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# *INTRODUCTION*

There are many factors contributing to a firm's success, board powers and composition, organizational structure and procedures. These factors, however, are still less important than the sufficiency of the firm's business model or the qualities of its top executives. Hence, we do not have to wonder why shareholders, consultants and politicians as well as scholars did not pay so much attention to such common corporate governance issues.

In past decades, the interest in corporate governance, especially in the board of directors, rose sharply. One of the reasons was the increase in US takeover activity in the 1980s and emerging globalization. Some consequences of emerging globalization are shorter product life cycles, decreasing profit margins and the intense competition we are promoting, which altogether lead to an increasing anxiety about the competitiveness of countries' institutions. The takeover activity lead to conflicts of interests between managers and shareholders, while the increasing competition did not leave room for neglecting any factors that could go a long way towards firm performance. Furthermore, increasing competition lead to pay more attention to differences in corporate governance, its global expansion and question the vast number of boards today, although most organizations are required to be governed by a board of directors.

One of the first economists who addresses boards of directors is Adam Smith (1776) with the following interesting statement:

> *"The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over the same anxious vigilance [as owners]…. Negligence and profusion, therefore, must always prevail, more of less, in the management of the affairs of such a company"* (p. 700).

Berle and Means (1932), figured out a similar point of view pointing out the agency problems in an organization as well as Smith:

> *"Control will tend to be in the hands of those who select the proxy committee and by whom, the election of directors for ensuing period will be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors"* (p. 87).

Both studies point out the agency problem in an organisation or more specifically, the agency problem between owners, shareholders and management. Hermalin and Weisbach (2003) consider that shareholders *"are generally seen as unable to control management directly"*, and management, however *"tend to be insufficiently vigilant or trustworthy when it comes to other people's property"* (p. 10).

Gugler, Mueller and Yurtoglu (2004) find that *"managerial costs have been higher in social democracies than elsewhere […]"* (p. 138). This finding linked together with the US takeover activities in the 1980s and the emerging globalization, make it is safe to assume that at that time, the agency problem was intensified in the 'Anglo-Saxon system', representing the US corporate governance system, and then spread likewise on emerging markets.

Gugler et al. (2004, p. 149) show that the 'Anglo-Saxon systems' are the one which *"are better at protecting shareholders than other systems and that they lead to superior macroeconomic performance"* – this is why many countries try to adopt this governance system partially or entirely. In emerging markets, where family ownership and business groups are part and parcel of the ownership structure in the corporate governance, agency problems occur and have to be reduced too. Gutierrez and Pombo (2007) find that the agency problem occurs because most firms are owned by large shareholders who in most cases belong to business groups too.

However, Hermalin and Weisbach (2003) present some solutions to the agency problem, though difficult to apply. One solution may be to provide management with strong incentives contractually. However, *"In most large corporations, the shareholders are too diffuse, rationally plagued by a free-rider problem, and, for the same reason, too uninformed to set managers' compensations"* (Hermalin & Weisbach, 2003, p. 10). Furthermore, Hermalin and Weisbach (2003) think that this problem, as well as the underlying direct control, could be eased in situations *"in which a large outside shareholder has sufficient incentive herself to tackle them"* (p. 10).

As you might see, board of directors are an important topic of research in many areas, not just in economics, but there is still more research to be done. In my diploma thesis I am going to investigate the 'Board of directors in emerging markets'.

The first part consist of general research on board of directors. There, I investigate the reason for the existence and structure of boards. In the latter, I present the three categories of directors such as the insiders, outsiders and the institutional portfolio holders.

Afterwards, I am going to face the effects of the boards' corporate performance with each board size and composition. The CEO turnover as well as takeovers and the executive compensation will be explained too. After presenting you the controversial board reforms with its global impact on corporations and the global adaptation of the Anglo-Saxon governance system, I am going to focus on emerging markets, the second part.

Brazil is going to be my choice of representing an emerging market because of its size and interesting corporate governance system. At first, however, I am going to show some characteristics of emerging markets, though limited on Latin America. Additionally, I am going to present the corporate governance in emerging markets, and then in Brazil, to establish a connection to further findings of my research which are based on Brazil. Furthermore, I have done some research on the corporate ownership and control. There I am taking account of the direct as well as indirect structure of ownership and control. Afterwards, I am going to illustrate relevant evidence of the consequences that a separation of ownership and control are facing. The board of directors in emerging markets, though specified on the Brazilian market, will complete my research and indicate some interesting findings regarding the board and ownership structure as well as the necessity of control and board of directors in Brazil.

The last section summarizes the major findings, concludes the diploma thesis and shows why boards of directors are such a controversial topic, where still a lot of research has to be done, especially in emerging markets.

## 1 WHY ARE THERE BOARD OF DIRECTORS?

On the one hand, board of directors are rumoured to be insufficient guardians of shareholders' money and too much in management's hand (cf. Lipton & Lorsch, 1992). On the other hand, boards exist for a long time and if they were really so inefficient, we can proceed on the assumption that the market would improve or even replace them.
To put it in other words, an institution which is not considered to be 'first-best' efficient, does not mean that the market need another regulatory solution. Hermalin and Katz (1993), for example, think that board of directors are a 'second-best' solution for companies being confronted with the agency problem between the members' different interests. Furthermore, Hermalin and Weisbach (2003), however, suggest that *"a board of directors is the equilibrium solution (albeit possible second best) to some agency problems confronting the firm"* (p. 9).

However, what agency problems are they referring to and why does a direct control problem arise? First of all, the agency problem exists between a company's owners, shareholders and management. Shareholders are always seen as being unable to control management and the management is seen as being insufficient to others people's money. In this love triangle, it is possible to keep the agency problem at bay by corporations, that should provide the management with strong incentives contractually. Furthermore, *"this problem, as well as the direct control problem, could be alleviated in situations in which a large outside shareholder has sufficient incentive herself to tackle them"* (Hermalin & Weisbach, 2003, p.10).

Therefore, we can not assume that board of directors are the product of regulation, and, if so, boards *"would represent deadweight costs to firms which subsequent lobbying would have eliminated, at least somewhere in the world"* (Braendle & Noll, 2004, p.10). So, we can expect boards to have minimum size because of resembling deadweight costs. In fact, boards are much bigger than required by law. Hence, the literature defines boards of directors as being a market solution to the contracting problems companies are facing. Some reasons of these contracting problems are the diffuse shareholders, the free-riding problem and the often too uninformed shareholders to be able to control managers.

Given their power and importance of boards of directors across boundaries in different organizational forms, boards have to meet a multitude of requirements. First of all, boards do have to have a specific number of members with at least some specified regularity. Then, boards may need to have various committees and finally, some directors have to have some nominal independence from management.

To put it shortly in another way, boards of directors emerged because shareholders did not trust the managers with their money and could control them.

## 2 HOW ARE BOARD OF DIRECTORS STRUCUTRED?

In general, boards of directors are made up of insiders and outsider. However, Gugler, Mueller and Yurtoglu (2004) found a third important category of owners in the USA; the institutional holders.

Now, we can classify different owners into those three categories. At first, we have the company's managers, who are **insiders**. Then we have the **outsiders**, who can be classified into families, institutional holders such as pensions and funds, and "affiliated" or "gray" directors. Furthermore, independent directors are classed among outside directors too. Finally, other financial institutions such as banks, and non-financial institutions such as other firms belong to the third category, the **institutional portfolio holders**.

Independently, Hermalin and Weisbach (2003) indicate that without knowing the whole theory of why there are boards of directors, it is still possible to study their structure and tasks. So, the first modelling approach of Hermalin and Weisbach (2003) is to see *"the board as a "principal" to management's "agent" in a classic principal-agent framework"* (p.10). This principal agent modelling, however, does not provide any detailed information about board-specific phenomena such as the ratio of insiders to outsiders and the influence, that management has towards the selection of directors. This model, more precisely, the Hermalin-Weisbach model, derives about eight predictions about the dynamics of the CEO and board's relationship. Hermalin and Weisbach (2003, p.11) outlined their predictions as follows:

1. *A CEO who performs poorly is more likely to be replaced than one who performs well.*
2. *CEO turnover is more sensitive to performance when the board is more independent.*
3. *The Probability of independent directors being added to the board rises following poor firm performance.*
4. *Board independence declines over the course of a CEO's tenure.*
5. *Accounting measures of performance are better predictors of management turnover than stock price performance.*
6. *There should be long-term persistence in corporate governance.*

7. *The stock price reaction to management changes should be negative if the CEO is fired based on private information, but positive if the manager is fired on the basis of public information.*
8. *A CEO's salary should be insensitive to past performance at relatively low levels of past performance, but sensitive at relatively high levels of past performance.*

Those three dominant categories of shareholders – the inside owners, the outside individuals as blockholders and the institutional portfolio holders – are going to be explained in more detail.

## 2.1 INSIDERS

Managers, employees or former employees of the firm are considered to be insiders. They are not independent to the CEO, because the success of the insiders' careers depends on the CEO's success. Due to this, there is no chance that there is going to be a conflict between the manager and the owner of the firm and so, they both can pursue their businesses. Since the existence of a separation of ownership and control, which was evaluated by Berle and Means (1932), a number of new studies examined the enormous economic consequences of the conflict between managers and owners. Additionally, an "Anglo-Saxon" corporate-governance system was assumed, which I am going to explain in section 6.2 in more detail.

Nonetheless, outside directors are shareholders. Hence, they have an incentive to control the company's actions. There is an assumption that when managers do not hold large amounts of their companies' stakes, they do not have the same financial interest as their shareholders. However, if they would hold a large amount of shares from their own company, they would have an interest in maximizing the shareholder's profit.
Morck, Shleifer and Vishny (1988) found out, that there are two effects on the incentive to maximize shareholder wealth when increasing insiders' shares. First of all, the market value of the firm increases and second, when the shares of management increases, the chance of a manager being replaced by a hostile takeover, because management pursues their own goals of profit maximization.

Furthermore, Gugler et al. (2004) have evidence that the performance of companies worsens by managerial entrenchment from the view of shareholders and due to this, shares hold by management give an perfect incentive to improve the company's performance.
In sub-item 3 you will find more information about corporate performance/action in subject to both board composition and size.

## 2.2 OUTSIDERS

Families, institutional holders such as pensions and mutual funds, "gray" directors and independent directors do belong to the outside directors.

Braendle and Noll (2004) find that *"starting from 1987, in the US institutional investors, pension funds in particular, deviated from their prior role as passive investors by submitting proxy proposals focusing largely on corporate governance issues and therefore the decision when to reorganize a company"* (p. 13).
Various empirical studies document that **institutional investors** do have an important role as being external monitors (cf. Hansen and Hill 1991; McConnell and Servaes 1990). These authors indicate that the higher the investment levels of investments by institutional portfolio holders are, the more effective is monitoring. So, institutional investors have the incentive and motivation to monitor the management's actions and decisions when holding a vast number of the company's shares. Additionally, even when monitoring is costly, institutional investors are able to monitor management effectively and profitably. Furthermore, institutional investors are often characterized as *"preferring exit in the classical dilemma of "exit" and "voice", this situation has changed, and they are nowadays often seen as strong monitors who are interested in the processes of the companies and voicing their opinion"* (Braendle & Noll, 2004, p.13-14).

Outside directors are not employed in the firm where they hold positions of a director and are typically CEOs from another company or prominent individuals in other areas. About 10 percent of directors do not fall into one of these categories except of businesspeople and attorneys who have a long-term relationship with the firm. Hence, *"These directors are usually referred to as "affiliated" or* ***"gray" [!] directors****"* (Hermalin & Weisbach, 2003, p.22). Another important aspect of outside directors is that they have a monitoring role

over the board and a strong incentive to build up a high reputation of the company. However, Gugler et al. (2004) find disagreements considering evidence that outside shareholders with small stakes are powerless in maximizing the value of their shares. Furthermore, they find that outsiders have a small impact on firm actions but no impact on firm performance, though.

Additionally, outside directors are more independent, provide a better monitoring role than insiders and are less informed about the firm's constraints and opportunities. Additionally, Linck, Netter and Yang (2007) find, that *"[…] as the benefits (costs) of monitoring increase, boards will do more (less) monitoring leading to more (less) outsiders"* (p. 5).

**Independent directors** are outside directors without such affiliations as being "*former company officers or relatives of company officers and persons who have or are likely to have business relationships with the company, such as investment bankers and lawyers"* (Bhagat & Black, 1998, p. 283).

Companies with a majority of independent board members are more likely to be managed in the interest of the shareholders and additionally, Bhagat and Black (1998) found out that *"greater board independence remains high on the agenda of activist institutional investors"* (p. 283). Furthermore, there is no empirical evidence that firms with majority independent boards achieve better performance than other firms. *"Independent directors often turn out to be lapdogs rather than watchdogs"* (Bhagat & Black, 1998, p.283).

## 2.3 INSTITUTIONAL PORTFOLIO HOLDERS

Institutional portfolio holders are the third category of the ownership structures are meant to be highly effective external monitors, especially in the US and UK. To distinguish these sorts of institutions from the institutional holders (pensions and mutual funds), which belong to the outsiders, Gugler et al. (2004) refer to them as 'institutional portfolio holders'. Other financial institutions (banks) and non-financial institutions (other firms, state) belong to the institutional portfolio holders.

Friedman (1996) find that *"Between 1950 and 1994 the fraction of shares held by institutional portfolio holders in the United States rose from 10 per cent to over 50 per cent"*. Hence, *"the managers of institutional portfolio obviously possess sufficient voting authority to intervene in shareholders' meetings and affect outcomes"* (Gugler et al., 2004,

p. 140). Furthermore, the portfolios of the companies are not materially affected by their portfolio managers.

**Banks** belong to the **'financial institutions'** that are very important in the corporate governance in Germany and Japan. In Germany, banks play a monitoring role for the companies that they lent to or owned shares. In Japan, however, the keiretsu's main bank will become important when a company of this conglomerate has a problem with *"intervening with a cash infusion, a plan of restructuring, or engineering a change of management"* (Gugler et al., 2004, p. 140).
However, because of the poor overall performance of the banks' economies over the last 20 years, observers are sceptical about the roles of banks in Germany and Japan. There are three reasons of the banks' poor performance. First of all, banks may not have a positive monitoring role because banks themselves are managed by professionals who have their on goals. Second, banks are free to pursue whatever goal they want to and third, Boehmer (2001) states that German banks are not interested in shareholder value.

The **state**, for example, belongs to the **'non-financial institution'**, where a state-owned company is typically assigned to a ministry. The transportation ministry, for example, has a monitoring role for the state's airline. A ministry, however, is monitored by the parliament, which is monitored by the citizens. Hence, the citizens can be regarded as the owners of the state companies. Now, Gugler et al. (2004, p. 143) find a *"triple principle-agent problem (citizen selects parliament, parliament monitors ministry, ministry monitors state company"*. Consequently, if managers of private companies have to act discreetly to pursue their goals because of the resulting principal-agent relationship between managers and shareholders, then managers of state companies have to be even more discrete about their actions. Hence, we can assume a better performance in private-controlled than in state-controlled firms, when performance is measured in terms of efficiency or profit rates.

## 2.4 EMPIRICAL EVIDENCE

Linck, Netter and Yang (2007) determine a downward trend in the percentage of **insiders** on the board of directors. However, small companies present the largest decrease. They indicate that *"Small firms had the highest percentage of insiders on the board in 1990.*

*This number decreased from about 46% in 1990 to about 34% in 2004. For large firms, this ratio dropped from about 28% to 24%"* (p. 16).

Considering that there are either insiders or outsider in a board of directors, we can determine the number of **outsiders**, when the number of insiders are known. So, taking the findings from Linck, Netter and Yang (2007) into account, which were shown above, we can say that repugnant to the insiders, outsiders increased from 54% in 1990 to about 66% in 2004. The increase of outsiders show that corporations are seeking for an increase of the monitoring role over the board and have a strong incentive to build up a high reputation of the company.

**Institutional portfolio holders** are large blockholders and their *"fraction of all shares of listed companies increased in Germany from 4% in the year 1990 to nearly 13% in 1998"* (Schmidt & Drukarczyk, 1997, p. 69). Furthermore, Friedman (1996) demonstrates that in the US, the amount of shares held by institutional portfolio holders increased from 10 percent to over 50 percent between the 1950s and 1994. In Japan, about 45% of the listed shares are held by institutional portfolio holders (Kanda, 1997) and in the UK, the shares increased from 29% in 1963 to 60% in 1994 (Davies, 1997).

## 3 EFFECTS OF BOARDS OF DIRECTORS

Before comparing the corporate performance/actions to both board composition and board size as a function of CEO turnovers, takeovers, poison pills and executive compensation, I am going to explain the so called "out-of-equilibrium phenomenon" and the "equilibrium phenomenon" shortly.

Either equilibrium or out-of equilibrium phenomena can be interpreted in many empirical results. Although they are difficult to distinguish in studies, they have an enormous different implication for policies. For example, empirical studies demonstrate that board size is negatively related to firm profitability. The out-of-equilibrium interpretation says that limits on board size should be promoted or even mandated. However, the equilibrium interpretation implies that some other factor is causing both board size and board profitability so that such regulations are counterproductive and useless.

**Figure 1:** Heuristic Illustration of the Distinction between Out-of-Equilibrium and Equilibrium Explanations for Certain Empirical Results. Source: Hermalin, B. E., Weisbach, M. S., 2003, p. 8

*"Both endogeneity considerations and the equilibrium nature of the results should be carefully considered when evaluating any study of boards or any other aspect of corporate governance"* (Hermalin & Weisbach, 2003, p.8).

## 3.1 BOARD COMPOSITION AND CORPORATE PERFORMANCE

Now the question arises, if corporate performance will increase with more outside directors? There are three methods trying to answer this question. The first method examines at the same time correlations between the proportion of outsiders on boards and accounting measures of performance. MacAvoy, Cantor, Dana and Peck (1983), Hermalin and Weisbach (1991), Mehran (1995), Klein (1998), and Bhagat and Black (2000) are of the opinion, that there is an insignificant relationship between the ratio of outside directors on boards and the measurement of performance. A second approach was presented by Morck, Shleifer and Vishny (1988). They had the idea to reflect the "value added" of intangible factors such as governance by using Tobin's Q as a performance measurement tool. However, "*there is no noticeable relationship between the proportion of outside directors and Q"* (Hermalin & Weisbach, 2003, p. 12). Finally, Bhagat and Black (2000) examine the effect of board composition on long-term stock market and accounting performance. The findings were predictable; there is no relationship between board composition and firm performance/action.

However, there is evidence that there is an increase in board independence on the supposition that a company has a poor performance, but there is no empirical relationship between board composition and firm performance. This result is not surprising. As Hermalin and Weisbach (2003) stated correctly, *"firm performance is a function of so many different factors that it is difficult to imagine that the effect of occasional board meetings, etc., would be detectable…"* (p. 12).

Rosenstein and Wyatt (1990) tried to explain the interaction of board composition and corporate performance from another point of view. They examined the board composition with changes of the firm value; more precisely, they compared the stock price reaction of the day of announcement that outside directors will be added to the board. *"They find that on average there is a statistically significant 0.2 percent increase in stock prices in response to the announcement of these appointments"* (Hermalin & Weisbach, 2003, p.13). Additionally, there is no notable reason to add an insider to the board. In contrast, Rosenstein and Wyatt (1997) find out seven years later, that adding an insider to the board, somehow increases the stock price. As you see, it is really difficult to distinguish and interpret results from the empirical literature.

