Private Sector Opinion

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Corporate Governance in Emerging Markets: Why It Matters to Investors—and What They Can Do About It

Melsa Ararat and George Dallas

What should investors do when scholarly research on corporate governance in emerging markets does not provide conclusive evidence on which aspects of governance matter most across all the emerging markets and how they affect firm performance? A researcher and a practitioner team up to offer guidelines and recommendations that focus on board independence and business group affiliation.

Foreword

Every day, institutional investors in emerging markets must make practical decisions on the basis of incomplete and at times conflicting information. So, it is critically important that they make the best use of this imperfect knowledge. Moreover, investors too often enter emerging markets with misguided perceptions of the underlying realities. And worse, they may cling to a conceptual framework of governance that does not allow them even to consider the searching questions they should be asking.

This Private Sector Opinion, by Melsa Ararat and George Dallas, explicitly highlights this problem. The authors identify a serious gap in research on emerging markets—between high-level cross-country studies, with their inconclusive findings on good governance indicators at the macro level, and the separate effort to establish firm-level or country-specific governance metrics, typically based on what works "in the West." Unfortunately, fewer than one percent of the research papers available on corporate governance focus on emerging markets.

The challenge for institutional investors is how to weight country factors, even if the investors conclude, as this paper notes, that "optimal governance is firm-specific." Alongside the country factors—rule of law, risk of corruption, competitive intensity, and capital market capabilities—the

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The Forum's mandate is to promote the private sector as an engine of growth, reduce the vulnerability of developing and emerging markets to financial crisis, and provide incentives for corporations to invest and perform efficiently in a transparent, sustainable, and socially responsible manner. In doing so, the Forum partners with international, regional, and local institutions, drawing on its network of global private sector leaders.

The Forum is a multi-donor trust fund facility located within IFC, co-founded in 1999 by the World Bank and the Organisation for Economic Co-operation and Development (OECD).

indicator that bridges to the firm-specific context is the structure of ownership. The heart of this paper is an exploration of two key dimensions of ownership structure: the quality of board independence, and mitigation of the risks of business group affiliations. The authors also provide practical guidance to investors in each of these areas.

In discussing the first of the two dimensions, the quality of board independence, Ararat and Dallas address the fundamental difference between the governance challenge for boards that operate in those developed markets where shareholders are dispersed, and boards that operate in emerging markets, which are characteristically dominated by controlling shareholders, often family members. In the former, the key governance risk is the agency problem of self-interested management. In emerging markets, the central issue is subversion of minority interests by the controlling shareholder bloc, whether it is a family, a group of business partners, or a state-owned enterprise.

Can good governance practices overcome, or at least offset, the power of the dominant ownership bloc? The authors are cautious, noting that a wealth of scholarly literature suggests that the influence of independent directors is hard to demonstrate. More research is needed to better understand the links between outside shareholders, such as institutional investors, and their board representation.

But, to its credit, this paper does not stop there. Recognizing investors' enduring interest in identifying well-functioning boards, the authors provide their own set of health checks and warning lights, designed to squeeze as much substance as possible from the limited evidence that is typically available. Their recommendations on what investors should press for are clear and well-reasoned. However, the inescapable problem is the uneven balance of power: controlling shareholders will be receptive to such proposals only if these proposals are demonstrably in their own interests. Ararat and Dallas set out some promising mechanisms; it is up to the global investor community—equity investors and bondholders—to devise inducements that will encourage controlling shareholders voluntarily to make some concessions to achieve best practice.

The second dimension explored in this paper—how to mitigate the risks of business group affiliations—presents a similar story. These risks have provided a field day for cynical scholars, who have delighted in categorizing the multiple routes through which related-party transactions can siphon or "tunnel" resources away from minority investors. The presence of large-scale business groups maximizes the potential for such practices. Offsetting this risk, as Ararat and Dallas point out, internal markets can at times be highly beneficial when external product, labor, and capital markets are functioning poorly.

Too often, however, controlling shareholders have the opportunity to engage in abusive behavior, a circumstance that can be exacerbated in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse. Once again, the authors offer a practical helping hand. If on other grounds a potential minority shareholder is inclined to invest, here are the health checks that will offer some comfort, even if no certainty.

The overriding theme of this important and highly practical paper is the need for institutional investors to work assiduously with boards and controlling owners to demonstrate the value of ongoing engagement. The authors argue convincingly that investors can and should play a role in shaping governance practices in emerging markets through informed voting and, perhaps more importantly, ongoing engagement with companies and regulators.

