

# The Influence of Institutional Investors on Firm Value

By

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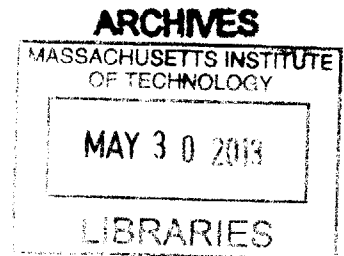
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## **ABSTRACT**

The impact of corporate governance on firm value has been extensively debated by academics and business practitioners. Some studies show that companies that allow minority shareholders to have more control are likely to create greater shareholder value than those firms with concentrated control, while other studies suggest that the impact of having democratic governance is either negligible or even negative. In developed countries institutional investors have a significant stake in most of the companies. Active engagement by institutional investors is expected to decrease agency costs by strengthening monitoring mechanisms of operations and performance evaluations of the management, resulting in an increase in firm value. However, some academics and business practitioners argue that such minority shareholders' active engagement could be detrimental to firm value. In this thesis, I study the influence of institutional investors' active shareholder engagement on firm value and the relationship between the characteristics of corporate governance and firm value of target companies. I review previous studies that have evaluated both the effect of corporate governance and of institutional investors' activism on firm value. I conduct empirical analyses to examine the relationship between the institutions' shareholder engagement and firm value.

**Thesis Supervisor:** David McLean

**Title:** Visiting Associate Professor of Finance



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Yong Seung Lee



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## Chapter I: Introduction

### A. Introduction

Currently, institutional investors constitute a significant proportion of ownership in corporations in developed countries. Theodore Auzens (1998) states that with 2 to 3% of ownership, an active investor can exercise significant influence over an organization.

It has been argued by some academics that minority investors' engagement increases firm value, since minority shareholders' involvement can reduce costs associated with the agency problem (Agency cost). They point out that corporate governance is the mechanism that allows minority shareholders to exercise their influence over the firm's operation. They say that a firm with characteristics of corporate governance that allows minority shareholders to have more control is likely to create more firm value than other firms.

However, other prior studies suggest different views about the relationship between the characteristics of corporate governance and firm value. Some say that institutional investors' active engagement effort strengthens monitoring of firm operation and hence disciplines the management. On the other hand, others claim that active shareholder engagement by institutional investors is either detrimental to firm value or has only negligible impact.

This debate comes down to two questions: what type of corporate governance allows firms to maximize firm value? Can institutional investors' active exercise of voting rights lead to an increase in firm value by affecting corporate governance of these companies?

### B. Corporate Governance on Firm Value

Different studies provide alternate conclusions regarding the influence of corporate governance on firm value. Gompers, Ishii, and Metrick (2003) state that companies with democratic corporate governance are likely to have greater firm value, while Gillian and Starks (2000) say that such a correlation is negligible. I review previous studies on corporate governance to assess the underlying ideas behind these arguments and summarize their empirical findings.

### C. The Influence of Institutional Investors on Firm Value

There has also been disagreement on the issue of the influence of institutional investors on firm value. According to Aggarwal, Erel, Ferreira, and Matos (2010), institutional ownership positively affects the functioning of target corporations, resulting in the improvement of corporate governance. However, Karpoff, Malatesta, and Walkling (1996) say that there is no conclusive evidence that supports such a positive correlation between the two.

### D. Empirical Study

I explore these questions empirically. Most prior empirical studies tend to focus on US corporations. I analyze the relationships globally using Thomson Reuter's ASSET4 database that provides the Corporate Governance Scores of 4,109 listed companies in almost 60 countries. (US firms 25~30%, Non-US firms 75~70%)

I examine the relationship between the institutional ownership and corporate governance through regression analyses. My study also includes multivariate analyses on the influence of corporate governance on firm value.

My empirical tests suggest the following: there is a positive and significant relationship between institutional investor ownership and high Corporate Governance Score. Also, there is positive and significant correlation between the Corporate Governance Score and firm value.

## Chapter II: Review of Previous Research

### A. Corporate Governance

#### 1. Separation of Ownership and Control

Governance stems from the Greek verb *κυβερνάω*, a term that means to steer. This term has been interpreted as sets of activities that define the directions and establish the objectives. Management is derived from the Italian verb *maneggiare*. Management is a process to select the means to proceed in the direction and to achieve the goals using the resources available within an organization.

In the past, owners of corporations ran their organization by themselves. However, the increasing demands for specialization in management and risk taking have led firms to separate ownership and control. As a result, in majority of the listed corporations in developed countries ownership and control are separate. Instead of owners, managers, including chief executive officers, exercise direct control over the day to day operations.

This separation of ownership and management leads to dispersion of ownership. It has been argued that with the concept of limited liability, the separation of ownership and management has driven capitalism to prosper as it provides companies an easier access to capital. However, this separation often leads potential conflicts of interest within the business organizations.

#### 2. Fiduciary Duty

Under the business laws of most countries, corporate managers have a fiduciary duty to the all of the shareholders. Fiduciary refers to a legal or ethical relationship of trust between two or more parties. Often the term is used to describe a person appointed and authorized to hold assets in trust for another person. The fiduciary manages the assets for the benefit of the other person rather than his or her own profit. Different shareholders might have different investment objectives. Nevertheless, regardless of their financial circumstances, most asset owners would like to be better off rather than worse off. Therefore, fiduciary duty is usually interpreted as managers' duty to maximize the owners' wealth. However, it has been often observed that managers pursue their own self-interest at the expense of shareholders.

#### 3. Conflict of Interest

In *The Wealth of Nations*, Smith (1776) states, "being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."(330)

Fama and Jensen (1983) also warn that without effective control procedures, managers are more likely to take actions that deviate from the interest of residual claimants. (5)

What induces managers to attempt to derive private benefits at the expense of asset owners is information asymmetry. According to agency theory, usually the insiders of the corporations including the managers have more access to information than the outsiders including the shareholders. Therefore, it

is often possible for the managers to prioritize their private benefits over that of their clients without being caught or interrupted.

Managers can exploit information asymmetry by not taking risky investment projects to secure their position (Avoiding Risk), or taking up unprofitable projects to increase their compensation and reputation within industries (Empire building), allocating resources within the subsidiaries to benefit themselves (Tunneling and Propping, Friedman, Johnson, and Mitton, 2003), or engaging in deals to self-benefit deals (Self-dealing, Djankov et al., 2008). These are often described as typical agency problems. (Brealey, Myers, Allen, 291)<sup>1</sup> In the US, agency problem refers to the conflict between shareholders and the management. Outside the US, it refers to the conflict between controlling shareholders, usually the founding families who are also the managers of the corporations, and minority shareholders.<sup>2</sup>

#### 4. Corporate Governance

These agency problems have led modern firms to establish a system of control, called corporate governance. Corporate governance is defined as the legal and regulatory mechanisms that set management objectives in a corporation and monitor and evaluate managers. The purpose of corporate governance is to achieve the corporate objectives and ensure accountability, fairness, and transparency in the company's relationship with all its stakeholders by overseeing corporate management. The parties involved in corporations include shareholders, creditors, suppliers, customers, communities, board of directors, executives, and other employees.

In a typical corporation, shareholders, in lieu of direct participation, elect a board of directors to represent them in various corporate affairs. The board of directors makes rules on how the corporations should be run, sets policy, evaluates the performance of the management, and hires new managers. According to Berk and Demarzo, however, the board of directors delegate most decisions to corporate management including day-to day operation. (922)

#### 5. Corporate Governance in Practice

The country's legal environment plays an important role in corporate governance practice. La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1997) state that the legal rules to protect investors and the quality of legal enforcement differ systematically across countries, producing vast differences in the nature and effectiveness of financial systems around the globe. (33) They further outline that the common law system provides more minority shareholder protection than the civil law system. For instance, countries in the common law environment, including the US and the UK, allow more controls to minority

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<sup>1</sup> Brealey, Myers, and Allen summarize the typical characteristics as following:

- Reduced effort: Managers intentionally avoid high-effort, high-pressure positive NPV projects.
- Perk: Managers take private benefits on a non-financial format.
- Empire building: Managers take unprofitable projects in order to increase their influence and enjoy the prestige of running a large organization.
- Entrenching investment: Managers take projects that can reward the skills of existing managers.
- Avoiding risk: Managers do not take positive NPV projects to avoid the risk of losing jobs.

<sup>2</sup> According to La Porta, Lopez-De-Silanes, and Shleifer (1999) and Anderson and Reed (2003), a large fraction of the companies around the world are family controlled. Family-controlled firms include not only privately held firms but also publicly held firms: 65% of the 20 largest firms in Argentina, 70% of the 20 largest companies in Hong Kong (La Porta et al.), and 35% of S&P500 companies in the US (Anderson and Reed, 1302).

shareholders than those countries in the civil law regime, like France, Germany, and Scandinavian countries, do. (6)

Fama and Jensen (1983) point out that the stock market provides a monitoring mechanism to organizations. They claim that stock prices provide signals that summarize the implications of internal decisions regarding the profitability of the corporations. Hence, an active stock market forces managers to run the corporations on behalf of their shareholders. (16)

An active takeover market also affects corporate governance practices. (Fama and Jensen, 16) When a company is poorly managed, often a third party takeover provides final remedy; it replaces incompetent managers and re-structures the firm so that the company becomes more efficient. The possibility of takeover disciplines the board of directors and managers to work toward the best interest shareholders, as well as provides more room for the minority shareholders to exercise their voting rights on corporate affairs.

Each country's corporate governance regime reflects that nation's political, social, institutional, cultural, and economical environment. Referring to the prevalence of family control in Korea, Kang (2005) points out that a company's corporate governance results from the business entity's market adaptation to each country's unique environment. (35) He states that in order for companies in developing countries to conform to US and UK style of corporate governance (Democratic Governance), the preconditions have to exist – a perfect privatization of financial industry, a flexible labor market, a developed capital market, a better credit scoring system, an improvement in transparency in overall business practice, and a removal of the barriers to exit from business. (36)

In the US corporate managers tend to focus on shareholder maximization. However, outside US, especially in Japan, managers are expected to serve the interests of all stakeholders, such as the government, employees, suppliers and consumers, as well the shareholders.<sup>3</sup> However, regardless of the location or culture, corporate governance system exists to mitigate the conflicts of interest among different stakeholders.

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<sup>3</sup> A majority of respondents in US and UK believe that corporations should focus on maximizing shareholders' best interest. On the other hand, in Japan and European countries, many people believe that corporations' primary objective is not maximizing the share value. According to a survey by East Economics Magazine (1995), in US and UK 75.8% and 70.5% of participants respectively responded that corporations should prioritize the shareholders' interest over those of other stakeholders, while 97% of participants in Japan (82% in Germany and 78% in France) responded that corporations should serve all stakeholders' interests. Responding to the question as to what is more important between the objectives of paying dividends and providing job security to employees, 89.2% of survey participants in the US and 89.3% in the UK said that paying dividends is more important. In the same survey, 97.1% of survey participants in Japan, 59.1% in Germany, and 60.4% in France responded that providing job security is more important. (Hwang et al. 1999. (39).)

## B. Corporate Democracy vs. Corporate Dictatorship

### 1. The Debate

Kang (2005) notes that when a founding family runs a corporation, their participation allows the firm to reduce agency costs since the controlling family, as insiders, can monitor and evaluate the management performance better than outsiders. He points out that the reduction of agency costs enables these firms to increase firm value more than other firms in the industry. (22) However, this argument overlooks the possibility that all shareholders' interests are not perfectly aligned. For instance, for some controlling shareholders to maintain corporate control is more important than to make additional capital gains from their investments because as long as they have corporate control, they can use the company's resources to benefit themselves.

La Porta, et al. (2000) state that when investor rights, including those of minority investors, are poorly protected, corporate insiders gain opportunities to expropriate efficiently. (13) In many family controlled corporations in developing countries, it is often observed that the founding families maximize their utilities through tunneling capital and resources away from minority shareholders.

