

International Corporate Governance

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Abstract

We survey two generations of research on corporate governance systems around the world, concentrating on countries other than the United States. The first generation of international corporate governance research is patterned after the US research that precedes it. These studies examine individual governance mechanisms – particularly board composition and equity ownership – in individual countries. The second generation of international corporate governance research considers the possible impact of differing legal systems on the structure and effectiveness of corporate governance and compares systems across countries.

Keywords: corporate governance, ownership, control, takeovers, block holders, boards, investor protection

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I. Introduction

Jensen and Meckling (1976) apply agency theory to the modern corporation and model the agency costs of outside equity. In doing so, they formalize an idea that dates back at least as far as Adam Smith (1776): when ownership and control of corporations are not fully coincident, there is potential for conflicts of interest between owners and controllers. There are also benefits to separating ownership and control; otherwise such a structure is highly unlikely to have persisted as it has.¹ The conflicts of interest, however, combined with the inability to costlessly write perfect contracts and/or monitor the controllers, ultimately reduce the value of the firm, *ceteris paribus*. These ideas form the basis for research on corporate governance. How do entrepreneurs, shareholders, and managers minimize the loss of value that results from the separation of ownership and control?

The publication of Jensen and Meckling's model spawned a voluminous body of research, both theoretical and empirical. Through the 1970s and 1980s that research was largely focused on the governance of US corporations, and US-based corporate governance research continues to expand. By the early 1990s, however, research on governance in countries other than the US began to appear. In the beginning, that research focused primarily on other major world economies, primarily Japan, Germany, and the United Kingdom. More recent years, however, have witnessed an explosion of research on corporate governance around the world, for both developed and emerging markets. The result is an extensive and still growing body of research on international corporate governance. Our task here is to survey that expanding body of literature.

We define corporate governance as the set of mechanisms – both institutional and market-based – that induce the self-interested controllers of a company (those that make

¹ Individuals are not necessarily endowed with both managerial talent and financial capital. The ability to separate ownership and control allows the holder of either type of endowment to earn a return on it. In addition, the ability to raise capital from outside investors allows firms to take advantage of the benefits of size, despite managerial wealth constraints and/or managerial risk aversion.

decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital). Or, to put it another way: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” (Shleifer and Vishny (1997), p. 737).

The governance mechanisms that have been most extensively studied in the US can be broadly characterized as being either internal or external to the firm. The internal mechanisms of primary interest are the board of directors and the equity ownership structure of the firm. The primary external mechanisms are the external market for corporate control (the takeover market) and the legal/regulatory system.

A. Internal Governance Mechanisms

A.1 Boards of Directors

Corporations in most countries of the world have boards of directors. In the US, the board of directors is specifically charged with representing the interests of shareholders. The board exists primarily to hire, fire, monitor, and compensate management, all with an eye towards maximizing shareholder value. While the board is an effective corporate governance mechanism in theory, in practice its value is less clear. Boards of directors in the US include some of the very insiders who are to be monitored; in some cases they (or parties sympathetic to them) represent a majority of the board. In addition, it is not uncommon that the CEO is also the chairperson of the board. Finally, the nature of the selection process for board members is such that management often has a strong hand in determining who the other members will be. The primary board-related issues that have been studied in the US are board composition and executive compensation. Board composition characteristics of interest include the size and structure of the board: the number of directors that comprise the board, the fraction of these directors that are outsiders, and whether the CEO and chairperson positions are held by the same individual. Executive compensation research is fundamentally concerned with the degree to which managers are compensated in ways that align their interests with those of their companies' shareholders.

A.2 Ownership Structure

Ownership and control are rarely completely separated within any firm. The controllers frequently have some degree of ownership of the equity of the firms they control; while some owners, by virtue of the size of their equity positions, effectively have some control over the firms they own. Thus, ownership structure (i.e. the identities of a firm's equity holders and the sizes of their positions) is a potentially important element of corporate governance.

It is reasonable to presume that greater overlap between ownership and control should lead to a reduction in conflicts of interest and, therefore, to higher firm value. The relationships between ownership, control, and firm value are more complicated than that, however. Ownership by a company's management, for example, can serve to better align managers' interests with those of the company's shareholders. However, to the extent that managers' and shareholders' interests are not fully aligned, higher equity ownership can provide managers with greater freedom to pursue their own objectives without fear of reprisal; i.e. it can entrench managers. Thus, the ultimate effect of managerial ownership on firm value depends upon the trade-off between the alignment and entrenchment effects.

Shareholders other than management can potentially influence the actions taken by management. The problem in the typical US corporation, with its widely-dispersed share ownership, is that individual shareholders own very small fractions of an individual firm's shares and, therefore, have little or no incentive to expend significant resources to monitor managers or seek to influence decision-making within the firm. Moreover, the free-rider problem reduces the incentives for these disparate shareholders to coordinate their actions. However, individual shareholders who have more significant ownership positions have greater incentives to expend resources to monitor and influence managers.

As with ownership by managers, ownership by outside blockholders is not an unequivocally positive force from the perspective of the other shareholders. Blockholders can use their influence such that management is more likely to make decisions that increase overall shareholder value. These are the shared benefits of control; i.e. blockholders exercise them but all shareholders benefit from them. However,

there are private benefits of control as well – benefits available only to blockholders. These private benefits can be innocuous from the perspective of other shareholders; e.g. a blockholder may simply enjoy the access to powerful people that comes from being a major shareholder. However, if blockholders use their control to extract corporate resources, the private benefits they receive will lead to reductions in the value of the firm to the other shareholders. Thus, the ultimate effect of blockholder ownership on measured firm value depends upon the trade-off between the shared benefits of blockholder control and any private extraction of firm value by blockholders.

In many countries of the world, the government is a significant owner of corporations. Government ownership represents an interesting hybrid of dispersed and concentrated ownership. If we view the government as a single entity, state-owned corporations have very concentrated ownership. Unlike private blockholders, however, government ownership is funded with money that ultimately belongs to the state as a whole and not to the individuals within the government that influence the actions of the firm. In this regard, the ultimate ownership of state-owned companies is, in fact, quite dispersed. Over time, there has been a trend away from state ownership of corporate assets. The conversion from state to private ownership, termed privatization, provides an interesting setting in which to examine the effects of ownership on firm performance.

B. External Governance Mechanisms

B.1 The Takeover Market

When internal control mechanisms fail to a large enough degree – i.e. when the gap between the actual value of a firm and its potential value is sufficiently negative - there is incentive for outside parties to seek control of the firm. The market for corporate control in the US has been very active, as have researchers interested in this market. Changes in the control of firms virtually always occur at a premium, thereby creating value for the target firm's shareholders. Furthermore, the mere threat of a change in control can provide management with incentives to keep firm value high, so that the value gap is not large enough to warrant an attack from the outside. Thus, the takeover market has been an important governance mechanism in the US.

As with other potential corporate governance mechanisms, however, the takeover market has its dark side for shareholders. In addition to being a potential solution to the manager/shareholder agency problem, it can be a manifestation of this problem. Managers interested in maximizing the size of their business empires can waste corporate resources by overpaying for acquisitions rather than returning cash to the shareholders.

B.2 The Legal/Regulatory System

The literature that we term first-generation international corporate governance research, and which we survey in section II, is largely patterned after the existing US studies. Individual first-generation studies generally focus on board structure, executive compensation, equity ownership, and/or external control mechanisms. The typical individual study examines one (or a small number) of non-US countries. This generation of international corporate governance research, and the US research on which it is patterned, is important and informative. However, it pays only scant attention to another external corporate governance mechanism, the legal/regulatory system. Jensen (1993) acknowledges the legal system as a corporate governance mechanism but characterizes it as being too blunt an instrument to deal effectively with the agency problems between managers and shareholders. Practically speaking, studies that examine evidence from a single country provide little scope for studying the effects of legal systems, as all of the firms in such a sample are subject to the same national legal regime.

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) hypothesize that the legal system is a fundamentally important corporate governance mechanism. In particular, they argue that the extent to which a country's laws protect investor rights and the extent to which those laws are enforced are the most basic determinants of the ways in which corporate finance and corporate governance evolve in that country. This basic idea has spawned a growing body of research that examines differing legal regimes across countries. Such research allows for meaningful comparative studies of corporate governance. Given the interrelationships among the various corporate governance mechanisms, it also has the potential to provide a more complete understanding of the roles of firm-specific corporate governance mechanisms such as the board of directors

and equity ownership. We term this line of research the second generation of international corporate governance research and survey it in section III.

Comparisons of differing systems of corporate governance inevitably lead to certain obvious questions. Is there one ‘right’ system of corporate governance? If so, what are the characteristics of that system and are we observing convergence towards it? If there is not one right system of governance, what characteristics of countries or companies determine which systems are optimal for them? Several authors have tackled these important questions and we review their ideas and ours in section IV. Section V concludes.