Yes, naïve and opportunistic investors can be exploited by manipulative bloc holders. Yet, ultimately such exploitation is a short-term strategy for incumbent owners and their management teams. The tide of events is moving inexorably, if gradually but inexorably, toward the greater integration of capital markets. Far-sighted controlling shareholders will increasingly see the merits of responding more openly and willingly to investors' reasonable demands. Meanwhile, this paper provides practical guidance to investors in emerging markets.

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Corporate Governance in Emerging Markets: Why It Matters to Investors—and What They Can Do About It

Melsa Ararat and George Dallas[1]

Emerging markets play an increasingly important role in the global economy, given their high economic growth prospects and their improving physical and legal infrastructures. Combined, these countries account for nearly 40 percent of global gross domestic product, according to the International Monetary Fund.

For some investors, emerging markets offer an attractive opportunity, but they also involve multifaceted risks at the country and company levels. These risks require investors to have a much better understanding of the firm-level governance factors in different markets.

The Complexity of What Matters in Emerging Markets[2]

Over the past two decades, the relationship between corporate governance and firm performance has received considerable attention from inside and outside academia. Most cross-country studies on corporate governance focus on the relationships between economic performance and countries' different legal systems, particularly the level of investor protections.

On a different track, researchers have investigated how different firm structures determine corporate governance and the effect of those firm-level governance choices on firm performance. These studies, largely based on data from developed countries with dispersed ownership, assess several governance indicators that could be associated with higher valuation and better performance.[3]

However, country-specific research on emerging markets has delivered mixed results, suggesting that empirical evidence on the relationship between corporate governance indicators and firm performance in emerging markets is inconclusive. Governance arrangements that are optimal for investor protection in one country could be suboptimal for companies in another. For example, the level of ownership concentration at which owners are more likely to expropriate minority shareholders changes from country to country,

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2 The analysis of existing research on corporate governance in emerging markets draws in part from M. Ararat's scholarly articles (available at http://ssrn.com/author=439363 and an F&C Investments report, *Corporate Governance in Emerging Markets: An Investor's Roadmap*, December 2008 (available at www.fandc.com/governance).

3 See La Porta et al. (1998) for anti-directors index, which uses governance indicators related to board contestability; Djankov et al. (2008) for anti-self dealing index; and Gompers, Ishii, and Metrick (2003) and Bebchuk, Cohen, and Ferrell (2009) for governance indexes.

depending on the regulations and the level of enforcement. Further, in some circumstances, "friendly" outside directors may also be more trusted and more knowledgeable than "independent" directors.

For the past three years, approximately 1,000–1,200 papers have been published each year on the Social Sciences Research Network with the term "corporate governance" appearing as a key word in the abstract. However, fewer than 1 percent of these papers focus on emerging markets. These numbers indicate a relatively limited scholarly focus on emerging markets, possibly due to data limitations. Much of the work thus far has focused on board structures, for which data are relatively more available.

Whatever the underlying reasons, we are left with comparatively little specific scientific research to guide companies or investors in emerging markets—which is why the Global Corporate Governance Forum has supported the Emerging Markets Corporate Governance Research Network. This network informs the Forum and its partners, among others, about the most recent literature on corporate governance and development. It also identifies priorities for future research in the Forum's areas of activity, generates and publishes discussion papers and research working papers, and promotes a research strategy that supports academic research capacity in developing countries on corporate governance. (See the summary of select papers from the network's latest conference in Seoul in May 2011 at the end.)

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Factors That Shape Firm Performance

Despite being limited, country-specific empirical studies do reveal fundamental differences among individual emerging markets. Also, scholars and practitioners reached consensus that optimal governance is firm-specific. In other words, the best governance structure for a particular firm will depend heavily on the context in which it operates—even in the same market

Several factors have proven to be fundamentally important in shaping firms' governance choices in emerging markets:[4]

- The **quality of public governance** affects the level of law enforcement and, in turn, the extent of bribery and other forms of corruption. These factors influence the quality of corporate governance and corporate transparency in a country. Compliance with the law and the avoidance of bribes can be a source of competitive

[4] See Fan, John Wei, and Xu (2011) for a review.

disadvantage in countries where compliance adds to the operating costs and runs counter to business norms that tolerate bribery.[5] Further, research suggests that it is a misconception that all companies in countries with weak investor protection have weak corporate governance systems.