Due to this reason, as might be reasonably expected, there are big differences from the results of the equilibrium and non-equilibrium point of view too. Hermalin and Weisbach (2003) summed the findings up as follows:

> *"If the equilibrium interpretation is correct, it is hard to explain how certain actions could consistently increase firm value. In contrast, if one believes the out-of-equilibrium interpretation, one must first address the issue of how the firms arrived at this out-of-equilibrium situation"* (p. 13).

## 3.2 BOARD SIZE AND CORPORATE PERFORMANCE

Is it true, that large working groups are less effective than small groups? And can we adopt it to boards? Can we segue from too big working groups and there inefficiency into boards? It depends. We all know, that the agency and free-rider problem occurs when boards of directors become more symbolic and are indigently implemented in the management. There are two tools to measure the size of the board and the effectiveness. The first measurement was indicated by Yermack (1996). On a sample of American corporations he examines the relationship between Tobin's Q and board size with the result, that there is a negative relationship between those two factors supporting that thesis. The second approach examines the view of participants in the marketplace of board size. Researchers find out, that boards tend to be smaller and are decreasing, because of pressure from active investors. Furthermore, they are decreasing, because of market participants that think, that small boards do monitor management better than bigger boards do. One problem why big boards are undesirable is, that they cause a free-rider problem. But then, the following question arises. Why do still big boards exist and are excepted?
As discussed in 3.1, it depends, on whether you are estimating an equilibrium or non-equilibrium situation or, if you are on the right or left side of Figure 1. Unfortunately, there is no definite answer, so there has to be more research being done on that topic.

## 3.3 EXTERNAL MONITORING AND CONTROL MECHANISMS

There are internal as well as external control mechanisms, whereas both mechanisms have the same influence on a corporation. Board of directors, however, belong to the internal control mechanism. Now, I analyze three external monitoring and control mechanisms.

The **CEO turnover** belongs to the first external monitoring and control mechanism. The most important responsibility of a board is to elect, monitor and in the worst case scenario, to replace the firm's CEO. Therefore, there is only one way to evaluate the efficiency of a CEO; to look at his decisions. A large number of papers indicate, that there is a positive relationship between CEO turnovers and poor performance in companies[1]. However, there is an important distinction between voluntary and involuntary turnovers. Those distinctions are difficult to distinguish. "Voluntary turnovers are unlikely to be related to performance, and negative relationship between performance and CEO turnover is extremely robust across samples" (Hermalin & Weisbach, 2003, p. 14).

So, if there is a negative relationship between performance and turnover, boards will probably fire the CEO. Lets consider attentively the role of the board. Weisbach (1988) interacts board composition and firm performance in a CEO turnover equation. To understand this concept, we do have to know the following to indications. First of all, if a board is outsider dominated, than the relationship between CEO turnover and performance is more sensitive than it would be with an insider-dominated board. In contrast, insider-dominated boards do not replace CEOs on performance related reasons.

How can we find a plausible explanation to statements mentioned above? Well, Hermalin and Weisbach (2003) did find four answers explaining CEO turnover and performance considering board composition:

> First, *"boards controlled by outside directors do a better job of monitoring the CEO than do boards controlled by inside directors"* and that second, *"inside directors make their turnover decisions on the basis of inside information"* even though *"insider-dominated boards are responding to performance, the performance they are responding to is not measurable by an outside observer"*. Furthermore, *"Inside directors' careers tend to be tied to the CEO's, which gives them incentives to advance the CEO's career regardless of the stock price"*.

[1] Among them are Coughlan and Schmidt (1985), Warner, Watts, and Wruck (1988), Weisbach (1988), Jensen and Murphy (1990) and Kaplan (1994).

> Moreover, *"any potential inside information that inside directors use to justify a firing has to reflect negatively on the CEO without reflecting negatively on them; otherwise, shareholders would likely respond to the CEO's dismissal by demanding a clean sweep of top management"* (p. 14).

Again, it is really difficult to find just one answer! Hermalin and Weisbach did need four attempts to state their findings. However, there are some other researchers that have found evidence consistent with the findings from the authors mentioned above. Borokhovich, Parrino and Trapani (1996), and Huson, Parrino and Starks (2000) find out, that *"outsider-dominated boards are more likely than insider-dominated boards to replace a CEO with someone form outside the firm"* (p. 15).
However, Perry had a remarkable finding by breaking down *"the cross-sectional relationship between CEO turnover and firm performance by whether the outside director are paid by using incentives"* (Perry, 2000). He suggests that incentives lead the board of directors to better performance and that an high payment make a rather professional than personal relationship to the CEO and thus are more independent.

Do characteristics of boards such as board size, composition and compensation really affect the board's monitoring? Or do independent boards make their work correct and monitor more effective? Well, a board dominated by a CEO will not monitor regardless its characteristics. A board dominated by independent directors, however, is paid with incentives and so arrange themselves regarding factors like size, composition and performance.

The second external monitoring and control mechanism are **takeovers**. Activities on the takeover market provide a laboratory of information for board actions and composition. We now do know, that boards do effect the quality of corporate governance and influence shareholders and we also know, that those actions can effect takeover decisions. Shivdasani is one of the leaders evaluating such processes and find three interpretations of acquiring hostile takeovers with a majority of outside directors on boards. At first, the quality of outside directors' decisions depends on the quantity of outside directors in boards. It is an important measurement of whether being taken over or not. Then, Shivdasani (1993) found out, that *"directors in higher demand will turn down directorship opportunities at poorly managed firms, which are more prone to being acquired"*. The last

interpretation states that the quantity of outside-director-positions hold by an outsider depends on his reputation. If he has a good reputation, he will get more outside director positions in more companies than having a bad reputation. Shortly, if he does not want to maximize his property in the firm at first case, but work for the shareholders' interests, he will get more positions as an outsider.
Furthermore, Shivdasani (1993) finds *that "controlling board seats appears to affects the takeover process"* and that *"board composition of a potential target is an important factor in the takeover process"*.

An important factor of influence regarding takeovers are poison pills. Investopedia (n. d.) defines poison pills as follows:

> *"A strategy used by corporations to discourage hostile takeovers. With a poison pill, the target company attempts to make its stock less attractive to the acquirer. There are two types of poison pills:*
> *1. By purchasing more shares cheaply (flip-in), investors get instant profits and, more importantly, they dilute the shares held by the acquirer. This makes the takeover attempt more difficult and more expensive.*
> *2. An example of a flip-over is when shareholders gain the right to purchase the stock of the acquirer on a two-for-one basis in any subsequent merger"*.

Furthermore, poison pills, when used correctly, can protect the current management at the expense of shareholders. Additionally, the bargaining position can be increased by poison pills, when a takeover appertains. Furthermore, poison pills have positive as well as negative reactions on stock markets; positive, when the majority of the board are independent, negative, when it does not. Hence, boards with a majority of outsiders should adopt poison pills for their shareholders' interests. Insider-dominated boards should use poison pills to entrench management.

Finally, the third external monitoring and control mechanism I am dealing with is the **executive compensation**. Another important role of the board of directors is to introduce the compensation policies for management. The board has to control if these compensations are too high or too low. Specifically Core, Holthausen & Larcker (1999) find that *" CEO pay rises with the number of outsiders appointed during the CEO's tenure, and about whose appointments the CEO therefore had a says. CEO pay also rises with variables likely to indicate a lack of board involvement […]"*. Those variables are board

size, the quantity of directors over age sixty-nine and the number of directors that hold other directorships, also called “busy” directors. However, the more successful a CEO is, the higher is his compensation. The so called pay-performance- relationship indicates, that the higher the board size, the lower the incentives to bear more risk and the lower the compensation.

## 4 BOARD REFORMS

The takeover activity during the 1980s in the U.S. and around the world are a significant reason of increasing conflicts between managers and shareholders, while because of increasing competition, the firm performance could not be neglected. Furthermore, directors approved extraordinarily high compensations without justifying themselves and failed to minimize financial manipulation and so, directors are the ones whose fault is the breakdown of worldwide operating major firms. Boards of directors did not monitor them adequately and so, improvement has to be done.

In the late 1990s, board reforms started to flourish due to scandals of well-known corporations such as Enron, WorldCom and Parmalat. *"Law-makers in the EU, the USA, and elsewhere took the view that weak boards were a distinct feature of companies engaging in fraud and had to be reformed so as to play effectively their first-line-of-defence role against corporate malpractice"* (European Commission). Due to this, both the Securities and Exchange Commission (SEC) and the Delaware judiciary think about giving the shareholders more of a say in board elections. However, board reforms are kind of inefficient considering the board's multiple functions such as strategy setting, management monitoring, crisis management and regulatory compliance for example. Furthermore, reforms make mistakes such as short-term rebuilding confidence of investors or calming down shareholders' anger to next elections.

Board reforms can be divided in three broad categories. The first is the constraining of discretion by reinforcing the powers of shareholders and auditors. The second category aims reinforcing board independence and finally, directors incentives are targeted through compensations and provisions.

Reinforcing the powers of shareholders and auditors will **constrain board discretion**. In the USA, board elections are performed by the firm's executives, whereas in Europe controlling block holders reinforce their power over the board by minimizing corporate affairs of small shareholders. However, there are two options of unsatisfied shareholders with board nominees, though. The first option is to *"mount a costly and uncertain campaign for rival proxies"* (Hertig, 2005, p. 271). The second is to keep back their vote. The latter option indicates the board of directors opposition, but is not binding.

While the Delaware judiciary wants to find a solution to increase shareholders' powers to vote out the unwanted directors with representatives of institutional investors, "*in Europe, by contrast "the focus is on giving the general meeting the right to vote on remuneration policies and stock option plans"* (Hertig, 2005, p. 271). The UK Combined Code for example, allows investors in listed companies an advisory vote on executive pay plans with the effect to force corporations to take into account their investors opinion. Additionally, *"the European Commission recommends that member states let shareholders of listed companies vote on director remuneration policies as well as on schemes under which directors are remunerated in shares or share options, or on the basis of share movement"* (Hertig, 2005, p. 271). Well, the new German policies containing a strong union and political pressure are a standard practice in the UK.

Board powers also fall prey to board reforms. In the USA, reforms are aiming to constrain the auditors because of their complacency. Furthermore, *"the USA has taken the lead by requiring auditors to attest the adequacy of internal controls over financial data"* (Section 404, Sarbanes-Oxley Act-SOX). This requirement forces directors to acquiesce to auditor instructions until the directors are ready to inform investors about not dealing with material weaknesses which were identified by the audit. Hence, board discretion will be reduced. In Europe, however, the European Commission proposes to reinforce the independence of auditors with the adaptation of a Directive, which reinforces the independence of auditors by limiting dismissals of restricting auditors and by boards, that have to participate in audit executions.

Another very important category of board reforms is to **reinforce board independence**. Hertig (2005) find that the set up of boards of directors should contain a majority of independent directors and the separation of CEO and board chairpersons. However, to reinforce board independence and to improve boards, we do have to define the term independent directors at first. The revised New York Stock Exchange (NYSE) defines independent directors as *"those having 'no material relationship' with the listed company"*, while the UK Combined Code invokes to *"non-existence to 'relationship or circumstances that are likely to affect or appear to affect the director's judgement"* (Hertig, 2005, p. 272).

While independence is still defined as being released from family members, business ties and other relationships, the *"examples of non-independence have been relegated to an 'additional guidance' annex"* (Hertig, 2005, p. 272). As you might see, the factor

independence is not only question mark of board composition and board structure, but also of the detailed board procedures. Furthermore, both the NYSE and the European Commission accentuate the need for the board of directors to evaluate their own performance.

The **director incentives is** the last of overall three categories of board reforms. The NYSE wants the audit committee to be financially literate and that at least one of them has an area of expertise in accounting or financial management. The European Commission, however, wants to have boards with members of sane judgement, expertise and specific knowledge to complete their tasks. Furthermore, the European Commission recommends that listed companies are under obligation to reveal the compensation data of directors containing information about *"the variable and non-variable remuneration, as well as information about non-cash and retirement benefits"* (Hertig, 2005, p. 2712). We will see, if less board friendly reforms will change the profit seeking point of view of directors on shareholders.

## 4.1 DOES ONE SIZE FITS ALL?

There is a wide-spread variety of different organizations around the world. There are listed and non-listed publicly held firms and of course, privately held firms. But, there is just one, but very doubtful factor on board reforms. Those of the said *"board reforms have de facto one-size-fits-all consequences, which raises efficiency issues"* (Hertig, 2005, p. 273). Nonetheless, there are still cultural differences, financial structures and different ownership structures that have to be considered in reforms and so, Hertig (2005) thinks it is *"naïve to believe that firms can easily avoid compliance"*, because of standardization effects that emerge due to corporate governance provisions. The first effect, the default nature of governance codes, can cause high costs to non-compliance companies, even without having particular advantages. The second effect, however, is that financial analysts have to be integrated in several publicly held corporations to engage specific governance assessments. Thus, there is a one-size-fits-all matter, because of firms *"that by examining the magnitude of changes induced by the board"* are likely *"to be subject to disproportionate costs"* (Hertig, 2005, p. 274).

## 4.2 MINIMUM STANDARDS, NOT "BEST PRACTICES"

The reformers of corporate governance are of the opinion that they provide *"'best practice' or 'good governance' provisions"* (Hertig, 2005, p. 274). However, researchers do not think so and refer more to 'average practice' and 'minimum standards'. In general, though, reforms tend to trace instead of causing changes in board of directors. *"Hence, recent board reforms do not seem to have had a significant impact"* (Hertig, 2005, p. 274). Furthermore, directors of the European Union noticed that corporate governance reforms do not make any difference at all and do not even have an effect of the directors' remuneration. Additionally, board changes are not caused because of regulatory changes; they are caused due to market forces! Due to this, market shocks are caused by adjustments of the US board structure and not as many people think, because of regulatory reforms.
However, is there an explanation why actually the so called 'best practices' are no more than 'minimum' standards only? Yes, there are three explanations trying to answer this question. The first explanation is that board reforms prefer to be ineffective than to be called an inefficient innovation. Then, the 'minimum' standard is not really that easy to implement in corporations and third, the regulatory capture plagues the reform process.

In the next section I will clarify that board reforms are both inefficient and insufficient anyway and does not produce better results.

## 4.3 EFFICIENCY AND REGULATORY CAPTURE SIZE

In this section I will show you some issues containing both efficiency and regulation. Inefficiencies can be minimized by adopting largely similar governance forms worldwide to minimize transactions. Then, trade-offs should be taken into account and because of an increasing number of shareholders, corporations should watch for opportunistic behaviour by controlling or minority shareholders. Another important issue is that reinforcing the monitoring function of board of directors can interfere with the boards tasks to carry out the strategy function. Considering these standards and taking into account multiple factors worldwide, reforms can be either inefficient or inadequate.

### *4.3.1 Trade-offs*

Evidence shows that reformers forgot to take factors such as trade-offs into account and so, there is an impact functions of the board, on the role of gatekeepers and at last but not least on the compensation. I am going to present you those impacts in the section below.

#### *4.3.1.1 Functions of the board*

The board of directors has many important functions such as setting strategies, approving corporate actions, monitoring functions and risk management. Those functions depend on the shareholder structure, firm size and firm specific corporate governance as well as other things. However, two factors do attract attention by reformers; the monitoring and the conflict-of-interest function. The reason for attraction attention are simply. At first, scandals have shown examples of *"non-compliance with accounting and disclosure requirements"* (Hertig, 2005, p. 275). Second, because of not paying attention to related-party transactions, the asset diversion was facilitated by managers and controlling shareholders.

The result of reforms on boards is, that the core reform is the director independence and so reformers chose *"to adopt a combined structure and relationship approach"* (Hertig, 2005, p. 275). As mentioned before, independence provisions belong to directors with no personal or financial links with the company or its managers or even controlling shareholders. Another problem constitute the so called 'no relationship' director. This kind of directors may have poor knowledge about the corporation's business activities, but in contrast, boards with a majority of trustful 'no relationship' directors soften conflicts of interests. Additionally, the risk of information reduction increases because of the scope of definitions of independence. Another, but very important problem to deal with is the quality of strategic decisions regarding industry and firm specific knowledge. This deficiency will be reinforced when board independence reduces cooperation between managers and directors. So, it is important to work on that issue, because evidence indicates that the most successful boards are those where insiders as well as outsiders work together and not against each other. Furthermore, *"board independence is a function of*

*negotiations between the CEO and directors, the result of which varies with CEO quality, which in turns effects policy"* (Hermalin & Weisbach, 1998).
However, proceedings between CEOs and directors hold a mirror up to a high request for board members that are able to act as outsider advisors rather than belonging to 'no-relationship' directors. In the USA, outside directors are more common in the pre-deregulation period than thereafter, for example. Nevertheless, it is more efficient to have outside directors on board that are in pursue to fulfil an important advisory function. Recapitulating, there is a need of independent outside directors, but it is still unclear, in what kind of degree of independence they are needed.

Those discernments admit following improvement suggestions for board reformers. First of all, reformers should omit to adopt too detailed rules. Second, a minimum independence standard should be composed as general as possible and finally, too detailed lists with the field of duties should avoid costly unwanted consequences that would change boards.

#### *4.3.1.2 Role of Gatekeepers*

Board reformers should contemplate the role of gatekeeper issue. To do so, reformers should recruit independent auditors with a financial expertise to reinforce independence and power.
However, gate keeper reforms are very costly. Those reforms may force the board of directors to avoid costs of non-compliance with regulated standards for the risk-averse auditors. Furthermore, those reforms would increase the monitoring function of the board by putting auditing issues at the forefront. However, it cannot be denied that audit committees did not performed tolerable. Coffee (2002) states *"that past US limitations on auditor liability risk had resulted in auditors becoming more complacent and less likely to discover or deter asset diversion or financial misrepresentations"*.
Anyway, researches still do not understand why reformers do have to deal with audit issues such detailed as they do. Summarized, reformers have adopted rules that are too detailed considering the independence issue.

*4.3.1.3 Compensation*

According to board reformers, corporations should have a compensation committee composed of independent directors in majority or in total. Various codes recommend outside consultants for benchmarking compensations on which to judge managerial performance. The idea behind this is stop executives from maximizing short-term earning per share.

Reforms considering the compensation do have some flaws too. First of all, managers are not only motivated by money and so, it can unleash an adverse selection effect by picking out those, who are not money oriented. Second, an inefficient compensation will increase, if additional compensation advisors are hired. And finally, consultants get into the habit of operating as head hunters whose earnings depend on their candidates' remuneration by reinforcing their self-esteem driven behaviour.

Summarized, reforms are still needed, but performance related incentives for outsiders are difficult, though. There is evidence, that when the board does not have enough independence, even a very well paid CEOs tend to perform badly. On the other hand, shareholder will gain because of a collusion between executives and board of directors, if the firing risk is limited by reducing compensation. Furthermore, institutional investors do have an important compensation-monitoring role. So, this monitoring role *"reduces the need for regulatory intervention"* (Hertig, 2005, p. 278).