Having indicated what we do in this paper, it is incumbent upon us to point out what we do not do. Because numerous excellent surveys of the extensive US literature on corporate governance have been written over the years, we do not survey that literature here.² We do, however, briefly review certain papers and subject areas from the US literature to help frame and interpret the international evidence that we present.

Equity holders, of course, are not the only suppliers of capital to corporations and Jensen and Meckling (1976) also model the agency conflicts between shareholders and debtholders. Other than to acknowledge its existence, we do not deal with that particular agency relationship in this survey.

Finally, the traditional caveat for survey papers applies to this one as well. It would not be possible to give due consideration to all of the many excellent papers that have been written in the area of international corporate governance. The global scope of the topic makes this more true than usual: there are undoubtedly good papers written in languages other than English and/or published in outlets with which we are not familiar. We apologize in advance to the authors of each paper omitted. We have tried, however, to cover a broad spectrum of papers and the major topics in a way that will provide a representative view of what the literature has to say about international corporate governance.

² See, for example, Denis (2001) and Shleifer and Vishny (1997) on general corporate governance; John and Senbet (1998) and Hermalin and Weisbach (2002) on boards of directors; Core, Guay, and Larcker (2001) and Murphy (1999) on executive compensation; Holderness (2002) on blockholders; Holmstrom and Kaplan (2001) on merger activity; and Karpoff (1998) on shareholder activism.

II. First Generation International Corporate Governance Research

The international corporate governance research that we label first generation is largely patterned after a large body of US research. In this section, we review the international evidence on internal control mechanisms, in particular the board of directors and equity ownership structure, and on the external market for corporate control.

The first generation of research on corporate governance mechanisms generally concerns itself with two questions regarding a particular mechanism. First, does that mechanism affect firm performance, where performance is typically measured by profitability or relative market value? Second, does that mechanism affect the particular decisions made by firms; for example with respect to such issues as management turnover and replacement, investment policy, and reactions to outside offers for control?

A. Boards of Directors

A.1. Board Composition

In the US, the board of directors is charged with representing shareholders' interests. As such, it is the official first line of defense against managers who would act contrary to shareholders' interests. A considerable body of evidence addresses the effectiveness with which US boards protect shareholders' interests. Hermalin and Weisbach (2001) review this literature.

The board characteristics that have been most extensively studied are the relative proportion of outside directors and the size of the board. Hermalin and Weisbach summarize the US evidence as follows: (1) Higher proportions of outside directors are not associated with superior firm performance, but are associated with better decisions concerning such issues as acquisitions, executive compensation, and CEO turnover. (2) Board size is negatively related to both general firm performance and the quality of decision-making. (3) Poor firm performance, CEO turnover, and changes in ownership structure are often associated with changes in the membership of the board.

The earliest non-US evidence on boards of directors comes from Japan. Kaplan and Minton (1994) examine the effectiveness of boards of directors in the Japanese system. In particular, they concentrate on the appointment of outside directors to Japanese boards, where outside directors are defined as individuals previously employed by banks or other nonfinancial corporations. They find that such appointments increase following poor stock performance and earnings losses, and that they are more likely in firms with significant bank borrowings, concentrated shareholders, and membership in a corporate group. As evidence that such outside directors are effective corporate governance mechanisms, Kaplan and Minton show that, on average, such appointments stabilize and modestly improve corporate performance, measured using stock returns, operating performance, and sales growth.

Wymeersch (1998) details extensively the makeup of European boards of directors. He reports that, in most European states, the role of the board of directors has not been prescribed in law. Thus, in many European countries shareholder wealth maximization has not been the only – or even necessarily the primary – goal of the board of directors. This varies across countries, with the British, Swiss, and Belgian systems being the most focused on shareholder welfare.

Boards of directors in Europe are most often unitary, as in the US. In some European countries, however, boards are two-tiered. A two-tiered structure is mandatory in some countries, e.g. Germany and Austria, and optional in others, e.g. France and Finland. Two-tier boards generally consist of a managing board, composed of executives of the firm, and a supervisory board. In Germany, representation of employees on the supervisory board, termed co-determination, is mandatory.

Until recently there have been few published papers that study the effectiveness of European boards of directors. Despite this lack of evidence, and despite the fact that the US evidence is somewhat open-ended regarding the effect of board characteristics on firm value, various European commissions have embraced the idea that appropriate board composition is important to good corporate governance. Codes of Best Practice have been issued in a number of European countries, starting with the UK in 1992. Common to most of these codes is a requirement for specified numbers and/or percentages of independent directors on the boards of firms in the country. The codes are typically

voluntary in nature and the degree of compliance with them varies across countries. Wymeersch (1998) hypothesizes that compliance is more difficult on the continent than in the UK, due to the greater presence there of controlling shareholders who do not wish to see their influence reduced by the addition of independent directors to their companies' boards.

Dahya, McConnell, and Travlos (2002) address the effect on board effectiveness of the UK Code of Best Practice, put forth by the Cadbury Committee. Among other things, the Code recommends that boards of UK corporations include at least three outside directors and that the positions of chairperson and CEO be held by different individuals. While the Code is voluntary (as of the writing of this paper), the London Stock Exchange does require that all listed companies explicitly indicate whether they are in compliance with the Code. If a company is not in compliance, an explanation is required as to why it is not.

Dahya, McConnell, and Travlos document that CEO turnover increased following issuance of the Code and that the sensitivity of turnover to performance is stronger following its issuance. These increases are concentrated among those firms that chose to adopt the Code. They further conclude that it is the increase in the fraction of outsiders on the board, rather than the separation of the Chairperson and CEO positions, that explains the turnovers. These results are consistent with the findings of Weisbach (1988) for US firms, but inconsistent with the evidence documented by Kang and Shivdasani (1995), who are unable to document a definitive relation between the presence of outside directors and the sensitivity of CEO turnover to performance for Japanese firms. Franks, Mayer, and Renneboog (2001) examine a sample of poorly-performing firms in the UK and find that boards dominated by outside directors actually impede discipline of poorly-performing managers.

Dahya and McConnell (2002) examine the effect of the UK's Code on appointments of new CEOs. They report that a firm's board is more likely to appoint an outside CEO after the firm has increased the representation of outside directors to comply with the Code. This result is consistent with the findings of Borokhovich, Parrino, and Trapani (1996) for the US. Based upon an event study of stock prices, Dahya and

McConnell also report that appointment of an outside CEO is good news for shareholders.

As stated earlier, some Codes of Best Practice specify that the Chairperson and CEO positions should be held by different individuals. There is relatively limited evidence on whether such a separation influences governance effectiveness. That evidence generally indicates that separating the two positions has no significant effect; i.e. it does not result in better firm performance or in better decision-making by firms. (See, for example, Brickley, Coles, and Jarrell (1999) for the US and Vafeas and Theodorou (1998) for the UK.)

Evidence regarding the effectiveness of boards of directors elsewhere in the world is scattered. Blasi and Shleifer (1996) examine board structure in Russia in 1992/1993 and then again in 1994. They report that most firms are majority-owned by insiders and employees and that the boards are solidly controlled by insiders. Most managers indicate resistance to outsiders on the board. Those board members that are outsiders are typically blockholders. Blasi and Shleifer note that a government decree urging that boards be composed of no more than 1/3 insiders has been ignored by all but a very few small Russian companies.

Hossain, Prevost, and Rao (2001) examine the relation between firm performance and the presence of outside directors in New Zealand firms both before and after the 1994 Companies Act. This Act was issued in 1994 with the intention of enhancing the performance of New Zealand firms through better monitoring by boards. Hossain, Prevost, and Rao find a positive relation; i.e. a higher fraction of outside directors leads to better performance. However, they find no evidence that the strength of that relation was affected by the Companies Act. Rodriguez and Anson (2001) examine the market reaction to announcements by Spanish firms that they will comply with the Spanish Code of Best Practice, which contains 23 recommendations that aim to strengthen the supervisory role of Spanish boards of directors. Rodriguez and Anson report that the stock prices react positively to announcements of compliance when such announcements imply a major restructuring of the board; this reaction is stronger for firms that have been performing poorly.

Consistent with the findings for the US, there is some evidence that boards with more outside directors in other countries are more likely to dismiss top management. Suchard, Singh, and Barr (2001) find that the incidence of top management turnover in Australia is positively related to the presence of non-executive directors on the board. Renneboog (2000) documents a similar result for firms listed on the Brussels Stock Exchange.

Also consistent with US evidence, there is some evidence of a negative relation between board size and firm performance in several non-US countries. Mak and Yuanto (2002) find evidence of an inverse relationship between board size and Tobin's Q in Singapore and Malaysia, while Eisenberg, Sundgren, and Wells (1998) document an inverse relation between board size and profitability for small and midsize companies in Finland. Carline, Linn, and Yadav (2002) find that board size is negatively related to operating performance improvements following UK mergers.