- In countries where state ownership is common, **the incentives and the quality of government officials and regulators** are key determinants of corporate behavior. For example, state ownership is associated with better performance in some countries, such as in China; in others, such as in Turkey, the correlation is negative. This difference, which can be attributed to many factors, is usually contingent on the incentive structures for public officials.
- **Product market competition**, although frequently considered a positive influence on corporate governance practices, is generally far from perfect in emerging markets, particularly in protected sectors.
- **Financial market development** is often hampered by weak legal foundations and enforcement. As a result, the controlling shareholders invest their free cash in new businesses that they control. Such diversified investments under common control lead to the formation of business groups. In some emerging markets, such as India, business group structures that function as internal financial markets are correlated with better performance. In others, such as Colombia, group affiliation is negatively associated with performance. Based on our analysis, this variation likely depends on the primary motivation for the emergence of business groups in the first place, which varies from tax optimization to lowering transaction costs to diversifying risks. There is also a question of how—and whether—group structures are regulated. In Taiwan, for example, connected enterprises are mandated to disclose crossholdings and pyramidal links. In India, under the new Company Law, a company can hold as many subsidiaries as it likes, but a subsidiary cannot act as the holding company of another company. These provisions aim to prevent private control over public companies through pyramidal structures.
- **Ownership structures** determine the nature of the relationship between the board and performance. In many emerging economies, controlling families occupy managerial positions in listed firms, and succession planning is often focused on family members and not on professional managers. Family presence, especially the founders' presence on the board, is associated with better performance in some countries where relationships matter more and the business elite are tightly connected, such as in Thailand. In other markets, such as the Republic of Korea, the presence of outsiders has a positive effect on performance.

[5] See United States Department of Justice (2006) "Foreign Corrupt Practices Act Antibribery Provisions" for a summary of discussions on how American companies were operating at a disadvantage due to the Foreign Corrupt Practice Act, which led the U.S. government to negotiate, with OECD, the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

Traditional econometric research provides relatively little guidance at this point, because the interplay between institutions and their effect on performance outcomes is very difficult to model.

Traditional econometric research provides relatively little practical guidance at this point, yet corporate governance remains a key risk factor for investors in emerging markets.

Yet, corporate governance remains a key risk factor for investors in emerging markets and an important determinant of portfolio investment decisions. This is the case at both the country level, where rule of law, regulatory quality, and corruption are key drivers for country-level risks, and at the firm-specific level, where controlling shareholders (state, families, or other financial or industrial groups) play a decisive role and are a source of strength or weakness. These risks are relevant to equity investors and fixed-income investors.

The Role of Investors

For companies with high-quality governance in weak legal regimes, the comparatively few companies with good governance are likely to be valued more highly.

Even though investors tend to assign some form of discount in their valuation of firms in countries with relatively poor corporate governance, one option for active investors is to work with companies to improve their governance. The longer-term endgame should be to realize value by reducing, or possibly eliminating, this governance discount.

Notwithstanding the constraints they face, investors can and should play a role in shaping governance practices in emerging markets. This role should involve informed **voting** and, perhaps more importantly, ongoing **engagement** with companies and regulators.

> **Voting:** In practical terms, voting by institutional investors tends to have a minimal near-term effect on the outcome of general assembly resolutions. Within the current prevailing ownership structures, the outcome typically is determined by the way the controlling shareholder votes. However, voting does deliver a message to management about specific investor concerns. Particularly for those companies that want to cultivate international investors for longer-term capital-raising purposes, expressions of minority investor confidence—or concerns—through the voting process provide important feedback and can be an influential agent for change.
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> **Engagement:** Many forms of engagement are possible, such as face-to-face meetings, letters, and e-mail, and it can occur unilaterally by individual investors or collectively by a group of investors. Unlike voting, engagement allows investors to focus on specific issues for in-depth dialogue with company management, and the nature of feedback is not limited to ballot items. Engagement can be productive, if investors

understand the peculiarities of different markets and firms. It also helps if investors understand the underlying reasons for a company's deviations from generally accepted norms of good governance.

Both voting and engagement present the same challenge: to understand which choices matter in individual companies, especially given the external governance factors, and then to focus on those choices. Emerging market firms are generally affiliated with multiple networks connected by formal or informal ties. These structures present challenges for quantification of governance risks.

Board Independence and Business Group Affiliation

The rest of this article discusses two internal corporate governance factors with broad relevance: 1) board independence, and 2) business group affiliation. We chose the first topic because it is the most researched aspect of boards in emerging markets and the second because scholarly research indicates that ownership structure is a key determinant of governance choice at the firm level. For each factor we present a summary of related scientific research, an outline of the warning signs for associated risks, and a list of recommended remedies to mitigate these risks. Although the individual recommendations may not be relevant for every company, they may provide a useful reference for framing investor-firm dialogue.