As assumed, there is the same conclusion for compensation as for board functions as well as for gatekeepers. Board reforms have too detailed rules! Such an extraordinarily detailed catalogue of rules have *"the advantage of reducing legal uncertainty and constraining judicial activism"*, the disadvantage, however, compared *"to the costs resulting from the failure properly to take into account trade-offs faced by larger firms and one-size-fits-all effects for smaller firms […] that is reinforced by regulatory capture considerations"* (Hertig, 2005, p. 278).

*4.3.2 Regulatory capture*

Altogether, board reforms are either transparent nor democratic and so there are two consequences of self-regulation and political entrepreneurs.

First of all, small investors have been ignored. However, institutional investors do have an interest in reforms and so, they provide financial and political private benefits to their controllers. They also permit their managers to blame the boards of operational companies, when performances are not given. Here are some examples of inefficient institutional investors influence. Rules on the separation of CEOs and chairmen of the board have been adopted, regardless of the fact that their benefits can be lower than their costs. Furthermore, fund managers may want to disclosure their compensation data because of trying to justify their salaries and deflecting their own performance. At last but not least, the negative effect of balance among board emerge because of provisions of board independence. This board independence would reflect investors' view of the directors monitoring role.

Second, a lot of issues are ignored by reformers. However, although issues such as board collective decision making, compensation structure, institutional investor governance and individual shareholder monitoring were solved, there is still a lot of work to do. The managers and owners of institutional investors, for example, do not want to be the *"target of board independence or retail investor protection regulation"* (Hertig, 2005, p. 279). Hertig (2005) states that the American mutual fund industry for example, has *"strongly opposed the adoption of new SEC rules requiring that the chairman as well as 75 per cent of mutual fund board members be independent"* (p. 279).

As mentioned before, here, too, reformers should avoid too detailed rules and focus on more relevant topics. One of those relevant topics is to assume, *"that institutional investor board deficiencies resemble board deficiencies in operational firms"* (Hertig, 2005, p. 279). Furthermore, minimum standards should be examined if funds require specific intervention, when funds do have more individuals rather than institutions. Honestly, we can not deny that board reforms have suffered from regulations. However, it is still good for the extent that involvements of management, controlling and shareholders as well as institutional investors prevent ineffective regulatory interference.

## 4.4 RESULTS OF BOARD REFORMS

Board reforms were performed to obtain investor's confidence and to shatter the bad boards and to support good boards. As we have seen before, reforms were conducted into too detailed circumstances and so, two major disadvantages occurred. The first problem facing reforms of board of directors are the new standing rules that were forced due to market forces and regulations. Those rules were not only implemented in large listed industrialized jurisdictions, but also in small and non-listed companies in emerging markets. Due to this, reforms gained the reputation to be a 'costly one-size-fits-all product'. Second, trade-offs were taken into account because of regulatory implications being too detailed and being scared of negative impacts of failing. Furthermore, interest groups started to avoid reforms that would significantly endanger their private benefits.

Now, reformers are trying to simplify the 'minimum standards' and so, to minimize trade-offs and 'one-size-fits-all' issues even for small corporations. Furthermore, they have to distinguish between operational firms and other financial institutions. Just because most reforms are good for operational firms, does not mean it is good for pension funds and mutual funds as well as other financial institutions. Reforms are supposed to be more flexible and help all kind of corporations or financial institutions.

# 5 BOARD OF DIRECTORS AND GLOBALIZATION

As mentioned before, there are different organizational and financial institutions and different types of boards of directors. However, is there a single corporate governance system that is the best and can be adopted by all corporations worldwide?
To answer this question we do have to pick the most particularly promising characteristics of worldwide corporate governance institutions and clarify the following differences. First of all, we do have to differentiate the identities of owners of corporations and the size distribution of their ownership stakes. Then we have to understand and finally differentiate the governance structure such as number – one tier boards (the 'Anglo-Saxon' company law) and two-tier boards (the Continental European company law) - and size as well as the composition of the monitoring boards. At last but not least, we have to realize differences in legal and political institutions that affect managerial behaviour.

Understanding those varieties considering differences in economic performance as well as corporate-governance systems, we will clarify the governance systems around the world and learn some facts about legal systems as well as politics. Furthermore, I am going to introduce to you some important factors of globalization and implicate those new findings to the global market.

## 5.1 GOVERNANCE SYSTEMS

In section 2, *'How are board of directors structured?'*, I have presented you the four groups of owners in detail; the insider, outsiders and institutional holders as well as the independent directors. However, now I am going to present you the differences between the 'insider' and 'outsider' models and finally, their governance systems.

Gugler, Mueller and Yurtoglu (2004) indicate that the outsider model is a governance system, in *"which ownership stakes are dispersed, and owners exercise indirect control on management by electing representatives to the monitoring boards, or perhaps by voting on specific proposals of management"* (p. 130). Furthermore, Gugler et al. (2004) define insider government systems, in *"which ownership stakes are concentrated and the major*

*stakeholders are directly represented on the boards that monitor managers and perhaps in management itself*" (p. 130).

The outsider governance system is represented in the USA and in UK and is consequently called the 'Anglo-Saxon system", whereas the insider governance system which is represented in the German speaking countries – Austria, Germany, Switzerland and some other Continental European countries - is therefore called the 'Germanic system'. In this system, control is typically unidirectional. Furthermore, there is a 'Japanese form' of an insider governance system, which is represented in Japan and is called 'keiretsu'. In the latter insider model, several corporations are linked together through interlocking directorships that are mostly intertwined, where control is multidirectional. 'Keiretsu' is represented by banks and other financial institutions.

### *5.1.1 "Anglo-Saxon system"*

In the USA, the board of directors' task is to appoint and dismiss the managers, to approve payments and acquisitions and to decide on important strategies. Boards are elected by the shareholders at their annual meetings that is typically nominated by the management. Furthermore, in the U.S. each board of directors is required to have a couple of directors that are actually not members of management and where the majority of directors are outsiders. The advantages of management representing the boards is the qualitative know how and best knowledge of their companies' operations and strategies to decide whether acquire a new plant or not. The advantage of having outside directors on boards is their favour to support shareholders over the management. Hence, conflicts are the order of the day, of course.

In the UK, the board of directors' composition do have to contain of at least two directors who can be managers or not; it is simply their choice. However, due to the Cadbury Code in 1990, outside directors are an requirement in UK boards, although the size differs from corporation to corporation. Apart from that, UK boards are the same as US board of directors.

*5.1.2 "Germanic system"*

Another very important and in German speaking countries such as Austria, Germany and Switzerland as well as some other Continental European countries, common two-board governance system is the 'Germanic system'. The 'Vorstand' decides whether to introduce new products or not, to cut prices and manages the firm, in general. The 'Vorstand' is responsible for day-to-day decisions.

Then we have the 'Aufsichtsrat', were managers are no members of the board of directors. The 'Aufsichtsrat' has following responsibilities: It has to appoint the members of the 'Vorstand', approve dividends and the company's accounts and decide on investments. The 'Aufsichtsrat' is elected by the representatives of the employees and unions and by the shareholders. Furthermore, in corporations (Aktiengesellschaften) with a minimum of 2000 employees, fifty percent of the seats are occupied by representatives by shareholders and fifty percent by representatives by employees. In German corporations the 'Aufsichtsrat' plays the role of outside directors of U.S. and UK companies. Furthermore, a very important issue is that 'Aufsichtsrat' has a limited range of rights. It can only control managers of the corporation in extreme circumstances by not renewing their contract or blocking proposed mergers.

*5.1.3 Business Groups: "Keiretsu" and "Chaebol"*

**'Keiretsu'** is the Japanese form of an insider system, where several companies are linked together through interlocking directors. These companies – Japanese conglomerates – are supported by cross-holdings of one another's shares. Financial institutions and/or banks belong to the conglomerates that hold shares in those companies. Furthermore, the main bank and some other financial institutions are represented on the conglomerate's supervisory board. An important aspect is the multi-directional control, where each company belonging to the 'Keiretsu' is able to exercise some control over the companies that control it.
Additionally, there is a single board of directors that is dominated by managers; over three-quarters of a board's members are managers. As a consequence, Japanese shareholders will

be protected from their board of directors in situations involving conflicts with management.

**'Chaebol'**, however, is the Korean form of the Japanese 'Keiretsu'. Gugler et al. (2004, p. 132) describe the Korean model as being *"a hybrid between the German corporate pyramid and the Japanese keiretsu"*. The top position of the structure is filled by the founding family, who can perpetuate their empires through cross-shareholdings among the member companies that result in an imbalance between control and ownership rights. Furthermore, the founding families can maintain their power, thus control by the fact, that banks and other financial institutions do not play a monitoring role in the company. In the late 1990s, the Asian crisis pressurized the Korean 'Chaebol' and their affiliated banks and so, some companies completely withdraw from day-to-day management and started to restructure the entire group. International investors were placed in management positions and parts of the companies were partitioned and sold. Due to many changes in 'Chaebol', predictions concerning the future Korean corporate government structure are difficult.

## 5.2 LEGAL SYSTEMS AND POLITICS

In this section you will gain information about the legal systems including issues of protection and the agency-cost problems. Furthermore, I am going to show why European laws are as good as American laws and the political point of view of agency costs.

### *5.2.1 Legal systems*

Shareholder's protection differs form country to country and so do country legal institutions. In some country shareholder are allowed to access the names and addresses of all other shareholders to be able to call a special meeting. In other countries this is impossible because of data privacy acts. La Porta, Lopez-de-silanes, Shleifer and Vishny (1997) examined the content and developed of legal institutions in different countries to determine which ones best align shareholder and managerial interests. They found out, that there is a greater protection against managerial abuse in the 'Anglo-Saxon system' than in civil law systems. In the civil law systems, French, German and Scandinavian systems

were compared and results indicate, that the French systems offers the shareholders the least protection, and the best protection provides the Scandinavian system.

The agency-costs offer another problem. Jensen and Meckling (1976) explain, that *"an owner-manager who decides to issue equity bears all of the agency costs from this action"*. Hence, there are two predictions explaining the agency-cost issue. First of all, however, the greater the agency costs, the less incentive founders of firms have to issue equity. Furthermore, high agency costs signify the weak protection of shareholder. The first prediction is, that equity markets will be thinner in countries with poor shareholder protection. The second prediction indicates that ownership concentration is higher in countries with poor shareholder protection.

It is important to mention the question, why do actually legal institutions affect the economic performance of countries? One reason is, that legal systems distinguish in different countries, so do mechanisms protecting small shareholders. Countries either have strong or weak mechanisms to protect shareholders. If the shareholder protection is strong, more shareholders will invest in the market, because they trust it and so, the market will grow. If the shareholder protection is weak, shareholders will not invest and so, the market will shrink. Another reason is the protection offered to citizens of a specific country, and not the protection of common-law systems. Evidence shows that if stronger protection of property rights are provided, common-law systems will protect citizens from the arbitrary expropriations of property that occur in civil-law systems. Additionally, this protection provides greater incentives to enter into new contract and to start new businesses as well as make investments, which lead to a great growth.
Figure 2 shows the comovement in various stock markets in 1995. Thereby, most of the emerging markets have strong comovements.

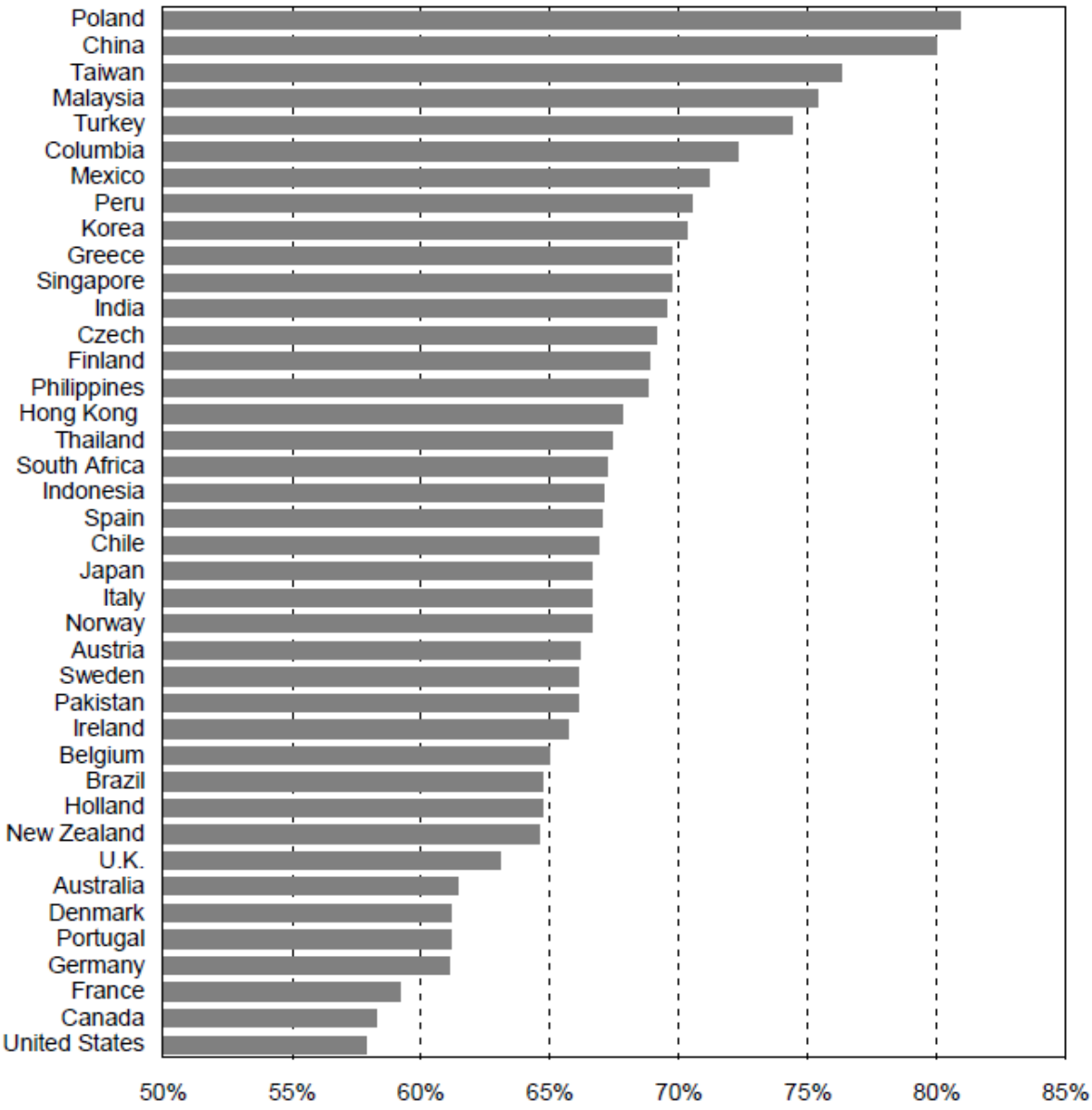


**Figure 2**: Comovement in Various Stock Markets in 1995. Source: Morck, R., Yeung, B., 2002, p. 24

*5.2.2 Politics*

Although there are differences in ownership and capital market structure between European and American corporations, European laws are as good as U.S. laws. However, countries such as Germany and France would have more economic advantages if they would adopt the 'Anglo-Saxon' corporate governance system. The problem, however, lies in their politics and not in their legal systems.

Furthermore, agency costs are higher in democracies than in other countries. The reason is, that *"social democracies do not strongly control public firm agency costs because they do not want unbridled shareholder-wealth maximization, and, hence, by weakening shareholder-wealth maximization institutions, they widen the gap between managers and dispersed shareholders"* (Gugler et al., 2004, p. 138). So, large firms that are publicly held are unstable when the spread is wide enough and are leaded with the so called 'American-style'. Furthermore, in social democracies, small shareholders can opt for fixed-income forms of investments over common equity, to be better protected. And those *"who do own common equity in social democracies prefer large blocks, which offer them some protection against managers' opportunistic behaviour"* (Gugler et al., 2004, p. 138).

## 5.3 FACTORS OF GLOBALIZATION

In this section, you will learn about the most important factors of globalizational performance in detail. Furthermore you will be able to differentiate them and so understand the performance driven decision making criteria considering board of directors.

### *5.3.1 Ownership identity and concentration*

Summarized, board of directors are divided into four dominant categories of owners; the inside directors, outside directors and institutional portfolio holders as well as independent directors.
For an easier understanding and the course of my diploma thesis, I worked out the details of the 'ownership identity and concentration' in section 2. Please see section 2 for detailed information.

### 5.3.2 Corporate boards

One important topic considering corporate boards are **the effects of board characteristics on board actions**. As mentioned before, there are two important factors; their size and composition. We already know that if the board of directors is small, dominated by

outsiders and the firm is performing badly, the CEO will be removed pretty fast. Additionally, if the majority of directors in a board are outsiders, the corporation will not be the target of hostile takeovers so easily because of doing harm to their shareholders'. Another factor is the board size, which is linked with the pay-for-performance issue. Is the board of directors large, the link between firm performance and CEO payment is weak. Gugler et al. (2004) find that these results indicate that board actions which should *"improve a company's performance are positively related to the fraction of outside directors on the board, and negatively related to its size"* (p. 143).

Another important issue considering boards are **the effects of board characteristics on firm performance**. Hermalin and Weisbach (2003) find some evidence, that *"there is little to suggest that board composition has any cross-sectional relationship to firm performance"* (p. 12). This means, that a high number of outside directors worsens the performance of corporations because of their deficit in specific knowledge compared to insiders. However, bad managers are more likely to be replaced by outsiders which, in contrary, increases the performance. The effect of these two tendencies is to minimize or rather eliminate the systematic relationship between board composition and firm performance.

### *5.3.3 Legal systems*

There a many countries that differ in their legal rules and regulations as well as in their economic situation, but legal scholars believe that some national legal systems become adequately similar to permit classification of national legal systems into major families of law[2]. Additionally, Zweigert and Kotz (1998) find that the following factors are decisive for the lifestyle of a legal system or a legal family: *"(1) its historical background and development, (2) its predominant and characteristic mode of thought in legal matters, (3) especially distinctive institutions, (4) the kind of legal sources it acknowledges and the way it handles them, and (5) its ideology"* (p. 68).

[2] Among them are David and Brierley (1985), Reynolds and Flores (1989), Glendon et al. (1992, 1994) and Zweigert and Kotz (1998).

Occasionally, countries adopt laws from different legal traditions, but generally, one tradition dominates in each country. Furthermore, it is important to mention, that the key feature of legal traditions is that they have been transplanted from a country into another. By the use of transplantations, the national laws of most countries changed, generated and adopted some basic legal infrastructure (legal codes, legal principles, parts of the judiciary organization and judiciary) to local circumstances. Furthermore, cultural, political, historical and economic conditions are reflected in the countries' national laws, so that no country will have identical legal and regulatory systems. However, La Porta, Lopez-de-Silanes and Shleifer (2007, p. 5) find that today, many developing countries *"are heavily over-regulated in crucial spheres of economic life, in part because of their legal origin heritage"*.

In general, there are two main legal traditions; the common law and the civil law tradition. In the latter, there are several sub-traditions, more precisely, the French, German, Scandinavian and socialist.

