demand raises the country’s interest rate. As a result, entrepreneurs with moderately productive projects supply their funds to the market in countries with good investor protection.

This proposition sheds light on an important question raised by Lucas (1990), that is a standard production function implies greater marginal product of capital and hence higher interest rate in developing countries compared to rich countries, so why does not capital flow from developed countries to poor countries? This proposition gives another explanation that the real interest is higher in better investor protection countries. It thus eliminates the incentive for capital to flow to worse investor protection countries, because too much of it is expropriated in the worse investor protection country.

This argument raises the question of why do not countries with bad investor protection that suffering from financial underdevelopment improve their legal environment? We do not cover this question in this article.

## Evidence on the investor legal protection

Strong law and well-developed institutions can help resolve agency problem and protect minority shareholders. In this section, we review some of the studies on the relationship between investor legal protection as a corporate governance mechanism and finance market, firm valuations, and other related issues.

In an important study by La Porta et al. (1997), using the data of 49 countries, they find that countries with better investor protection, measured by both the character of the legal rules and the quality of law enforcement, have a larger and broader capital market, both of equity and debt markets. They also find a systematic difference between countries from different legal origins; specifically, French civil law countries have both the weakest investor protections and least developed financial markets, especially compared to English common law countries.

Furthermore, Djankov et al. (2008) present a new measure of investor protection level against expropriation by insiders, namely the anti-self-dealing index. They show that a high anti-self-dealing index is associated with valuable stock markets, more domestic firms, more IPOs, and lower private benefits of control. The index is also a statistically signiﬁcant and economically strong predictor of a variety of measures of stock market development across countries, and it is associated with a more developed securities market.

In another paper, La Porta et al. (2002), by developing a simple model and testing with data of 27 countries, show that consistent with the model, firms in better investor protection countries have higher valuation.

Moreover, La Porta et al. (2000) argue that firms in poor investor protection countries may need to have concentrated ownership. Moreover, traditional bank versus market-centered distinction between financial systems is not a useful way to distinguish them; rather legal approach is a more fruitful way to understand corporate governance and its reform.

In an interesting research, Johnson et al. (2000) find that in the Asian financial crisis 1997-98, which affected all the emerging markets open to capital flows, measures of corporate governance, particularly the level of protection for minority shareholders, explain the extent of exchange rate depreciation and stock market decline better than do macroeconomics measures.

They argue that as long as growth lasts, the institutions which protect shareholder and creditor rights are not important, but when growth prospects decline, the lack of good corporate governance becomes crucial. Because expropriation by managers increases when the expected rate of return on investment falls, then an adverse shock to investor confidence will lead to increased expropriation as well as lower capital inflow and greater attempted capital outflow for a country. This leads to exchange rate depreciation and stock market decline.

Also, Poor investor protection harms share liquidity. Brockman and Chung (2003) compare Hong Kong (HK)-based blue-chip firms and China-based firms that are listed on the Hong Kong Stock Exchange. The institutional environment in Hong Kong is much better than that of mainland China. They find that stocks of China-based firms have larger bid-ask spreads and thinner depth than stocks of HK-based firms.

During the early 2000s, property rights started to improve in China, but to varying degrees. Cull and Xu (2005) consider two aspects of property rights: risk of expropriation by the government and the ease and reliability of contract enforcement. Using data from a survey of firms based in 18 cities in China during 2000–2002, their study finds that when managers perceive the risk of expropriation to be low and the ease/reliability of enforcement to be high, they reinvest more of their firms’ profit back into their firms.

Moreover, strong legal protection can encourage innovation. To test the role of intellectual property rights in China, Fang, Lerner, and Wu (2017) use survey data from 66 prefectures to examine the privatization of SOEs. They find that on average, firms’ patent stock increases by 200% to 300% in the 5 years after privatization compared to the 5 years before—and, importantly, that the increase in innovation is significantly larger in prefectures with higher IPR protection.