1) Board Independence

In emerging markets where external governance mechanisms are weaker, boards' ability to effectively monitor managers on behalf of shareholders has been crucially important for corporate governance. However, this board function may be undermined if shareholders and managers (ownership and control) are not fully separated. This is a particular concern for minority shareholders in emerging market companies. Therefore, corporate governance codes commonly recommend a high level of board independence—especially independence from management.[6] A study of outside directors in Korea, for example, shows that their impact depends on the board's overall composition and the market in which the firm operates. Independent directors perform their role more effectively in diverse boards, such as when boards include foreign directors. In countries where independent members are not mandated by law, the labor market for independent directors does not develop, which, in turn, affects the quality of independent board members.

Corporate governance codes commonly recommend a high level of board independence—more specifically, independence from management.

[6] See Zattoni and Cuomo (2010) for an overview of requirements related to board independence in corporate governance codes.

Review of Research on Board Independence

Paradoxically, empirical evidence to support this view is limited. Three comprehensive surveys of the literature in developed markets find that "there is little to suggest that board composition has any cross-sectional relationship to firm performance."[7] Regarding board independence in particular, existing studies on emerging markets also present inconclusive results. Some studies report a significantly positive relationship between board independence and performance, while others present insignificant or negative relationships. (See Table 1 at the end of this article for an overview.)

One possible interpretation of mixed results is that the nominally independent directors are not independent enough or not really independent at all. The independent directors may also be in such a minority on many boards that they are ineffective in the face of nonindependent or affiliated directors. There is some empirical support for arguing that a critical mass of independent directors would decrease the likelihood of their marginalization.[8]

Scholars generally agree that the existence of a controlling shareholder in a firm has fundamental influence on the meaning of independence and the board's role.[9] A variety of possible links between the dominant shareholders and the independent directors may not be captured by the letter of the corporate governance codes. Some researchers also report that independent directors' incompetence and their insufficient devotion of time contribute to their ineffectiveness, citing the ceremonial role they play in many controlled companies.[10]

A further complication arises in business groups, since important decisions are frequently made outside the board at the apex of the group, and the board meetings of subsidiaries remain a symbolic formality. More research is needed to clarify these issues.

Investor Perspective

Despite limited evidence of the impact of director independence in emerging markets, our review of investment policies of major institutional investors shows that many of them still expect boards to have a meaningful composition of independent directors to protect their minority interests, especially in companies controlled by families, other firms, or governments. Listed below are the risks of a nonindependent board, potential red flags, and possible remedies or best practices regarding board independence.

[7] See Hermalin and Weisbach (2003) and Bhagat and Black (2000) for reviews of literature on developed markets.

[8] For example, see Konrad, Kramer, and Erkut (2008) for an empirical study on the effect of diversity, suggesting that minority opinions are marginalized below a threshold of three.

[9] See Bebchuk and Hamdani (2009) for an excellent explanation of this position.

[10] See Li et al. (2011) for an explanation of the ineffectiveness of independent directors in the context of China.

Key Risks:

- Weak or ineffective boards—crowded by family members—that do not provide a constructive challenge to controlling shareholders. This, in turn, can lead to poor strategic decisions or to controlling shareholders pursuing an agenda that benefits neither the company nor minority shareholders.
- Entrenchment of weak executive management. This is a particular risk factor in family companies, where attracting and retaining high-caliber professional staff can prove difficult if top jobs are reserved for family members.
- Incentive systems that do not align the interests of executive management with those of long-term shareholders.

Red Flags (Indicators):

- Lack of board independence—lack of independent members of significant number and relevant expertise, or lack of information concerning board members' qualifications and skills.
- No evidence of effective succession planning.
- Lack of disclosure on board practices, poor shareholder access to board members, or disclosure that suggests poor attendance or a lack of rigor in board deliberations.
- Poor disclosure on executive remuneration, or remuneration policies that focus on short-term performance.

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Recommended Measures:

- ***Independent directors.*** Even where there are controlling or majority shareholders, there should be enough **quality independent directors to staff key committees**, particularly the audit committee. At a minimum, this implies **at least two or three independent directors—constituting at least one-third of the board**.
- ***Succession planning.*** The company should have clear and transparent succession-planning processes to guide the selection of new executive managers. The board should establish explicit policies to prioritize professional management standards and insulate executive appointments from political interference or inappropriate influence from controlling shareholders.

- ***Remuneration.*** The company should develop a remuneration strategy—approved by independent directors—that aligns executive management with minority shareholders through a focus on long-term value creation.
- ***Best practices to enhance board effectiveness and independent oversight.*** These can include:
  - Identification of a s**pecific director contact** for investor outreach;
  - Access to **timely information flows**, including financial statements and risk-management reports;
  - **Private meetings of independent directors** without the presence of executive management and controlling shareholders;
  - An independent **board audit committee,** whose members have relevant financial experience;
  - **Disclosure of the risk-management process.** There should be clarity on how the board and executive management define and oversee management of risks, including financial, operational, and reputational risks. Relevant structures, policies, and processes should be featured in company public disclosures.