A.2. Executive Compensation

Among the tasks specifically assigned to the board of directors is that of determining the structure and level of compensation of the top executives of the firm. Murphy (1999) and Core, Guay, and Larcker (2001) survey the existing evidence on executive compensation in the US. The compensation issue that is of greatest interest from a corporate governance perspective is the degree to which executive compensation aligns top executives' interests with those of their shareholders; i.e. the sensitivity of executive pay to performance. The US research surveyed by Murphy and by Core, Guay, and Larcker supports several broad conclusions. First, the sensitivity of pay to performance in the US has increased over time. Second, the vast majority of this sensitivity comes through executive ownership of common stock and of options on common stock. Finally, stock options are the fastest growing component of CEO compensation in the US.

The non-US evidence on executive compensation has been relatively limited. Kaplan (1994) studies executive compensation in the US and Japan. He concludes that top executive compensation in both countries is related to stock returns and to earnings losses. The magnitude of that relation is quite similar in the two countries, though

Kaplan points out that US managers own more stock and stock options than do Japanese managers. Conyon and Murphy (2000) compare executive compensation in the US and the UK. They find that the level of cash compensation and the sensitivity of compensation to increases in shareholder wealth are much greater in the US than in the UK and attribute the difference largely to greater share option awards in the US.

Evidence on compensation has more recently expanded to include a greater number of countries. Crespi, Gispert, and Renneboog (2002) study executive compensation in Spain and find some evidence of increased pay following increases in industry-adjusted stock price performance. This sensitivity of pay to performance, however, holds only in the subset of firms that have strong blockholders. Bryan, Nash, and Patel (2002) investigate the relative use of equity in the compensation mixes of firms in 43 different countries. They find that firms in countries with more equity-oriented capital markets and firms with higher growth opportunities use more equity compensation.

Overall, the empirical evidence on board structure and executive compensation around the world supports the more extensive US evidence. Smaller boards of directors are associated with better firm performance. The presence of outsiders on boards of directors does not affect the ongoing performance of the firm, on average, but does sometimes affect decisions about important issues. Codes of Best Practice that have been issued in many countries around the world generally seek to move boards towards greater representation by outside directors. The evidence to date on the effects of compliance with these Codes tentatively hints that having more outside directors alters board decisions within some, but not all, countries studied. The limited non-US evidence on executive compensation indicates that, to varying degrees, pay is sensitive to performance.

For many countries in the world there is only limited empirical evidence regarding issues related to the effectiveness of boards of directors and of the compensation plans they put in place; for some there is no evidence at all. These are useful avenues for further research. In addition, boards of directors and executive compensation cannot be viewed in isolation. The interrelationship between board

composition, executive compensation, and other corporate governance mechanisms remains a fruitful area for research worldwide.

B. Ownership and Control

Early corporate governance research in the US centered on the idea that corporations are owned by widely-dispersed shareholders and are controlled by professional managers who own little or none of the equity of the firms they manage. Beginning in the late 1980s, however, research emerged that recognized that many US corporations do, in fact, have significant equity ownership by insiders and/or shareholders that own significant blocks of equity. Holderness (2002) surveys the US evidence on equity ownership by insiders and blockholders, where insiders are defined as the officers and directors of a firm and a blockholder is any entity that owns at least 5% of the firm's equity. He reports that average inside ownership in publicly-traded US corporations is approximately 20%, varying from almost none in some firms to majority ownership by insiders in others. Mehran (1995) reports that 56% of the firms in a sample of randomly selected manufacturing firms have outside blockholders.

Holderness (2002) also surveys the US literature that examines the effects of insider and blockholder equity ownership on corporate decisions and on firm value. Recall from the introduction that there are opposing hypotheses about these effects. Equity ownership by insiders can align insiders' interests with those of the other shareholders, thereby leading to better decisions and/or higher firm value. However, higher ownership by insiders may result in a greater degree of managerial control, potentially entrenching managers. Similarly, the greater control that blockholders have by virtue of their equity ownership positions may lead them to take actions that increase the market value of the firm's shares, benefiting all shareholders. However, that same control can provide blockholders with private benefits, i.e., benefits that are not available to other shareholders. The private benefits enjoyed by blockholders potentially reduce observed firm value.

The US evidence regarding the effects of ownership structure on corporate decisions and on firm value is mixed. Morck, Shleifer, and Vishny (1988) and

McConnell and Servaes (1990) find that the alignment effects of inside ownership dominate the entrenchment effects over some ranges of managerial ownership. However, as inside ownership increases beyond some level, the entrenchment effects of inside ownership dominate and higher inside ownership is associated with lower firm value. In contrast, Himmelberg, Hubbard, and Palia (1999) use panel data and conclude that changes in managerial ownership do not affect either firm decisions or firm performance.

Holderness (2002) indicates that there have been few direct attempts to separately measure the impact of outside (i.e. non-management) blockholders on firm value. Mehran (1995) finds no significant relations between firm performance and the holdings of a variety of different types of blockholders, including individuals, institutions, and corporations. There is, however, some evidence that the formation of a new block or the trade of an existing block are met with abnormal stock price increases. (See Mikkelson and Ruback (1985) and Barclay and Holderness (1991, 1992).) Overall, Holderness (2002) concludes that the body of evidence on the relation between blockholders and firm value in the US indicates that the relation is sometimes negative, sometimes positive, and never very pronounced.

While there is little strong evidence that blockholders affect the observed market value of firms, the US evidence does indicate that blockholders can enjoy significant private benefits of control. A number of studies document that block trades are typically priced at a premium to the exchange price, consistent with blockholders expecting benefits that are not available to other shareholders. (See Barclay and Holderness (1989), Mikkelson and Regassa (1991), and Chang and Mayers (1995).) The extent to which such private benefits lead to reductions in firm value remains an open question.

B.1. Ownership Concentration Around the World

Of the various corporate governance mechanisms that have been studied in the US, ownership structure is the mechanism that has been studied most extensively in the rest of the world. As with other aspects of corporate governance, the early non-US evidence on ownership focused on Japan, Germany, and the UK.

Equity ownership in the UK has historically been much like that in the US: large numbers of publicly-traded firms, most of which are relatively widely-held. Equity

ownership in Germany has historically been more concentrated than in the US. In addition, banks play more important governance roles in Germany and Japan. These distinctions led researchers to distinguish between market-centered economies (US and UK) and bank-centered economies (Germany and Japan).

Despite both being considered bank-centered economies, there are differences between the structure of equity ownership in Germany and Japan. Prowse (1992) indicates that financial institutions are the most important blockholders in Japan. It has been a common perception that the same is true in Germany; however, Franks and Mayer (2001) find that other companies are the most prevalent blockholders in Germany, followed by families. German banks do, however, have more voting power than their equity ownership would suggest by virtue of the fact that they vote the proxies of many individual shareholders. Thus, financial institutions have significant amounts of control over firms in both Germany and Japan.

Beginning in the mid-1990s, studies of equity ownership concentration expanded to include countries others than the ‘big four’. This body of evidence reveals that concentrated ownership structures are more typical of ownership structures around the world than are the relatively diffuse structures observed in large, publicly-traded US and UK firms.³ This generalization, however, masks important differences across countries with respect to the degree of ownership concentration and the identities of the blockholders.

Faccio and Lang (2002) examine western European countries and conclude that listed firms are generally either widely-held, which is more common in the UK and Ireland, or family-owned, which is more common in continental Europe. Blass, Yafeh, and Yosha (1998) document high ownership concentration in Israel, with banks and affiliated institutional investors as the most significant non-insider holders. Xu and Wang (1997) document high ownership concentration in China, with ownership split relatively equally between the government, institutions, and domestic individuals.

³ Dahlquist, Pinkowitz, Stulz, and Williamson (2003, this volume) present evidence that the existence of concentrated ownership of firms around the world explains some of the well-known home bias in equity ownership. Home bias refers to the overweighting of domestic stocks in investors’ portfolios. This bias has typically been calculated utilizing a world market portfolio. Dahlquist et al argue that large portions of the equity of firms with concentrated ownership structures are effectively unavailable to foreign investors

Valadares and Leal (2000) document high ownership concentration in Brazil; with the majority of blockholders being corporations or individuals.

Numerous non-US studies address the relation between ownership structure and firm performance. Kang and Shivdasani (1995) find that Japanese firms with blockholders restructure more quickly following performance declines than do Japanese firms without blockholders. They point out, however, that the response comes less quickly in Japan than in the US. Gorton and Schmid (2000) document that firm performance in Germany is positively related to concentrated equity ownership. Kaplan (1994), however, finds no relation between ownership structure and management turnover in Germany. Claessens and Djankov (1999) study Czech firms and report that firm profitability and labor productivity are both positively related to ownership concentration.

There are numerous potential types of large shareholders – other corporations, institutions, families, and government – and the evidence implies that the relation between large shareholders and value often depends on who the large shareholders are. Claessens, Djankov, Fan, and Lang (1998), for example, examine firms in nine East Asian countries and find that the impact of ownership varies according to the identity of the blockholder. Ownership by corporations is negatively related to performance, while ownership by the government is positively associated with performance. They find no relation between institutional ownership and firm performance. Gibson (2003, this volume) studies firms in eight emerging market countries and reports that, while CEO turnover is more likely for poorly-performing firms in the sample overall, there is no relation between CEO turnover and firm performance for the subset of firms that have a large domestic shareholder.