In 2007, China enacted the Property Right Law. Berkowitz, Lin, and Ma (2015) study announcement returns on December 29, 2006, the day when a draft of the Property Law was accepted by the Standing Committee of the National People’s Congress (NPC). The acceptance of the draft was a surprise, as this law had been debated by the NPC for many years. On that day, the mean stock market return was almost 4%. For event windows of (-2, +2) and (0, +5), where day 0 was December 29, 2006, the mean cumulative stock returns were over 6% and over 15%, respectively. These announcement returns are higher for firms with more tangible assets (that could have been expropriated by the local government), and without political connections (to prevent such expropriation).

## The Coasian View

The emphasis on legal investor protection and market regulation stands in contrast with the traditional view that originated in Coase(1961) theorem. According to this perspective, most financial regulations are unnecessary because contracts take place between two sides. In other words, absent significant transaction costs, capital suppliers, and users should negotiate, agree, and privately contract on the efficient level of investor protection when that level is not provided by law. Investors, on average, recognize the risk of expropriation and penalize firms that fail to disclose information. Because entrepreneurs bear these costs, they have the incentive to bind themselves contractually and limiting the expropriation. Hence as long as these contracts are enforced, financial markets do not require regulation.

But this theorem crucially relies on courts enforcing elaborate contracts. Nevertheless, this kind of contract enforcement cannot be taken in most countries. Moreover, courts are often unwilling or unable to invest the resources to interpret complicated contracts, and they are slow, subject to political pressure, and sometimes corrupt. Therefore, in these circumstances, other forms of protecting property rights may be more efficient. It may be better to have contracts restricted by the law that are enforced than unrestricted contracts that are not. The evidence suggests that private contracting is insufficient.

Consistent with this argument, Bergman, and Nicolaievsky(2007) find that Mexican private firms often offer significantly enhanced legal investor protection terms to their investors. They develop a model that endogenizes the level of investor protection using an assumption that legal regimes differ in their ability to enforce precisely filtering contracts that provide protection only in the cases that expropriation can occur. This is a clear manifestation of contractual opting-out from the law. It also indicates a reliance of the contracting parties on the Mexican courts to enforce those contracts.

Finally, An important implication of this approach is that leaving financial markets alone is not a good way to encourage them, they do need some protection of outsiders, whether by courts, government agencies, or private enforcing and market agents themselves.

In sum, investor protection has broad consequences on patterns of ownership and control, development of financial markets, the real part of the economy, institutional and legal reform, and allocation of resources.

Finally, laws in some countries like the U.S., Japan, and Germany protect the rights of investors relatively well; however, in these countries, the legal system leaves managers with vast discretion. In most countries, the laws are less protective, and law enforcement is worse comparatively; thus, legal protection alone is not enough for investors to get their money back.

# Large investors

If the legal system is not sufficient for protecting minority shareholder rights, then perhaps investors can get more effective control rights by being large. Most governance mechanisms used in the world like relationship banking, large shareholding, institutional investors, takeovers, large creditors, can be viewed as large investors exercising their power. While large investors rely on the legal system, they don’t require as many rights as the small investors do to protect their interests. Concentrated ownership, in effect, leverages up legal protection and can reduce agency costs. Nonetheless, large shareholding has its costs, which we discuss further in the following.

For presenting a big picture of ownership structure throughout the world, we refer to La Porta et al. (1999). They document that except in countries with very good shareholder protection like the United States, relatively few firms are widely held. In fact, in most countries, firms have a controlling shareholder. Controlling shareholder is typically a family or the state, and have control rights in excess of cash flow rights through pyramidal ownership structure or participation in management. For the sample of large firms, and using the 20 percent definition of control, 36 percent of the firms in the world are widely held, 30 percent are family-controlled, 18 percent are State-controlled, and the remaining 15 percent are divided between the residual categories.