Bertrand and Schoar point out that corporate empire building, a typical phenomenon of the concentrated ownership structure, impedes economic development within nations where these corporations reside. (74) Morck, Strangeland, and Yeung (2000) observe that if poorly managed firms survive, this can create barriers to the entry of new firms. (41) Referring to Schumpeter's "Capitalism, Social and Democracy (1942)," Fogel, Morck, Yeung (2008) argue that if few firms dominate a country's economy, this deters *creative destruction*, a process that stimulates the economy when upstart innovative firms replace old and inefficient companies. (25)

According to La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1997), if a country's legal environment is unfavorable, this discourages minority investors from participating in the financial market, leaving the capital market inefficient and making it difficult for innovative firms to grow. (1149) Brown, Martinson, and Petersen (2011) note that the presence of an efficient equity market is important for firms to grow businesses since the nature of most companies' R&D often does not allow firms to use debt financing to raise capital. (1)

Some academics suggest that weak corporate governance can increase macro risk in a region's economy. Johnson, Boone, Breach, and Friedman (1999) contend that weak corporate governance had an important negative effect such as radical currency depreciation and stock market declines during the Asian financial crisis of 1997. (11)

Despite these negative economic externalities, some academics and business practitioners argue that concentrated corporate governance leads to economic outperformance in the long run, for the following reasons:

First, companies under concentrated control allow managers to make prompt business decisions as under concentrated ownership control important business decisions are usually made at the discretion of a few controlling shareholders. For instance, in certain capital intensive manufacturing industries where price competition is severe, making timely decision to scale facilities ahead of competitors is important because the first mover advantage can secure economies of scale in production. Dictatorship corporate governance, a corporate governance style in which the firm is solely controlled by only a few

shareholders, allows the firm management to make important decisions without lengthy negotiations to convince the board and the minority shareholders.<sup>4</sup>

Second, some say that the concentrated ownership control enables management to embrace long-term business strategies. People who criticize investors' short-termism claim that if investors care only about receiving dividends and short-term capital gains, corporations might not have enough capital to invest for long term projects, like investment in research and development. When a company is controlled by shareholders whose primary focus is not to make capital gains and consequently do not push their managers to increase short term profits, the managers can make long term investment decisions without worrying too much about short-term repercussions. They claim that companies under concentrated control tend to make long term business relationships with various parties, creating intangibles that increase firm value.

Third, some claim that if a corporation is controlled by a few shareholders who have more knowledge and experience in the firm's business and culture, their expertise will allow the company to prosper in the long run. This idea provides the basis for some technology companies, such as Google and LinkedIn, to establish a dual class share structure, a structure that allows a group of a certain type of security holders, usually founding members who are expected to know more about the culture and business of these companies, to exercise more voting power than the owners of other types of shares. Outside the US, this knowledge and culture argument is deployed by advocates of concentrated control to enhance founding family's management control. Those in favor of family control argue that since family members grew up listening to business affairs, they are more knowledgeable than outsiders about business affairs, thus making them the most competent leaders of their organizations.<sup>5</sup>

Fourth, concentrated ownership control enables corporations to easily diversify business and maintain market position for longer periods. Kang (2005) observes that building an empire is one of most important growth strategies for corporations. (21) For instance, some well-known Asian conglomerates have maintained their competitiveness by tunneling the extra resources of cash cows to subsidize businesses in growing industries.

Some even argue that diversification allows corporations to weather fluctuations in economic cycles, helping them stay in business for longer periods. According to Modigliani-Miller, investors can diversify their risks on their own and hence they do not have to worry about idiosyncratic risks including default risk of a corporation they invest in. However, in societies that encourage business people to improve overall social welfare, corporate managers are expected to serve various stakeholders' interests and carry an implicit obligation to help the firms to stay in business. Their goal is to preserve jobs in the economy and to minimize the negative economic and social impacts related to defaults.<sup>6</sup>

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<sup>4</sup> At the media conference held in Berlin in 2010, Choi, Ji Sung, the CEO of Samsung Electronics said, "The most important task within a firm is to determine large capital investments and to decide the size and the timing of such investments. Only the owner can make such a decision that a CEO cannot see. The performance gap between corporations under an owner's management control and without it is huge." [IFA 2010] Choi, Ji Sung, CEO of Samsung Electronics, interviewed by Han, Joo Yeup. "Recovery of Ownership in Management Leadership – Next Year Investment to be 30 trillion Korean Won." 5 Sep 2010. *Digital Daily*. Web. 31March 2013.

<sup>5</sup> Bellow (2003) refers to the Rothschild family as an example.

<sup>6</sup> In some countries, government subsidizes domestic businesses to grow the nations' economies. They use tax payers' money either to provide direct funding or to guarantee. When a country privatizes government owned corporations that monopolized certain industries, in return for selling those firms to local firms at a cheap price, the governments implicitly ask the firms to provide more economic or social contributions to the nation. Furthermore, some developing countries intentionally depreciate their currencies to support exporters' business.

Finally, Bertrand and Schoar note that in countries with high level of corruption, political connections provide large benefits for private firms. According to them, companies with concentrated ownership control, especially family controlled companies, are well positioned to take government contracts, subsidized credit, or favorable legislation, utilizing their extensive kinship networks that stretch across the political and business realms. (77)

## 2. Review of Empirical Studies on Corporate Governance

### 2. a. Democratic Governance Performs Better

What is the relationship between corporate governance and firm value? Different academic studies give different answers to this question.

Gompers, Ishii, and Metrick (2003) (hereafter GIM) found that during the 1990s firms with stronger minority shareholder protections tended to perform better and increase firm value more than comparable firms with weaker minority shareholder protections. Deriving data from Investor Responsibility Research Center, GIM construct proprietary governance index with 24 characteristics related to shareholder rights. They name the companies whose score within the highest decile of the index as “Dictatorship Portfolio” and the lowest decile of the index as “Democracy Portfolio.” (109)

GIM ran regressions to find correlations with the governance index and firm value represented by industry adjusted Tobin’s Q. The coefficients of the governance variable are negative every year and significantly negative in nine of ten years during the 1990s. This implies that governance allowing more shareholders’ rights is positively correlated with greater firm value. Based on this empirical test, GIM conclude that companies with the stronger shareholder protection outperformed firms with weaker shareholder protection in terms of firm value generation. Lawellen and Metrick (2010) re-examine GIM’s study and confirm that corporations with stronger shareholder rights are likely to make significant positive industry adjusted abnormal returns. (34)

Bebchuk, Cohen, and Wang (hereafter CBW) (2012) study the relationship between governance and abnormal stock return using GIM’s methodology with samples from 2000 and 2008. They find that the governance-return correlation disappeared in 2000 because of market participants’ learning to appreciate the difference between well-governed and poorly governed firms. (35) CBW note that having witnessed large scale corporate scandals, such as those of Enron and WorldCom in early 2000, investors realized the importance of corporate governance and have responded accordingly. Since the different qualities of firms’ corporate governance have already been incorporated in the share prices and price adjustment occurred only once, it is impossible for companies under democratic governance to continuously outperform those under dictatorship governance.

### 2. b. Negative or Neutral

After examining GIM’s study, Bauer, Koedijk, and Otten (2002) point out that what seems to be a positive correlation actually results from bias, such as industry and small cap. vs. large cap. Their research suggests that in contrast to GIM’s argument, the impact could be negligible.

Anderson and Reeb (2003) examine the relationship between the family ownership, which does not allow minority shareholders to participate in firms’ affairs, and firm performance, using S&P500 samples. They conduct regression analysis to examine the relationship between the fractional equity of the firm’s founding family and the firm value represented by Tobin’s Q. Their research shows that family companies tend to have significantly higher Tobin’s Q than nonfamily controlled comparables. (1314)



Johnson, Moorman & Sorescu (2009) (hereafter JMS) criticize GIM's study advocating positive correlation with democratic governance and firm value for using too broadly defined industry classification. (GIM use FF 48 classification standard). JMS use three-digit Standard Industrial Classification (SIC) and find that abnormal returns shown on the GIM governance portfolio were due to the different characteristics of corporate governance and were in fact close to zero. JMS claim that the abnormal returns reported by GIM were due to an artifact of industry clustering or an imprecise asset pricing model. (6)

Analyzing Korea's listed companies' financial performance between 2001 and 2003, Kang (2005) argues that corporations under dictatorship governance in conglomerates empirically perform better in terms of performance measured by Return-on-Asset, Net Operating Income, and Stock Returns. (30) However, I find this study is not universally applicable, since the results reflect a unique characteristics of the regional economy in which large conglomerates dominate most of industries.

There is an on-going debate among researchers on the correlation of style of corporate governance and firm value. Many agree that the result is still inconclusive.

### C. The Influence of Institutional Investors on Firm Value

#### 1. Definition and Role

Institutional investors are organizations which pool large sums of money and invest these sums in securities, real properties, and other investment assets. Types of typical investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds. Like corporate managers who have fiduciary duty to shareholders of corporations, institutional investors have fiduciary duty to maximize the wealth of the asset owners.

Table 1: Types of Institutional Investors<sup>7</sup>

<b>Types of Institutional Investor</b>	<b>Description</b>	<b>Asset Under Management (2010)<sup>8</sup> (In trillions USD)</b>
Pension Funds	Any plan, fund, or scheme that provides retirement income	25.8
Bank	Financial intermediaries involved in taking deposits and lending money	96.4 <sup>9</sup>
Insurance Company	Provides financial protections in return for premium.	18.0
Mutual Funds	A type of collective investment vehicle that pools money from many investors to purchase securities	24.0
Foundation	Grant making institutions funded by gift and investment assets	N/A
Endowment	Long-term funds owned by operating non-profit institutions such as universities, hospitals, museums, and other organizations involved in charitable activities	2.4
Hedge Funds / Private Equity	Actively managed private investment funds, subject to few regulatory restrictions	2.2
Sovereign Wealth fund	State-owned investment fund composed of financial assets	1.5

<sup>7</sup> "Institutional Investment." *Wikipedia*. The Free Encyclopedia. Wikimedia Foundation, Inc. 22 July 2004. Web. 23 March 2013

<sup>8</sup> International Monetary Fund, "Global Financial Stability Report." September 2011

<sup>9</sup> TheCityUK. "Banking 2010." Chart 7-8. *IFSL Research*. 3-4.

## 2. Development of Institutional Investors' Activism

When investors are not satisfied with the corporations they have invested in, they can sell their stocks and leave. This is the so-called Wall-Street-walk. Gillian and Starks (2007) state that this can have disciplinary effects on companies.

In 1980s and early 1990s, institutional investors' equity ownership increased rapidly. According to Sias and Starks, large institutions' ownership of the securities listed in the New York Stock Exchange (NYSE) increased from 24% in 1980 to almost 44% in 1994, due to the growth of pension funds. (2877) Gillian and Stark note that institutional investors held only 10% of US equities in 1953 but that their ownership exceeded 60% by the end of 2005. (278)

But, this increase in ownership makes it difficult for the institutional investors to liquidate their shares when they are not satisfied with the management performance of the companies because their unloading could bring a significant impact on the share price. In other words, when institutions' stake increases, the costs of liquidation also increases. (278)

The cost concern led institutional investors to actively engage in the target companies' affairs to increase the value of their investments.<sup>10</sup> As of now, many institutional investors already have exercised significant influence on the firms in which they have invested.

Gillian and Starks say that the main motivation for shareholder activism was to increase the shareholder value. They point out that when investors are not satisfied with managers' performance in terms of creating shareholder value, the investors exercise their voting rights to increase firm value. Such an engagement is thought to be effective in dealing with agency problems. (276) For instance, when minority investors, including institutional investors, are not satisfied with performance of a management, they can replace the management to increase firm value by electing board members who would respect their interests.