The effects on value of ownership by management have been of particular interest in international research. With respect to inside ownership in the UK, Short and Keasey (1999) document that the entrenchment effects of managerial ownership begin to dominate the alignment effects when management ownership is 12%. Because Morck, Shleifer, and Vishny (1988) find that entrenchment dominates alignment beginning at 5%

interested only in portfolio diversification. The world market portfolio therefore overstates the amount of foreign stock available and, thus, overstates the extent of the observed home bias.

managerial ownership, Short and Keasey conclude that managers become entrenched at higher levels of equity ownership in the UK than in the US. They attribute this to better coordination of monitoring by UK institutions and less ability of UK managers to mount takeover defenses. Miguel, Pindado, and de la Torre (2001) document a similar nonlinear relation between inside ownership and firm value in Spain. Carline, Linn, and Yadav (2002) find that managerial ownership has a positive impact on performance improvements following UK mergers. Claessens and Djankov (1998) find for Czech firms that managerial equity holdings have no effect on performance. However, they do show that firm performance improves with the appointment of new managers, particularly if the managers are chosen by private owners rather than by the government. Craswell, Taylor, and Saywell (1997) document only a weak curvilinear relation between inside ownership and performance in Australia; the relation is unstable across time and inconsistent over firm-size groups.

Less direct evidence on the relation between inside ownership and firm performance comes from studies of diversified firms. A large body of US evidence documents a diversification discount; i.e. diversified firms are worth less than the sum of the stand-alone value of the separate pieces of the firm. (See, for example, Lang and Stulz (1995), Berger and Ofek (1995), and Servaes (1996).)⁴ Lins and Servaes (1999) measure the relation between concentrated ownership in the hands of insiders and the value of diversification for firms in Germany, Japan, and the UK. They find that inside owners have a positive effect on the value of diversification in Germany, but not in the UK or Japan. Chen and Ho (2000) study firms in Singapore and document that diversification has a negative effect on value only in firms with low managerial ownership.⁵

We indicated earlier that some governance researchers dichotomize economies into those that are market-centered and those that are bank-centered. Numerous studies

⁴ Several recent studies question whether the diversification discount is caused by diversification per se. (See, for example, Campa and Kedia (2002), Chevalier (2000), Graham, Lemmon, and Wolf (2001), Maksimovic and Phillips (2002), and Whited (2001).) There is, however, little disagreement about the fact that the average diversified firm is valued less than a similar group of stand-alone firms.

⁵ These results contrast somewhat with those of Denis, Denis, and Sarin (1997) for the US. Denis, Denis, and Sarin find that firms with high inside ownership are less likely to diversify. Conditional on diversifying, however, the valuation effects of diversification are unrelated to inside ownership.

address the impact of bank involvement on firm value. Morck, Nakamura, and Shivdasani (2000) find that the relation between bank ownership and firm performance in Japan varies over the ownership spectrum; in particular, the relation is more positive when ownership is high. Gorton and Schmid (2000) report that the positive relation between ownership concentration and firm value for German firms is particularly strong where there is block ownership by banks. Xu and Wang (1997) document an overall positive relation between ownership concentration and profitability in Chinese firms; this relation is stronger when blockholders are financial institutions than when it is the state that is the primary blockholder. Sarkar and Sarkar (2000) find that block equity ownership by lending institutions is positively correlated with firm performance in India. Blass, Yafeh, and Yosha (1998) report that banks are significant blockholders in Israel. They conclude, however, that the benefits that the powerful role of banks have for shareholders are outweighed by the costs, e.g. the lack of an external control market.

The evidence from around the world indicates that the relation between ownership structure and firm performance varies – both by country and by blockholder identity. Overall, however, this body of evidence suggests that there is a more significant relation between ownership structure and firm performance in non-US firms than there is in US firms. Concentrated ownership most often has a positive effect on firm value. The important role that banks play in governance in non-US countries is particularly interesting given that US banks are prohibited from taking a large role in governing US firms. An interesting question is whether such prohibitions interfere with optimal governance for US firms – or whether other aspects of US governance reduce the potential value of bank involvement.

B.2. Ownership Change Via Privatization

The ownership studies reviewed above are primarily cross-sectional in nature. The relationship between ownership structure and firm performance can also be evaluated by examining firms that undergo a discrete change in ownership. A relatively dramatic example of such a change occurs when a previously state-owned firm is privatized, undergoing a relatively rapid transition from ownership by the government to

ownership by private entities. Beginning in earnest in the early 1980s in Britain, privatizations have spread around the world, generating increasing amounts of revenue for the governments involved over the past two decades.

Meggison and Netter (2001) provide an exhaustive review of over 225 studies regarding various economic aspects of the myriad issues surrounding privatization. We do not propose to replicate that effort here and instead refer the interested reader to Meggison and Netter's excellent survey. We focus on a small subset of these studies as well as some studies not included in that survey in order to highlight the privatization findings that we consider most relevant to our survey.

The primary governance-related question addressed in the empirical privatization literature is whether firm performance increases when firms become privately owned. Meggison, Nash, and Van Randenborgh (1994) examine 61 state-owned companies from 18 countries that were privatized over the period 1979 – 1990. They report that, on average, privatized firms experience an increase in profitability, an increase in efficiency (measured as cost reduction per unit of production), and an increase in work force employed from before to after privatization. Boubakri and Cosset (1998) focus on privatizations in developing countries. They compare 79 partially or fully privatized firms in 21 developing countries to various benchmarks and report significant relative increases in profitability, operating efficiency, employment levels, and dividends following privatization.

LaPorta and Lopez-de-Silanes (1999) study 218 Mexican firms from a wide spectrum of industries that were privatized over the period 1983–1991. They document a significant increase in profitability for these firms, due primarily to reductions in employment and the associated reduction in labor costs. Claessens and Djankov (1998) conduct a large scale analysis of 6,354 newly-privatized firms from seven Eastern European countries for the period 1992-1995. Many of these firms became private by means of mass privatization schemes that transformed major sections of the Eastern European economy during the early 1990s. Using multivariate analysis, they conclude that privatization is associated with greater productivity and higher productivity growth.

Dewenter and Malatesta (2001) examine the relation between state ownership and performance cross-sectionally. They look at *Fortune* magazine's largest industrial firms

outside the US for the years 1975, 1985 and 1995; a sample which includes firms that are privately-owned and firms that are state-owned. After controlling for other factors, they report that state-owned firms are significantly less profitable than privately-owned firms. State-owned firms also exhibit significantly greater labor intensity, as measured by employee to sales ratio. They observe, however, that the higher profits are not directly linked to privatization. Rather, the increase in profits seems to occur immediately prior to privatization. Thus, it is possible that governments choose to privatize firms that have become profitable. Alternatively, the prospect of future privatization may prod the company to improve performance.

The studies above represent a larger number of studies that address the effects of state versus private ownership on performance. Overall, the existing body of evidence implies that private ownership is associated with better firm performance than is state ownership. Also relevant to this survey are the related questions of whether the identity of the new owners and the size of their ownership positions matter. A smaller number of studies address these questions.

Governments do not always fully privatize and evidence suggests that performance is negatively related to their continued role in companies. Boubakri and Cosset (1998) find that the performance improvement is greatest when governments relinquish voting control. Majumdar (1998) echoes these conclusions. He studies the performance of state-owned, privately-owned, and mixed-ownership companies in India over the period 1973–1989 and finds that privately-owned firms exhibit greater efficiency than state-owned or mixed-ownership firms and that mixed-ownership firms exhibit greater efficiency than state-owned firms.

A number of studies address the relation between performance and the presence of inside owners and/or foreign owners. Makhija and Spiro (2000) examine the share prices of 988 newly-privatized Czech firms and find that share prices are positively correlated with foreign ownership and with ownership by insiders. Similar results are reported by Hingorani and Makhija (1997), who conclude that insider and foreign ownership mitigate agency problems through incentives that align the interests of managers and investors. In a study of 506 privatized and state manufacturing firms in the Czech Republic, Hungary and Poland in 1994, however, Frydman, Gray, Hessel and

Rapaczynski (1999) find that performance does not improve when ownership resides with corporate insiders, but does improve when outside (i.e., non-employee) owners are introduced. Frydman, Pistor, and Rapaczynski (1996) study the ability of Russian privatization investment funds to effect change in the privatized Russian firms in which they invest. They conclude that domination by corporate insiders, particularly management, typically prevents the funds from accomplishing meaningful change.