The **common law** legal tradition includes the law of England and its former colonies. *"The common law is formed by appellate judges who establish precedents by solving specific legal disputes. Dispute resolution tends to be adversarial rather than inquisitorial."* (La Porta, Lopez-de-Silanes, Shleifer, 2007, p. 8). Furthermore, both the executive judicial independence and legislature judicial independence are central. Mahoney (2001) finds that *"English common law developed because landed aristocrats and merchants wanted a system of law that would provide strong protections for property and contract rights, and limit the crown's ability to interfere in markets*" (p. 504). The common law legal tradition spread to the British colonies, including Australia, Canada, India, South Africa, the United States and many other countries.

The **civil law** legal tradition, however, is the oldest, the most widely distributed and hence, most influential law tradition. The civil law tradition originates in Roman law, *"uses statutes and comprehensive codes as a primary means of ordering legal material, and relies heavily on legal scholars to ascertain and formulate rules"* (Merryman, 1969). The dispute resolution is inquisitorial rather than adversarial. In the Middle Ages, Roman law was rediscovered in Italy. It was adopted by the Catholic Church and from there, a basis of secular laws was formed in many European countries.

The **French civil law** tradition can be identified with the French Revolution and Napoleon's codes in the 19$^{th}$ century. The French civil law, in contrast to the common law

tradition, was developed because of the revolutionary generation and Napoleon. They wished more state power to alter property rights and tried to insure that judges did not interfere. *"Thus,*

*quite apart from the substance of legal rules, there is a sharp difference between the ideologies underlying common and civil law, with the latter notably more comfortable with the centralized and activist government"* (Mahoney, 2001, p. 505).

Napoleon's armies introduced his codes into Belgium, some parts of Germany, Italy and the Netherlands. In the colonial era, the French law influenced the Near East and Northern and Sub-Saharan Africa as well as Indochina and Oceania. Luxembourg, Portugal, Spain and some Swiss cantons were also influenced by Napoleon. Furthermore, in the 19th century, when the Portuguese and Spanish empires where dissolved in Latin America, the French civil law tradition was mainly adopted. At the same time, the French civil law tradition was modified and finally adopted by the Russian Empire influencing the Russian Empire's neighbouring regions too. After the Russian Revolution, these countries adopted the socialist law. However, after the fall of the Berlin Wall, these countries returned to the French civil law.

The **German civil law** tradition originates in Roman law. The German Commercial Code, however, was written after Bismarck's unification of Germany, in 1897. The German civil law shares many characteristics with the French system, but admits greater judicial law-making. Countries such as Austria, the former Czechoslovakia, Greece, Hungary, Italy, Switzerland, Yugoslavia, Japan, Korea and some countries of the former Soviet Union were influenced by the German legal tradition. Because of Germany's short-lived colonial influence, which come to an end by World War I, just a few countries belong to the German civil law.

The **Scandinavian civil law** tradition is therefore seen as a part of the civil law tradition, *"although its law is less derivative of Roman law than the French and German families"* (Zweigert and Kotz, 1998). As well as in the German civil law tradition, there are just a few countries that belong to the Scandinavian civil law. The reason is, that Scandinavian countries did not have any colonies.

The **socialist civil law** tradition originates in the Soviet Union and was spread by the Soviet armies to the former Soviet republics and then to Eastern Europe. This civil law was tradition was also implemented by some socialist states such as Mongolia and China. After the fall of the Berlin Wall, however, the former Soviet Union and Eastern Europe replaced

the socialist civil law by either the French or German civil law. However, there are still some countries, such as Cuba, maintaining the socialist legal system.

Figure 3 shows the distribution of legal origin of commercial laws worldwide.

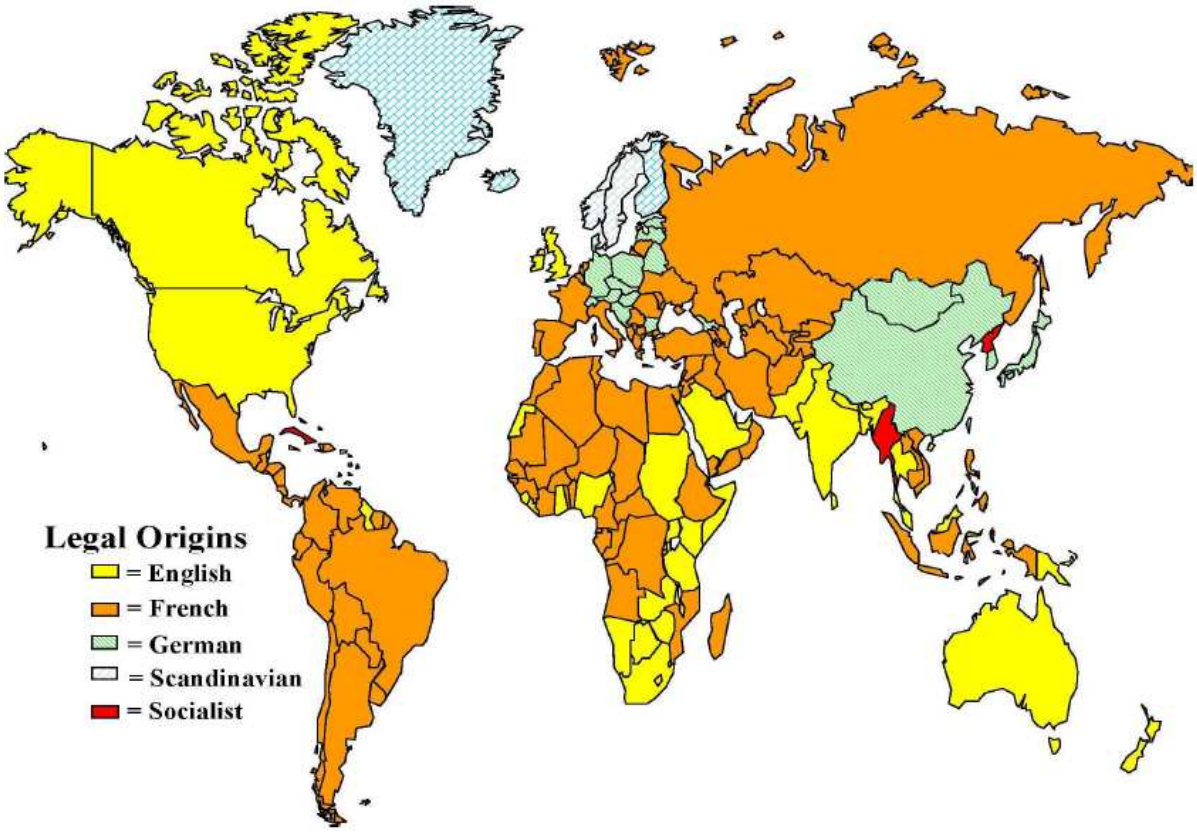


**Figure 3:** The distribution of Legal Origin. Source: La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 2007, p. 79

In general, legal origins have effects on a variety of outcomes. First of all, it is important to understand, what effects emerge, when some parts of a legal system are transplanted into another or when adopting a system entirely. Figure 4 illustrates these effects of legal origins on particular laws and regulations. Furthermore, it shows the effects of these laws and regulations on the economic outcome.

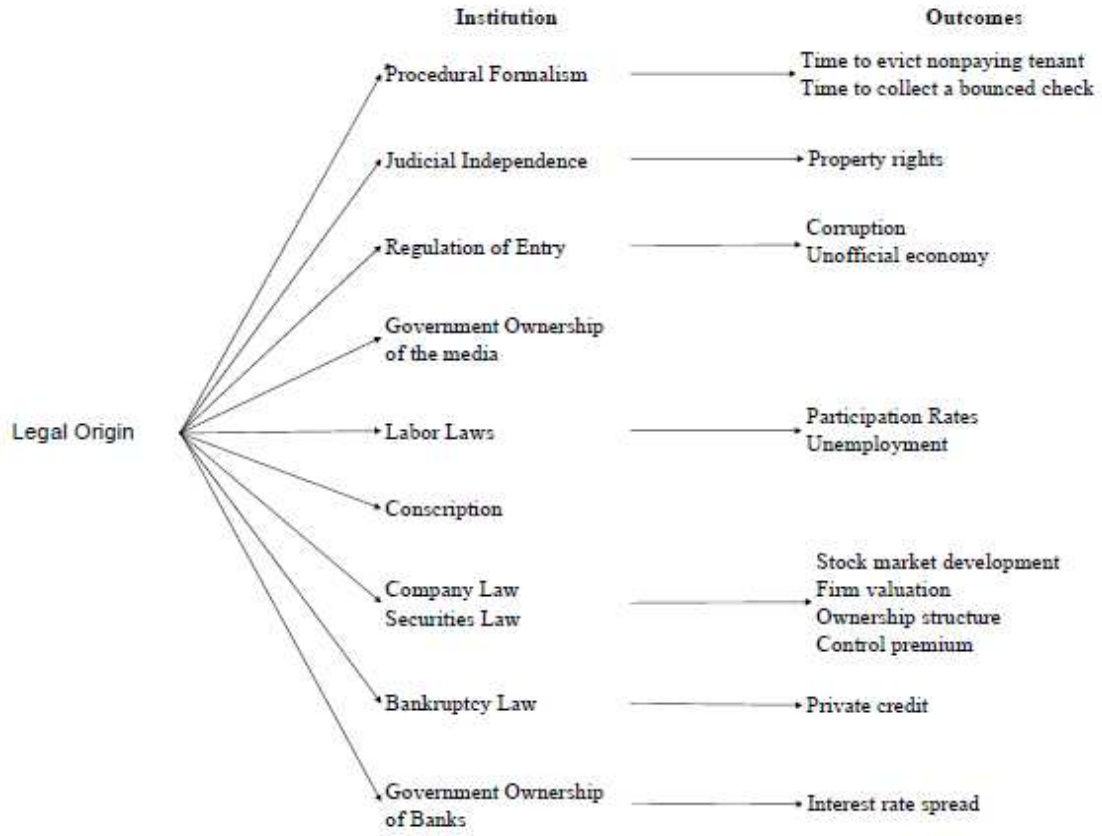


**Figure 4:** Legal Origin, Institutions, and Outcomes. Source: La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 2007, p. 80

In practical terms, a higher income per capita is associated with the following characteristics: A lower government ownership of banks, a better shareholder and creditor protection and a more efficient debt collection. Additionally, La Porta et al. (2007) conclude that a higher income per capita is generally associated *"with more developed financial markets, as reflected in a higher stock-market-capitalization-to-GDP ratio, more firms per capita, less ownership concentration, a lower control premium, a higher private-credit-to-GDP ratio, and lower interest rate spreads"* (p. 17). It is a fact that compared to common law, governments in civil law countries, especially the French legal origin, indicate a higher ownership of banks. Furthermore, shareholders and creditors are less protected and debt enforcement is less efficient. La Porta et al. (2007) determine that *"The effect of legal origins on legal rules and financial institutions is statistically significant and economically large"* (p. 17).

Furthermore, a high income per capita correlates with lower entry regulations and no labour regulations or conscriptions. However, both French and German legal origins indicate the opposite - high entry regulations and a heavy dependency on conscriptions.
At last but not least, there is a connection between income per capita and judicial institutions. A low legal formalism, a short judicial tenure and no approval for case law are connected with a high income per capita. La Porta et al. (2007) compared common law countries to civil law countries and find that the latter law tradition *"generally have more legal formalism, lower judicial tenure, and sharply lower constitutional acceptance of case law"* (p. 19).
Summarized, legal origins do have extensive consequences on economics. The majority of civil law countries are represented by the French civil law (See Figure 2). Thus, La Porta et al. (2007) present the following findings comparing common law to French law:

> *"Compared to French civil law, common law is associated with a) better investor protection, which in turn is associated with improved financial development, better access to finance, and higher ownership dispersion, b) lighter government ownership and regulation, which are in turn associated with less corruption, better functioning labor markets, and smaller unofficial economies, and c) less formalized and more independent judicial systems, which are in turn associated with more secure property rights and better contract enforcement."* (p. 20).

However, it is difficult to trade of common law against civil law to be able to say, which of these law traditions is the best? Naturally, *"The quality of law improves on average even when judges pursue their policy preferences; law making does not need to be benevolent"* La Porta et al. (2007, p. 34).

## 5.4 IMPLICATIONS FOR GLOBALIZATION

After discussing plenty issues concerning board of directors, its composition and size and matters concerning the governance systems, we are now ready to investigate and clarify following questions.

### *5.4.1 What governance system is the best?*

At first we do have to consider the level of national income to answer this question. The level of national income is regarded as being a long-run measurement tool of economic growth assuming that all countries have started with the same low level of income. Using this tool to measure performance, indicating the main forms of corporate governance systems, result in the following findings. The main corporate governance systems described in 5.1 prove oneself good, because all countries that have implied it, such as the U.S., UK and Germany as well as France, have all become very rich. Thus, there is no good or bad system of corporate governance, each of them has its strengths and weaknesses.

However, Gugler et al. (2004) can not support this conclusion, although they do agree with this statement, which is why in the present, companies in the major industrial countries have to deal with a more intense international competition compared to the 20th century. However, evidence implies, as discusses in the previous section, that the 'Anglo-Saxon' system is the best considering protecting shareholders *"and that they lead to superior macroeconomic performance"* (Gugler et al., 2004, p. 149). Hence, countries will achieve better economic performance, if they implement the 'Anglo-Saxon' corporate governance system.

Nevertheless, there is one problem that is worth to be mentioned. The population of all industrial countries of the world, except for a couple of 'Anglo-Saxon' countries such as the U. S. and Australia are aging rapidly. Hence, the governments of these countries will increase taxes to be able to pay future pensions. If the government finally understand that changes in the corporate governance including board of directors will have a positive turn in the long-run and may lead to economic growth, new changes will be welcomed and implemented more easily.

### *5.4.2 Are those systems converging?*

In the **United States** changes concerning strengthening the shareholders' hands versus managers were noticed even before the Enron and WorldCom scandals in the beginning of the 21st century. Some of those changes were adopted due to the roles of institutional

investors and court decisions as well as SEC rulings. The US Congress came into the picture because of changes that were forced due to the Enron scandal.

**Germany and Continental Europe** underwent certain changes too, however, in the 'Anglo-Saxon' direction, though. But for all that, this movement is partial. Companies are forced to make their financial statements more transparent and so, insider trading is decreasing. So, many companies are adopting accounting standards in accordance with the International Accounting Standards Committee. The necessity to raise large amounts of capital due to cross-border acquisitions is the reason why German and Continental European companies list their securities on the London or New York stock exchanges. Hence, their securities are subjected *"to Anglo-Saxon corporate-governance constraints even though their main headquarters remain outside of these countries"* (Gugler et al., 2004, p. 149).

In **Japan**, however, the financial sector has been deregulated because of Japan's weak economy, external pressures and its government. Overall, about 100 Japanese companies are either on the London or New York Stock Exchange and furthermore, Gugler et al. (2004) determine that *"Over the last 15 years, members of keiretsu have been reducing their holdings of one another's shares"* (p.149).

Finally, while taking into consideration, that a full convergence depends on many factors, I debate on the question, if a full convergence in corporate-governance systems will, will not or may be achievable.

A full convergence **will** be possible, if the "best-practice technology in an industry is characterized by a U-shaped average cost function […]" (Gugler et al., 2004, p. 150). Adopting this assumption, perfect competition will avouch that companies adopting the best-practice technology will be on the bottom of the U-shape. In other words, increasing world-wide competition will result in implementing the 'best-practice' corporate governance, which is the 'Anglo-Saxon' system.

A full convergence **will not** be achievable because, over a specific period of time, ownership structures change. These changes are identified by two causes, the structure-driven and rule-driven path dependence. The 'structure driven path dependence' arises when organizations adopt new ownership structures and immolate efficiency by changing. Another possibility is that stakeholders such as managers and shareholders would resist

such a change by shifting to a new ownership structure. Additionally, the 'rule-driven path dependence' can arise for similar reasons. A country may adopt corporate governance rules from laws and regulations with the target to make the ownership structure more efficient, although at the first glimpse, being inefficient, is to their advantage.

At last but not least, a full convergence **may be** possible, because in a competitive market, inefficient companies are not liquid and thus, go bankrupt and disappear finally. Countries, however, though being inefficient, can not go bankrupt that easily and can not disappear. The greater efficiency and growth is, the more easily it is to adopt new corporate governance rules and so, corporate governance should *"tempt politicians to introduce these reforms, but there are likely to be counter pressures resisting these reforms, and it is by no means clear that all country governments will resist these counter pressures"* (Gugler et al., 2004, p. 150). However, good corporate structures benefit shareholders by reducing managers' discretion to pursue their own goals. It is important to understand, that if national parliaments are sensitive over managers than shareholders, no reforms will take place in the corporate governance systems!

### *5.4.3 Will countries suffer from not being able to adopt those corporate governance systems strictly?*

Although being headquartered in countries with a strong corporate governance or having adopted a strong governance system, where the company and its shareholders benefit, managers still can lose. They may still prefer countries with a weak corporate governance system to pursue their own goals and so, partial movements abroad are taking place. Those movements happen in form of companies choosing to list their shares on foreign stock markets. The trend has been towards the U.S. considering more stringent requirements for listing shares. However, there are many other factors beyond corporate governance such as tax levels, labour laws, transaction costs and wage rages, to name but a few, that affect the location of a company.

A company in a country with a strong corporate governance system can avoid subjecting itself to this system by not going public. In contrast, Gugler et al. (2004) find out following:

> *"A company in a country with a weak corporate governance system, which is in need of large amounts of capital and wishes to go public, can only trap into the*

> *large capital markets of the countries with strong corporate-governance systems by listing its shares in one of these countries"* (p. 152).

The following two cases are predicted by Gugler et al. (2004) on "*how the globe's corporate landscape might appear as globalization continues to advance"* (p. 152).
First of all, in future, there will be two types of companies worldwide, when corporate governance systems will not converge on a variation of the 'Anglo-Saxon' system. There will be a number of large multinational companies with widely spread shares and a few small family controlled companies with national identities. Hence, 'Anglo-Saxon' companies will be headquartered in countries with a weak corporate-governance institution and family controlled firms will gain access to international capital markets only, when they have been acquired by multinationals.
The second case is a converging corporate-governance system. Surprisingly, the same two categories of companies will exist, the multinationals and family controlled companies, but with one difference: The locations of their corporate headquarters will change. Additionally, capital markets and companies as well as the corporate governance systems will look about the same around the developed world.

# 6 CHARACTERISTICS OF EMERGING MARKETS

Today, about thirty countries are in transition to higher levels of economic development and hence, adopted the name of "emerging markets" from the International Finance Corporation, short IFC, of the World Bank. In 1981, the IFC emerging market index included stocks of publicly traded companies from nine countries; the number however continued to grow up to thirty-three in 2002. However, the Standard & Poor's procured the IFC indices and since the year 2000, they are know as the S&P/IFC indices.

Emerging markets gained the investors' interest. Before 1980, little capital flowed into these markets. The lack of financial products and services available to foreign investors are one big issue to be dealt with. The second problem is the high market risk and volatility. In 1981, the private portfolio investment began to grow in the emerging markets and so, in the first half of the 1990s, the privatization and economic liberalization proceeded. Due to this, the securities in emerging countries enlarged for investors who developed a strong interest starting investing in portfolio investments.

The S&P/IFC is one of the most common indices because of its broad set of countries. Furthermore, the S&P/IFC categorizes an market as being emerging when at least one of the following criteria is met. The first criteria is, being in a low- or middle income country which is defined by the World Bank. And when the countries' investable market capitalization is lower than its most recent GDP (gross domestic product), we do have gained the second criteria for being an emerging market.