In 1986 and 1987, large public pension funds began actively exercising their voting rights to submit shareholder proposals. According to Gillian and Starks, most of those proposals were to repeal anti-takeover amendments, to adopt cumulative voting, or to enhance board independence. (284)

In the mid-1980s, the Department of Labor issued an opinion that parties managing assets in ERISA-governed pension plans have the fiduciary duty not only to vote all of their portfolio shares but also to do so in accordance with a "Prudent Man Standards."<sup>11</sup> (Nathan and Mehta, 1) The Security and Exchange Commission (SEC) Division of Investment Management also issued a similar ruling that investment advisors have obligation to vote all shares in the managed portfolios in accordance with duty of loyalty and duty of care. (Nathan and Mehta, 5)

In 2003, the SEC began requiring mutual funds to disclose their proxy voting policies and voting records on form N-PX. In 2009 alone, there were 20,000 proxy proposals at Russell 3000 companies, and institutional investors cast more than 3.9 million individual votes on those proposals. (Bew and Fields, 5) As a result of these changes, institutional investors have become more active at achieving their objectives through their exercise of voting rights.

Despite this development, many find that institutional investors' active shareholder engagement is insufficient. This is partially due to the costs associated with oversights and engagement. For instance,

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<sup>10</sup> O'Neill and Swisher (2003) find that insider trading is less correlated with large institutional investor ownership.

<sup>11</sup> ERISA requires fiduciaries to act prudently, solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable plan expenses. "Section 404(a)" ERISA.

managers of mutual funds that invest in stocks of a thousand companies might find it difficult to attend all the shareholder meetings and would have little time to review all the proposals.

Since most Institutional Investors do not have sufficient resources to analyze proxy proposals, they tend to rely on outside proxy advisory firms. Proxy advisors provide institutional investors advice on governance issues, guidelines, and recommendations on specific ballot issues, and voting platform services. Currently in the US two advisory firms dominate the market: ISS and Glass, Lewis & Co. In most cases, institutional investors follow the advisory firm's recommendations. According to Bew and Field, researchers agree that the voting outcomes of institutional investors, especially mutual funds, are more closely aligned with proxy advisors' recommendations than those recommended by managers. (8)

Some investors set their own guidelines and have exercised voting rights accordingly. In the US, California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF) are renowned for their active shareholder engagement using their proprietary guidelines.

Brav, Jiang, and Kim (2009) point out that there are stronger financial incentives for hedge funds to actively exercise their voting rights. For hedge funds, revenues are based on performance fees, and hedge fund managers put significant proportion of their private money in the funds they manage. Hedge funds are relatively less regulated and are not subject to Employment Retirement Income Security Act of 1974 (ERISA), a mandate that stipulates asset managers' fiduciary duty to clients. (2) Unlike mutual funds, hedge funds are not required to diversify their holdings. Therefore, hedge fund managers can easily accumulate large stakes in target companies. Moreover, hedge funds usually do not have other business relationships with the companies they invest in. Finally, most hedge funds have 'lock-up' provisions that prevent investors from taking capital out of the funds. These enable certain hedge funds to take a long term position and to pursue activist investing mandate. (3)

According to OECD and IFC, outside US, institutional investors' active engagement has often fallen short of the potential. In 2004 revision of *the OECD Principles of Corporate Governance*, OECD recommends institutional investors to be more actively involved in corporate affairs to improve corporate governance of target companies.

### 3. Concerns on Institutional Investor Activism

Nevertheless, some argue that institutional investors' active engagement could destroy firm value.

First, the people who believe concentrated governance allows firms to prosper say that institutional investors are only interested in their short term return on investment. Therefore, their active involvement in corporate decisions ultimately forces the management to focus on improving short term profitability at the expense of long term growth potential. Instead of investing capital for future growth, they argue, those companies under diversified control tend to focus on cost cutting and redistribution of capital to investors, undermining their long term growth prospects.

A second argument is that institutional investors usually do not have the expertise to maximize firm value. Therefore, investors' active engagement negatively affects firm value maximization. Usually company managers have more knowledge than financial investors. It has been argued that the decisions suggested by financial investors are not likely to be the optimal strategy for shareholder maximization in the long run.

A third argument is that not all institutional investors' objectives are on firm value maximization. For instance, socially responsible investing includes investment objectives other than shareholder

maximization, they argue that if those investors have more say about the firms' operations, it would make it more difficult for the managers to implement value maximizing strategies that might create socially undesirable externality.

#### 4. Review of Empirical Studies on Institutional Investor's Activism on Firm Value

##### 4. a. Positive:

Anson, White, and Ho (2005) assess the impact of CalPERS (California Public Employees' Retirement System), an active institutional investor, on firm value. They examine the performance and shareholder values of companies on the CalPERS "Focus List" – a list of public companies with poor corporate governance principles and poor financial performance. (102)

Anson, White, and Ho's event study of the inclusion in Focus List shows that companies on the list provided more returns to shareholder after CalPERS made investment than those comparable firms not on the list over 1992-2001 period. The wealth effect was greater for those firms with larger market capital, diverse shareholder base, more analyst coverage, and firms previously identified as bad performers in the stock market. (111)

Aggarwal, Erel, Ferreira, and Matos (hereafter AEFM, 2010) examine the effect of institutional investor's active shareholder engagement in 23 countries between 2003 and 2008. AEFM's study focuses on 5,000 US companies and 2,000 non-US companies. Utilizing 41 governance attributes derived from RiskMetrics, they construct a governance index. This governance index incorporates measure of board structure, anti-takeover provisions, auditor selections, and compensation and ownership structure. They first examine how institutional investors' share ownership affects this governance index. (3)

AEFM's empirical study indicates that there is a positive relationship between the institutional investor ownership, especially for foreign institutional investors, and democratic corporate governance practices around the world. AEFM further examine the causal relationship between the institutions' ownership and corporate governance. They discovered that institutional investor ownership leads to change in corporate governance, not vice versa.

Through regression analyses, AEFM discover that institutional investors without any business relationship with target companies are likely to bring more positive impact on the corporate governance of the target companies than those institutions with pre-existing relationship.<sup>12</sup> Also in a legal environment, where shareholder protection is not strong, foreign institutional investors from countries with stronger legal protection bring positive influence on governance than domestic institutional investors. Regarding causality, they find ownership of institutional investors, especially foreign investors, leads to change in governance, not vice versa. (32)

AEFM further investigate whether institutional ownership makes a difference in terms of firm valuation. AEFM replicate the results in Ferreira and Matos (2008) with non-US companies for the period 2003 to 2008. They find that the correlation coefficients between institutional investor ownership and

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<sup>12</sup> AEFM recognize that the different economic, social, and political environment of different countries affects corporate governance practices. According to them, compared to foreign institutions, domestic institutions are likely to have more business relationship with corporations which they are investing in. This encourages domestic institutions to be loyal to the management of the target companies. The degree of legal protection for investors also makes a difference. They find that in countries where investors' rights are not well protected, the domestic investors' influence over corporate governance is limited.

Tobin's Q are both positive for domestic and foreign investors. The correlation is especially significant for the foreign institutions. Through regression analysis with variables in different time frames, AEFM conclude that institutional investor ownership brings positive impact on firm value and the impact is significant for the changes in foreign institutional investor's ownership. (33)

4. b. Negative or Negligible:

Karpoff, Malatesta, and Walkling (1996) use Investor Responsibility Research Center's data (IRRC data) on corporate governance proposals during 1987 and 1990 proxy seasons to study the impact. They discover that there is not sufficient empirical evidence to indicate a positive relationship between the proposals initiated by shareholders and the stock return. (29)

Gillian and Starks (2000) examine the shareholder activism by analyzing 2,042 corporate governance proposals between 1987 and 1994, utilizing the IRRC data. (7) Gillian and Starks investigate the share price appreciation over 150-day period and the 8-day period before and after the proposal mailing date. From this empirical study, Gillian and Starks conclude that there is an insignificant negative correlation between the shareholders' proposals and the stock return in general. (29)

Gillian and Starks acknowledge that there may be a large information effect regarding institutional investor's proposal. Since the institutional investors usually attempt to privately negotiate their proposals with the companies' managers before they officially submit the proposals, the public announcement of such proposals could only signal the market of the managers' unwillingness to accommodate the investor's requests. (6)

Analyzing S&P500 companies, Anderson and Reed (2003) find that firm value is negatively correlated with unaffiliated blockholdings. (1321) Instead of institutional investors' blockholdings, they discover that founding family's stakes are significantly positively associated with greater firm value. (1324)

Bebchuk, Cohen, and Wang claim that even if there were significant positive correlation in the past, as time goes by, it is not likely that such a correlation remains effective. The researchers repeat GIM's study of 1990s for 2000 and 2008. They find that unlike the previous study, investing in corporations with democratic governance does not help investors realize more profitable investment.

## Chapter III: Empirical Study

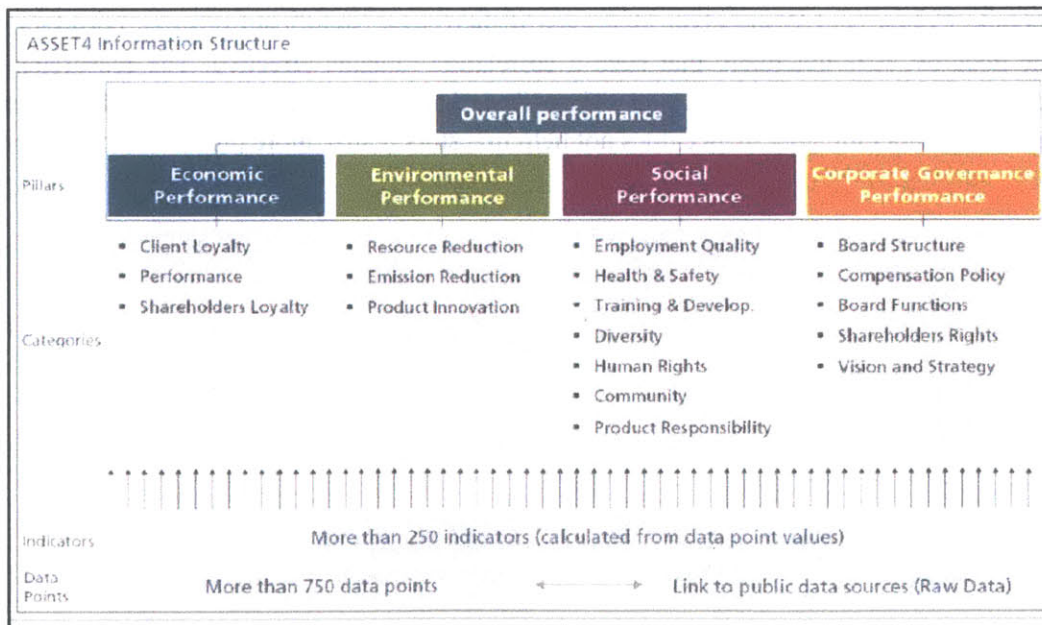
### A. Data Description

As indicated in the previous chapter, with regard to the correlations between corporate governance and firm value, as well as the relationship between the institutional ownership and firm value, various studies provide different results dependent on the data and the methodologies that the researchers adopt. In order to assess overall influence of institutional investors around the globe, it would be necessary to analyze a data sample that is composed of companies incorporated in various countries and to employ a methodology that provides more reasonable measure of the influence of institutional investors.

Thomson Reuters releases Corporate Governance Score of corporations through the ASSET4 database. The ASSET4 Database is composed of over 4,100 listed companies in major global indices. The ASSET4 Database has been widely used by professional investors to define socially responsible investment strategies. The data include Environmental, Social, and Government scores of global companies that are included in MSCI World, MSCI Europe, STOXX 600, NASDAQ 100, Russell 1000, S&P 500, FTSE 100, ASX 300 and MSCI Emerging Market Indices.<sup>13</sup>

According to Thomson Reuters, this integrated ESG score is based on over 280 key performance indicators (KPIs) and over 750 data points per company. According to Thomson Reuters, over 120 analysts collect only publicly available information. These analysts gather raw data from SEC filings, annual reports and corporate sustainability reports, non-governmental organization websites, and news sources.

Table 2: ASSET4 Information Structure



THOMSON REUTERS. "ASSET4 ESG SCORES ON CREDIVIEWS"

<sup>13</sup> Founded in 2003, ASSET4 has collected data since the fiscal year 2002. ASSET4 was acquired by Thomson Reuters in 2009. Over 120 analysts collect data and score corporations on economic, social, environmental, and corporate governance dimensions. (There were data from 4,109 companies available as of March 25, 2013.)