Claessens and Djankov (1999) report that the presence of a significant foreign investor is associated with higher profitability in recently privatized Czech firms. D'Souza, Megginson and Nash (2001) study 118 firms from 29 countries that were privatized between 1961 and 1995. They find that greater foreign ownership is associated with greater efficiency gains post-privatization and that efficiency gains increase as government ownership declines. They also report a negative relation between employee ownership and profitability. Similarly, Boubakri, Cosset and Guedhami (2001) find that, in a study of 189 privatized firms in 32 developing countries, profitability and efficiency gains are associated with the presence of a foreign owner. They caution, however, that any positive effect of governance on value can only operate in an open competitive economy with respect for private property rights. In a study of the prices of privatized Mexican firms, Lopez-de-Silanes (1997) finds that prices are positively correlated with the presence of a foreign investor and with turnover in the position of CEO. In a study of 506 privatized and state manufacturing firms in the Czech Republic, Hungary and Poland in 1994, Frydman, Gray, Hessel and Rapaczynski (1999) find that performance does not improve when ownership resides with corporate insiders, but does improve when outside (i.e., non-employee) owners are introduced.

There is some evidence that privatization is most valuable when it results in relatively concentrated private ownership. Claessens (1997) examines the mass privatization and voucher distribution schemes of the Czechs and Slovak Republics in 1992 – 1993. Under this scheme, 1,491 private firms emerged from formerly state owned enterprises. For a relatively modest price, individual citizens could buy points (or vouchers) with which to bid for these corporations. The companies were then sold through a five-round auction. As the auction process evolved, investment companies emerged that bought vouchers from individuals or individual could exchange their points

for shares in the investment companies. Investment companies ended up owning the largest fraction of shares. Indeed, individuals directly held shares in only 168 companies. Claessens regresses standardized share price against controls variables and various measure of share ownership concentration. Both with prices from the original auction and with secondary market prices, he reports that share prices are highly positively correlated with ownership concentration. One interpretation is that dispersed ownership among heterogeneous small shareholders leads to less effective management oversight in firms that are newly privatized. In a later, more detailed, time series study of 706 newly-privatized Czech firms, Claessens and Djankov (1999) find evidence consistent with concentrated ownership leading to better performance in newly-privatized firms. In particular, they report a positive correlation between ownership concentration and post-privatization profitability.

Meggison and Netter (2001) caution that there are numerous potential problems in carrying out empirical privatization research, including bad data, lack of data, omitted variables, endogeneity and selection bias. Comparisons of state-owned to private enterprises require appropriate benchmarks, which can be difficult to identify. With these caveats in mind, however, the evidence to date from the empirical literature on privatization implies that the identity of owners and the size of their positions does influence firm performance. Ownership by insiders and by foreign investors is most often associated with better performance, while ownership by the government is associated with worse performance. There has been little or no evidence, however, regarding other aspects of the governance structures of newly privatized companies, such as board structure and executive compensation. Such firms, with their significant discrete changes in governance structure, remain a fruitful area for international corporate governance research.

B.3. The Private Benefits of Control

Equity ownership provides holders with certain rights to the cash flows of the firm. To the extent that large shareholders have both the incentive to monitor management and enough control to influence management such that cash flow is increased, all shareholders of the firm benefit. These are the shared benefits of control.

Examination of the relation between equity ownership by blockholders and firm performance is essentially measuring whether there are any shared benefits associated with having large shareholders. However, there are potential private benefits of control as well, private in that they are available only to those shareholders who have a meaningful degree of control over the firm.

To the extent that control has value beyond the cash flow rights associated with equity ownership, there is an incentive to hold disproportionate shares of control. There are a number of ways in which shareholders can achieve control rights that exceed cash flow rights in a given firm. In the US, this is most typically accomplished through ownership of shares of common stock that carry disproportionately high numbers of votes. Several studies examine firms that deviate from one share-one vote in the US and find that superior voting shares trade at a small premium to inferior voting shares (See Lease, McConnell, and Mikkelsen (1983, 1984), DeAngelo and DeAngelo (1985), Zingales (1995).) Such evidence is consistent with there being private benefits of control. Studies of voting share premiums around the world confirm the US evidence. The premium is larger in all other countries that have been studied than in the US, ranging from a low of 6.5% in Sweden (Rydkvist (1987)) to a high in Italy of 82% (Zingales (1994)). One interesting exception to the general pattern is in a very small sample of Mexican firms. Pinegar and Ravichandran (2003, this volume) examine firms that have American Depository Receipts (ADRs) on each of two different classes of common stock with differing voting rights. Of the ten pairs of so-called sibling ADRs that they examine, five pairs are Mexican firms and for these five firms the superior voting shares trade at a discount, on average, to the inferior voting shares. Further analysis leads Pinegar and Ravichandran to conclude that control for these Mexican firms has shifted to creditors and competitors, eroding equity voting premiums.

Control in excess of proportional ownership can also be achieved through pyramid structures or by cross-holdings. In a pyramid structure, one firm owns 51% (for example) of a second firm, which owns 51% of a third firm, and so on. The owner at the top of the pyramid thereby has effective control of all of the firms in the pyramid, with an increasingly small investment in each firm down the line. Cross-holdings exist when a group of companies maintain interlocking ownership positions in each other. To the

extent that the interlocking of their ownership positions makes group members inclined to support each other, voting coalitions are formed.

Consolidation of control via dual share classes, pyramids, and cross-holdings are common around the world. Claessens, Djankow, and Lang (2000) examine firms in nine East Asian countries and find that voting rights frequently exceed cash flow rights, typically via pyramid structures and cross-holdings. The result is that in over two-thirds of the firms in these countries there is a single shareholder that has effective control over the firm. Faccio and Lang (2002) report that the use of dual class shares and pyramids to enhance the control of the largest shareholders is common in western Europe, though the resulting discrepancy between ownership and control is significant in only a few countries. For Brazilian companies, Valadares and Leal (2000) document that the vast majority of firms they study have some non-voting shares, while Lin (2003) finds that pyramiding is common.

Group ownership structures are common in a number of countries. In Japan they are termed keiretsu, in Korea chaebols, and in Russia financial-industrial groups. Groups are also common in India, Italy, and Brazil. Kantor (1998) reports that South Africa is dominated by five large groups – three of which are controlled by founders or their families. These groups often have control of individual firms within the groups, despite having made only minority cash flow investments in the firms.

In general, the international evidence indicates that the accumulation of control rights in excess of cash flow rights reduces the observed market value of firms. Lins (2003, this volume) examines 18 emerging market countries and documents that the uncoupling of control rights from cash flow rights is common and value-reducing. Volpin (2002) reports that the sensitivity of top management turnover to performance in Italy is lower when controlling shareholders own less than 50% of the cash flow rights. Nicodano (1998) finds that the voting premium in Italy is higher when there are business groups involved. Lins and Servaes (1999) find that the diversification discount in Japan is concentrated in firms that are part of industrial groups. Lins and Servaes (2002) examine publicly-traded firms in seven emerging market countries and observe a diversification discount only when firms belong to industrial groups or when management ownership is in the 10-30% range. The discount is most severe when

management control rights substantially exceed their cash flow rights. Joh (2000) shows for Korean firms that controlling blockholders in Korean firms are more effective when they also have high cash flow ownership. He finds that firms associated with business groups are less profitable overall. Gorton and Schmid (2000) document that bank control in Germany has a positive effect on firm return on assets when banks own the shares that they are voting, but has no impact on ROA when banks are proxy voting shares held by others.

Several studies address the effect of membership in a group on investment policies in companies within the group. In general, they find that investment is less sensitive to cash flow for firms that belong to groups than for firms in the same country that do not. Hoshi, Kashyap, and Scharfstein (1991) find that Japanese firms with ties to large banks have lower sensitivity of investment to liquidity. Shin and Park (1999) show that investment by firms in Korean chaebols is less sensitive to firm cash flow than is investment by non-chaebol Korean firms. Perotti and Gelfer (1999) document the same for Russian firms that belong to financial-investment groups, particularly those led by banks. While reliance on internal capital markets is not necessarily value-reducing, evidence from the US implies that it more often does reduce value. Scharfstein (1998), Rajan, Servaes, and Zingales (2000), and Ahn and Denis (2002) present evidence consistent with the hypothesis that diversified firms invest inefficiently, investing too much in some business units and/or too little in others.

On a more positive note for group membership, Hoshi, Kashyap, and Scharfstein (1990) present evidence showing that keiretsu membership in Japan reduces the costs of financial distress by mitigating the free-rider and information asymmetry problems that make renegotiation with creditors difficult. Firms that belong to keiretsu, as well as non-keiretsu firms that have a strong tie to a main bank, invest more in productive assets and maintain higher revenues in financial distress than do other Japanese firms.

A number of conclusions can be drawn from the international literature on the ownership of publicly-traded firms. First, ownership is, on average, significantly more concentrated in non-US countries than it is in the US. Second, ownership structure appears to matter more in non-US countries than it does in the US – i.e. it has a greater impact on firm performance. Overall, private ownership concentration appears to have a

positive effect on firm value. Third, there are significant private benefits of control around the world, and they are more significant for most non-US countries than they are for the US. Structures that allow for control rights in excess of cash flow rights are common, and generally value-reducing.