Additionally, Li & Hoyer-Ellefsen (2008) define a market being "developed" as followed:

> *"… if it is in a country where the GNP (gross national product) per capita exceeds the World Bank's upper income threshold for at least three consecutive years and the investable market capitalization-to-GDP ratio is the top 25% of the emerging market universe for three consecutive years"* (p. 2).

Furthermore, there are five more dimensions to consider, whether a country is developed or belonging to an emerging market. These characteristics are market size, openness, efficiency and transparency as well as liquidity.

## 6.1 MARKET ORIENTED CHARACTERISTICS

**Market size** and the size of a country's financial market are two important factors in relationship with a country's economy. Although, quantitatively compared, there are less emerging than developed markets, but both have a similar market capitalization on average. Numerical, the average GDP of the 22 developed countries is over $ 1 trillion, about more than six times the average of the emerging market countries. Additionally, the difference of these two groups are still higher comparing their GNP. There, the average of developed countries is about seven times higher than that from the emerging markets.

The depth of financial markets keep apart the emerging markets from the frontier markets. The market depth is defined as the ratio of market capitalization to GDP, which in fact, is a useful indicator of the level of development in an economy's financial market. On the one hand, in developing countries, however, the value of the average market capitalization was as high as their GDP. On the other hand, the market capitalization of emerging markets is about one-third of their GDP, where the market depth is still higher than of a frontier market. Summarized, market depth is the main distinction between frontier and emerging market countries.

Furthermore, there is another possibility to compare emerging and developed markets; by the number of listed firms. Except for a few large developed countries such as the U.S., Japan and the U.K., developed and emerging markets have about the same number of listings. However, comparing the size of listed firms, emerging markets have a smaller market capitalization than developed market listings have.

**Market openness** and market activity can be examined using the *S&P/IFC Global Index* and the *Investment Index*. The Global Index represents the market and includes the most actively traded firms in the market and captures the majority of the total market capitalization of all listed stocks. So, firms in the Global Index are bigger and do trade more actively, in general. Hence, those companies do represent a majority of the market capitalization and trading intensity in each market.

Due to the fact, that not all markets are open for foreign investors and that stakes for a particular stock may be limited, the Investment Index captures the global exposure of companies in a market for foreign investors. Evidence shows, that about 18 firms in emerging markets are 100% open for foreign investors. The other 15 companies are closed or do have restrictions on foreign ownership. According to Li and Hoyer-Ellefsen (2008),

these restrictions include "*special classes of shares for foreign owners, limits on foreign ownership, limits on ownership held by a single foreign shareholder, company-imposed limits that differ from national law, national limits on aggregate foreign ownership"* (p. 4). Furthermore, S&P/IFC implemented three additional criteria. The first criteria is that stocks do have to have $ 50 million for a minimum of an investable market capitalization. Then, over the last year, the stock must have traded at least $ 20 million and finally, the stock must have traded on at least half of the local exchange trading days.
Finally, a market is 'open' with a high proportion of firms being in the Global Index and passing the screen for the involvement in the Investable Index. In contrast, 'closed' markets are exclusionary of foreign investors.

In general, stock markets indicate a country's **market efficiency** by processing information about individual companies, which derive from the trades of informed investors. To gain as much information as possible from a stock market's efficiency and to understand the co-movements more easily, the variation of stock returns has to be divided into a market-related and firm-specific component.
The market-related component of stock return variation contains market movements that are common across most stocks. To understand the market-related returns on variation, an example will illustrate the results. If an anti-business government is elected, the prices of stocks will fall en masse. If the central bank, in contrast, stimulates the economy by reducing interest rates, the price of almost all stocks will rise as one.
The firm-specific component of stock return variation contains unique stock price movements for a single company. An example will illustrate this component of stock return variation as follows: If a company is hit with a product liability lawsuit, it is highly probable that the company's share price will fall. However, little or almost nothing will happen to the stock prices of other companies across the economy.
Richard Roll (1988) finds that market-related price movements are often connected with major news announcements, while firm-specific price movements are a result of trades of stock prices being pushed up and down by informed investors. Furthermore, firm-specific information is more complete in developed stock markets than in emerging markets and so, the absence of firm-specific price movements in emerging markets are the consequence.

Now, I am going to probe the causes of this problem in more detail. In the US, Canada, Ireland and actually all other developed economies, stock prices move quite independently

of each other. In emerging markets, however, it is not the case. There, stocks tend to fall and rise en masse. Morck and Yeung (2002) get to the bottom of it and they find that this fact does not appear to be because of the basic values of emerging economy stocks moving together. Additionally, stock return co-movements are not explained either by economy and market characteristics (size, diversification, etc.) nor by direct measures of fundamentals co-movement (earnings co-movement across firms). Stocks falling and rising en masse are the matter of economies protecting private property rights. Thus, *"economies that better protect private property rights have stock prices that move more independently"* (Morck & Yeung, 2002, Abstract).

The reasons for ups and downs are as follows: If investors expect a designated company to do well, informed investors push the price up by buying its stock. Whereas, if investors expect a company to perform poorly, informed investors push the price down by selling or shortening the company's stock.
A falling share price lead to the following problems: (1) expected lenders withhold capital, (2) shareholders force the board of directors to improve corporate governance, (3) the CEO is resigned by the board, (4) the board demands new strategies and (5) raiders launch takeovers by accumulating the heavily discounted stock. These effects trigger many mechanisms resulting in changes in the corporate governance.
A rising share price, however, entails confidence in the company's corporate governance by instilling confidence in the CEO and strategy and by rewarding the CEO with stock options that increase in value.

In this sense, share price movements affect the capital allocation. Tobin (1982) defines the market as functionally efficient, if share price movements effect economically efficient capital allocation.
However, how can the difference between emerging markets and developed markets be explained? Morck and Yeung (2002) find statements such as the clustering tendency in certain industries and the emerging economy being too affected by a couple of firms too superficial, because *"large or diversified emerging economies do not have more independent stock prices than small or undiversified emerging economies"* and in addition, *"firm fundamentals, such as earning ratios, are only slightly more synchronous in emerging economies than in developed ones […]"* (Morck & Yeung, 2002, p. 2).

Based on the stock price synchronicity that highly correlates with the measurement of private property rights protection, Morck and Yeung (2002) find that economies have more independent stock prices, when corruption is low. Thus, in economies where corrupt practices (arbitrageurs and noise traders) hardly exist, more independent stock price movements are in progress than in economies, where corruption is at the top of the agenda.

Figure 5 shows the behaviour of US stock prices over the past decades. Additionally, in the 1930s, the US stock returns are pointed out as being highly synchronous, rising and falling together. The synchronous stock movement is comparable to stocks in emerging markets nowadays.

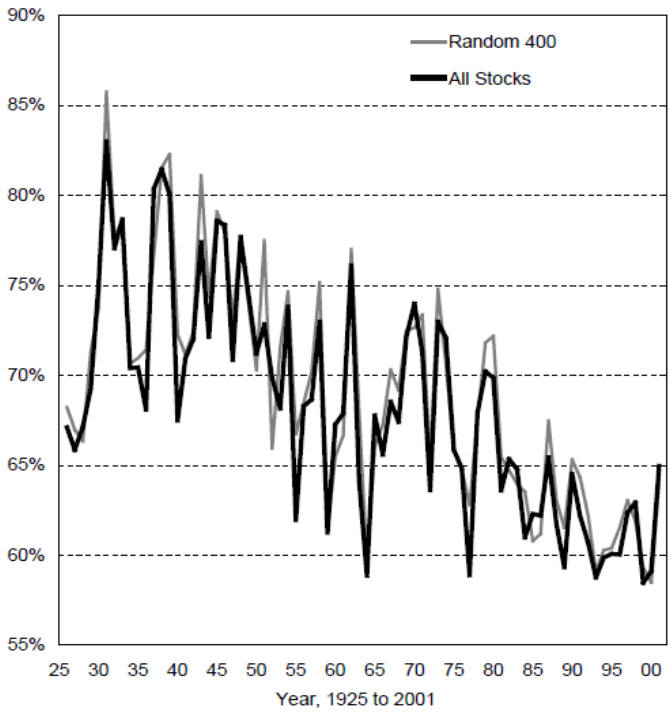


**Figure 5:** Comovement in US Stocks from 1926 to 2000. Source: Morck, R., Yeung, B., 2002, p. 25

Furthermore, in economies where investors do perform information about individual companies and the quality of their corporate governance, firm-specific stock price movements calibrate the capital allocation. In economies, however, where investors do not provide information considering the companies' tasks, *"stock prices move together because of either economy-wide fundamentals or investor sentiments"* (Morck & Yeung, 2002, p. 3). In both cases, the quality of capital allocation is compromised. In accordance

with this, a higher quality of microeconomic capital allocation decision is shown in economies with more independent stock prices, which allow faster productivity growth. Consequently, Morck and Yeung (2002) prove that independent stock price movements are an indicator for a functionally efficient stock market.

The **market transparency** is a big issue in emerging markets. It depends on how transparent and competitive those markets are and the ability to gain information for investors. Emerging markets are less transparent than developed markets and so, two indicators have been developed to pursue market transparency – the *Opacity Index* and the *Corruption Perception Index (CPI)*.

The Opacity Index is constructed to measure the transparency using dimensions for about thirty-five countries. The Opacity Index, also known as the 'O-Factor', which was constructed by PricewaterhouseCoopers, is composed of five dimensions as follows: corruption, legal, economics, accounting and regulatory, of course. The 'O-Factor' is the average of the index values on each dimension. The Corruption Perception Index, however, provides an annual index by 'Transparency International', to rank about 100 countries on the level of perceived corruption. The most corruptive countries are settled in emerging markets – 18 countries. The 13 lowest corruption countries are in developed nations.

In general, investors are concerned about a country's **market liquidity**. In other words, they are concerned about the ease of capital movement. Developed markets allow more trading and so, the ability to make large trades in specific stocks without provoking big changes in stock prices. In contrast, emerging markets, however, vary in their liquidity creating tools to measure those irregularities.

The first measurement tool are the turnover ratios, which are a percentage of the market. Li and Hoyer-Ellefsen (2008) define turnover ratios as the *"ratio of value traded over one month to the total market capitalization"* (p. 9). In addition to this, a high turnover ratio indicates a large number outstanding rates that were traded. Thus, large turnover ratios indicate a great liquidity and the larger and more developed countries achieve due to this fact higher turnover ratios. Furthermore, the second tool to measure market liquidity is the dollar value of traded shares. Shortly, this means to give all the money entering and leaving a market during a day some kind of value. The easiest way to do so is the value of money.

Almost all Latin American countries belong to the French civil law tradition. Guyana and Cuba, however, are deemed to be the exemptions; Guyana belongs to the English legal origin and Cuba to the socialist civil law tradition.

The market in **Brazil** is open, but with some restrictions for foreign investors. Since May 1991, foreign institutions are allowed to possess up to 49% of voting common stock and 100% of nonvoting stocks. Furthermore, some corporate limitations do apply and the voting class of barks is not available. The **Chile**an market as well as the **Peru**vian market are 100% open. Since February 1, 1991, the market in **Colombia** is considered to be open too. At last but not least, stocks in **Venezuela** are considered to be 100% open.

Therefore, I am going to present you some characteristics of Latin American markets such as Brazil, Chile, Columbia, Peru and Venezuela.

## 6.2 FIRM PERFORMANCE ORIENTED CHARACTERISTICS

In this section I am going to clarify the firm performance of an corporation and take into consideration two groups of ownerships. The first group of owners is the family ownership, the second are business groups.

Several authors believe that the costs of family ownerships are the capability to attain resources from other shareholders in the company and to employ incompetent family members to positions in the firm. Others advocate the family ownership because of its remarkable benefits such as long-tem commitment, stewardship of the firm and the monitoring function. Although recent studies examined the performance differences between family and non-family firms of US firms and evidence was found that benefits provided from family-owned companies outweigh their costs, there are still conflicting opinions of that group of ownership.

Business groups and their effects, however, are a controversial topic too. A positive effect is the diversification of the group’s activities that lead to the foundation of internal markets when the existing markets are incomplete. This effect leads to numerous positive aspects concerning business groups. In contrast, such an accumulation of strong companies do have negative effects on minority shareholders and companies, that do not belong to such business groups.

According to what one sees, there are two sides of the same coin. Now, I am going to clarify the firm performance of both family ownership and business groups more detailed.

### *6.2.1 Family ownership*

Martinez, Stöhr and Quiroga (2007, p. 87) define a 'family-controlled firm' as a company that falls into one of the following criteria:

> *"1. A firm whose ownership is clearly controlled (electing over half the board members) by a family, where family members participate as members in the board of directors and/or top management.*
>
> *2. A firm whose ownership is clearly controlled (electing over half the board members) by a group of two to four families, where members of these families are also members of the board of directors.*
>
> *3. A firm that is included in a specific business group, as explicitly and unambiguously classified by the SVS[3], and this group is clearly associated with a business family.*
>
> *4. A firm that is included in a specific business group, as explicitly and unambiguously classified by the SVS, and this group is clearly associated with an entrepreneur or businessperson who does not have any direct descendants, but has designated his or her family successors, and/or the market has internalized a continuity in time as an FCF through his or her nondirect descendants (i.e., siblings, cousins, nephews, nieces, or others)".*

In general, good family-owned company practices differ from bad family-owned company practices in the degree on how effective corporate governance mechanisms actually limit family opportunism. Chile is a very good example to investigate the impact on performance because of Chile's remarkable laboratory *"to examine the importance of family influence in a setting with governance safeguards that differ from those of the United States and East-Asia"* (Martinez et al., 2007, p. 83).

Some additional negative effects of family ownerships or family businesses are that family members can pursue other goals than their minority shareholders and so are detrimental to

[3] Superintendencia de Valores y Seguros (the Chilean Securities and Exchange Commission; SVS) – a Chilean governmental agency, which is in charge to regulate public companies and the stock market.

the economy. Furthermore, families could follow strategies to improve and participate firm growth, technological innovation or even firm survival instead of maximizing the shareholder value or maximizing profits. Martinez et al. (2007) find that other studies report that *"family control leads to wealth expropriation in the presence of less than transparent financial markets"* (p. 84). Another aspect of family-owned firms is that they favour to fill manager positions from the family which leads to competitive disadvantages compared to non-family corporations. At last but not least, the opinion is widespread that family ownership increases firm value when the founders of the firm serve as either CEOs or chairman of the family company. However, the firm value decreases when the descendents obtain one of the above positions. There is still a problem that family-owned companies are facing: the trust issue. Stock market participants do not trust that family firms will fairly share wealth with other shareholders in the firm. This is a reason, why such shareholders more heavily discount family firm's shares, although family share are much more profitable. So, these companies ruled by family owners are punished with discounts in stock market prices for their liquidity and low market presence due to their high ownership concentration.

As mentioned before, there are two sides of the same coin. There are positive effects about family ownerships too, of course. There is evidence indicated by many scholars, that family ownership leads to a higher firm performance. This happens because of the following findings. Owners of a family business do have high incentives to monitor managers thus reducing agency problems and maximizing firm value. Furthermore, the difference between family ownership and non-family firms is that families do have longer investment perspectives than other shareholders and so harvest long-term profits. Another important aspect is that families invest more efficiently with their hidden agenda to pass the firm onto succeeding generations. However, is there an effect of family-owned companies on firm performance? Yes, there are positive effects. Evidence shows that two arguments against family ownership are destroyed: First of all, that family business have a negative influence on firm performance and second, that minority shareholders are unfavourably affected by family ownership.

To answer the question "why do family-controlled firms that are listed on the stock market perform better than non-family firms?", we have to clarify the advantages and disadvantages of such companies. Martinez et al. (2007) summarized that:

> *"Among these advantages or strengths we can identify a closer monitoring, an essential long-run perspective, higher unity of goals among shareholders, quicker decision making, stronger culture that come from family values […]. On the other side, some of those weaknesses or disadvantages are related to the overlap of family and business issues, lack of succession planning, nepotism, resistance to change and to professionalization, agency issues […]"* (p. 85).

However, most of the above mentioned disadvantages and weaknesses are the reason for the lack of accountability, effectiveness and professionalization of management as well as market pressure.

Now the question arises, why Chile is actually a very good example to investigate the impact on performance. I mentioned Chile's remarkable laboratory correctly, but it is not the only reason. Chile enjoys many privileges in Latin America. It's high diversity of natural gases and important public policies that aim stability are several reasons. Furthermore, although Chile has a relatively small economy, it is a very trade-dependent nation and more opened and developed than most developed countries, though being an emerging market. The Chilean stock market is well developed and do attract al kinds of investments. Hence, the trading volume of stocks as a percentage of GDP is one of the highest in Latin America. At last but not least, Chile has a high mobility of capital flows in and outside the country and the Chilean Private Pension System is very successful and recognized worldwide.

Due to this, it is worth to mention that family-owned companies dominate almost every sector: *"forestry; fishing; manufacturing of food and beverages; textile and apparel; metal products, machinery, and equipment; retail trade; restaurants and hotels; and transport and storage"* (Martinez et al., 2007, p. 89). On the other hand, family businesses are lower presented in water works and supply as well as communications and basic metal industries.

Summarized, family-controlled firms do have a better performance than non-family controlled firms. If family-controlled companies improve their management skills and governance bodies, start to feel the pressure of market control and are accountable to minority shareholders, they will overcome the majority of their traditional weaknesses and take advantage of their strengths to succeed.

*6.2.2 Business groups*

In Chile, business groups are defined by Security Law No. 18,045 as:

> *"collection of legal entities which share ownership, administration, or credit responsibility ties of such a nature that there is ground to believe that their economic and financial behaviour is guided by common interests, or that their financial risks of debt and equity are interconnected"*.

This means that two or more corporations are in the same business group if they have a shared administration in the conglomerates and their integration in the financial sector as well as a family-ownership-relationship. Furthermore, business groups differ from loose corporations by financial ties and a good social structure.

As with family-owned corporations, business groups do have some positive as well as negative effects on performance too.

Effects are expected to be positive when the dispersion of the business group's activities leads to internal markets. This mechanism makes up for deficiencies in the operation of typically less developed markets by improving efficiency and the economic of scope. There are three reasons facing that statement. First of all, business ties reduce transaction costs by enabling coordinated actions. Second, *"corporate diversification facilitates the transfer of resources to divisions with better opportunities, in particular when common knowledge about the organization exists"* (Silva, Majluf, and Paredes, 2005, p. 315). At last but not least, there is a reason why business groups are large and diversified in emerging markets. Many institutions actually do not exist or just work poorly and so, it is very difficult to implement new technologies, to finance cheap or to obtain high-toned management knowledge. Those factors are the reason for contributing a positive performance in developing economies.

However, there are negative effects on performance too, if business groups take advantage to dispossess their minority shareholders at the cost of efficiency. Minority shareholders, for example, may use transfer prices *"by exploiting relationships with other companies they control, by transferring assets to themselves at values below the prevailing market prices, by getting private loans using the firm's assets as collateral, or by paying special dividends to themselves"* (Shleifer & Vishny, 1997).