2) Business Group Affiliation

Many of the risks to shareholder value ultimately relate to concentrated ownership, which is the predominant form of ownership in most emerging market companies.[11] In many cases, controlling shareholders can be a positive influence by providing strong oversight over executive management and by fostering a corporate culture focusing on long-term value creation.

Too often, however, controlling shareholders have the opportunity to engage in abusive behavior, a circumstance that can be exacerbated in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse.

For example, the case of Satyam Computer Services in India in 2009 demonstrates how a controlling owner can perpetrate fraud and serve the owner's interests at the expense of minority shareholders. Similar examples exist in other markets. In 2008, Sibir Energy in Russia agreed to engage in property transactions to accommodate one of the company's largest shareholders. In Gome Electrical Appliances in China, the company's chairman and controlling shareholder was convicted in 2010 of manipulating the company's stock—and has attempted to control the company from prison.

[11] Bebchuk and Hamdani (2009).

Business group structures that bring together diversified businesses under the common control of a controlling shareholder add further complexity to concentrated ownership. In many countries, most firms are affiliated with a business group that is controlled by an owner through a complex web of ownership structures.

Review of Research on Business Group Affiliation

Most of the empirical studies focus on understanding the role of business groups as an internal market. Intragroup transactions involve transfer of labor, materials, goods, assets, and financial capital. These related-party transactions may be subject to conflicts of interest or may have hidden objectives, because businesses are frequently organized into groups that include a diversified portfolio of firms controlled by the same controlling shareholder.[12]

A key risk in business group affiliations is the potential for expropriation or use of a company to serve the interests of controlling shareholders rather than the company's own interests. The likelihood of expropriation increases when the controlling shareholder is a minority owner but controls the majority of the votes by corporate pyramids and cross shareholdings. Family-owned business groups (multiple firms controlled by a single family) are likely to adopt a pyramidal ownership structure. Researchers present evidence of a significant amount of tunnelling[13] that takes place in such firms.[14] Diversion of cash flow is higher in firms placed in a pyramidal structure than in firms controlled directly by families. The lower the direct ownership, the higher is the diversion. Transfers can be accomplished via loans with no or low interest or even without any expectation of repayment, via overpayment for services, or by selling a firm's assets for a fraction of its market price.

On the other hand, controlling owners may also act as a positive force and inject resources into a controlled company. There is some evidence that, in state-controlled business groups, the state can provide constructive support to firms in a way that benefits minority shareholders by preventing managerial overinvestment.[15] However, in other cases, state influences in emerging market companies can reflect government agendas that suggest limited commercial motivation or regard for the interests of minority shareholders. For example, in Chinese state-owned enterprises, the rotation of chief executives from one state-controlled firm to another (sometimes competing firms) raises questions about commercial effectiveness and succession planning.

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[12] See, for example, Kar (2010).

[13] Tunnelling is a transfer of assets and profits out of firms for the benefit of their controlling shareholders.

[14] See Bertrand, Mehta, and Mullainathan (2002); Almeida and Wolfenzon (2006); and Morck, Wolfenzon, and Yeun (2005) for ample evidence of the tunnelling propensity of controlling shareholders.

[15] Yu, Van Ees, and Lensing (2009).

Corporate governance literature indicates a consensus that business groups function primarily as tunnelling devices for their controlling shareholders, yet strategy literature argues that business groups can substitute for weak market institutions in emerging economies.[16] Business groups can effectively nurture and manage human capital through resource sharing or internal labor markets to compensate for a shortage of skilled labor, and they can leverage free cash to substitute for inefficient public capital markets. There is also some evidence that group companies perform better than stand-alone firms, based on productive capabilities, although in some countries the results indicate the reverse.[17]

A key risk in business group affiliations is the potential for expropriation or use of a company to serve the interests of the controlling shareholders rather than the company's own interests.

Investor Perspective

Many investors take an agnostic view of business group affiliations. They recognize that the presence of controlling shareholders can serve a positive or negative function, and so their influence should be assessed on a case-by-case basis. Listed below are the risks of business group affiliations, potential red flags, and possible remedies or best practices.

Key Risks:

- Controlling shareholders that pursue private benefits of control at the expense of minority shareholders or creditors.
- Mild or extreme forms of expropriation through asset transfers and self-dealing.
- Related-party transactions involving transfers of wealth on uneconomic terms that deprive minority shareholders of value. (Some related-party transactions are beneficial to both parties.)