C. The External Control Market

A vast literature on the takeover market in the US indicates that it is an important corporate governance mechanism, a ‘court of last resort’ for assets that are not being utilized to their full potential. Holmstrom and Kaplan (2001) review this literature. Several stylized facts stand out. Average announcement abnormal returns to target firm shareholders are positive, while average abnormal returns to acquiring firm shareholders are, at best insignificantly different from zero and are, in most studies, significantly negative. The combined abnormal returns to a target and acquiring firm pair are relatively small, but significantly positive. Poorly-performing firms are more likely to be targets of takeover attempts and the managers of poorly-performing firms are more likely to be fired.

The takeover market in the UK is also active. Franks and Mayer (1996) examine UK hostile takeovers and find that they are followed by high turnover among members of the board of directors and significant restructuring. Target firms do not appear to be performing poorly before the acquisition bids, however. Carline, Linn, and Yadav (2002) document average increases in industry-adjusted operating performance following UK mergers. Short and Keasey (1999) suggest that managers are less able to avoid being taken over in the UK than in the US due to the inability of UK managers to mount takeover defenses.

Firth (1997) reports that New Zealand’s takeover market is relatively unregulated and that there are a high number of takeovers relative to the size of the economy. The evidence is largely consistent with that for the US: average positive returns to target firm shareholders, average negative returns to acquiring firm shareholders, and an overall gain for the combined firms. He also documents a positive relation between takeover returns and the equity ownership of the acquiring firm’s directors.

Hostile takeover attempts in Germany have been rare, due presumably to the significant ownership concentration that characterizes the equity market. However, a number of authors present evidence that a German control market does exist, albeit one that is different in form from that of the US and the UK. Jenkinson and Ljunqvist (1997) assert that outsiders attempt to take control by seeking to acquire one or more blocks from existing blockholders. Franks and Mayer (2001) confirm these findings. Other evidence indicates that such changes in blockholder identity, and the turnover in board members that typically accompany them, are more likely following poor performance. (See Kaplan (1994), Franks and Mayer (2001), and Koke (2001).) Koke (2001) finds that changes in the blockholders of German firms are followed by increased restructuring activity, particularly management turnover, asset divestitures, and employee layoffs.

In general, takeover activity does not appear to be an important governance mechanism around the world. Kabir, Cantrijn, and Jeunink (1997), for example, find that hostile takeovers are relatively rare in the Netherlands, while Blass, Yafeh, and Yosha (1998) indicate that there is only a very thin takeover market in Israel. Xu and Wang (1997) indicate that there is no active takeover market in China. This general lack of importance of takeovers is perhaps not surprising given the relatively high ownership concentration in most other countries.

The first generation of international corporate governance research provides an interesting look at governance in individual countries around the world. Some recent work on international corporate governance is aimed at comparing governance systems across countries. The authors of these comparative governance studies examine numerous countries in a unified framework, seeking to understand the factors that explain differences in corporate governance around the world. We review this literature in the following section.

III. Second Generation International Corporate Governance Research

The evidence discussed in section II indicates that block shareholders are more common in most other countries of the world than in the US. In addition, the presence of block shareholders is more likely to have a statistically significant effect on firm performance in countries other than the US. In general, the first generation of international corporate governance research does not directly address the reasons for the increased prevalence and impact of large shareholders outside of the US. There are, however, some hints. For example, Zingales (1994) hypothesizes that the premium on voting shares in Italy is so much larger than in other countries of the world because the law does not adequately protect the rights of minority shareholders, giving whoever controls a company greater scope to dilute minority shareholder rights.

Legal and regulatory issues play a relatively small role in the first generation of international corporate governance research. U.S research involving these issues consists primarily of studies involving some specific legal issues, e.g. state of incorporation and state anti-takeover statutes. The effects of the more general underlying system of corporate laws and regulations on corporate governance and firm value are not generally considered. This is perhaps not surprising, given that there can be little variability in such factors in a sample made up entirely of US firms. In addition, some researchers downplay the legal system as an effective means of corporate governance.

The research that we term second generation effectively begins with the work of LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV). In “Law and Finance” (1998) they hypothesize that the extent to which a country’s laws protect investor rights – and the extent to which those laws are enforced - are fundamental determinants of the ways in which corporate finance and corporate governance evolve in that country. Their empirical evidence indicates that there are significant differences across countries in the degree of investor protection, and that countries with low investor protection are generally characterized by high concentration of equity ownership within firms and a lack of significant public equity markets. LLSV measure ownership concentration in each country by computing the total percentage equity ownership of the three largest

shareholders for each of the ten largest domestic, non-financial firms in the country. The median figure for the 49 countries in the sample is 45%. The US figure of 20% is the lowest in the sample; only six countries are under 30%. LLSV assign each of the 49 countries to one of four general groups: common law countries, French civil law countries, German civil law countries, and Scandinavian civil law countries. They find that the laws in common law countries provide the strongest degree of protection for shareholders, while the laws in French civil law countries provide the least protection. Enforcement of the laws is stronger in the German and Scandinavian law countries than in the common law countries, with the weakest enforcement observed in French civil law countries.

Concentrated ownership may be a reasonable response to a lack of investor protection. If the law does not protect the owners from the controllers, the owners will seek to be controllers. LLSV (1998) point out that, in this situation, the agency conflict between managers and shareholders – the primary conflict around which most of the US corporate governance research has revolved - is not meaningful because large shareholders have both the incentive and the ability to control management. LLSV suggest, however, that highly concentrated ownership leads to an equity agency conflict between dominant shareholders and minority shareholders.

In addition to their insight about the agency problems between large and small shareholders, LLSV provide international corporate governance researchers with important data by developing objective measures of investor protection for each of the 49 countries in their samples. These overall scores are made up of variables related to specific shareholder and creditor rights, which measure the protection afforded by the law, and variables related to the rule of law, which measure the degree to which the existing laws are enforced. The variability in legal structures around the world – and the ability to measure it – provide greater opportunities for comparative corporate governance studies.

A. Legal Protection and Economic Growth

One branch of the existing literature on the effects of legal systems on economies and on the firms within them is concerned with their effects on the availability of external finance and, therefore, on economic growth. Rajan and Zingales (1998) hypothesize that financial development facilitates economic growth. Consistent with this, they find that industrial sectors that need more external finance develop disproportionately faster in countries that have more developed financial markets. Wurgler (2000) examines investment by firms in 65 countries. Using the size of stock and credit markets relative to GDP as a proxy for financial development, he finds that firms in countries with developed financial sectors increase investment more in growing industries and decrease it more in declining industries.

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1997) hypothesize that better legal protection leads investors to demand lower expected rates of return and that companies, in turn, are more likely to use external finance when rates are lower. They compute three aggregate measures of the use of external finance and find that all three measures are highest in common law countries, where investor protection is greatest, and lowest in French civil law countries, where investor protection is weakest. Regression analysis indicates that the use of equity finance is positively related to shareholder rights. Demirguc-Kunt and Maksimovic (2002) examine firms in 40 countries and document that the development of a country's legal system predicts firms' access to external finance.

Giannetti (2003, this volume) examines the effect of creditor rights and the degree to which they are enforced on the availability and use of debt for firms in eight European countries. She focuses primarily on unlisted firms, suggesting that their lack of access to international markets makes them more subject to the constraints imposed by their own domestic markets. Giannetti finds that the ability of her sample firms to obtain loans for investment in intangible assets is positively related to the level of protection of creditor rights and the degree to which these rights are enforced; the same is true for access to long-term debt for firms operating in sectors with highly volatile returns.

Himmelberg, Hubbard, and Love (2002) hypothesize that lack of investor protection forces company insiders to hold higher fractions of the equity of the firms they

manage. These high holdings subject insiders to high levels of idiosyncratic risk, which, in turn, increases the risk premium and, therefore, the marginal cost of capital. Himmelberg, Hubbard, and Love find results consistent with their hypotheses for firms in 38 countries. They document a negative relation between the degree of investor protection and the fraction of equity held by insiders, and a positive correlation between inside equity ownership and the marginal return to capital.

Johnson, Boone, Breach, and Friedman (2000) provide evidence that the degree of investor protection in a country also affects the way in which that economy's capital markets respond to adversity. They examine 25 countries during the Asian crisis of 1997-1998 and find that the magnitude of decline in the stock market and the degree of depreciation of the exchange rate are negatively related to the degree of investor protection.

The results detailed above imply that strong economic growth requires developed financial markets and that strong investor protection is necessary if strong financial markets are to develop. Thus, studies indicate that investor protection laws and the degree to which they are enforced affect the size and extent of countries' capital markets and, with them, the level of economic growth.