Now I am going to discuss the performance which is affected by exactly two dimensions related to corporate governance to understand their tasks, procedures and importance in Chile, an emerging market. The first dimension is the ownership-control structure of the business group which is characterized by the economic rights and voting rights of the controlling shareholders. The second, are the social ties of the firm within the business group containing interlocking directors and family ties of controlling shareholders in the board of directors. These two dimensions are important effects on performance.

The **ownership concentration** is measured as the part of the company that is owned by the board of directors. A high ownership concentration will support the firm if it decreases the incentives to take out private benefits for the controlling shareholders. Additionally, the firm will be supported too, if short-term projects are not favoured over long-term projects any more.

Furthermore, there is evidence that there is a relation between the ownership concentration and the market value that both are significant on a business group's performance. Now, it is important to discuss the **economic rights** and voting rights. Economic rights are rights to have at command cash flows and dividends of the company, whereas voting rights *"refer to the percentage of votes in the hands of the controlling shareholder for the nomination of board members"* (Silva et al., 2005, p. 316).

Both are linked to the ownership structure, because of their impacts. However, those impacts on performance have different outcomes in different categories. There are three categories of economic rights: low, medium and high. Silva et al. (2005) find that:

> *"At low concentrations of economic rights value creation dominates value expropriation., probably because monitoring by other shareholders is closer and more effective. At medium concentrations, the controlling shareholder are progressively less monitored by the market, making expropriation more likely. Finally, at high concentrations, the incentives for the controlling shareholders to extract private benefits decrease, because these shareholders largely bear the costs of their actions themselves"* (p. 319).

When **voting rights** of controlling shareholders are higher than their economic rights, it is common that those shareholders do have incentives to take out or transfer value away from the firm. This is a common procedure in business groups. Furthermore, business groups are able to maintain voting rights in a surplus of economic rights by having cross-ownerships and holding a number of different stocks, but also by building a pyramidal ownership structure, for example. It is important to consider the gap that arises between voting rights

and economic rights. A large gap indicates *"a higher risk of expropriation by the controlling shareholders, and consequently, a lower value of the firm against the industry"* (Silva et al., 2005, p. 316). Finally, voting rights do have similar results considering a business group's performance, but are less solid.

To finalize the investigation on performance, I am going to present you the last dimension that has an impact on performance – **social ties**, represented by the interlocking directors and family ties. There is evidence that including more family members and economic rights into companies do have a positive impact on performance. However, performance is reduced when there are too many voting rights in a business group. Numerically, when economic rights do not change and voting rights increase up to 90 percent, performance decreases with family ties. In turn, when voting rights do not change and economic rights increase up to 67 percent, there is an even stronger positive impact on performance considering family ties.

Summarized, the effects of business groups on firm performance depend not only on the corporate governance, but on the firm consolidation too. As mentioned before, there is a relation between ownership concentration (economic and voting rights) and social ties (interlocking directors and family ties).

First of all, an increase in social ties do not have to lead to an increase in performance regarding on voting rights. Low voting rights indicate an increase in performance because of better coordination and thus monitoring function by relevant shareholders. Furthermore, increasing economic rights strengthen these positive impacts because of reduced expropriation incentives that are linked to the costs of expropriation by the controlling shareholders. Then, social ties decrease performance when voting rights are high. The reason is, that expropriation is then being favoured.

Second, social ties do effect, as mentioned before, different factors in a different way. Family ties have a positive impact on the majority of business groups, representing about 76 percent of the companies, in Chile. In contrast, for interlocking directors, the opposite is true. They do improve performance in only 26 percent of the cases. Furthermore, family ties in general do enhance efficiency in firms belonging to business groups, because of better communication, trust and coordination. Nonetheless, some Chilean boards of directors seem to exist to fulfil legal requirements only, instead of managing their companies efficiently.

## 7 CORPORATE GOVERNANCE IN EMERGING MARKETS

To understand the close link between the restrictions of corporate governance and the entity of emerging markets, some important factors have to be mentioned. However, the following question occurs: Do pressures of capital markets will improve the governance of corporations and will those changes promote the development of capital markets? We have to recognize that this chain of reactions do matter on a couple of important factors, as mentioned above. So, what does matter? Legal rules, legal families, political structures and history are several of those factors. With these "mechanisms" it is possible to measure the effectiveness of the function of legal rules and the functionality of capital markets by comparing the efficiency of corporate governance in emerging markets. We should keep in mind, that legal rules are *"the product of and dependent on political action"* (Jordan and Lubrano, 2007, p. 3). Additionally, it is still difficult to analyze the consequences of the intensity of the activity on how capital markets as well as financial systems grow and develop!

In the previous section we have discussed some problems emerging markets are facing and so, researchers do ask in these globalizing times, if one or another corporate governance system – when implemented - possess the "mechanisms" to gain a competitive advantage compared to the 'old' governance system in emerging markets. Or, can one system be transplanted into the other? The answer is, that the manner of transplantation is significant. An important predictor of effectiveness is the extent to which a foreign legal system has been introduced. An important factor is, however, the promotion of international standards in both capital markets and corporate governance which is an important indicator of convergence of legal rules. International standards proved themselves in the past and so, *"gauging the effectiveness of convergence to these standards becomes a more complex matter"* (Jordan and Lubrano, 2007, p. 3).

Before presenting you the answers to the question, 'what could work?', I have to mention following: When adopting foreign standards in an emerging country, we have to take into account the target country's legal system. Finally, I am going to present you several general observations from Jordan and Lubrano (2007) that can be made about the importance of private and public legal rules to promote the development of capital markets and enhance the governance processes of corporations.

## 7.1 PRIVATE AND PUBLIC LEGAL RULES

At first Jordan and Lubrana (2007, p. 25) find out that "***Private legal rules are important***". Over the past several years, the debate about the regulation of capital markets and the corporate governance find their origin in the Anglo-American law. So, this debate is more an Anglo-American one. Particularly in the USA, a contractual governance mechanism arises because of the development of fairly standardized private legal rules that balances and protects future market participants while providing an exit from contracts by undesirable courts.

In the Latin American case, however, three important aspects are faced considering the contractual governance mechanisms. At first, private legal rules, also known as contracts, are important anyways – protecting economic interests and rights. Then, contracts generate market-tested solutions and finally, private legal rules can migrate back to the private sector in search of a more effective form of implementation.

*Then, they realized that "**Different legal traditions have different balances in terms of the effectiveness of private or public legal rules**"* (Jordan and Lubrana, 2007, p. 25). Even in the Anglo-American governance mechanism, there are significant differences in the tradition, namely the English tradition and the American. History shows that because of the American Revolution, the American common law has greater affinities with continental European tradition than with English common law.

In English common law, the importance of judicial action dominates statutory/written law ex ante public legal rules). Furthermore, the English common law has an aversion to law as legislation (ex ante public legal rules). In some cases, however, there are no judge-made rules (public legal rules) at all. Furthermore, England has parliamentary conventions and no written constitution. Those parliamentary conventions are practices and principles being developed on a consensual basis for ages.

The American common law has no aversion using legislation (ex ante public legal rules). Therefore, the American law's proclivities are similar with continental European legal traditions. This is the reason why the US have uniform commercial codes such as a bankruptcy or federal code for example.

The continental European tradition is the basis for the legal systems of the non-Commonwealth world (English common law). A characteristic of the continental European

law tradition is the importance of written law (ex ante public legal rules) and the hierarchy of law (constitution, code, statute, regulation).

Furthermore, Jordan and Lubrana, 2007 find that "***A predictor of effectiveness of any particular governance mechanism may be its form (private, public, or semi-public legal rule) and the legal tradition in which it operates***" (p. 26). It is important to understand that the same government mechanism may take different forms and that the form in which it will be implemented and most efficient will be determined by the legal system in which it operates.

Additionally, Jordan and Lubrana (2007) indicate that there are three examples of the most popular corporate governance mechanisms that are not able to be transplanted to another legal system because of being an appropriate form of rule. **Voluntary Codes of corporate governance** are the first malfunctioning mechanisms. Flexibility, responsiveness and sensitivity to industry-specific concerns as wells as considerations are some important factors why voluntary codes are favoured. Furthermore, the aversions to written law (ex ante public legal rules) are forcing British governance systems to favour voluntary codes of corporate governance. The reason why those codes cannot be transplanted into most foreign governance systems is the result from the unsuccessful attempt to implement a voluntary code into an continental European corporate governance system which cannot recognize the concept used in the target country. The second malfunctioning mechanisms are the **voluntary codes and institutional markets** where the capital markets of the target country ironically have an uncommon effect on governance systems. Furthermore, the international capital market has been so dominated in the last decades by Anglo-American law and practices that the spillover into local laws and practices was unavoidable. As you might imagine, some of those spillovers were ineffective as well as inefficient because of incompatible underlying legal systems or contradict provisions in the civil or commercial code. However, one problem is faced as being devious. As long as there is little interest in international capital markets, there will be still interest to introduce a domestically malfunctioning, but internationally recognized corporate governance system! At last but not least, **cumulative voting and class actions** are the last of the most popular corporate governance mechanisms that are not able to be transplanted to another legal system. Cumulative voting and class action mechanisms were introduced only because of the popularity of voluntary codes. Both are originated from the US to enhance minority shareholder representation on boards and to promote management accountability. Both

mechanisms were implemented for public investors to be able to influence the corporate governance of firms. Again, both mechanisms signal the interest on international capital markets and so, the American debate on corporate governance started.

Further on, another observation can be made about the importance of private and public legal rules to promote the development of capital markets and enhance the governance processes of corporations. Jordan and Lubrana (2007) find that "***Public policymakers should anticipate, and encourage, private and quasi-public legal rules that complement and reinforce public legal rules of corporate governance***" (p. 31). They indicate that the relationship between private legal rules and public legal rules are linked together. There is evidence, that when effort is being put to improve governance systems of corporations in emerging markets, there are simultaneously initiatives in the public and private sector spheres. The Brazilian Institute of Corporate Governance, for example, developed a voluntary code of best practices and an active training program for companies and corporate directors to be able to deal with the growing activity at the public legislative level successfully.

"***The optimal content and mix of mechanisms in any market will depend on a variety of factors. Some of the most effective mechanisms may be found in these intermediate forms-semi- or quasi-public legal rules- enforceable by private means***" (Jordan and Lubrana, 2007, p. 33). There are four key market characteristics for emerging markets to be able to implement a foreign corporate governance system. The first one is the **relative adequacy of existing practices**. This means that before implementing a new governance system, emerging markets should be investigated if there are, for example, too many non-voting shares, uncertain rules for protecting minority shareholders or if there is poor quality of audits or even conflicting managers, boards as well as investors and regulators. Then, there should be a focus on the **number, size, and industry of public issuers**. Hereby, financial markets should question if the relationship and atmosphere between controlling shareholders and corporate executives is too calm or too aggressive towards traditions, political views and co-operation. Furthermore, the **number, size and nature of principal investor groups** – institutional, pension and international – should consider the quality of investors being governed. Additionally, contortions appertaining to the investors' incentives of interest such as profit-maximizing should be questioned too. Finally, **resources of the enforcement mechanisms** such as courts, regulators and existing

alternative dispute resolutions should be considered. Hereby, the following question arises: What enforcement agents are able to notice already performed contracts, are able to observe standards and regulations? Answering this question will help to understand key market characteristics of emerging markets.

Now, I will present you shortly some key characteristics of Latin America that are relevant to the problems this market is facing. The ownership structure of Latin America is similar to other countries in other markets in continental Europe and East Asia, for example. Those countries, as well as Latin America, have a high equity concentration and very complex business group structures in several forms – pyramids, cross-shareholding, rings etc. Those structures allow *"controlling shareholders to leverage their voting power though business group affiliation and to deviate from the one-share-one-vote rule"* (Gutierrez & Pombo, 2009, p. 115). Additionally, there are three mechanisms that imply deviation from this statement. At first, the publishing of non-voting shares, then the dual shares and at last, the dividend-preferred share. However, the issuance of dual shares are forbidden by corporate law in most Latin American countries. Other countries, such as Chile for example, restrict cross-shareholdings and *"impose a cap on the issue of preferred stocks relative to shares outstanding"* (Gutierrez & Pombo, 2009, p. 115).

The corporate governance faces many problems and opponents but also proponents in emerging markets. Due to scandals in Chile, Mexico as well as Brazil and Argentine, also in emerging markets reforms are on the to-do-list. Jordan and Lubrano (2007) described the problems of some investors in Brazilian and Argentine companies that *"were forced to accept low-ball offers from controlling shareholders who had decided to delist the companies"* (p. 9). Hence, the majority of Brazilian shareholders felt themselves treated unfairly because of being excluded of transactions in which holding the majority of voting shares sold control of the company.
We already know that capital market participants do have private initiatives in the area of corporate governance that are often simultaneously following the amendment of the legal framework. So, problems occur for those companies, that have proven track records in the market or have dominant positions in the equity indexes. Additionally, the following question arises with justification: Why do such companies have to disclose additional information to shareholders or to allow outsiders onto their boards?

During the debates over reforms, many corporations in Latin America were never thinking of public security markets as a source for capital. In contrast, many of those companies started to sell control to larger national as well as international competitors and thus were indifferent to the prices at which their securities were traded.
So, in the end, the executives and legislatures of the Latin American countries approved a mild version of the proposed reforms. Chile's reformers were the most successful. However, even in Chile, *"majority shareholders were permitted to suspend application of the law's mandatory tender-offer provision for three years"* (Jordan & Lubrano, 2007, p. 10). In Mexico, however, reforms do not anticipate the desired triumph. *"Mexico's legislation (probably unwisely) delegated authority for setting the parameters of the mandatory tender-offer rule to the banking and securities regulator, which has so far proven unable to issue the required regulation"* (Jordan & Lubrano, 2007, p. 10).

These circumstances lead to impacts in the long-term and short-term. The promoters of reforms in corporate governance in emerging markets wanted to mandate greater transparency, to provide shareholders securities and to reinforce judicial enforcement, with an positive effect on capital market development. There are some important long-term effects such as the access to new capital, gaining new offerings, security prices as well as liquidity and an improvement in corporate performance. In the short-run, it is still difficult to conclude whether those changes do have a positive short-term impact or not. However, reforms succeeded in focusing on directors, managers and companies as well as institutional investors. The public was informed about the urgent changes in corporate governance, especially in emerging markets.

In the next sections, I am going to engross the thoughts of corporate ownership and control in Latin America and present some reasons for a high ownership and control concentration in most emerging markets, especially in Brazil. Additionally, I am going to indicate the effects of the relationship between the corporate governance structure and market valuation and present you the problems when ownership and control will be separated.

## 8 CORPORATE GOVERNANCE IN BRAZIL

Brazil's first Corporation law was adopted in 1940 and the government started to run the stock exchanges. The tasks of brokers were fulfilled by civil servants who were allowed to trade shares on the exchanges and some government rules regulated the brokerage fees and the number of brokers in each area.

In 1964, after the military coup, some financial liberalizations started. Twelve years later, in 1976, the first law to regulate markets and security offerings was adopted by the new government. In the very same year, the Brazilian securities commission - Comissao de Valores Mobiliarios, short CVM – and a new Corporation Law were founded. The latter established separate rules for public and closely held corporations. Due to these reforms, private stock exchanges and broker-dealers emerged and the old servant brokers were eliminated.

The Brazilian government started to encourage the stock market development during the 1970s and 1980s by granting tax incentives to firms which went public and to investors who purchased shares in public companies. Furthermore, pension funds and insurance companies were required to invest a minimum of their assets in shares of public companies. During the 1980s, almost 600 publicly held companies arose. However, most of these companies went public to gain the advantages of taxation and not because of the interest of trading their shares actively or having public shareholders.

By the end of the 1980s, most of the companies that went public because of tax incentives returned to private ownership. At the same time, the government privatized a large number of state-owned companies. Furthermore, in the late 1990s, share trading with shares of privatized companies was common and many Brazilian companies cross-listed on the New York Stock Exchange (NYSE). Hence, the majority of trading moved to the NYSE and the number of public firms decreased.

In the meantime, in the 1980s, the Sao Paulo Stock Exchange, Bovespa, was designated to be the share trading market, after the Rio de Janeiro Stock Exchange collapsed. The remaining exchanges proceeded to Bovespa in 2000. In 1995, the Instituto Brasileiro de Governanca Corporativa, the Brazilian Institute for Corporate Governance or IBCG, was founded and released an initial Code on the Best Practices of Corporate Governance in 1999. Santana (2007) determines that three new listing segments were launched by Bovespa in 2000 – level 1, level 2 and Novo Mercado. Furthermore, he finds that these

listings contain stronger requirements than for a regular Bovespa listing. Additionally, in 2002, CVM issued its own Recommendations on Corporate Governance, which, however, are recommendations only and do not follow the *""comply or explain" regime, in contrast to a number of other countries"* (Black, de Carvalho & Gorga, 2008, p. 4).

The listing levels, more precisely the Bovespa and Cross-listings, are analyzed in the next section.

## 8.1 LISTING LEVELS

Gorga (2006) examines the regulations in the Brazilian financial markets and finds that they are heavily regulated.

However, Brazil's image of having a poor corporate governance was the reason for **Bovespa** to create listing levels with strict corporate governance requirements. Black, de Carvalho and Gorga (2008) find that *"The higher levels provided investors with a readily understood signal of their corporate governance posture"* (p. 7). The Bovespa listing levels became successful and now include the 'regular' Bovespa, Level 1, Level 2 and Novo Mercado.

It is important to realize that both common shares and nonvoting preferred shares are issued by many Brazilian companies. These shares are similar considering their economic rights to nonvoting common shares.

A Novo Mercado listing requires the following features:

> *"the firm issue only voting common shares; have a minimum free float (shares not controlled by the controlling shareholder) of 25%; provide financial statements which comply with U.S. GAAP or IAS; provide full takeout rights to minority shareholders in a transfer of control; and agree that conflicts with shareholders will be resolved by arbitration"* (Black, de Carvalho & Gorga, 2008, p. 7).

A level 2 listing is similar to Novo Mercado with the difference, that companies are allowed to issue preferred shares. The level 1 listing, however, focuses on improved disclosures and is almost an ordinary listing. Furthermore, new listings have to be at least on a level 1 listing or higher. Foreign companies, however, that want to cross-list on Bovespa, are the only exception.

Four years ago, in 2006, Bovespa Mais was founded by Bovespa, with the intend to help smaller companies with lower listing requirements than Novo Mercado.

**Cross-listing** are another way to provide Brazilian companies *"to signal their intend to maintain a higher level of disclosure and other corporate governance practices"* (Black, de Carvalho & Gorga, 2008, p. 7).

## 8.2 EMPIRICAL EVIDENCE

Black, de Carvalho and Gorga (2008) provide an extensive survey of Brazilian corporate governance in 2005. Overall, they received 116 replies from privately controlled companies, government-controlled companies and subsidiaries of foreign companies, respectively, 88, 17 and 11 replies.

In their sample of 116 companies, 9 have cross-listed their shares, most of them with the intend to gain nonvoting preferred shares. Only 3 companies are listed on Bovespa Level 2 and 2 firms are listed on Novo Mercado.