Among the medium firms, the world average incidence of dispersed ownership is 24 percent, compared to 36 percent for the large firms. So going down in size has the same effect as relaxing the strictness of the definition of control: it makes widely held firms more scarce. Note, however, that in the United States and the U.K., though not in Japan, the medium firms remain mostly widely held—a testimony to the attractiveness of selling out in the United States and the U.K. For medium firms, the percentage of firms controlled by families rises to a world average of 45 percent, making it the dominant ownership pattern. It seems that existing ownership structures are likely an equilibrium response to the domestic legal environments that companies operate in.

There is a free-rider problem inherent with small shareholders because small investors have small stakes in the firm; it does not pay to them to monitor management and bear the cost of monitoring. At the same time, large investors have a strong incentive to collect information and monitor management. Also, they have enough voting control over the firm to put pressure on management. Because they have a large ownership stake, it pays to them to maximize firm valuation and therefore minimizing expropriation and agency costs.

Although concentrated ownership has its benefits, it also has costs as well. The cost of having a large shareholder is best described by potential expropriation from minority shareholders by the controlling shareholder. This is the central problem of corporate governance in most of the world. For example, in China, the main agency problem is horizontal agency conflict between controlling and minority shareholders arising from concentrated ownership structure.

Controlling shareholders may treat themselves preferentially at the expense of other investors and employees. They may pay themselves special dividends by using business relations with other firms they control like the case often happens in business groups. The fact that shares with superior control rights trade at significant premiums is evidence of considerable private benefits of control at the expense of other minority investors.

Typically, ownership and control concentration has two effects on firm value. The first is more concentrated cash flow rights in the hands of controlling shareholder, the stronger is the shareholder’s incentive to run the firm properly because when the firm is run properly, would raise his wealth. Hence this results in a positive relationship between the firm value and cash flow rights of controlling shareholder.

The second effect is the entrenchment effect. In contrast with the first effect, the more control rights are in the hands of controlling shareholder, the more entrenched he is and thus better able to extract value at the expense of minority shareholders. This effect suggests a negative relationship between control rights of controlling shareholder and the firm value. The negative effect of entrenchment is more severe when there is a divergence between cash-flow rights and control rights that often occurs through pyramids because the willingness to extract value is less restrained by the cash-flow stake.

A straightforward inference of these arguments is that when the cash-flow ownership of controlling shareholder is higher, we should expect lower expropriation by controlling shareholder and more firm valuation. La Porta et al. (2002) present a model of the relationship between legal protection of minority shareholders and of cash-flow ownership by controlling shareholder on the firm valuation. This model is presented briefly in the following.

## A model of controlling shareholder

In this model, there is a firm fully controlled by a single controlling shareholder. This controlling shareholder has a cash flow in the firm, which we assume is exogenous, and we do not consider the sale of equity by the entrepreneur. The firm has the amount of cash I, which it invests in a project with the gross rate of return R. The firm has no costs so the profits are RI. As a private benefit of control, the entrepreneur can divert a share of s of the profits before distributing the rest as dividends. This diversion of tunneling has costs. Finally, he receives:

Where c(k,s) is the theft function, and that is the share of profits he wastes when fraction s is diverted. k denotes the quality of investor protection. Naturally, we assume:

The first inequality means that stealing is costlier in a more protective legal regime; the second means that the marginal cost of stealing is positive; the third means that the marginal cost of stealing rises as more is stolen; and the final—crucial—inequality means that the marginal cost of stealing is higher when investors are better protected.

The entrepreneur maximizes his payoff:

FOC:

This expression states that the higher is the cash-flow ownership by the entrepreneur, the greater are his incentives to distribute dividends in a non distortionary way rather than expropriate minority shareholders in a distortionary way, and hence the lower is the equilibrium level of expropriation for a given k. High cash-flow ownership reduces minority expropriation.

It simply can be shown that by the assumption of this model, these two results hold.

* + 1. In countries with better shareholder protection, there is less expropriation of minority shareholders.
    2. Higher cash-flow ownership by the entrepreneur is associated with less expropriation of minority shareholders.