In this thesis, I use ASSET4's Corporate Governance Score as a proxy for corporate governance. The Corporate Governance Score incorporates board structure, compensation policy, board functions, shareholders rights, vision and strategies and give a higher score for those firms that provide more control rights to minority shareholders.

Table 3: ASSET4 Environmental, Social and Corporate Governance Key Index<sup>14</sup>

<b>Corporate Governance Pillar Score</b>
<b>Board Structure</b>
Board Structure/Policy
Experience / Average years serving on Board
% Non-Executive Board Members
% Independent Board Members
CEO-Chairman Separation
Background and Skills
Size of Board (Number of Board Members)
Board Diversity
<b>Board Function</b>
% Audit Committee Independence
% Audit Committee Management Independence
Audit Committee Expertise
% Compensation Committee Independence
% Compensation Committee Management Independence
% Nomination Committee Independence
% Nomination Committee Management Independence
Number of Board Meeting
% Board Meeting Attendance Average
<b>Compensation Policy</b>
Compensation Policy
Highest Remuneration Package
Total Board Member Compensation
Stock Option Program
Senior Executive Long-term Compensation incentives
Vesting of Stock Options/Restricted Stock
<b>Shareholder Rights</b>
Shareholder Rights/Policy
Voting Rights
Ownership
Classified Board Structure
Staggered Board Structure
<b>Vision &amp; Strategy</b>
Integrated Vision and Strategy Challenges and Opportunities
CSR Sustainability Committee
GRI Report Guidelines
CSR Sustainability Report Global Activities
CSR Sustainability External Audit

<sup>14</sup> Thomson Reuters. "ASSET4 on Datastream Company Level Template (DFO 2.0).xism" (2012).

As of March 25, 2013, Thomson Reuter's ASSET4 universe is composed of approximately 4,109 companies across approximately 60 countries. I derive Corporate Governance Scores of corporations from Asset4 database through Datastream. I also use Datastream to download companies' ROEs of the current and the previous year, and ages. To derive Tobin's Q, institutional ownership, book value, and sectors of a firm, I use Bloomberg. In order to study the most recent trend, I use corporate data since 2009.

Table 4: Data Summary

Category	Year	No. of Companies	Source	Treatment
Tobin's Q (Adjusted)	2009	3,797	Bloomberg	Tobin's Q - Industry Median Tobin's Q
	2010	3,795		
	2011	3,689		
	2012	3,057		
GOV	2009	3,349	ASSET4	Natural Log
	2010	4,108		
	2011	3,315		
	2012	772		
ROE	2009	4,045	Datastream	
	2010	4,058		
	2011	4,076		
	2012	4,065		
AGE		4,059	Datastream	Natural Log
BOOK VALUE	2009	3,898	Bloomberg	Natural Log
	2010	3,855		
	2011	3,738		
	2012	3,077		
INST HLDG	2009	3,979	Bloomberg	
	2010	3,979		
	2011	3,979		
	2012	3,979		
SECTOR			Bloomberg	Dummy variable (0,1) <sup>15</sup>
Total # of Companies in the Universe		4,109	ASSET4	

<sup>15</sup> Sector classifications were derived from Bloomberg.



Table 5: Countries of Domicile

2009			2010			2011		
Country of Domicile	# of companies	%	Country of Domicile	# of companies	%	Country of Domicile	# of companies	%
ABU DHABI	1	0.0%	ABU DHABI	1	0.0%	ABU DHABI	1	0.0%
AUSTRALIA	190	6.0%	AUSTRALIA	269	7.5%	AUSTRALIA	254	8.8%
AUSTRIA	20	0.6%	AUSTRIA	18	0.5%	AUSTRIA	14	0.5%
BELGIUM	27	0.8%	BELGIUM	27	0.7%	BELGIUM	22	0.8%
BRAZIL	37	1.2%	BRAZIL	65	1.8%	BRAZIL	37	1.3%
CANADA	240	7.5%	CANADA	250	6.9%	CANADA	171	5.9%
CHANNEL ISLANDS	1	0.0%	CHANNEL ISLANDS	1	0.0%	CHANNEL ISLANDS	1	0.0%
CHILE	13	0.4%	CHILE	18	0.5%	CHILE	11	0.4%
CHINA	51	1.6%	CHINA	73	2.0%	CHINA	46	1.6%
COLOMBIA	2	0.1%	COLOMBIA	3	0.1%	COLOMBIA	3	0.1%
CYPRUS	1	0.0%	CYPRUS	1	0.0%	CYPRUS	1	0.0%
CZECH REPUBLIC	4	0.1%	CZECH REPUBLIC	4	0.1%	CZECH REPUBLIC	2	0.1%
DENMARK	23	0.7%	DENMARK	24	0.7%	DENMARK	24	0.8%
DUBAI	1	0.0%	DUBAI	1	0.0%	DUBAI	1	0.0%
EGYPT	2	0.1%	EGYPT	4	0.1%	EGYPT	3	0.1%
FINLAND	26	0.8%	FINLAND	27	0.7%	FINLAND	26	0.9%
FRANCE	89	2.8%	FRANCE	89	2.5%	FRANCE	82	2.8%
GERMANY	74	2.3%	GERMANY	76	2.1%	GERMANY	72	2.5%
GREECE	22	0.7%	GREECE	20	0.6%	GREECE	12	0.4%
HONG KONG	87	2.7%	HONG KONG	126	3.5%	HONG KONG	96	3.2%
HUNGARY	3	0.1%	HUNGARY	4	0.1%	HUNGARY	4	0.1%
INDIA	30	0.9%	INDIA	56	1.6%	INDIA	52	1.8%
INDONESIA	14	0.4%	INDONESIA	23	0.6%	INDONESIA	10	0.3%
IRELAND	13	0.4%	IRELAND	13	0.4%	IRELAND	13	0.5%
ISRAEL	12	0.4%	ISRAEL	13	0.4%	ISRAEL	5	0.2%
ITALY	47	1.5%	ITALY	46	1.3%	ITALY	35	1.2%
JAPAN	401	12.6%	JAPAN	402	11.2%	JAPAN	353	12.2%
JORDAN	1	0.0%	JORDAN	1	0.0%	JORDAN	1	0.0%
KAZAKHSTAN	1	0.0%	KAZAKHSTAN	1	0.0%	KUWAIT	2	0.1%
KUWAIT	4	0.1%	KUWAIT	4	0.1%	LUXEMBOURG	4	0.1%
LUXEMBOURG	3	0.1%	LUXEMBOURG	4	0.1%	MALAYSIA	32	1.1%
MALAYSIA	16	0.5%	MALAYSIA	39	1.1%	MEXICO	12	0.4%
MEXICO	17	0.5%	MEXICO	19	0.5%	NETHERLANDS	32	1.1%
MOROCCO	2	0.1%	MOROCCO	2	0.1%	NEW ZEALAND	10	0.3%
NETHERLANDS	32	1.0%	NETHERLANDS	33	0.9%	NIGERIA	1	0.0%
NEW ZEALAND	10	0.3%	NEW ZEALAND	10	0.3%	NORWAY	19	0.7%
NIGERIA	1	0.0%	NIGERIA	1	0.0%	OMAN	1	0.0%
NORWAY	20	0.6%	NORWAY	21	0.6%	PERU	1	0.0%
OMAN	1	0.0%	OMAN	1	0.0%	PHILIPPINES	10	0.3%
PERU	1	0.0%	PERU	1	0.0%	POLAND	15	0.5%
PHILIPPINES	6	0.2%	PHILIPPINES	11	0.3%	PORTUGAL	12	0.4%
POLAND	10	0.3%	POLAND	21	0.6%	QATAR	2	0.1%
PORTUGAL	12	0.4%	PORTUGAL	12	0.3%	RUSSIAN FEDERATION	16	0.6%
QATAR	2	0.1%	QATAR	2	0.1%	SAUDI ARABIA	5	0.2%
RUSSIAN FEDERATION	30	0.9%	RUSSIAN FEDERATION	30	0.8%	SINGAPORE	39	1.4%
SAUDI ARABIA	6	0.2%	SAUDI ARABIA	6	0.2%	SOUTH AFRICA	45	1.6%
SINGAPORE	50	1.6%	SINGAPORE	49	1.4%	SOUTH KOREA	60	2.1%
SOUTH AFRICA	18	0.6%	SOUTH AFRICA	48	1.3%	SPAIN	35	1.2%
SOUTH KOREA	40	1.3%	SOUTH KOREA	88	2.4%	SRI LANKA	1	0.0%
SPAIN	44	1.4%	SPAIN	43	1.2%	SWEDEN	47	1.6%
SWEDEN	48	1.5%	SRI LANKA	1	0.0%	SWITZERLAND	52	1.8%
SWITZERLAND	61	1.9%	SWEDEN	49	1.4%	TAIWAN	56	1.9%
TAIWAN	24	0.8%	SWITZERLAND	62	1.7%	THAILAND	15	0.5%
THAILAND	11	0.3%	TAIWAN	82	2.3%	TURKEY	14	0.5%
TURKEY	16	0.5%	THAILAND	20	0.6%	UNITED KINGDOM	270	9.4%
UNITED KINGDOM	303	9.5%	TURKEY	20	0.6%	UNITED STATES	726	25.2%
UNITED STATES	965	30.3%	UNITED KINGDOM	296	8.2%			0.0%
		0.0%	UNITED STATES	972	27.0%			0.0%
		0.0%	ZIMBABWE	1	0.0%			0.0%
Grand Total	3186	100.0%	Grand Total	3604	100.0%	Grand Total	2886	100.0%
Total # of Countries	57		Total # of Countries	59		Total # of Countries	56	

## B. Institutional investors' Shareholder Engagement and Corporate Governance

### 1. Correlation

#### 1. a. Test Method

In this part of the study, my purpose is to assess the overall impact of institutional investor ownership on corporate governance. There are several ways by which institutional investors exercise influence over the firm's operation. They can submit shareholder proposals, engage proxy fights to elect board members who represent the institutional investors' interest, submit formal letters to the management to express their dissatisfaction, or bringing a law suit against incumbent board members or managers.

One of the most widely used proxies for active engagement is measuring the impact of filing shareholder proposals. Shareholder proposal refers to a proposal for a publicly traded company to take a certain course of action.<sup>16</sup> However it is important to note that as Gillian and Starks point out it is possible that the shareholder proposals only signal the managers' unwillingness to respect the investors' request to maximize their investment. Hence, measuring the impact of proposals might not provide a reasonable proxy for the influence of institutional investors on the firms.

A better alternative to measure the influence would be to measure the ownership held by institutional investors. Assuming that most institutional investors are dedicated to fulfilling their fiduciary duty, institutional investors' influence in corporations is proportion to their stakes in the companies. Based on this assumption, I develop a hypothesis to measure the influence of institutional investors on corporate governance as following:

Hypothesis 1: Institutional ownership is positively correlated with high Corporate Governance Score.

I run regression analysis on the ASSET4 data to see where there is positive correlation between institutional investors' ownerships and the Corporate Governance Scores. I set the institutional ownership as independent variable and Corporate Governance Score as dependent variable to examine the correlation between institutional ownership and corporate governance through regression analyses.

First to examine whether correlation exists on absolute basis, I use recent institutional ownership data and Corporate Governance Scores for this regression.<sup>17</sup> Significant outliers exist within the

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<sup>16</sup> Any shareholder who owns more than \$2,000 in stock or 1% of the company is permitted to initiate a shareholder proposal. It must be placed on the agenda and put to a vote at the next annual shareholders meeting. "Shareholder Proposal." *The Free Dictionary Internet*. Web. 25 March 2013.