Furthermore, Black, de Carvalho and Gorga (2008, p. 8) provide a short overview of cross-listing and Bovespa listing as follows:

> *"From 1995-2003, there were only six initial public offerings by Brazilian firms […]. The number of IPOs then soared to 7 in 2004; 9 in 2005, 26 in 2006, and 64 in 2007. Of these 106 IPOs, 75 were on Novo Mercado, 15 on Level 2, 8 on Level 1, and 8 (all cross-listed firms) had a regular listing. […]. In addition, 16 older firms have upgraded their governance to meet the Level 2 or Novo Mercado requirements. Only 4 of the newly public firms were cross-listed in the U.S. on level 2 or 3 (all level 2 listings on the NYSE).. Another 23 of these firms have cross-listed in the U.S. on level 4 (Rule 144A) and 2 firms have cross-listed on level 1".*

# 9 CORPORATE OWNERSHIP AND CONTROL IN BRAZIL

In the 1980s, corporate governance models were examined to evaluate their effectiveness in the valuation and dividend policy of corporations in emerging markets. In Brazil, for example, important factors have stimulated efforts to consider a better corporate governance system. Such factors are the opening market process, privatizations and new foreign investors, especially foreign institutions.
Most studies focused on the corporate ownership and control structure. The ownership structure contains the cash flow rights, whereas the control structure contains the voting rights. There is evidence that the ownership structure in combination with the country legal protection, is one of the most important determinants of corporate governance.

Such as in Brazil, corporate ownership and control is highly concentrated in Colombia. Most of the business groups and conglomerates nowadays, started their corporations as family businesses and became corporate groups later.
Additionally, it is worth to mention that there are four facts regarding corporate ownership and control which are important to understand. First of all, **corporate ownership is highly concentrated**. The top four largest shareholders in Colombia indicate that they hold more than *"51 percent of a firm's cash flow rights […]. Under one-vote-one-share rule this provides a private control to the largest shareholders"* (Gutierrez & Pombo, 2007, p. 10). Consequently, the largest voting blocks of affiliated companies belong to the same business groups. Then, it is essential to know that **ownership concentration has increased**. On average, more than 80 percent of cash flow rights were held by the four largest shareholders in about 45 percent of the evaluated companies in 2002. By way of comparison, this number was about 32 percent in 1996. The third fact indicates a **low separation ratio within the largest voting block** which was recognized at *"the top-four voting blocks and at ultimate owner levels"* (Gutierrez & Pombo, 2007, p. 11). Finally, **investment corporations play a central role as controlling shareholders**.

Now, I am going to investigate the ownership and control structure more detailed and present you some problems, when ownership and control will be separated.

## 9.1 OWNERSHIP STRUCTURE VS. CONTROL STRUCTURE

The **ownership structure** in combination with the **cash flow rights** is an important corporate governance mechanism in emerging markets because it influences the efficiency of the market for corporate control directly. However, an agency problem may occur between managers and shareholders because managers may have not in mind to maximize shareholder's value in the first place. The agency problem will be discussed in section 9.3.
Furthermore, the ownership has two main categories - the identity of the large owner and the concentration of ownership. Due to this, there are owners such as institutional investors, government, family and foreigners of a corporation according to the point of origin of capital.

We already know that the corporate governance do have effects on the market liquidity, firm value and the organization of markets as well as organizations in a context of weak shareholder protection. Furthermore, the ownership structures provide a large environment to do research in a regional setting such as in Latin America. So, it is important to keep in mind, that in markets with a weak protection for minority shareholders, but a large ownership concentration, *"market participants impose a discount on the value of firms in which the voting rights of dominant shareholders exceed the cash-flow rights"* (Cueto, 2008, p. 2). Additionally, the dominant shareholders' close collaboration assume managerial functions, but instead, the firm's management is monitored by them. Furthermore, the ownership concentration of publicly held companies is widely dispersed among investors. This circumstance is not common in countries in which families, business groups and/or governments control most of the publicly traded firms. Compared to the USA, controlling shareholders govern many firms too, so it is a common phenomena. However, due to the concentrated ownership structure, a new conflict of interest is arising. This problem of interest arises between minority shareholders and dominant shareholders. Cueto (2008) notices exactly, that this conflict *"is characterized as the potential for asset diversion from the firms to dominant shareholders, reducing overall shareholder's value"* (p. 2).
Additionally, the gap between voting and cash flow rights is created and intensified by three mechanisms. The first is the aggregation of voting rights by business groups, then the use of multiple class shares and finally, the indirect ownership through pyramidal structures. In the latter mechanism, top companies are equipped with disproportional

voting rights over cash flows generated firms at the base. To bring up the asset diversion, it is included from the base up.

The **control structure** in combination with the **voting rights** do investigate, to whom the company finally belongs. Gutierrez and Pombo (2009) define voting rights as *"the total votes that a shareholder is entitled to on the basis of direct investment in a firm and indirect ownership"* (p. 115).
Important is a direct correspondence between voting rights and cash flow rights for each shareholder. To obtain this result, shareholders according to the level of voting rights have to be aggregated. Furthermore, the aggregation of voting rights may stabilize the position of dominant shareholders. Cueto (2008) assigns *"any treasury stocks' voting rights and cash-flow rights to dominant shareholders"* (p. 7). Another important statement from Cueto (2008) is that *"cash-flow rights of voting shareholders are diluted, with respect to the simple percentage of voting shares, as cash-flow rights of other non-voting shareholders are taking into account"* (p. 7). A wider discrepancy of voting rights and cash flow rights would be the consequence of not collecting voting and non-voting shares across members of a business group.

## 9.2 DIRECT STRUCTURE OF OWNERSHIP AND CONTROL VS. INDIRECT STRUCTURE OF OWNERSHIP AND CONTROL

To study the link between the ownership and control structure more detailed, we have to analyze two forms of shareholding composition; the direct and indirect ownership. Direct shareholders are those who own shares in the company itself and indirect shareholders are stockholders who actually own the company.

### *9.2.1 Shareholder composition*

The **direct structure of ownership and control** considering the shareholder composition indicates, that about 90 percent of companies in Brazil have one shareholder that owns more than 50 percent of the voting capital. To put it in another way, this single shareholder owns on average about 76 percent of the voting capital. This situation demonstrates that

when one single shareholder does not possess the majority of votes, the largest shareholder have a respectable amount of them. Carvalhal-da-Silva and Leal (2003) find that *"the largest, the 3 largest and the 5 largest shareholders have, respectively, 72%, 85% and 87% of the voting capital"* (p. 7) - indicating a high concentration of the voting capital.
Furthermore, there is a noticeable difference between the percentage of voting and total capital held by large shareholders. In Brazil, large shareholders use the issuance of non-voting shares to gain control of the company without having to possess 50 percent of the total capital. Additionally, an investor that is at the same moment a single shareholder, holds on average 76 percent of the voted, but only 54 percent of the total capital.
*"In Brazil companies are allowed to issue shares without voting rights in an amount up to two-thirds of the total capital"* (Carvalhal-da-Silva and Leal, 2003, p. 7). However, the New Law of Corporations (Law 10303) changed the maximum amount of non-voting shares, which is obligatory to non-public companies that indent to go public after October 2001 and for new corporations. The maximum amount of non-voting shares changed from two-third to 50 percent. This mechanism allows companies to issue shares without giving up control. Furthermore, it is also a way to separate ownership from control.

The **indirect structure of ownership and control** considering the shareholder composition indicates the indirect interest of shareholders. The difference between the direct and the indirect structure of ownership and control considering the major shareholder holding more than 50 percent of the voting capital is, that the indirect ownership is more diluted. The following example shows the difference numerically. The average majority shareholder owns about 76 percent of voting capital and 54 percent of the total capital in the direct form of ownership and control. Indirectly, the majority shareholder owns 69 percent of the voting capital and 40 percent of the total capital.

### *9.2.2 Market valuation and dividend payout*

The market valuation and dividend payout considering the **direct structure of ownership and control** is measured according to the identity of the controlling shareholder. Foreigners, the government and families as well as institutional investors class among controlling shareholders.

The direct structure of ownership and control indicate that a higher concentration of voting rights is associated with a lower firm valuation. Due to this, there is evidence that there is a negative relationship between control concentration and market valuation. Furthermore, evidence shows that companies controlled by the government are undervalued when being compared to family controlled corporations.

The market valuation and dividend payout considering the **indirect structure of ownership and control** states that the higher the concentration of cash flow rights, the higher is the firm valuation. Furthermore, evidence shows that the higher the voting/total capital ratio is, the lower is the firm valuation.

### *9.2.3 Effects of ownership and control on the market valuation*

The **direct structure of ownership and control** considering the market value indicate that *"companies wit a foreign or institutional controlling shareholder tend to present a higher valuation, when compared to family-owned companies, while government-owned firms tend to have the lowest valuation"* (Carvalhal-da-Silva and Leal, 2003, p. 11). An explanation can be that governance is more complex in government-owned companies and so, the control rights are in the government's hands. These control rights are dissociated from the cash flow rights, because of the ownership of the company that belongs to the citizens.

The **indirect structure of ownership and control** considering the market value are the same as in the direct structure.

### *9.2.4 Effects of ownership and control on the dividend payout*

The effects of the **direct ownership and control** on the dividend payout state, that companies with a high concentration of voting rights have a low payout, where as firms with a high concentration of cash flow rights have a high payout. Furthermore, evidence shows that corporations do have a low payout when separation between voting and cash

flow rights is high. Consequently, family-owned firms do have a lower payout when compared to government-owned corporation, that have the highest payout.

The **indirect ownership and control** do have the same effects on the dividend payout such as the direct structure.

## 9.3 SEPARATION OF OWNERSHIP AND CONTROL

Researchers have the problem now, when trying to separate the ownership and control, if it will be realizable in the first place and if it will lead to significant improvements of the corporate governance in the second place.
Berle and Means (1932) made remarkable progress in their survey of the differences between ownership and control by estimating the separation of ownership and control among the 200 largest American corporations. They figured out that:

> *"Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors (or its majority), either by mobilizing the legal right to choose them – 'controlling' a majority of the votes directly or through some legal device – or by exerting pressure which influences their choice"* (Berle and Means, 1932, p. 69).

To be able to measure the different separation levels, voting rights have to be measured under the portfolio view. The portfolio view is based on the concept of a shareholder's integrated direct as well as indirect ownership concentration, while the direct ownership is related to cash flows. Considering the control structure issue, the former provides indirect votes and the latter direct votes. Hence, different separation levels can be defined and concentration ratios are measurable. Gutierrez and Pombo (2007) applied such an measurement to 108 stock trading firms and find that the separation levels are low. This result implies that firm control is practised through direct ownership and so, corporate structure follows a strong owner management direction. Hence, *"owners command and control boards and appoint CEOs"* (Gutierrez & Pombo, 2007, p. 17). Furthermore, they

find that the concentration of voting is much stronger in sectors such as construction, manufacturing and health as well as personal services.

Gutierrez and Pombo (2007) have very interesting evidence concerning the separation ratios as follows.

Controlling shareholders have about 32 percent of cash flow rights and about 34 percent of voting rights. In 1996, ultimate owners were represented with 68 percent in corporations compared to 2002, the ultimate owners represented an remarkable increased to 86 percent. This happened because widely held companies decreased their participation as ultimate owners. Furthermore, in Colombia, investment companies do have an important role as controlling shareholders as well as for the whole business group, where families are the owners of investment firms and trust fund contracts. However, regulations prohibit banks to have direct shares in real sector companies and so, banks are participating through subsidiary firms as trust funds, investment banks and insurance companies. Hence, less than 9 percent of the controlling owners are represented by financial institutions.

Summarized, the separation of cash flow rights to voting rights ratios are low and the separation decreases slightly. This is a strong evidence that corporate control is privately-owned. Furthermore, *"the composition of ultimate owners shows that investment firms play a strategic role as a controlling shareholder"* and that family ties are the main source of ultimate owners (Gutierrez & Pombo, 2007, p. 40). Additionally, it is important to point out that the cash flow rights are positively related with a firm's better valuation and performance. Further on, the separation between the ownership and control structure has a negative effect on a company's performance and valuation.

As discussed before, modern corporations worldwide possess high degrees of ownership concentration and a strong separation between cash flow rights and control rights. However, exactly this composition faces big issues concerning the agency problem, the entrenchment effect and the tunnelling effect which I am going to discuss now.

The **agency problem** arises because concerns are now related to the divergence of interest between large shareholders and minority shareholders. In the UK and USA, ownership was atomized across small shareholders and so, *"an individual's total votes were derived from direct investment in a company's equity"* (Gutierrez & Pombo, 2009, p. 117). Due to this, the typical agency problem arises because of the lack of direct monitoring between managers and shareholders. This situation implies that an enormous internal power and discretion is being enjoyed by directives and executives. Therefore, if there would be a

direct monitoring that main shareholders use on management, the separation of ownership and control, or cash flow and voting rights, would have no effect on a corporation's performance.

The **entrenchment effect** arises, when firm value at first rises with insider ownership, also called the alignment effect, and then declines. The decline of the corporate value is called the entrenchment effect.

In the **USA**, the average of inside ownership is about 13,9 percent and there is evidence, that blockholders do not have an independent effect on the value of a corporation. Furthermore, institutional ownership reinforces the advantages and all conjugated positive effects of insider ownership on corporate value.

In **East-Asia**, *"firm value increases with the cash flow ownership of the largest shareholder, consistent with a positive incentive effect"* (Cueto, 2008, p. 11). The entrenchment effect in this case is, however, when control rights surpass cash flow rights for the dominant shareholder. This happens when firm value falls. There is evidence that indicates that the value discount is responsible for the separation of ownership and control, and not mechanisms such as dual-cross share and cross-holding or even pyramidal structures.

In **emerging markets**, research on the entrenchment effect was done too. Researchers find support for the entrenchment effect and conclude that *"the costs of the private benefits of control are capitalized into share prices in emerging markets"* (Cueto, 2008, p. 11). Furthermore, firm value is lower as a result of the cost intensive agency problem. This means, that if managers expect lower cash flows, they would tend to increase the difference between their voting and cash flow rights. In **Chile** for example, pyramids are often used to separate ownership and control of conglomerates. Furthermore, controllers of conglomerates hold more shares than necessary to preserve control. In addition, they find that *"board members are exclusively within firms associated to their economic groups"* (Cueto, 2008, p. 12).

The **entrenchment** and **tunnelling effect** are a consequence of low separation effects and thus limited. The reasons for the limited separation effects are the minimizing agency problems of control delegation and the separation ratios which reinforce the ultimate owners to control managers directly.

The results from the separation of ownership and control are presented in Figure 6.

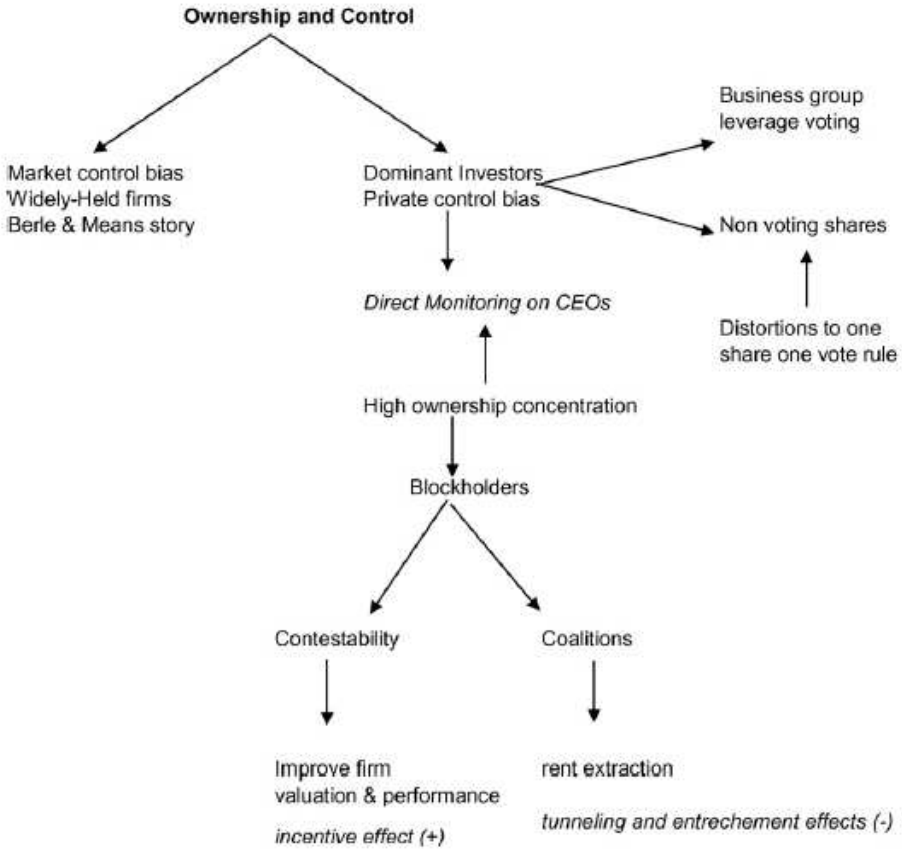


**Figure 6:** Ownership and control. Source: Gutierrez, L., H., Pombo, C., 2009, p. 118

# 10 BOARD OF DIRECTORS IN EMERGING MARKETS – CASE STUDY BRAZIL

Brazil wanted to become more competitive with the opening of new markets and the privatization of its companies in the 1990s and so, the corporate governance was forced to basic changes. Hence, the structure and composition of the board of directors is one of the central issues of many scientific studies in the corporate governance.

These days, the Brazilian stock market is one of the largest among the emerging markets and even the Brazilian economy has made it to the ten largest in the world, although being an emerging market. Furthermore, institutional and foreign investors become more active and understood, that partnerships and business agreements were a good strategy to be successful. From experience we have learned that *"the importance of a governance system that promotes healthy and transparent relationships among controlling shareholders, managers, outside shareholders, and creditors is now evident"* (Leal & De Oliveira, 2002, p. 21).

Before focusing on the board of directors in emerging markets in Brazil more detailed, I am going to present you some Brazilian market characteristics. We already know that the Brazilian market made it to the ten largest in the world, despite an equity market which is not liquid and active. More companies prefer going private over going public and those companies that decide to go public, cut corners through bond issuance and not stock issuance. Additionally, such an important economic factor like trade migrated abroad, especially to the USA.

Furthermore, very high interest rates are responsible for the raising costs of new equity capital and dislodging investors from the equity market to the local treasury paper market. Unsurprisingly, there several problems with the primary equity market in Brazil that are not going to be disposed so easily: (1) The discretionary allocation process favours institutional investors and tax avoidance, (2) there is a tax avoidance and lack of transparency in the Brazilian credit market, (3) the Brazilian judiciary is inefficient, (4) there is a weak investor protection, (5) some legal issues related to corporation law are becoming too complex and intricate, (6) there is evidence of minority shareholder

expropriation and (7) the different ownership structures result in different agency problems.

After this apercu I am going to discuss the structure of board of directors and focus on the ownership concentration subsequently. Afterwards, I am going to illustrate the necessity of control and board of directors and, thus indicate the need of board independence, monitoring and external directors.