Red Flags (Indicators):

- Opaque ownership structures.
- Mismatch between economic stake and voting rights—a system of different share classes that grants voting influence to the controlling shareholder in excess of its ownership stake.
- Weak regulatory environment for shareholder protections, compounded by a corrupt or ineffective judiciary.

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[16] See Khanna and Yafeh (2007) for an explanation of the role of business groups in allocating scarce resources and capital in the absence of effective labor and capital markets.

[17] See Mahmood and Mitchell (2004) for a discussion on innovation and business group affiliation.

Recommended Measures:

- ***Disclosures on ownership.*** Clarify the ownership structure (particularly ultimate beneficial ownership),[18] relationships with third-party affiliates, and the relationship between economic stake and voting control.
- ***Ensure that voting rights match economic ownership.*** This can include eliminating voting-rights differentials between different share classes or merging share classes following an independent valuation exercise to ensure that the rights of each class of owners are protected. Where this is not done, companies should at a minimum guarantee tag-along rights to owners of preferred or other nonvoting shares.
- ***Related-party transactions.*** Investors should insist that related-party transactions of a material nature be scrutinized and approved by independent board members, who should, in turn, ensure that they are conducted on the basis of independently vetted arms-length valuations.
- ***A relationship agreement.*** This is an arrangement whereby the controlling shareholder undertakes through a contractual agreement to promote the interests of the firm as a whole, and therefore to respect in full the rights of its minority shareholders and creditors. The terms of this form of agreement can relate to the appointment of board directors, the approval of capital transactions, areas of potential conflict where controlling shareholder-appointed directors cannot vote, and other forms of related-party transactions involving the controlling shareholder.

[18] Ultimate beneficial ownership refers to ultimate shareholders with voting rights whose ownership is disguised by institutional ownership.

Conclusion

More research is needed to better understand the many aspects of the relationship between corporate governance and firm performance in emerging markets. Published research is limited. But, because emerging market firms are generally affiliated with multiple networks connected by formal or informal ties, the structures themselves present challenges for quantification and scientific data analysis.

Recent corporate governance research has been interdisciplinary, including law and finance research as well as investigation from organizational, management, and sociology perspectives.[19] These studies reflect the importance of looking at corporate governance holistically to gain a better understanding of how drivers of "good" governance are supported or undermined by the institutional framework.

The guidance and recommendations presented in this paper must be framed within the overarching context of complexity. Firms need to engage in a more **systematic outreach to minority investors** to demonstrate how their own approach to governance addresses investor risks and concerns. Doing so could carry the benefit of reducing, or possibly eliminating, discounts that are often made on emerging market firms, reflecting both macro and micro governance concerns.

Also, institutional investors in emerging market firms should take greater responsibility for building a **sustained dialogue with the boards and executive management of the firms** they invest in. This means that investors should exhibit the patience necessary to take a long-term view and to work with firms to help them improve their governance standards—and ultimately their valuations, over time. This process of engagement has the potential to add value to firms and to investors.

Finally, the **dialogue between academia and the investment community** should improve further. This is where the Global Corporate Governance Forum has a role: supporting research on corporate governance in emerging markets and facilitating a dialogue between the scientific community and investors. The Forum is addressing this need through the Emerging Markets Corporate Governance Research Network.

[19] Aguilere et al. (2008).

Insights from the Emerging Markets Corporate Governance Research Network

To promote corporate governance in emerging markets and transition economies, the Forum supports the Emerging Markets Corporate Governance Research Network. The network's conference in Seoul, Korea, in May 2011, included the presentation of nearly 40 papers. Among the topics were "the impact of corporate governance on firm performance and economic development" and "the role of legal, economic, and political institutions in shaping corporate governance systems in emerging markets." (All of the papers are available at: http://www.gcgf.org/ifcext/cgf.nsf/Content/Korea_RN_May2011.)

Firm mechanisms to mitigate agency conflicts are key institutional investor considerations.

Researchers Joseph A. McCahery (Tilburg University), Zacharias Sautner (University of Amsterdam), and Laura T. Starks (University of Texas at Austin) surveyed institutional investors with significant portfolio holdings in two countries—the United States and The Netherlands—to learn more about how their preferences determine their investment selection. In their paper, "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors" (December 2010), the researchers report the following findings:

> [I]n the presence of weaker investor protection, firm-level corporate governance mechanisms are highly important, with the most important being mechanisms that mitigate agency conflicts between managers and shareholders (through incentives provided by executive compensation) as well as mechanisms that mitigate potential agency conflicts between large and small shareholders (through dispersed ownership structures, transparency regarding large blockholdings, and independent board structures). An important implication of these results is that firms in countries with weak legal regimes may be able to attract investors through stronger corporate governance mechanisms.
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> Finally, we find that the majority of institutional investors that responded to our survey are willing to engage in shareholder activism. Their preferred methods would be, first, to vote with their feet (i.e., simply sell the shares), second, to vote against the company at the annual meeting, and third, to engage in discussions with the firm's executives. Further, a substantial number of the investors would consider contacting the firm's directors to discuss their concerns and some would even employ the more extreme measure of taking legal action. The strength of these responses combined with the fact that only a small percentage of the investors would engage in public criticism imply that behind-the-scenes shareholder activism may be more prevalent than previously thought.