The positive effects of investor protection on economies are echoed for the individual firms within them. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2000) find that firms in common law countries where investor protection is stronger make higher dividend payouts when firm reinvestment opportunities are poor than do firms in countries with weak legal protection. Dittmar, Mahrt-Smith, and Servaes (2003, this volume) report that firms in countries with strong legal protection are less likely to maintain excess cash balances. They reject the possibility that their results are driven by the difficulty of raising needed external capital for firms in countries where investor protection is weak. Thus, the agency costs associated with free cash flow appear to be lower in countries with stronger investor protection. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2002) find that firms in countries with better investor protection have higher Tobin's Q ratios. Gul and Qiu (2002) relate LLSV's legal protection measures to information asymmetry for 22 emerging market countries, measuring information asymmetry based on the degree of importance that investors place on current versus

future earnings. Their results indicate that greater legal protection is associated with lower levels of information asymmetry and, therefore, with less serious agency problems.

The relation between investor protection and financial systems has implications for the design of other aspects of governance. John and Kedia (2002) model the interactions between ownership structure, debt structure, and the external control market. Their model implies that optimal governance systems are, in part, functions of the degree of development of financial institutions and markets. There is evidence that individual firms within an economy do sometimes structure their own governance to overcome the deleterious effects that the lack of investor protection in their economy has on their ability to raise external capital. Durnev and Kim (2002) examine the quality of individual firm governance for firms in 26 countries using corporate governance scores compiled by *Credit Lyonnais Securities Asia* and *Standard and Poor's*. These scores are assigned based on a wide variety of firm characteristics, including characteristics related to disclosure, board structure, ownership structure, and accountability. Durnev and Kim find that the quality of governance in individual firms varies greatly within countries; in particular, firms with better investment opportunities and firms that rely more on external finance have higher governance scores. Durnev and Kim also find that these firms are valued more highly. Klapper and Love (2002) examine firm-level corporate governance characteristics for emerging market firms and find that these characteristics matter more in countries that have weak investor protection.

There is evidence, however, that without underlying legal protection, individual company governance structures put into place when capital is needed to take advantage of investment opportunities do not necessarily survive when such opportunities disappear. Lemmon and Lins (2001) examine the response of firms in eight East Asian countries to the Asian financial crisis. They find that Tobin's Q falls further and stock price performance is worse for those firms in which minority shareholders are potentially more subject to expropriation. They conclude that ownership structure may be especially important in times of declining investment opportunities. Consistent with this, Mitton (2002) reports that East Asian firms that had higher outside ownership concentration experienced significantly better stock price performance during the crisis.

Fauver, Houston, and Naranjo (2003, this volume) present evidence on another means by which firms may be able to partially compensate for the negative effect of poor investor protection on the availability of finance. They analyze the effect of diversification on value for a sample of more than 8,000 companies from 35 countries. They find that diversification has a more positive (less negative) effect on value for firms in countries with weaker investor protection and suggest that one interpretation of their results is that the internal capital market created by diversification is more valuable in countries in which investor protection is poor and external capital is less available.

Coffee (2001) suggests that social norms may also be an important determinant of the extent to which those in control of the firm take advantage of minority investors. He notes that the Scandinavian legal systems are considered to be relatively strong, despite the fact that they are more like other civil legal systems than they are like common law systems. He points out that Scandinavian countries have very low crime rates and hypothesizes that social norms in Scandinavia may discourage expropriation of minority investors. The fact that such expropriation is relatively low in the US, despite its high crime rate, leads Coffee to suggest the possibility that law and social norms are intertwined. In particular, he hypothesizes that the impact of social norms may be greatest when law is the weakest.

The first generation of international corporate governance reviewed in section II establishes that equity ownership within firms is much more concentrated in most countries of the world than it is in the US, and that this ownership concentration tends to have a positive effect on firm value. The results above offer an explanation for both findings – concentrated ownership is a rational and valuable response to a system that does not protect minority investors.⁶ LLSV (1998), however, point out that there are costs to concentrated ownership as well; namely the potential agency conflicts between large shareholders and minority investors.

⁶ Esty and Megginson (2003, this volume) examine the impact of countries' creditor rights on the concentration of debt ownership in firms by analyzing 495 project finance loan tranches granted to borrowers in 61 different countries. In an interesting contrast to the results regarding equity ownership concentration, Esty and Megginson find that loan syndicates' average response to weaker creditor rights and poor enforcement of rights is to *decrease* debt ownership concentration. Because a larger number of creditors makes re-contracting more difficult, Esty and Megginson interpret their results as evidence that banks faced with weak protection of their creditor-rights see deterring strategic defaults as their primary governance role.

B. Control vs. Ownership: The Private Benefits of Control

If large shareholders benefit only from proportionate cash dividends and appreciation in the market value of their shares there is no conflict between large shareholders and minority shareholders. The evidence in section II, however, establishes that there can also be private benefits of control. Furthermore, the existence of such benefits leads investors in many countries to seek control rights that exceed their cash flow rights. While concentrated ownership is more often associated with increased value, control rights in excess of cash flow rights tend to be value-reducing.

Dyck and Zingales (2002) measure the private benefits of control using the differences between the premiums for voting and non-voting shares for block control transactions in 39 countries. Like previous researchers, they find that private benefits vary greatly around the world and that they are quite significant in some countries. More importantly, they find that the individual voting premiums are negatively related to the degree of investor protection in the country; i.e. in countries where investors are less well protected by law, controlling shareholders can and do extract larger private benefits of control. Nenova (2003) studies 661 dual-class firms in 18 countries, using data for 1997. She isolates control benefits and vote values from stock prices and estimates that the private benefits that controlling shareholders extract from their control range from 0% of firm value in Denmark to 50% of firm value in Mexico. Nenova further finds that variables related to the legal environment explain 75% of the cross-country variation in the value of control benefits.

The second generation international corporate governance literature identifies at least two important ways in which controlling shareholders extract value from the firm. The first is termed tunnelling, defined by Johnson, LaPorta, Lopez-de-Silanes, and Shleifer (2000) as transfers of assets and profits out of firms for the benefit of those who control them. They suggest that there are numerous ways in which tunneling can occur, that it happens even in developed economies, and that it is more likely to occur in civil law countries than in common law countries.

Tunnelling is prevalent in firms in which excess control rights are achieved by pyramid ownership structures. LaPorta, Lopez-de-Silanes, and Shleifer (1999) examine 27 wealthy economies and find that pyramids are the most common method by which controlling shareholders achieve control rights that exceed their cash flow rights. Recall that, in a pyramid structure, one entity owns a controlling interest in a chain of firms in such a way that the controlling shareholder of the firm at the top of the pyramid achieves effective control of all of the subsidiaries down the line, while actually owning an ever smaller portion of each firm. The controlling shareholder can extract value from the firms that are farther down the line by transferring resources of those lower-level companies to the firms that are higher in the pyramid. This can be done in a variety of ways, e.g. by selling goods from higher-level firms to lower-level firms at inflated prices, or by selling goods from lower-level firms to higher-level firms at below-market prices.

Control of a firm also allows the controller to install whoever he/she wishes as managers. Burkhart, Panunzi, and Shleifer (2002) develop a model in which they assume that a professional manager is more capable of managing a company well than is an heir to the founder. Their model predicts that the equilibrium in legal regimes that protect minority investors will be widely-held firms managed by professional managers, while weak-shareholder-protection regimes will tend to have family ownership with heir as managers. Several authors present evidence that controlling shareholders – or their family members - often manage the firms they control. Claessens, Djankow, and Lang (2000) find this to be true for nine East Asian countries, while Lins (2003, this volume) documents the same in his sample of firms from 18 emerging market countries. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1999) find for 27 wealthy economies that controlling shareholders usually participate in management.

Of course, installing family members as managers is not harmful to minority shareholders if the managers installed are the best possible people to operate the firm. What evidence exists, however, demonstrates that this is not the case. The evidence in a number of US studies indicates that CEOs that are family members are more entrenched and more likely to detract from performance. For example, Johnson, Magee, Nagarajan, and Newman (1985) document a positive stock price response to the sudden deaths of founding chief executives; this result does not hold for non-founder chief executives.

Morck, Shleifer, and Vishny (1988) find that, among older firms, Tobin's Q is lower when firms are managed by members of the founding family than when they are managed by unrelated officers. Volpin (2002) finds that the sensitivity of top management turnover to Tobin's Q in Italy is lowest when controlling shareholders are the managers, when control is fully in the hands of one shareholder, and when controlling shareholders own less than 50% of the cash flow rights.

There is currently conflicting evidence on whether the problems associated with the presence of a controlling shareholder are alleviated by also having a large non-management shareholder. LLSV (1999) indicate that it does not help for their sample of firms from 27 wealthy countries. Lins (2003, this volume), however, finds that outside blockholders reduce the valuation discount associated with managerial agency problems for firms from 18 emerging market countries.