## Evidence of the effects of large investors

In a celebrated study, Claessens et al. (2002), using data for 1,301 publicly traded corporations in eight East Asian economies, find that firm valuation increases with the cash-flow ownership of the largest shareholder. More specifically, they show that concentrated ownership in the hands of all types of owners is associated with a higher market to book ratio. Moreover, they show that firm value falls when the control rights of controlling shareholders exceed its cash-flow ownership. These results are consistent with the positive incentive effect associated with increased cash-flow rights of controlling shareholder and the negative entrenchment effect with the sizeable controlling shareholder. They also find that this negative effect is particularly severe when the deviation between controlling and ownership rights is higher.

They find that East Asian firms also show a sharp divergence between cash-flow rights and control rights—that is, the largest shareholder is often able to control a firm’s operations with a relatively small direct stake in its cash-flow rights. Control is often enhanced beyond ownership stakes through pyramid structures and cross-holdings among firms, and sometimes through dual-class shares, with the divergence between cash-flow rights and control rights most pronounced in family-controlled firms. Their main contribution in this study is disentangling the incentive and entrenchment effect of large ownership that are so difficult to tell apart in the U.S. market because, in the U.S., firms are typically widely held.

In an earlier study, Claessens et al. (2000) used data for 2,980 corporations in nine East Asian countries. Find that in all countries, corporate control is typically enhanced by pyramid structures and cross-holdings. In this study, they show that the separation of ownership and control is most pronounced among family-controlled firms and among small firms. They also find that a single shareholder controls more than two-thirds of listed firms. Separation of management from ownership control is rare, and management of 60% of the firms that are not widely held is related to the family of the controlling shareholder; Older firms are more likely family-controlled, which dispels the claim that dispersion of ownership is just a matter of time. Finally, significant corporate wealth in East Asia is concentrated among a few families.

A study on Korean business groups by Bae et al. (2002) reveals that in business groups, tunneling often occurs. They find that when a group-affiliated firm makes an acquisition, its stock price on average falls. While minority shareholders of a firm making an acquisition lose, the controlling shareholder of that firm on average benefits because the acquisition enhances the value of other firms in the group.

In a similar study, Bertrand et al. (2002), show that in Indian business groups, a significant amount of tunneling happens, much of it occurs via nonoperating components of profit. Their methodology rests on isolation and testing distinctive implications of the tunneling hypothesis for propagation of earning shocks across firms within a group.

Family ownership of firms is common around the world as a large shareholder. In a study, Anderson and Reeb (2003) find that family ownership is prevalent and substantial among the S&P 500 firms and account for 18% of the outstanding equity. Contrary to their conjecture, they find that family firms perform better than non-family firms, and the performance is even better when family members serve as CEO than with outside CEOs. Based on the average ROA (EBITDA) in the sample, family firms appear to return 6.65 percent more than non-family firms. Their results suggest that family ownership is an effective organizational structure.

## Institutional investors’ monitoring

Here in this section, we briefly discuss the role of institutional investors by explaining the results of two empirical studies.

First, it is worth mentioning that institutional ownership of common stock has increased substantially over recent decades. According to the Federal Reserve Board’s Flow of Funds report, institutions owned approximately 7% of US equities in 1950 and 51% by the end of 2004. Also, According to the International Monetary Fund (2005) (IMF), these professional investors manage ﬁnancial assets exceeding US$45 trillion (including over US$20 trillion in equities). So, understanding their role in financial markets is an important issue. Institutional investors are major players not just in developed countries but also in emerging market countries.

Institutional involvement can have various forms, such as threatening the sale of shares, actual share sale known as the “wall street walk,” actively using voting rights, and meeting and influencing management.

The question is whether these large types of investors are useful in monitoring and influencing management towards creating shareholder value. It is reasonable to think that not all money managers are equally equipped or motivated to be active monitors. For instance, Parrino, Sias, and Starks (2003) conclude that rather than exerting effort to inﬂuence management, some institutional investors vote with their feet by selling their shares (wall street walk) when they are dissatisﬁed with corporate performance.