A director's social network matters in determining a firm's value—so, too, does his or her "independence" or "friendliness."

Fudan University professor Qianru (Cheryl) Qi examined how directors' interconnections influence director appointments, firm performance, and board behavior, "whether the board is the firm value maximizer or social alliance to the CEO." After reviewing the "interlock network data" of U.S. and Chinese publicly traded firms over 10 years, Qi finds that "social network connections in both countries are important in determining who gets which directorship." In her paper, "How Does The Director's Social Network Matter? Evidence from Structure Estimation" (January 31, 2011), Qi notes that the possibility of obtaining a board seat increases by 30–150 times if the director has a tie to the hiring board. She also found that "boards discount the value of directors with a large number of outside directorships, indicating a desire for effective monitors."

Connections also play a role in determining whether an "outside" director is "independent" or "friendly," the subject of a study by Seoul National University researchers Sung Wook Joh and Jin-Young Jung. The researchers examined business, professional, and social ties of directors to determine whether board independence and lack of independence affect firm value. Their paper, "Effects of Independent and Friendly Outside Directors," states: "Our main finding is that, on average, independent outsiders have positive impact on firm value while friendly outsiders have negative impact." Also, "Independent boards as monitor perform better in large firms with less-information asymmetry. However, friendly boards increase firm value more than independent boards when facing financial volatility and M&A threats. Furthermore, politically connected friendly outsiders have more positive impacts on the domestic companies. Our results suggest that the effectiveness of boards' multiple roles as monitor, advisor, and facilitator depends on their independence and corporate environments. . . . Although facing a negative response from the markets for appointing friendly directors, firms might benefit from outside directors who can be close counselors and trusted facilitators depending on corporate environments."

Corporate social responsibility alone is limited in its ability to drive reforms.

Villanova University Professor Jonathan P. Doh and lecturers Kenneth Amaeshi (University of Edinburgh) and Onyeka K. Osuji (University of Exeter) express some skepticism regarding the power of corporate social responsibility (CSR) to drive institutional change. In their paper, "Corporate Social Responsibility as a Market Governance Mechanism: Any implications for Corporate Governance in Emerging Economies?" they write that, "despite the promises of CSR, it will be dangerous to rely on it, in isolation of other complementary institutional configurations, to drive institutional change and enable a progressive society in different institutional contexts."

Firm performance could be improved by limiting family involvement.

Family firms dominate economies in emerging markets and developing countries. Researchers En-Te Chen (Queensland University of Technology), Stephen Gray (University of Queensland), and John Nowland (City University of Hong Kong) study the ways in which families are involved in firms, from ownership to board director positions to management. They find that the "form of family involvement" is a function of the firm's characteristics, with "family representatives" being more likely in acquired or second-generation family firms. In their paper, "Family Involvement and Family Firm Performance" (January 2011), they write: "[W]e find negative relationships between family directors, family managers and firm performance. No relationships are found for family ownership and family CEOs. Consistent with our expectations, we find that family member directors have a greater negative effect on firm performance than family representative directors."

Firms with greater transparency experience less liquidity volatility, particularly during market downturns.

Researchers Mark Lang and Mark Maffett (both at the University of North Carolina at Chapel Hill) used a diverse global sample to demonstrate that "firms with greater transparency, as measured by quality of accounting standards, quality of auditor, level of earnings management, analyst following and analyst forecast accuracy, are characterized by less volatility in liquidity, as well as lower correlations between firm level liquidity and stock returns. Further, more transparent firms are less likely to experience 'extreme illiquidity events,' where liquidity essentially vanishes. . . ." Their paper, "Transparency and Liquidity Uncertainty in Crisis Periods" (October 2010), goes on to say that "the effect of transparency on each of our liquidity variables is more pronounced during market downturns."