<sup>17</sup> As of March 21, only 772 companies' Corporate Governance Scores were available. Since many Corporate Governance Scores of 2012 data are not yet available and neither Bloomberg nor Datastream provides previous years ownership data, I had to use the most recent data for this analysis. In about 12% of the observation, the sum of institutional investor ownership percentage exceeds 100%. This is because Bloomberg data team collects holdings information from multiple sources and some of those reported holdings across different filings are duplicated. (This is explanation by Bloomberg Help Desk. The collected data include 13Fs, US and International Mutual Funds, Schedule Ds (US Insurance Companies) and Institutional stake holdings that appear on the aggregate level.). Before running regression, I adjust these data by trimming down the share ownership over 100%.

Bloomberg ownership data.<sup>18</sup> I run linear regression to find correlation of two variables, institutional investor ownerships and Thomson Reuter's Corporate Governance Score from ASSET4 database.<sup>19</sup>

$$CG_t = \alpha + \beta_1 * Institutional\ Ownership_t + e_t$$

In addition, to assess how the legal and market environment of different countries affect the relationship between institutional ownership and firm value, I add more regression analyses such as the following. First, I exclude the samples from three developed countries like US, UK, and Japan from the pool and then run a regression with the remaining data sample. Second, I further limit the samples, so that the data only include companies in the emerging markets and then run regression with the selected data. In selecting companies that reside in emerging markets, I use MSCI Emerging Markets Index, which is composed of indices of 21 countries, such as Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Morocco, Peru, Philippine, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.<sup>20</sup>

#### 1. b. Result

I find positive correlations between institutional investor ownership and democratic corporate governance in my analysis of the entire corporate pool between 2010 and 2012. Compared to the tests using year 2010 and 2011 data (R-square below 0.01), the analysis with 2012 data provides more explanatory power (R-square 0.08).

The correlation coefficients of the test using all data sample are all positive in 2010, 2011, and 2012 (B = 0.00005 in 2010, 0.000004 in 2011, and 0.29 in 2012 respectively.). In the test with 2012 data, the correlation coefficient is 0.292. The t-statistics is 6.248. If I set a null hypothesis stating that there is no positive relationship between the two, I could reject the null hypothesis at 95% confidence level. The 95% confidence interval is between 0.2 and 0.39. Therefore it might as well be said to be at 95% of probability, 1% of institutional investor ownership translates to 0.2 - 0.4 point increase in Corporate Governance Score.

However, when limiting the sample either by eliminating corporations in US, UK, and Japan, the correlation coefficients become almost zero (in 2010 and in 2011) or slightly negative (B = -0.05 in 2012). The correlation coefficients of the linear regressions using the emerging market data only, the correlation coefficients are all slightly negative for all three years. They are close to zero in 2010 and 2011 and negative in 2012 (B = -0.16). When limiting the data sample by excluding all companies in developed countries, the t-scores decrease. In 2010, the t-score of the entire sample is 2.33. For the same year, the t-scores of the data excluding US, UK, and Japan and those of emerging market sample are 2.0 and -0.43 respectively.

Therefore, it seems obvious that the positive correlation between institutional investor ownership and corporate governance tend to be positive and strongly correlated in developed countries as compared to developing countries.

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<sup>19</sup> Since Bloomberg only provides most recent ownership data, I chose to use Corporate Governance Scores for the year 2012. Since many Corporate Governance Scores for the year 2012 have not become available as of 25 March, I run the regression with 402 companies' data using the Corporate Governance Score as dependent variable and institutional investors' share ownership as independent variable.

<sup>20</sup> "Index Definition – Tools and Data." MSCI. Web. 14 April 2013.

Although the test result has weak explanatory power (R-square 0.002, 0.0008, 0.09 in 2010, 2011, and 2012), it seems obvious that overall institutional ownership is correlated with high Corporate Governance Score, but the degree of positive correlation varies according to the countries' characteristics. In general, the correlations between institutional ownership and corporate governance are positive when the pools include more developed countries, while it becomes zero or slightly negative when the portion of emerging market companies in the dataset increases.

Table 6: The Influence of Institutional Investors' Ownership on Corporate Governance Score

I run linear regression to find correlations between two variables, institutional investor ownerships and Thomson Reuter's Corporate Governance Score from ASSET4 database for corporate data between 2010 and 2012. I set the institutional ownership as independent variable and Corporate Governance Score as a dependent variable to examine the correlation.

		Multiple R		R Square		Adjusted R Square		Standard Error		Observations	
2010	ALL DATA	0.043847		0.001923		0.001567		29.719354		2811.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		53.735807		0.560903		95.802343		0.000000	
		INST_10_TRIM		0.000055		0.000024		2.326123		0.020083	
	EXCEPT US, UK, JP	0.051839		0.002687		0.002015		28.154428		1485.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		48.278184		0.731546		65.994741		0.000000	
		INST_10_TRIM		0.000045		0.000022		1.998997		0.045791	
	EMG ONLY	0.022608		0.000511		-0.002190		20.080732		372.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		22.735883		1.042963		21.799316		0.000000	
		INST_10_TRIM		-0.000011		0.000024		-0.434994		0.663820	
2011	ALL DATA	0.027951		0.000781		0.000427		29.640507		2823.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		55.434112		0.558059		99.333806		0.000000	
		INST_11_TRIM		0.000043		0.000029		1.485132		0.137621	
	EXCEPT US, UK, JP	0.033052		0.001092		0.000421		27.980911		1490.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		50.705510		0.725429		69.897320		0.000000	
		INST_11_TRIM		0.000035		0.000028		1.275679		0.202268	
	EMG ONLY	0.025289		0.000640		-0.002054		21.368601		373.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		25.644869		1.107887		23.147546		0.000000	
		INST_11_TRIM		-0.000013		0.000026		-0.487252		0.626367	
2012	ALL DATA	0.298182		0.088913		0.086635		27.171876		402.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		41.743482		3.056742		13.656200		0.000000	
		INST_12_Trimmed		0.292752		0.046856		6.247866		0.000000	
	EXCEPT US, UK, JP	0.055273		0.003055		-0.002514		21.773548		181.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		66.516133		3.265954		20.366525		0.000000	
		INST_12_Trimmed		-0.049244		0.066490		-0.740633		0.459887	
	EMG ONLY	0.155851		0.024290		-0.138329		27.743832		8.000000	
		<i>Coefficients</i>		<i>Standard Error</i>		<i>t Stat</i>		<i>P-value</i>		<i>Lower 95%</i>	<i>Upper 95%</i>
		Intercept		49.213378		28.182410		1.746244		0.131371	
		INST_12_Trimmed		-0.159128		0.411739		-0.386478		0.712477	

## 1. c. Discussion

This test result suggests that in general there is a positive correlation between institutional ownership and democratic Corporate Governance Score. The correlations tend to be positive and stronger in the developed market companies while they are zero or slightly negative in the developing market firms.

It is important to note that the test result proves a positive correlation between corporate governance and firm value but not causalization between these variables. In other words, it is both possible that institutional ownership leads to improvements in governance practices and also that democratic governance practices induce more institutional investors' investments. The causal relationship, however, does not seem to be clear. I will adumbrate possible explanations for both these cases. (The causal relationship will be studied in the next part of empirical analysis in greater detail.)

First, if institutional investors' increasing ownership leads improvements in governance practices, the stronger positive correlation in developed markets could suggest that if there are less regulatory or institutional constraints, institutional investors can make a positive impact on governance practices.

Second, if corporations' democratic governance practices induce institutional investors' stakes in corporations – the stronger positive correlation in developed countries might indicate that in terms of making investment decisions, educated investors tend to prefer making investments in companies with democratic governance.

Because of barriers to international trade, it could be assumed that there are more domestic investors than foreign investors in any country, and further that these investors tend to be more educated in developed markets. It seems reasonable to assume that these educated investors tend to make their investment decisions based on academic theories. After the publication of Fama and Jensen's, "Separation of Ownership and Control (1983)," many finance professional have learned about agency theory. According to this theory, it is likely that a corporation with democratic governance outperforms other firms in terms of financial performance. Therefore it might be natural for educated investors to prefer to invest in companies with democratic governance to ensure better returns.

What could explain this weak explanatory power of the test result? If institutional investors' increasing ownership leads an improvement in governance, this test result would indicate that the composition of institutional investors or the countries' market environment do create differences in terms of the relationship between institutional ownership and corporate governance.

In developing markets, the weaker legal protection for minority shareholders and inefficient capital markets make the market less attractive from the foreign investors' point of view, inducing fewer foreign investments in the market. Previous studies, including those by Gillian and Starks and AEFM, suggest that foreign institutional investors tend to be more active as compared to domestic investors who are likely to have business relationships with the target companies. It seems possible that the higher percentage share ownership held by domestic institutional investors in developing countries is the reason for a weaker correlation between the institutional ownership and democratic governance practices.

In some developing countries, the lack of legal protections for minority shareholders does not permit institutional investors to be active, resulting in a weaker correlation between their percentage ownership and the degree of activism in corporations.

This test does not account for the divergent characteristics of companies across different sectors. As indicated in Table 10, companies in certain sectors, such as those that include various diversified conglomerates, tend to have lower Corporate Governance Score than other sectors, such as energy. This

might be largely due to the different nature of the businesses. Had this test accounted for such differences, the test results would have been more robust.

The weak explanatory power might be due to the bias in sample selection. When creating Asset4 database, Thomson Reuters includes companies listed in major global indices such as MSCI World Index and S&P500. Since those indices are widely used among the asset managers including index fund managers, it is likely that institutional investors automatically invest in the companies that are included in these indices over companies not included in these indices, and therefore institutional ownership could be overly represented in these companies included in the major indices. Had I been able to precisely measure the different impact of the stocks' inclusion in different indices and adjust the data accordingly, this analysis would have been more robust.

Furthermore, even though ASSET4 data that are popularly used by Socially Responsible Investors, the Corporate Governance Score might not be a perfect representation of the governance practices of the target companies in terms of measuring diversified control. While examining ASSET4's Key Performance Index, I find that some of the measurements do not fully incorporate the characteristics of corporate governance in developing countries. For instance, ASSET4 Corporate Governance Score does not account for the influence of controlling shareholders without legal title or rights, the real influence of the boards in making important corporate decisions, or the records of white collar crimes in corporations.<sup>21</sup>

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<sup>21</sup> In some conglomerates in developing countries, often conglomerate chairmen, who neither have board membership nor legal rights, exercise absolute control over the firms' operation.

## 2. Causalization

### 2. a. Test Method

I further examine whether institutional ownership causes an improvement in corporate governance. In order to assess the causality, I run a regression with independent variable and dependent variable in different time frames. After an increase in institutional ownership, it would take time for the firms' corporate governance to improve as board meeting and shareholder meeting take place only a few times a year. In line with AEFM, I set the changes in institutional ownership at time t-1 as independent variable and changes in Corporate Governance Score at time t (t = 2011) as dependent variable and then run a regression.

$$\Delta CG_t = \alpha + \beta_1 * \Delta Institutional\ Ownership_{t-1} + e_t$$

In order to assess whether causality exists in the opposite direction, I set that the change in Corporate Governance Score at t-1 as independent variable and the institutional ownership at t as dependent variable to run a regression (t = 2011).

$$\Delta Institutional\ Ownership_t = \alpha + \beta_1 * \Delta CG_{t-1} + e_t$$

The different characteristics of the countries where institutional investors reside might have differential impact on these analyses. Following the previous setting for the correlation, I first run a regression with the entire data sample and then start limiting the dataset. After running the regression with all data, I exclude US, UK and Japan corporations from the sample and then limit the sample to only those firms that reside in the emerging markets as per the MSCI Emerging Market Index classification.

### 2. b. Result

The explanatory power of the test of the causal relationship is weak; in all tests, R-squares are below 0.01, and t-scores are all below 95% confidence level. The correlation coefficients are all positive in both directions. This suggests it is both possible that an increase in institutional investor ownership results in an improvement in corporate governance and that an improvement in corporate governance induces more institutional investors' investment in target companies.