The evidence for the debate on whether institutional investors monitoring and activism is effective is somewhat mixed. Parrino, Sias, and Starks (2003) ﬁnd that institutional selling inﬂuences the decision of the board of directors to ﬁre a CEO, while Gillan and Starks (2003) ﬁnd typically modest stock price reactions to shareholder proposals by activist institutions. McConnell and Servaes (1990) detect a positive relation between Tobin’s Q and the fraction of shares owned by institutions. However, Woidtke (2002) shows that ﬁrm value is positively related only to ownership by private pension funds.

Institutional monitoring consists of two elements: first, information gathering that institutions use it for portfolio selection decisions, and second, using such information to actively influencing firm policies and thereby benefiting all investors. It is highly plausible that some institutions prefer one aspect over another.

Ferreira and Matos (2008) study the role of institutional investors around the world using a comprehensive dataset. They find all institutional investors seek large ﬁrms and ﬁrms with strong governance indicators, but foreigners overweight ﬁrms in the Morgan Stanley Capital International World Index and ﬁrms cross-listed on a U.S. exchange.

Moreover, their findings suggest that some (but not all) institution groups are effective monitors of the ﬁrms they invest in. They also find that, The presence of foreign and independent institutions enhances shareholder value. These institutions are able to exert pressure because they have fewer business relations with the ﬁrm to jeopardize, unlike domestic or grey institutions. Their tests show that ﬁrms held by foreign and independent institutions have higher valuations; there is no similar evidence for ownership by domestic and grey institutions. Furthermore, they document that foreign and independent institutions are associated with better operating performance and reduced capital expenditures. Their results are robust in many several ways.

In another research considering the monitoring role of institutions, Chen et al. (2007) find that, independent long-term institutions(ILTIs) monitor firms effectively and other type of institutional investors will not monitor.

In their study, they use a cost-benefit framework and hypothesize that ILTIs will invest in monitoring and influencing firms rather than trading. Using acquisition data they show that presence of ILTIs are related to better post-merger performance and the likelihood of withdrawal of bad bids is higher. These institutions make long-term portfolio adjustments rather than trading for short-term gain. In sum, for ILTIs the gain from effective monitoring is shared with other shareholders, while the gain from long-run portfolio adjustment is private.

# Financial analysts as an external corporate governance mechanism

In previous sections, the role of legal protection and large investors have been discussed. However, this is not the entire story. There are more known corporate governance mechanisms and probably numerous unknowns. In this section as of another form of corporate governance we briefly discuss about financial analysts.

Analysts can serve as an external governance mechanism through at least two channels. First, analysts track firms' financial statements on a regular basis and interface with management directly by raising questions in earnings announcement conference calls, which can be regarded as direct monitoring. 1 Second, analysts provide indirect monitoring by distributing public and private information to institutional investors and millions of individual investors through research reports and media helping investors to detect managerial misbehavior.

Chen et al. (2015) examine the role of analysts as an external corporate governance in mitigating agency conflicts over corporate policies. Their study relies on two natural experiment which are exogenous. They scrutinize the causal effects of analysts’ coverage on managerial expropriation of outside shareholders. they find that as a firm experiences an exogenous decrease in analyst coverage, shareholders value internal cash holdings less, its CEO receives higher excess compensation, its management is more likely to make value destroying acquisitions, and its managers are more likely to engage in earnings management activities.

Also, they find that these effects are more pronounced two subsample of firms first for firms with lower initial analyst coverage where losing an analyst is more important marginally; second for those with less product market competition, meaning there are fewer substitute constraints on agency problems. These findings show that financial analysts play an important governance role.

# Final Remarks

In this article I briefly review corporate governance and ownership structure literature but it is worth mentioning that I do not cover in details and also several other corporate governance mechanisms. This article extensively borrows from the papers in the reference section.

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