Table 1: Summary of Empirical Studies of Board Independence in Emerging Markets

Study	Country	Dependent Variables	Independent Variable (mean)	Main Results
Lefort and Urzua (2008)	Chile	Tobin's q	Proportion of independent directors (20%)	OLS and fixed effects: not significant 3 SLS: significantly positive
Liang and Li (1999)	China	Return on investment	Proportion of outside directors (25%)	Positive significant
Peng (2004)	China	ROE, SGR	Proportion of affiliated (30%) and nonaffiliated outside directors (11%)	Positive significant (affiliated outside directors on SGR)
Chen, Firth, Gao, and Rui (2006)	China	FRAUD: A dummy variable for firms subject to an enforcement action.	Proportion of outside (or nonexecutive) directors (13%)	Negative significant
Lo, Wong, and Firth (2010)	China	Gross profit ratio on related party transactions	Proportion of independent directors (34.5%)	Negative significant
Kyereboah-Coleman (2007)	Ghana, South Africa, Nigeria. and Kenya	ROA and Tobin's q	Proportion of nonexecutive directors (42%)	Positive significant (ROA) Not significant (Tobin's q)
Cheung, Rau, and Stouraitis (2006)	Hong Kong	CARs for announcements of connected transactions	Proportion of independent directors (28.6% median)	Not significant
Cheung, Connelly, Limpaphayom, and Zhou (2007)	Hong Kong	Market-to-book ratio, ROE	Number of outside directors	Not significant
Jaggi and Tsui (2007)	Hong Kong	Abnormal insider trading	Proportion of independent nonexecutive directors (16.68%)	A higher proportion of independent directors moderates the positive association between insider selling and earnings management.

Study	Country	Dependent Variables	Independent Variable (mean)	Main Results
Chen and Nowland (2010)	Hong Kong, Malaysia, Singapore, and Taiwan	ROA and Tobin's q	Proportion of independent directors (23% family firms, 34% other firms)	Concave relationship with an optimal level of board independence at 36%
Ghosh (2006)	India	ROA, ROE, the average value of ROA, ROE and ROS	Proportion of nonexecutive directors (7%)	Not significant
Ramdani and Witteloostuijn (2010)	Indonesia, Malaysia, Korea, Rep., and Thailand	ROA	Proportion of outside directors (69%)	OLS: Not significant RR: Positive significant QR: Positive significant at the median and 75th percentile
Barako (2007)	Kenya	The level of voluntary disclosure	Proportion of nonexecutive directors (>50%)	Negative significant
Choi and Hasan (2005)	Korea, Rep.	ROA, ROE, Profit efficiency, Risk measures	Proportion of outside directors (50%)	Not significant
Black, Jang, and Kim (2006)	Korea, Rep.	Tobin's q and profitability	Dummy variable indicating whether firms have 50% or more outside directors	Positive significant
Choi, Park, and Yoo (2007)	Korea, Rep.	Tobin's q	Proportion of outside directors (31.2%) Proportion of independent directors (21.3%)	Not significant Positive significant
Cho and Kim (2007)	Korea, Rep.	ROA	Proportion of outside directors (46.2%)	Positive significant
Kim (2007)	Korea, Rep.	Tobin's q	Proportion of outside directors (26%)	Not significant

Study	Country	Dependent Variables	Independent Variable (mean)	Main Results
Black and Kim (2007)	Korea, Rep.	Cumulative market-adjusted returns and Tobin's q	Board independence index based on the existence of 50% or more outside directors	Positive significant
Mak and Kusnadi (2005)	Malaysia and Singapore	Tobin's q	Proportion of independent directors (34%)	Not significant
Filatotchev, Lien, and Piesse (2005)	Taiwan	ROA, ROCE, EPS, STIC	Dummy variable: Independent board chairman (23%)	Not significant Negative significant (STIC)
Kaymak and Bektas (2008)	Turkey	ROA and asset growth	Proportion of outside directors (69%)	Negative significant (ROA) Not significant (asset growth)
Ararat and Yurtoglu (2011)	Turkey	Tobin's q, ROA	Fraction of independent directors (7%)	Negative significant
Dahya, Dimitrov, and McConnell (2008)	22 countries, including 7 emerging markets	Tobin's q	Proportion of outside directors (69%)	Positive significant

CAR (Cumulative Abnormal Returns)EPS (Earnings Per Share)
OLS (Ordinary Least Squares)
QR (Quintile Regression))
ROA (Return On Assets)
ROCE (Return On Capital Employed)
ROE (Return On Equity)
ROS (Return On Sales)
RR (Ridge Regression)
SGR (Sales Growth Rate)
SLS (Savings and Loan Societies)
STIC (Sales-To-Issued-Capital ratio)
Tobin's q (the ratio between the market value and replacement value of the total assets)

Source: Ararat, Orbay, and Yurtoglu (2011).

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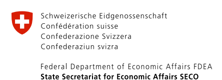

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