## 10.1 THE STRUCTURE OF BOARD OF DIRECTORS

At first, I am going to classify the four groups of directors belonging to the board of directors with appliance of the model used by Leal and Oliveira (2002, p. 101), whose distinguishing criteria followed the model applied by Bhagat and Black (2000):

> *"1. director responding the control group: individual who holds a seat either on the board or in the management of companies belonging to the control group, or who is a member of the family holding the control, or member of the government that holds or is part of the control;*
>
> *2. "internal" director: professional who takes part both on board and in the management of the company at the same time;*
>
> *3. "affiliate" director: professional who has one of the following characteristics: former employee of the controlling company or group; employee of beneficiary of the pension foundation sponsored by the same company; representative elected by employees; former member of the government or public company which is part of or holds the control; or managing director or director of the controlled company or its affiliates;*
>
> *4. "other" directors: professionals with no apparent links with the company or its controlling shareholders"*.

The board composition ratio of 142 Brazilian companies that were surveyed by Leal and Oliveira (2000) illustrate that 49 percent of total directors are controlling directors. 10, 20 and 21 percent of total directors representing the board belong to internal, affiliate and other directors, respectively.

Furthermore, Brazilian corporate law stipulates a minimum of three members in the board. However, the average board size is 6.8 members. 30 out of 142 surveyed Brazilian companies have a board of directors with fewer than 5 members; and 18 out of those 30 have controlling shareholders.

Additionally, the relationship between companies and stockholders is satisfactory and conflicts between minority shareholders and controlling shareholders hinder the board from acting effective.
*"According to IBGC (1998), 48.7 percent of the companies have their directors chosen by shareholders, 17.9 percent by their CEO, and only 2 percent by an independent group"* (Leal & De Oliveira, 2002, p. 23). Furthermore, shareholders are represented in 51.2 percent of the boards, suppliers in 14 percent, and institutions in 11.6 percent. However, the directors that were selected by shareholders are mostly not allowed to be independent, while controlling shareholders control the board of directors.
In Brazil, the corporate law authorize that the chairman and CEO jobs can be performed by the same person. Numerically, about 41 percent of them the CEO is the chairman of the board while 72 percent of the companies have the CEO as a member of the board. Frequently, the board of directors operate only as advisers. About 81 percent of the corporations do not have regulations detailing the role and duties of directors.

### *10.1.1 Board size*

In a company's corporate governance, the board of directors is an important aspect. Considering that, the composition differs in every company, also in an emerging market such as Brazil. At least three board members are required by the Brazilian corporate law (Law 6404/76, arts. 138 §2, 140). Closely held companies, however, are not required to have a board of directors. Both the Brazilian Institute for Corporate Governance (IBGC) and the Brazilian securities commission (CVM) recommend 5-9 members in a board. Furthermore, the CVM Recommendations on Corporate Governance require companies to have at least 5 board members when listed on Bovespa Level 2 or Novo Mercado. In practice, however, boards tend to be smaller.

Table 1 indicates the breakdown of the size of the board of directors in Brazil. Over two-thirds of the firms that responded have boards of directors with between 3 and 7 board members. Only five Brazilian companies and so 6% have more than 11 directors.

| No. of Directors | No. of firms | percentage | cumulative percentage |
|---|---|---|---|
| 3 | 14 | 16% | 16% |
| 4 | 3 | 3% | 19% |
| 5 | 19 | 22% | 41% |
| 6 | 11 | 13% | 53% |
| 7 | 15 | 17% | 70% |
| 8 | 6 | 7% | 77% |
| 9 | 4 | 5% | 82% |
| 10 | 4 | 5% | 86% |
| 11 | 7 | 8% | 94% |
| 12-15 | 4 | 5% | 96% |
| 22 | 1 | 1% | 100% |
| **mean (median)** | | 6.8 (6) | |

**Table 1:** Size of the Board of Directors: Black, B. S., de Carvalho, A. G., Gorga, E., 2008, p. 10

*10.1.2 Board independence*

In many countries companies have to report whether the directors are non-independent or independent. Firms can choose between reporting this information publicly or in a way their status can be inferred. However, not so in Brazil. It is pretty easy to find out from annual reports which board members are also company officers. One way to do so is to compare the director's last names, but it is not a promising method.

Furthermore, many countries require public companies to have a minimum number of independent directors. These requirements are stated through a 'comply or explain' code of corporate governance. This means that companies can either choose to adopt the recommendations or explain why not. An example for the 'comply or explain' code of corporate governance is the U.K. Combined Code of Corporate Governance. Brazil, however, does not have legal requirements for board independence. Furthermore, Brazilian corporate law states that only one-third of board members may be company officers, to be

specific, Law 6404/76, art. 143, § 1. Black et al. (2008) refer to 'executive directors' and 'non-executive directors'. Persons who are both directors and officers belong to the first category, other directors to the latter category. Black et al. (2008) find that *"in many Brazilian companies, some or all of the non-executive directors represent the controlling family or group"* (p. 11). Furthermore, they indicate that firms must have 20% of independent directors, when companies want to be listed on Bovespa Level 2 or the Novo Mercado. In other words, a board of directors should have either one or two independent directors, depending on the board size.

Brazilian companies compared to international standards have few independent directors. Over a third of the companies do not have independent directors at all. Another 18% have only one independent director. A majority of independent directors in Brazilian companies are represented with 10%. However, Black et al. (2008) find that *"The tendency for Brazilian firms have either no or few independent directors is not limited to smaller firms"* (p. 12).

### *10.1.3 Representatives of controlling shareholder and minority shareholder*

Brazilian companies issue both non-voting preferred shares and voting common shares. The majority of the latter are held by a controlling shareholder or group that are represented in almost all Brazilian companies. These shareholders and groups choose the majority of the board members. Black et al. (2008) state that under legal rule, preferred shareholders or minority common shareholders have the right to elect their own representative or representatives to the board.

Among companies with at least one **independent director**, 42% of firms with preferred shares have a representative of the preferred shareholders in the board. Further 42% have a representative of the minority common shareholders and another 63% have a representative of one or both groups of minority shareholders.

Among companies with no independent directors, 41% have one or more independent directors representing minority shareholders.

Now I am going to focus on **non-independent directors**. There are 3 or more non-independent directors represented in the majority of Brazilian companies. Due to the legal requirement that officers can not exceed one-third of the overall board, most companies have only one or two officers or former officers on their board of directors; a few have none. In total, only 26% have three or more directors in this category.

Furthermore, Black et al. (2008) determine that *"If most directors are not independent, […], and only a minority can be officers, it makes sense that a fair number will be non-officer representatives of the controlling family or group"* (p. 15). So, about 76% of the sample of Brazilian companies have at least one such person; 66% have two or more such directors and on average there are three such person on the board of directors.

## 10.2 OWNERSHIP CONCENTRATION

One of the main focuses on studies considering corporate governance and the board of directors is the identification of causes and consequences of stock ownership concentration. One of the basic conclusions deals with the differences in the degree of the shareholder's protection. However, there were discrepancies considering the ownership concentration, the market size, liquidity, dividend policies, etc.
I am going to investigate the ownership concentration in emerging markets, particularly in Brazil.

In general, the degree of protection varies to the characteristics of legal frameworks in different countries. Hence, the concentration of stock ownership is negatively related to the protection of the shareholder's rights. This means that countries with a better protection, do have a better spread of corporate ownership. Furthermore, countries with a legal tradition system coming from the French civil legislation, such as Brazil, indicate a higher degree of ownership concentration. Additionally, countries with a less efficient protection mechanism for shareholders are corporations under family or state control. In these family-owned and state-owned firms, there is not a significant separation of ownership and management.

Furthermore, there are different rights that can be derived from stock ownership. These rights can be classified into two uniquely defined types. The control rights belong to the first type. Control rights imply the possibility of appointing the corporation's manager. The second type, however, is the right to participate in the distribution of dividends. Both rights are secured for controlling shareholders in countries with a high shareholding concentration only. According to legal requirements, other shareholders do have some rights too. They do have the right to dividends and other gains paid by their company.
These types of rights operate through three mechanisms: *"establishing differentiated voting rights to several stock classes or types, creating pyramidal shareholding structures, and reciprocal participation among companies"* (Saito & Dutra, 2006, p. 99). The 'private benefits of control' is one of the results from these mechanisms, through which the two rights are operating. Saito and Dutra (2006) define the 'private benefits of control' as *"benefits appropriated by the controlling shareholder that are not distributed to other shareholders"* (p. 99). In other words, this is an incentive to less circulation of voting rights in countries where minority shareholders enjoy low protection.

Furthermore, there is evidence for the rise of this type of benefits by the controlling shareholders. There is evidence that premiums were paid by acquirers of controlling stock. Additionally, those premiums were in relation to the market value of shares before sale. It is interesting to see that such extra premiums reflect the idea that benefits from control stock ownership outweigh the benefits from diversifications of their investment portfolio.

Due to the ownership concentration and the evidence for expropriation, there is a necessity of control and the board of directors which I am going to present in the next section after presenting you some board actions.

## 10.3 THE NECESSITY OF CONTROL AND BOARD OF DIRECTORS

However, what specific actions do board of directors have to accomplish and why is there a necessity to control them?
Black et al. (2008) show that about 23% of board of directors had to replace the CEO. Replacing, however, can have two meanings. The first, a dismissal for poor performance

and second, a normal replacement when the CEO retires or becomes ill. Similarly, about 25% of companies had to replace or were asked to replace one or more officers. Furthermore, in 8% of the firms the board asked an independent director to resign or did not propose re-election of an independent director. At last but not least, no independent director had to resign because of a conflict with a policy. Table 2 shows some more actions of the board.

| Within the last 5 years, has | Yes | % Yes | No or missing | Total |
|---|---|---|---|---|
| the board replaced the CEO | 20 | 23% | 68 | 88 |
| the board replaced (or asked the CEO to replace) one or more other officers | 22 | 25% | 66 | 88 |
| the board asked an independent directors to resign, or did not propose reelection of an independent director | 4 | 8% | 48 | 52 |
| an independent director resigned because of a dispute over policy | 0 | 0% | 52 | 52 |

**Table 2:** Actions of the Board: Black, B. S., de Carvalho, A. G., Gorga, E., 2008, p. 21

Now I am going to show you why there is a necessity of control and board of directors. Monitoring, external directors and board independence are the catchwords to decrease the possibility of expropriation by controlling shareholders of company values. It is not that easy to monitor the manager's activities. Mechanisms are required to be implemented *"to restrain the creation of rules that benefit exclusively controlling shareholders, so shares can be priced by the market in an equitable way*" (Saitro & Dutra, 2006, p. 100). However, Brazil does not depend on external control mechanisms, in which senior managers have to deal with the pressure of stock market values and the risk of hostile market acquisitions. In Brazil, the only alternative for the internal control is the board of directors. *"Board exist in all publicly held companies, with deliberative functions, and constituted by professionals elected by their own shareholders"* (Saitro & Dutra, 2006, p. 100). The role of board of directors is to supervise directors, to account books and papers and to activities related to the company.

In the USA for example, there is a need of external directors who are independent from management and step in with a vast majority, because of disagreements that occur between

the shareholders and senior managers. Hence, the majority of executive directors in boards would take over the controlling function and settle differences.

In countries such as Brazil, however, conflicts emerge in the relationship between controlling shareholders and minority shareholders. Therefore, an independent board of directors would depend on the controlling shareholders and not on the influence of executive directors.

## 11 CONCLUSION

For hundreds of years, research is done on the importance of board of directors across boundaries in different organizational forms facing the agency problem that exist between company's owners, its shareholders and management. Nowadays, many areas of corporate governance are still unsolved. Scholars and experts, occasionally, investigate the role of board of directors and how to improve them to be as efficient as possible while considering the shareholders' profit maximizing orientation.

I have analyzed four groups of directors – the insiders, outsiders, institutional portfolio holders and independent directors. However, the board composition and board size differs from country and corporate governance system and do affect performance whether the corporation is estimating an equilibrium or non-equilibrium situation. Unfortunately, insufficient findings on this topic circulate among a large number of scientific studies and so, more research has to be done to consider the board's efficiency very carefully.

In the late 1990s, board reforms started to flourish because of scandals of well-known corporations and takeover-activities. The increasing competition, the firm performance and the shareholder protection as well as many other factors called for changes. However, studies provide evidence of the inefficiency of board reforms considering the board's multiple functions such as strategy setting, management monitoring, crisis management and regulatory compliance. Furthermore, reforms make mistakes such as short-term rebuilding confidence of investors or calming down shareholders' anger to next elections. So, reforms are rumoured to have one-size-fits-all consequences that tend to trace instead of causing changes in boards and are caused due to market forces and regulations. The consequences of board reforms are obvious: (1) new rules were implemented in large listed industrialized jurisdictions, but also in small and non-listed companies in emerging markets with the consequence of being an inflexible 'costly one-size-fits-all product', (2) too detailed regulatory implications result in trade-offs and (3) interest groups started to avoid reforms that would significantly endanger their private benefits.
Furthermore, reformers have to consider the corporate governance system when trying to improve corporate governance issues. The strong international competition among corporations originating from the 'Anglo-Saxon' corporate governance systems lead to

reformers wanting companies to adopt parts of the ‘Anglo-Saxon-system’ that, however, is not converging to all corporate governance systems at all. It is worth to mention that the ‘Anglo-Saxon-system’ has the best shareholder protection compared to other systems. Again, scholars and experts do not know if there is a corporate governance system that will be flexible enough to converge easily. However, if world-wide competition increases, companies and organizations will result in implementing the ‘best-practice’ corporate governance, which is the ‘Anglo-Saxon’ system.

About thirty countries are in transition to higher levels of economic development and hence, adopted the name of “emerging markets”. The emerging markets gained the investor’s interest, though indicating a high market risk and volatility as well as the lack of financial products and services available to foreign investors.
Latin America do exhibit interesting corporate governance systems and a high ownership and control concentration, especially in Brazil and so, is my choice of representing emerging markets.
To be able to understand the consequences that a separation of ownership and control are facing, I had to measure the importance of the ownership and control structure by comparing voting rights with cash flow rights. The latter represent the ownership structure which influences the efficiency of the market for corporate control directly, while voting rights represent the control structure which investigate to whom the company finally belongs. There is strong evidence that corporate control is privately owned because of the low cash flow rights to voting rights ratios and the slightly decreasing separation. Though the separation is being encouraged because of shareholder protection and so on, the result is remarkable. Evidence indicates that the separation between the ownership and control structure has a negative effect on a company’s performance as well as valuation and engender the agency problem, entrenchment and tunnelling effect, additionally.

Another important aspect are the effects of the most prevalent Latin American ownership structures on firm performance, in particular family structures and business groups.
Evidence shows that family-controlled firms do have a better performance than non-family controlled firms. Furthermore, if family-controlled companies would improve their governance bodies, management skills and start to care about market control, they will overcome the majority of their traditional weaknesses and take advantage of their strengths to succeed.

The effect of business groups on performance depend on the corporate governance and the firm consolidation and the relationship between ownership concentration - economic and voting rights - and social ties - interlocking directors and family ties.

The emerging markets have enough sources to research on board of directors. Leal and Oliveira (2002) find four groups of directors belonging to the board of directors: (1) director responding the control group, (2) internal directors, (3) affiliate directors and (4) other directors. In their study of 142 Brazilian companies, 49 percent of total directors are controlling directors. 10, 20 and 21 percent of total directors representing the board belong to internal, affiliate and other directors, respectively. Furthermore, Brazilian corporate law stipulates a minimum of three members in the board. However, the average board size is 6.8 members. 30 out of 142 surveyed Brazilian companies have a board of directors with fewer than 5 members; and 18 out of those 30 have controlling shareholders. These results indicate that because of the ownership concentration showed above, there is evidence for expropriation and a necessity of control and the board of directors.
At last but not least, there are possibilities to reduce the expropriation by controlling shareholders of company values. These possibilities are reinforcing the monitoring function, implementing external directors and reinforcing board independence.

In the end, my diploma thesis has shown that there is still more research to be done on every aspect considering board of directors, particularly in emerging markets. This is a rather new topic, so we have to watch how corporate governance will develop and how board reforms will affect the board of directors as to new developments. Scholars and experts differ in opinion. This may be a reason that they focus on different aspects and aim at different results considering board of directors, their tasks and it’s development. They have to realize that when in Rome, do as the Romans do - it is impossible to standardize corporate governance systems worldwide. The only possibility is to adapt parts of different systems that can be implemented, otherwise the whole system will break down.

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# V. APPENDIX

## (1) Abstract

Das Interesse an Corporate Governance, im Speziellen der Aufsichtsräte, stieg im Laufe der letzten Jahrzehnte rasant an. Im Mittelpunkt vieler Diskussionen steht eine zielgerichtete und verantwortungsvolle Unternehmensführung, die aufgrund von steigenden Unternehmensübernahmen angestrebt und gefordert wird. Einige Gründe für das ankämpfen des Privatsektors gegen Misstrauen und Zweifel sind milliardenhohe Defizite amerikanischer Investmentbanken in den Jahren 2007 und 2008, Bilanzskandale in internationalen Unternehmen sowie die Präsenz von überdurchschnittlichen Managementgehältern. Aufgrund dessen werden besonders in börsennotierten Unternehmen immer höhere Anforderungen an transparente Unternehmensaktivitäten gestellt. Weiters wird ein Hauptaugenmerk auf die Bewahrung von Aktionärsinteressen gelegt. Vor allem in Schwellenländern wie jene in Latein Amerika, in denen die Rechtssysteme tendenziell unterentwickelt und der Aktionärsschutz schwach sind, ist der Bedarf einer erfolgreichen Corporate Governance hoch. Studien indizieren, dass eine durch Aufsichtsräte erfolgreich gelenkte Corporate Governance zu Wirtschaftswachstum und Stabilität am Finanzmarkt führen.

Trotz des hohen Marktrisikos, dem Mangel an Finanzprodukten und unzureichenden Informationen für ausländische Investoren, gewinnen die Schwellenländer immer mehr an Interesse. Im Rahmen meiner Diplomarbeit behandle ich die theoretischen Ansätze der Aufsichtsräte und analysiere anschließend deren Entwicklung in Brasilien. Brasilien ist ein Beweis dafür, dass auch in einem Schwellenland mit einem schwachen Rechtssystem, ein hoher Aktionärsschutz und hohe Transparenzauflagen aufrechterhalten werden können, die dem internationalen Wettbewerb durchaus standhalten.

49 Prozent aller Direktoren gehören den Controlling Shareholdern an. 10, 20 und 21 Prozent aller repräsentierenden Aufsichtsräte, gehören jeweils den internen, externen und anderen Direktoren an. Überdies setzt das brasilianische Unternehmensgesetz vor, dass mindestens drei Mitglieder dem Aufsichtsrat angehören. Die durchschnittliche Größe des Aufsichtsrates besteht aus 6.8 Mitgliedern. 30 von insgesamt 142 begutachteten

brasilianischen Unternehmen weisen eine Anzahl von weniger als 5 Aufsichtsratsmitgliedern auf, und 18 aus den 142 haben Controlling Shareholders. Diese Resultate veranschaulichen das Problem der Zwangenteignung und beweisen, dass Aufsichtsräte und Kontrollfunktionen im brasilianischen Markt von Nöten sind.

Entwicklungen der Unternehmenspolitik müssen beobachten werden, um zu erforschen, inwieweit Reformen die neuen Entwicklungen der Aufsichtsräte beeinflussen. Zuerst jedoch müssten Experten realisieren, dass die Unternehmenspolitik den örtlichen Gepflogenheiten angepasst werden muss, da eine weltweite Standardisierung der Unternehmenspolitik zu keiner Lösung führt und das ganze System mit einem Zusammenbruch droht.

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| | |
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