In two out of three tests, the t-statistics is higher for the former. In the test using all data samples, t-statistics is higher for the test in which a positive change in Corporate Governance Score leads to an increase in institutional ownership in the subsequent period (t-statistics 1.705) than for the other test in which an increase in institutional ownership leads to an increase in the governance score in the next period (t-statistics 0.528). However, in the tests with the samples that exclude developed countries, it is more likely that increase in institutional ownership leads to a positive change in Corporate Governance Score in the subsequent period. In the sample which excludes US, UK, and Japan corporations, the t-statistics of the former is 0.364 and the latter is -0.745. In the sample with emerging market data only, the t-statistics of the former is 0.959 and the latter is 1.246.

There is a consistent pattern in the tests that examine the likelihood of influence of institutional investor leading to the improvement in corporate governance toward a more democratic one. While eliminating more companies in the developed countries from the sample, the t-statistics becomes larger. (t-statistics of all data, data excluding US, UK, and Japan, and emerging market data are 0.529, 0.745, and 1.246 respectively.)

Table 7: The Causal Relationship between the Change in Institutional Ownership and the Change in Corporate Governance Score

In order to assess the causality, I run a regression with independent variables and dependent variables in different time frames. If institutional investors' increasing stake leads to an increase in Corporate Governance Score, after an increase in institutional ownership, it would take time for the firms' corporate governance to improve as board meeting and shareholder meeting take place only a few times a year. In line with AEFM, I set the changes in institutional ownership at time t-1 as independent variable and the changes in Corporate Governance Score at time t (t = 2011) as dependent variable and then run a regression. I assess whether the causal relationship exists in the opposite direction. In the next test setting, I set the changes in Corporate Governance Score at t-1 as independent variable and the institutional ownership at t as dependent variable.

	ALL DATA	Multiple R	R Square	Adjusted R Square	Standard Error	Observations					
		0.010435	0.000109	-0.000280	11.059959	2571.000000					
		Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%		
CHANGE IN INST10 ON CHANGE IN CG11	EXCEPT US, UK, JP	Intercept	1.601233	0.218339	7.333687	0.000000	1.173094	2.029372	1.173094	2.029372	
		2010_CHANGE_INST	-0.005449	0.010303	-0.528908	0.596915	-0.025651	0.014753	-0.025651	0.014753	
		Multiple R		R Square	Adjusted R Square	Standard Error	Observations				
		0.020797	0.000433	-0.000346	12.322825	1286.000000					
	EMG ONLY	Intercept	2.449564	0.344788	7.104546	0.000000	1.773154	3.125974	1.773154	3.125974	
		2010_CHANGE_INST	-0.009362	0.012561	-0.745378	0.456179	-0.034004	0.015279	-0.034004	0.015279	
		Multiple R		R Square	Adjusted R Square	Standard Error	Observations				
		0.070116	0.004916	0.001747	10.654554	316.000000					
	CHANGE IN INST10 ON CHANGE IN CG11	EXCEPT US, UK, JP	Intercept	2.707036	0.608528	4.448495	0.000012	1.509727	3.904345	1.509727	3.904345
			2010_CHANGE_INST	0.027219	0.021854	1.245518	0.213870	-0.015779	0.070217	-0.015779	0.070217
			Multiple R		R Square	Adjusted R Square	Standard Error	Observations			
			0.070116	0.004916	0.001747	10.654554	316.000000				
CHANGE IN CG10 ON CHANGE IN INST11		ALL DATA	Intercept	3.193142	0.450385	7.089809	0.000000	2.309912	4.076372	2.309912	4.076372
			2010_CHANGE CG	0.057062	0.033468	1.704966	0.088344	-0.008571	0.122694	-0.008571	0.122694
			Multiple R		R Square	Adjusted R Square	Standard Error	Observations			
			0.036542	0.001335	0.000876	12.760788	2176.000000				
		EXCEPT US, UK, JP	Intercept	4.263348	0.937753	4.546346	0.000006	2.422933	6.103763	2.422933	6.103763
			2010_CHANGE CG	0.022644	0.062200	0.364044	0.715910	-0.099429	0.144716	-0.099429	0.144716
			Multiple R		R Square	Adjusted R Square	Standard Error	Observations			
			0.012080	0.000146	-0.000955	26.005607	910.000000				
	EMG ONLY	Intercept	-4.792140	2.563440	-1.869418	0.064023	-9.868008	0.283727	-9.868008	0.283727	
		2010_CHANGE CG	0.186274	0.194254	0.958918	0.339544	-0.198369	0.570917	-0.198369	0.570917	
		Multiple R		R Square	Adjusted R Square	Standard Error	Observations				
		0.087566	0.007668	-0.000671	22.491678	121.000000					



## 2. c. Discussion

The test does not provide strong evidence to support causality in either direction. However, it shows that in emerging markets institutional investors' increasing ownership leads to subsequent improvement in Corporate Governance Score of target companies rather than vice versa. This could indicate that if there is room for improvement in corporate governance, institutional investors' increased presence indeed puts more pressure on target firms' corporate governance practices, changing the governance characteristics toward more democratic ones.

The test result indicates that after an increase in institutional ownership, subsequent marginal improvement in corporate governance is larger in developing countries. According to the law of diminishing return, an additional input leads to an increase in output at a decreasing rate. Therefore it is possible that the greater presence of active investors would not lead to significant improvements in corporate governance in developed countries that already provide strong investor protection. On the other hand, the marginal improvement in corporate governance practices should be significant in developing countries as there is more room for improvements.

In the analyses to assess the possibility that democratic corporate governance practices lead to increase in institutional ownership, the t-statistics is the highest when the sample includes the maximum number of developed market data. This might indicate that in developed countries the educated investment managers prefer to invest in companies with democratic governance.

The weak explanatory power of this test could be explained in various ways. First, legal and regulatory environment plays an important role in causal relationships. Different characteristics of investors affect corporate governance of the companies in different degrees. As noted in the previous discussion, in some countries, where minority investor protection is weak, the correlation between institutional ownership and the influence of their engagement might not be strong.

Second, different characteristics of incumbent corporate governance of target companies could also make a difference in terms of the influence of the institutional investors on corporate governance practice. Here I set the test in such a way that the independent variable precedes the dependent variable by a one year period. However, one year might not be long enough a time to measure such an impact for certain corporations. For instance, if a corporation adopts staggered board, it would take at least three years to replace all board members. Therefore it would not be possible to observe a significant improvement in terms of corporate governance within a year.

Third, as noted in the previous test, this test setting does not incorporate the different sector characteristics of corporations. Table 10 shows that companies that belong to certain sectors tend to have higher governance scores. Had I adjusted the data for these differences, I would have acquired more robust results.

Finally, here I assume linear independence between independent and dependent variables. However, this might not be a valid assumption. Analyzing the influence of family control on firm value, Anderson and Reed (2003) discover that in large public corporations, the influence of family's concentrated control on firm value is nonlinear; they say that compared with firms with diversified control, firm value of those firms first increases and then decreases, as the possibility of entrenchment increases. (1324) It seems possible that such a nonlinearity also exists in my regression analyses.

## C. Corporate Governance and Firm Value

### 1. Test Method

In this section, I analyze the relationship between good corporate governance and firm value. I assume that a firm's governance characteristics are reflected in the share price within unspecified period of time. Therefore studying overall firm value rather than stock return for a certain period provides a more reasonable indicator in measuring the governance effect. For this empirical analysis, I apply multivariate regression analyses in line with GIM (2003) study. But, I use more recent and globally diversified data for the analysis.

Hypothesis 2: There is a positive correlation between democratic corporate governance and firm value.

In measuring firm value, GIM use Tobin's Q, a ratio that measures the relative size of the market value of a firm to the replacement cost of the firm's assets. The replacement cost is represented by the asset value in the financial statement.<sup>22</sup> In order to eliminate the effect of industry bias, GIM regressed industry adjusted Q (Each firm's Q minus the median Q of the industry the company belongs to) with  $X_{it}$ , a vector of governance variable and  $W_{it}$ , a vector of firm characteristics.

$$Q_t = a_t + b_t X_{it} + c_t W_{it} + e_{it}$$

In line with GIM (2003), Shin and Stulz (2000), Daines (2001), Yermack (1996), and Bauer, Gunster, and Otten (2003), I run multiple-regression that includes the company's book value (BV), age (AGE), Return-on-Equity (ROE) in the current and previous year, and a vector of sector dummies (SD) as independent variables and adjusted Tobin's Q as the dependent variable. Following GIM, I take natural logs on CG, BV, and AGE. I run multiple regressions from 2009 to 2011.<sup>23</sup>

$$Q_{it} = \alpha + \beta_1 * CG_{it} + \beta_2 * BV_{it} + \beta_3 * AGE_{it} + \beta_4 * ROE_{it} + \beta_5 * ROE_{it-1} + \beta_6 * SD_{it} + e_{it}$$

I calculate Tobin's Q ratio as following: (Market Capital + Liabilities + Preferred Equity + Minority Interest) / Total Assets (Book Value). I adjust each firm's Tobin's Q by subtracting industry median Tobin's Q of the universe. In line with Eccles, Ioannou, and Searfeim's study (2012), I exclude financial sector samples. This is largely due to the difference between the nature of the business model of the financial institutions and those of other business models and a significant degree of multicollinearity.<sup>24</sup> The numbers of financial institutions excluded from this empirical test are 639 in 2009, 707 in 2010, and 544 in 2011 respectively.

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<sup>22</sup> Tobin's Q has been frequently used by academics to estimate firm value. This is based on the belief that in the long run the market value of a company should be equal to the replacement cost of the company's assets.

<sup>23</sup> I derive Corporate Governance Scores, ages, ROEs, industry classifications from Datastream and book values in US dollar, sector classifications, and Tobin's Q from Bloomberg.

<sup>24</sup> Eccles, Ioannou, and Searfeim (2012) study on sustainability on corporate behavior and performance use Thomson Reuters ASSET4 database.

Table 8: Industry Median Tobin's Q Ratio

TRBC Industry Group	2009	2010	2011	2012
No Industry Classification Available	1.305	1.305	1.305	1.305
Aerospace / Defense	1.428	1.428	1.428	1.428
Air Freight / Courier Services	1.556	1.593	1.583	1.638
Airline Services	1.119	1.206	1.077	1.118
Automobiles / Auto Parts	1.113	1.360	1.174	1.176
Banking Services	1.016	1.023	1.002	1.009
Beverages	1.631	1.764	1.715	1.704
Biotechnology / Medical Research	2.074	2.315	1.813	2.085
Biotechnology / Pharmaceuticals	1.697	1.722	1.554	1.661
Chemicals	1.301	1.604	1.357	1.349
Coal	1.902	2.002	1.664	1.177
Commercial Services / Supplies	1.494	1.552	1.440	1.548
Communications Equipment	1.532	1.544	1.349	1.337
Computers / Office Equipment	1.474	1.420	1.346	1.222
Construction / Engineering / Materials	1.151	1.203	1.088	1.098
Construction Materials	1.223	1.217	1.116	1.116
Containers / Packaging	1.300	1.335	1.217	1.305
Diversified Trading / Distributing	0.992	1.076	1.051	1.023
Electric Utilities	1.143	1.115	1.110	1.102
Energy Related Equipment / Services	1.305	1.415	1.360	1.330
Financial Services – Diversified	1.042	1.060	1.074	1.054
Food / Drug Retailing	1.359	1.403	1.428	1.432
Food / Tobacco	1.325	1.494	1.413	1.458
Gas Utilities	1.188	1.260	1.203	1.191
Healthcare Equipment / Supplies	2.190	2.241	2.039	1.962
Healthcare Providers / Services	1.325	1.340	1.385	1.349
Homebuilding / Construction Supplies	1.073	1.112	1.044	1.083
Hotels / Entertainment Services	1.380	1.492	1.551	1.496
Household Goods	1.165	1.311	1.117	1.243
Industrial Conglomerates	1.055	1.138	1.096	1.118
Insurance	1.002	1.008	0.998	1.009
Investment Services	1.126	1.102	1.054	1.084
Investment Trusts	1.066	1.255	1.385	2.171
Leisure Products	1.586	1.738	1.633	1.526
Machinery / Equipment / Components	1.336	1.570	1.371	1.404
Marine Services	1.028	1.215	0.948	0.940
Media / Publishing	1.298	1.362	1.276	1.425
Metal / Mining	1.583	1.788	1.332	1.117
Oil / Gas	1.378	1.419	1.186	1.207
Paper / Forest Products	0.960	1.050	1.031	1.066
Personal / Household Products / Services	2.254	2.316	2.102	1.994
Rails / Roads Transportation	1.251	1.232	1.163	1.157
Real Estate Operations	1.047	1.045	0.950	1.005
REIT - Residential / Commercial	1.084	1.089	1.050	1.093
Renewable Energy	1.379	1.062	0.883	0.891
Retailers – Diversified	1.392	1.544	1.448	1.341
Retailers – Specialty	1.372	1.626	1.755	1.621
Semiconductors / Semiconductor Equipment	1.745	1.819	1.468	1.448
Software / IT Services	1.886	2.130	1.983	2.044
Telecommunications Services	1.403	1.480	1.435	1.469
Textiles / Apparel	1.465	1.843	1.334	1.698
Utilities – Multiline	1.101	1.118	1.136	1.143
Utilities - Water / Others	1.190	1.210	1.237	1.233

Table 9: Sample Summary Statistics (Mean, Standard Deviation, Total Number)

	2009			2010			2011		
	Mean	Std. Deviation	N	Mean	Std. Deviation	N	Mean	Std. Deviation	N
ADJ_Q_09	0.2221	0.99085	3186	0.2895	1.169372	3604	0.2454	1.08542	2886
LN_AGE_09	2.7504	0.60838	3186	2.7563	0.594327	3604	2.8502	0.55134	2886
LN_BV_09	8.7941	1.65433	3186	8.7269	1.696508	3604	8.8693	1.70897	2886
LN_CG_09	3.585	1.0568	3186	3.6257	1.019638	3604	3.7227	0.95136	2886
ROE_08	19.527	106.438	3186	92.891	5092.4747	3604	8.7635	52.8542	2886
ROE_09	4.4232	98.8139	3186	9.4973	147.8898	3604	13.042	29.8049	2886

Table 10: Sample Summary Statistics by Sectors (Min, Max, Mean)

2009	Sector	Count	ADJ_Q	LN_AGE	LN_BV	LN_CG	ROE_08	ROE_09
Mean	Basic Materials	317	0.298	2.650	8.102	3.559	13.832	4.807
	Communications	253	0.415	2.572	8.733	3.485	37.995	-3.846
	Consumer, Cyclical	403	0.166	2.851	8.429	3.481	17.136	-0.388
	Consumer, Non-cyclical	476	0.426	2.789	8.295	3.723	21.243	16.019
	Diversified	35	-0.081	2.897	9.322	2.907	18.662	2.291
	Energy	253	0.221	2.516	8.582	3.868	16.091	11.405
	Financial	635	0.115	2.712	10.072	3.505	16.182	-2.350
	Industrial	489	0.135	2.937	8.496	3.526	20.191	7.264
	Technology	171	0.224	2.706	8.097	3.805	25.393	-4.361
	Utilities	154	0.052	2.832	9.495	3.612	12.870	11.641
Max			<b>14.189</b>	<b>3.367</b>	<b>14.897</b>	<b>4.575</b>	<b>5523.910</b>	<b>876.290</b>
Min			<b>-1.715</b>	<b>0.000</b>	<b>2.328</b>	<b>0.270</b>	<b>-642.950</b>	<b>-3210.250</b>
2010	Sector	Count	ADJ_Q	LN_AGE	LN_BV	LN_CG	ROE_09	ROE_10
Mean	Basic Materials	380	0.480	2.651	7.929	3.635	2.129	1.693
	Communications	268	0.512	2.616	8.646	3.630	6.393	14.827
	Consumer, Cyclical	472	0.242	2.852	8.371	3.487	2.396	5.014
	Consumer, Non-cyclical	516	0.496	2.804	8.255	3.778	16.760	19.613
	Diversified	45	-0.020	2.965	9.116	3.214	188.454	195.982
	Energy	275	0.294	2.531	8.485	3.993	1121.893	4.218
	Financial	707	0.139	2.724	10.067	3.573	-0.484	1.827
	Industrial	572	0.184	2.899	8.440	3.477	7.634	7.387
	Technology	198	0.291	2.717	8.084	3.667	-2.438	-2.127
	Utilities	171	0.075	2.813	9.488	3.704	11.309	11.983
Max			<b>18.173</b>	<b>3.401</b>	<b>14.798</b>	<b>4.573</b>	<b>305570.100</b>	<b>8364.630</b>
Min			<b>-1.481</b>	<b>0.693</b>	<b>2.502</b>	<b>0.507</b>	<b>-3210.250</b>	<b>-1834.190</b>
2011	Sector	Count	ADJ_Q	LN_AGE	LN_BV	LN_CG	ROE_10	ROE_11
Mean	Basic Materials	297	0.377	2.763	8.206	3.721	0.669	7.846
	Communications	219	0.453	2.716	8.710	3.735	20.572	17.860
	Consumer, Cyclical	386	0.215	2.938	8.535	3.608	5.018	12.205
	Consumer, Non-cyclical	419	0.400	2.895	8.400	3.891	22.097	19.341
	Diversified	31	0.006	3.025	9.144	3.379	12.489	15.602
	Energy	198	0.222	2.652	8.743	4.101	3.677	10.020
	Financial	544	0.123	2.830	10.254	3.700	4.329	10.364
	Industrial	490	0.142	2.970	8.537	3.578	7.957	12.850
	Technology	172	0.320	2.786	8.205	3.711	3.214	15.711
	Utilities	130	0.083	2.850	9.621	3.665	11.303	11.371
Max			<b>25.612</b>	<b>3.434</b>	<b>14.847</b>	<b>4.567</b>	<b>2177.780</b>	<b>487.410</b>
Min			<b>-1.294</b>	<b>0.693</b>	<b>3.700</b>	<b>0.489</b>	<b>-504.900</b>	<b>-411.530</b>

## 2. Result

From the empirical testing, I find that the correlation coefficients for corporate governance variables are all positive during 2009 – 2011. The correlation is positive and significant especially in 2010 and 2011.

The correlation coefficients of Corporate Governance Scores are 0.015, 0.045, and 0.081 in 2009, 2010, and 2011 respectively. In other words, a 1% increase in the log of the Corporate Governance Score is associated with 0.02% increase in Tobin's Q in 2009, 0.05% in 2010, and 0.08% in 2011.

The t-statistics are 0.931, 2.483, and 4.094 respectively for the same period. This indicates that at 95% confidence level the correlation was significant in 2010 and 2011. If I were to set a null hypothesis such that there is no positive correlation between corporate governance and firm value represented by Tobin's Q, I can reject this null hypothesis at 95% confidence level based on empirical tests with 2010 and 2011 data.

For robustness check, I examine the correlations among the independent variables. I confirm that the correlations among the different variables for the three year periods are all less than 0.5. When I run these multiple-regressions without sector dummies, I obtained similar results for each year.

I also try to examine the causal relationship between the Corporate Governance Score and Q. In order to test whether changes in corporate governance lead to increase in Tobin's Q, I run regression on changes in logs of Corporate Governance Scores from 2009 to 2010 on changes in Tobin's Q from 2010 to 2011. To test whether the causal relationship is in opposite direction, I run regressions to trace the effect of changes in Tobin's Q from 2009 to 2010 on the logs of changes in Corporate Governance Scores from 2010 to 2011.

The test on causalization shows that the correlation coefficient of the change in the log of Corporate Governance Score on the changes in Tobin's Q is -0.1 and the correlation coefficient of changes in Tobin's Q on the changes in the log of Corporate Governance Score is 0.008. However, I find this result has weak explanatory power (The R-square of the former is 0.006 and the R square of the latter is 0.000.)

Table 11: Corporate Governance on Firm Value

I run multiple-regression that includes the company's book value (BV), age (AGE), Return-on-Equity (ROE) in the current and previous year, and a vector of sector dummies (SD) as independent variables and adjusted Tobin's Q as dependent variable. Following GIM, I take natural logs on CG, BV, and AGE. I run multiple regressions from 2009 to 2011.

$$Q_{it} = \alpha + \beta_1 * CG_{it} + \beta_2 * BV_{it} + \beta_3 * AGE_{it} + \beta_4 * ROE_{it} + \beta_5 * ROE_{it-1} + \beta_6 * SD_{it} + e_{it}$$

	2009					2010					2011				
	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta			B	Std. Error	Beta			B	Std. Error	Beta		
(Constant)	2.06	0.134		15.418	0	2.638	0.145		18.211	0	1.856	0.155		12	0
LN_AGE_t	-0.172	0.03	-0.106	-5.823	0	-0.182	0.034	-0.092	-5.421	0	-0.082	0.036	-0.042	-2.249	0.025
LN_BV_t	-0.153	0.012	-0.255	-13.05	0	-0.215	0.013	-0.312	-16.93	0	-0.183	0.013	-0.288	-14.31	0
LN_CG_t	0.015	0.016	0.016	0.931	0.352	0.045	0.018	0.045	2.483	0.013	0.081	0.02	0.071	4.094	0
ROE_t-1	0.001	0	0.067	3.988	0	-2.85E-06	0	-0.012	-0.793	0.428	0.003	0	0.168	8.405	0
ROE_t	0.001	0	0.107	6.363	0	0	0	0.055	3.511	0	0.005	0.001	0.147	7.383	0
Industrial	-0.195	0.06	-0.071	-3.24	0.001	-0.272	0.066	-0.085	-4.127	0	-0.299	0.067	-0.103	-4.484	0
Utilities	-0.145	0.085	-0.031	-1.718	0.088	-0.183	0.094	-0.033	-1.948	0.052	-0.181	0.098	-0.035	-1.85	0.064
Consumer Noncyclical	0.027	0.061	0.01	0.441	0.659	-0.036	0.068	-0.011	-0.528	0.597	-0.181	0.07	-0.059	-2.598	0.009
Consumer Cyclical	-0.179	0.063	-0.06	-2.831	0.005	-0.237	0.069	-0.068	-3.419	0.001	-0.218	0.07	-0.068	-3.097	0.002
Technology	-0.201	0.084	-0.046	-2.386	0.017	-0.278	0.092	-0.054	-3.036	0.002	-0.206	0.091	-0.045	-2.269	0.023
Basic Materials	-0.135	0.068	-0.041	-1.982	0.048	-0.136	0.075	-0.036	-1.82	0.069	-0.101	0.076	-0.028	-1.32	0.187
Diversified	-0.276	0.163	-0.029	-1.691	0.091	-0.389	0.171	-0.037	-2.27	0.023	-0.333	0.185	-0.032	-1.803	0.071
Energy	-0.176	0.072	-0.048	-2.447	0.014	-0.237	0.081	-0.054	-2.938	0.003	-0.22	0.085	-0.051	-2.587	0.01
Communications	0.059	0.071	0.016	0.832	0.406	0.039	0.081	0.009	0.486	0.627	-0.06	0.082	-0.015	-0.735	0.462
	R	R Square	Adjusted R Square	Std. Error of the Estimate		R	R Square	Adjusted R Square	Std. Error of the Estimate		R	R Square	Adjusted R Square	Std. Error of the Estimate	
	.334 <sup>a</sup>	0.112	0.108	0.935924		.353 <sup>a</sup>	0.125	0.122	1.09603		.403 <sup>a</sup>	0.162	0.158	0.995889	
Change Statistics	R Square Change		F Change	df1		R Square Change		F Change	df1		R Square Change		F Change	df1	
	0.112		28.483	14		0.125		36.595	14		0.162		39.718	14	
	Change Statistics			Durbin-Watson		Change Statistics			Durbin-Watson		Change Statistics			Durbin-Watson	
	df2	Sig. F Change				df2	Sig. F Change				df2	Sig. F Change			
	3171 <sup>a</sup>	0		2.024		3589 <sup>a</sup>	0		2.015		2871 <sup>a</sup>	0		1.993	
	Sum of Squares	df	Mean Square	F	Sig.	Sum of Squares	df	Mean Square	F	Sig.	Sum of Squares	df	Mean Square	F	Sig.
Regression	349.302	14	24.95	28.483	.000 <sup>b</sup>	615.45	14	43.961	36.595	.000 <sup>b</sup>	551.49	14	39.392	39.72	.000 <sup>b</sup>
Residual	2777.65	3171	0.876			4311.4	3589	1.201			2847.4	2871	0.992		
Total	3126.95	3185				4926.9	3603				3398.9	2885			

Table 12: Causal Relationship: Corporate Governance Score on Tobin's Q

In order to test whether changes in corporate governance lead to increase in Tobin's Q, I run regression in which I set the changes in logs of Corporate Governance Scores from 2009 to 2010 as independent variable and changes in Tobin's Q from 2010 to 2011 as dependent variable.

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
				R Square Change	F Change	df1
.078 <sup>a</sup>	0.006	0.006	0.516895918	0.006	14.969	1
	Mean	Std. Deviation	N	Change Statistics		Durbin-Watson
ADJ_Q_11 - ADJ_Q_10	-0.012194	0.518356101	2470	df2	Sig. F Change	
LN_CG_10 - LN_CG_09	0.1489135	0.370400388	2470	2468	0	1.999
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
(Constant)	0.004	0.011		0.356	0.722	
LN_CG_10 - LN_CG_09	-0.109	0.028	-0.078	-3.869	0	
Model	95.0% Confidence Interval for B		Correlations			
	Lower Bound	Upper Bound	Zero-order	Partial	Part	
(Constant)	-0.018	0.026				
LN_CG_10 - LN_CG_09	-0.164	-0.054	-0.078	-0.078	-0.078	

Table 13: Causal Relationship: Tobin's Q on Corporate Governance Score

In order to test whether the changes in Tobin's Q leads to subsequent changes in Corporate Governance Score, I run regressions to trace the effect of changes in Tobin's Q from 2009 to 2010 on logs of changes in Corporate Governance Scores from 2010 to 2011. I set the changes in the Tobin's Q as independent variable and logs of changes in Corporate Governance Scores as dependent variable.

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
				R Square Change	F Change	df1
.013 <sup>a</sup>	0	0	0.303223	0	0.449	1
	Mean	Std. Deviation	N	Change Statistics		Durbin-Watson
LN_CG_11 - LN_CG_10	0.04542	0.303189	2470	df2	Sig. F Change	
ADJ_Q_10 - ADJ_Q_09	0.00916	0.49329	2470	2468	0.503	1.882
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
(Constant)	0.045	0.006		7.431	0	
ADJ_Q_10 - ADJ_Q_09	0.008	0.012	0.013	0.67	0.503	
Model	95.0% Confidence Interval for B		Correlations			
	Lower Bound	Upper Bound	Zero-order	Partial	Part	
(Constant)	0.033	0.057				
ADJ_Q_10 - ADJ_Q_09	-0.016	0.033	0.013	0.013	0.013	

### 3. Discussion

Through my empirical test, I confirm that there is a positive and significant relationship between democratic governance and firm value. However, regarding the causality, I do not find strong evidence that an improvement in corporate governance leads a subsequent increase in firm value. A possible explanation would be information effect. When a corporation's reputation improves, the market appreciates it. However, this price adjustment might be only one-time adjustment. Therefore it is possible that marginal improvement after the adjustment in corporate governance hardly makes a difference in terms of change in Tobin's Q.

My empirical study has some limitations. First, the test does not account for the effect of each stock's inclusion in major stock market indices. ASSET4 database is comprised of stocks included in well-known indices such as S&P 500 and MSCI World Index. The different characteristics of different market indices might affect the characteristics of the universe, and the inclusion could lead to an increase in institutional investor ownership. It should also be noted that several indices included in ASSET4 are market-cap based ones. Therefore the result could include a large cap bias.

Second, the model does not incorporate the impact of economic cycle on firm value. My empirical test examines the relationship between corporate governance and firm value and I run regression over three years. However, three years might not be a sufficient period of time to capture the impact of economic cycles. An empirical study over a longer period that can capture a full economic cycle would provide a stronger conclusion.

Third, the model does not take into account the different characteristics of the countries where the firms are incorporated. Previous research suggests that the country's legal environment affects the characteristics of corporate governance practice and firm value (Ferreira and Matos, 2008) (AEFM). I run regression with about 60 country dummy variables, but because of multicollinearity I did not arrive at a useful result from the multivariate analyses.<sup>25</sup>

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<sup>25</sup> SPSS automatically exclude variables that cause a significant degree of multicollinearity. In the test with country dummies, US and Japan company data are usually excluded.



## Chapter IV: Summary and Conclusion

In this study, I review previous studies of corporate governance and the effect of institutional investors on firm value.

Anson, White, and Ho (2003) and AEFM (2010) argue that institutional investors' active engagement increases firm value, whereas Karpoff, Malatesta, and Walkling (1996), Wahal (1996), and Woods (1996) suggest that there is no supporting evidence that indicates a positive correlation between the institutional investors' shareholder engagement and firm value.

Regarding the characteristics of corporate governance on firm value, GIM (2003) and Lawellen and Metrick (2010) suggest that there is a significant positive correlation between these two, while Anderson and Reeb (2003) argue the opposite.

From my empirical test with more recent and globally diversified samples, I confirm that there is a positive and significant relationship between institutional investor ownership and democratic governance. Although the test results on causality is not statistically significant, the test on causality indicates that it is more likely that the institutional ownership leads to an improvement in corporate governance when there is room for improvement in corporate governance practice of target companies rather than vice versa.

From my multivariate regression analyses, I also discovered that there is a significant positive correlation between democratic corporate governance and firm value measured by Tobin's Q. Based on this I believe it is possible to infer that the influence of institutional investors' active engagement on firm value is positive.

Policy suggestion for developing countries: What is Asian Style Corporate Governance?

It has been argued that corporations in Asian countries such as Japan and South Korea tend to have dictatorship corporate governance. People who are in favor of this dictator style of governance practice argue that concentrated corporate governance and control allows companies to contribute more to the overall welfare of the community. This belief is closely related to the unique history of economic development of these countries.

Many of Asian corporation's successes have been indebted to the government support from their home countries. In order to cultivate domestic business, these governments limited import, provided subsidies to exporters in the form of cheap government lending and guarantee, gave tax credit to companies, sided with the corporations in dealing with labor issues, and depreciated domestic currencies in favor of exporters.<sup>26</sup>

The general public in these countries also contributed to this process. As consumers, they chose domestic goods to protect infant industries and accepted lower household purchasing power caused by artificial currency depreciation. As workers, they had to accept low wages and compensations. As

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<sup>26</sup> According to Korea's tax law, corporations which report operating income greater than 20 billion won (Approximately US\$18 million) have to pay 22% of taxable income as corporate tax. However, in 2010, the effective tax rate in Korea was 17.6%. This is substantially lower than Hong Kong's (24.3%) and Singapore's (25.5%). This is largely due to *Restriction of Special Taxation Act*. According to this law, companies can receive tax credit for their expenditure on certain R&D, capital expenditure, and employment. Since large corporations have greater capability to spend substantial amount of money on such expenses, critics say that most of credits are now exploited by large corporations and smaller firms pay higher tax rates than larger corporations. "Why Samsung Electronics Receive 2 Trillion Won Tax Return?" *Weekly Chosun*. (2241). 21 Jan 2013. Web. 16 April 2013.

investors, they had to accept low dividends or capital gains on their investments to support companies' capital expenditure. And, as tax payers, they had to pay more taxes to make up the fiscal holes caused by corporate failures.<sup>27</sup> As a result, it became quite natural for governments and the people to believe that corporations had an obligation to contribute to the overall welfare of the economy.

As Bertrand and Schoar suggest, concentrated ownership control has also allowed the companies to efficiently manage their relationships with the politicians and the government. In the case of Japan and Korea, this close relationship has helped a few firms in these nations to grow very rapidly. Referring to those firms' success, even now a majority of business practitioners in the region warn that if firms adopt Western style democratic corporate governance without having all the preconditions that the developed countries have, such a change will weaken the corporations' competitiveness in the global market. They stress that having democratic corporate control will put downward pressure on corporate credit ratings due to the uncertainty associated with corporate control, increase possibility of hostile takeovers, distort cash flows to increase dividends and to defend incumbent controlling shareholders' control through share buyback, undermining corporations' growth potential, and allow foreign investors to extract wealth out of the nations.<sup>28</sup> Having suffered under imperialism in early 20<sup>th</sup> century, many people in developing countries find these claims quite convincing.

However, theoretically these arguments seem to lack sound basis. First, a corporation's cash flows do not decrease just because the firm is controlled by more than one investor, rather cash flows depend more on management skills and market condition. Second, even under the democratic governance if a firm's management successfully convinces the investors of the need to save cash for future investment, investors tend to wait, as shareholders of Microsoft and Apple have done. Third, if the firm's management uses cash flows to protect the control of incumbent controlling shareholders, this is a breach of fiduciary duty to minority shareholders. If democratic corporate governance indeed distorts cash flows, controlling shareholders and incumbent management should be subject to blame, as they are using other investors' money to protect their own interests. Fourth, the stock market is not a zero sum game. In other words, even if foreign investors extract cash after driving up firm value, this benefits not only themselves but also other investors including domestic investors. If it is true that foreign investment does indeed threatens a country's economic independence, perhaps the country most concerned would have to be the US. Finally, some say that unlike debt holders, equity investors tend to be actively involved in business affairs of the companies they invest in, leading the firms to adopt innovative technology and management know-how to increase firm value. This increased firm value allows a company to successfully defend itself from potential hostile takeover.

In Asian countries, the size of total stock market capital relative to the nation's GDP tends to be smaller than that of other developed countries. According to the World Bank, in 2011 the stock market sizes relative to GDP are respectively, 118.7% in the UK, 104.3% in the US, and 109.8% in Canada.

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<sup>27</sup> Daewoo, once the second largest conglomerate in Korea, went bankrupt in 1999, leaving financial liability of \$80 billion. Most of these losses were shared by local financial institutions that were bailed out by the government. Kim, Woo-jung, the ex-chairman of the company was found guilty of embezzlement and accounting fraud estimated to be between \$20 billion and \$40 billion. In May 2006, Kim was sentenced to serve eight and a half years in prison and held responsible for approximately \$18 billion penalty. In 2007, he was pardoned after serving 20 months in jail. Kim, Joongi. "A Forensic Study of Daewoo's Corporate Governance: Does Responsibility Solely Lie With the Chaeol and Korea?" *Northwestern Journal of International Law and Business*. 28.3 (29).

<sup>28</sup> Hwang, Dong Kyu. "The Way to Prevent the Second Sovereign Case." *Weekly Korea Economic Review*. 05.29. 8 August 2005. Hyundai Research Institute. 2-6.

However, they are 60.3% in Japan, 89.1% in South Korea, 46.3% in China. Perhaps the lack of transparency and weak legal protection for minority shareholders explains this phenomenon.<sup>29</sup>

Referring to the nation's future economic growth strategy facing challenges from other developing countries with cheaper labor forces, policy makers in Asian countries often claim that these nations must develop sophisticated service and financial industry to continue their future economic growth.<sup>30</sup>

My research suggests that investor activism is positively correlated with higher firm value. Although my research has some limitations, it seems quite obvious that by implementing more transparent and accountable corporate governance, companies can increase their firm value, while also developing the nation's financial industry. The debate over dictatorship governance versus democratic governance seems to continue like that about protectionism versus free market economy has for the last several hundred years. My study on corporate governance does not claim to provide a conclusion to this on-going debate, but might nonetheless provide some insights for policy makers and business practitioners in the region.

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<sup>29</sup> "Market Capitalization of Listed Companies (% of GDP)." *Standard & Poor's Global Stock Markets Factbook and Supplemental S&P data*. Web. 20 April 2013.

<sup>30</sup> Due to technology development and specialization, companies in that region tend to focus on high value-added products and started moving facilities outside their countries. For instance, in Korea, it has been said that 10 families controls 80% of Korea's national GDP, but the ten largest corporations hire only 6% of the total population.

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