Based upon currently existing second generation research, legal structure – in particular the degree to which investors rights are protected – is important to the development of financial markets and to the structure of governance within firms around the world.⁷ The evidence discussed in section II indicates that equity ownership structure has a stronger relation to performance and value in non-US countries than it does in the US. The results presented in this section offer a possible interpretation of this finding. Demsetz and Lehn (1985) hypothesize that ownership is endogenous; i.e. firms will adopt the ownership structure that is most appropriate given the characteristics of the firm. If this is true, the uncertain relation between ownership and performance in the US may not suggest that ownership does not matter – only that different ownership structures are most appropriate for different firms. Under this view, the more significant relation between ownership and performance in some other countries in the world may stem from their weaker legal systems. In other words, without strong protection of investor rights, firms do not have the luxury of developing optimal firm-specific governance systems. Concentrated ownership is a necessity, despite the fact that it creates its own set of problems. Consistent with this, Lins (2003, this volume) finds stronger positive relations between ownership and performance in countries with less legal protection and Durnev

and Kim (2002) find that relations between governance quality scores and Tobin's Q are stronger in countries that are less investor friendly.

Do these results suggest that concentrated ownership is suboptimal in an overall sense, that its incidence would be greatly reduced if legal systems the world over provided strong protection of investors? Would corporate governance systems converge in such an environment? Are they converging in the current environment – and, if so, towards what are they converging? We turn to these questions in the following section.

IV. Convergence in Corporate Governance Systems

For as long as we have recognized fundamental differences in corporate governance systems across countries, there has been debate about which system is 'best.' Because the earliest non-US evidence was from Germany, Japan, and the UK, the early debate centered around these countries and compared the bank-centered governance systems of Germany and Japan to the market-centered governance systems of the US and the UK. During the 1990s, the system of governance in Japan was compared favorably to that of the US. While the US system was heavily market-based, the Japanese system was more relationship-based. Proponents of the Japanese system characterized it as a superior substitute for the external control market, one in which managers were less subject to short-term pressures from the market. Critics, however, argued that the system entrenched managers, potentially protecting them from the value-increasing discipline of the market.

Shleifer and Vishny (1997) assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. The US and UK systems rely somewhat more heavily on stronger legal protection, while the German and Japanese systems are characterized by weaker legal protection but more concentrated equity ownership. Shleifer and Vishny downplay the debate about the corporate governance systems of these particular countries and characterize all four of them as having good corporate governance systems.

As corporate governance evidence from countries other than the ‘big four’ has grown in volume, the scope of the debate has expanded as well. Shleifer and Vishny (1997) argue that other countries of the world lack the necessary legal protection to develop good corporate governance systems. In other words, while there is some room for variation in legal protection, there is a reservation level of legal protection that is required if an economy is to have an effective corporate governance system – and this reservation level is not met in many of the world’s economies. Rajan and Zingales (2000) hypothesize that, while a relationship-based system of corporate governance can overcome some of the problems associated with the lack of investor protection, the long-run ability of firms to raise capital and allocate it efficiently will be better served by a market-based system. They emphasize that a market-based system can only be effective with transparency and strong legal protection of investors. Bradley, Schipani, Sundaram, and Walsh (2000) stress that a contractarian system of governance, such as that observed in the US, allows for greater flexibility and, therefore, allows firms to better adapt to dramatic changes. They cite the important role of law in dealing with aspects of the modern corporation that cannot be completely contracted upon.

It is likely that an evolution towards stronger legal protection for investors in many countries would lead to improved corporate governance systems and greater economic development. What is less clear is the likelihood of such an evolution occurring. Coffee (1999) hypothesizes that corporate evolution is likely to follow the path of least resistance and that evolution in corporate laws faces too many obstacles to be predicted. LLSV (1999) and Bebchuk and Roe (1999) conjecture that the controlling shareholders of the world will fight to protect the private benefits of control that accompany their concentrated equity ownership. Attempts to improve laws protecting minority shareholders clearly threaten those private benefits of control. To the extent that controlling shareholders are influential people within economies, convergence to legal systems that are more protective of minority investor rights will be difficult. Stronger laws will expropriate value from controlling shareholders; thus, controlling shareholders will demand to be compensated for their losses.

Because the large number of changes in laws that are needed to bring about legal convergence are likely to be politically difficult, Coffee (1999) and LaPorta, Lopez-de-

Silanes, Shleifer, and Vishny (2000) put more store in what they term functional convergence. Functional convergence occurs when individual investors and/or firms adapt in ways that create stronger governance, despite a lack of appropriate legal structure. For example, investors can opt to invest their money in firms that are domiciled in more investor-friendly regimes. Firms in less protective regimes can bond themselves to practice better corporate governance by listing on exchanges in more protective regimes or by being acquired by firms in more protective regimes. Coffee points to the significant number of Israeli firm that have effected their initial public offerings on NASDAQ in the US. Reese and Weisbach (2001) present evidence indicating that foreign firms that list in the US do so to protect shareholder rights. Doidge, Karolyi, and Stulz (2001) examine firms at year-end 1997 and find that foreign companies listed in the US have greater Tobin's Q ratios than do firms from the same countries that are not listed in the US. They hypothesize that the firms that list in the US are better able to take advantage of growth opportunities and that their controlling shareholders cannot extract as many private benefits of control. Bris and Cabolis (2002) document that the Tobin's Q of an industry typically increases when firms in that industry are acquired by firms domiciled in countries that have stronger corporate governance systems.

Hansmann and Kraakman (2000) argue that there is a strong likelihood of convergence towards a single governance model. They assert that the basic corporate form has already achieved a great deal of uniformity; i.e. that economies are approaching a world-wide consensus that managers should act in the interests of shareholders and that this should include all shareholders, whether controlling or non-controlling. They believe that there are three principal factors driving economies towards consensus: the failure of alternative models, the competitive pressures of global commerce, and the shift of interest group influence in favor of an emerging shareholder class. They acknowledge that convergence in corporate law proceeds more slowly than convergence in governance practices; however they expect that the pressure for convergence in law will be strong and ultimately successful.

Perotti and von Thadden (2003, this volume) stress the role of transparency in any convergence to a market-oriented system of governance. They hypothesize that lenders

have less desire for transparency than do equity holders. Perotti and von Thadden believe, however, that increases in financial integration and product market competition around the world are likely to increase the returns to information gathering, thereby generating greater information revelation. Ultimately, this process will lead to reduced influence by banks and a convergence towards market-oriented financial systems.

What about convergence in corporate governance mechanisms other than the legal system? There is evidence of convergence in a number of areas. Shleifer and Vishny (1997) and Hansmann and Kraakman (2000) report that governance systems in Germany, Japan, and the US show signs of convergence towards each other. Large shareholders are on the increase in US firms, while board structure in Germany and Japan are moving more toward the US model of a single-tier board that is relatively small and has both insiders and a meaningful number of outsiders. Wojcik (2001) examines changes in ownership structure in German firms over the period from 1997 through 2001. He reports that the level of ownership concentration fell significantly over this period, that cross-holdings began to dissolve, and that financial sector institutions declined in importance as blockholders. He concludes that German firms are, on average, moving towards the Anglo-Saxon system. The significant incidence of privatizations around the world represents a move towards the private ownership that characterizes the major economies of the world.

Codes of Best Practice around the world are consistent with convergence towards an Anglo-Saxon governance structure. As discussed earlier, Dahya, McConnell, and Travlos (2002) and Dahya and McConnell (2002) report evidence of significant changes in board structure in the UK following code adoption there. However, evidence from some other countries is less favorable. Bianchi and Enriques (1999) that attempts by the Italian government to increase protection of minority shareholders by fostering greater activism by institutional investors have not been successful. DeJong, DeJong, Mertens, and Wasley (2001) study firms in the Netherlands following a private sector initiative to promote change in the balance of power between management and investors. They find no substantive effect on corporate governance characteristics or on the relations between these characteristics and corporate value.

Liu (2001) reports that securities laws in Taiwan and China are increasingly influenced by the American common law model. In China such laws are meant to reduce asset stripping by directors and managers of state-owned companies, while in Taiwan it is minority expropriation by founders of family-controlled listed companies that the government wishes to curb.

In a more comprehensive study, Khanna, Kogan, and Palepu (2002) analyze 37 countries to determine whether globalization is leading firms to adopt a common set of the most efficient governance practices. They find *de jure* convergence – i.e. convergence in law - at the country level. Rather than converging towards any single system, however, they find convergence between various pairs of economically interdependent countries. They find no evidence of *de facto* convergence – i.e. convergence in practice. They conclude that while globalization has induced adoption of some common corporate governance recommendations, these recommendations do not yet appear to be being implemented.

Time will tell what the bottom line on the convergence of corporate governance systems around the world will be. Presumably market forces will affect the extent to which convergence occurs; however market forces are not allowed to operate unimpeded throughout the world. Convergence towards stronger legal protection of investors is likely to result in increased investment and growth; however, it is not clear whether or how quickly such convergence will occur. Convergence in other aspects of corporate governance – such as board composition and ownership structure – are evident in some places. Broad convergence may be hampered by the fact that there is not yet agreement on the factors that determine the optimal structures for individual firms.

V. Conclusion and Directions for Future Research

The literature on international corporate governance tells us much about corporate governance but the message in the information is far from clear or complete. Much more work remains to be done. Our understanding of the relationship between systems of governance and the value of economies and the firms within them is of increasing

importance as emerging markets around the world look to the developed markets to decide how to set up their own economic and corporate governance systems.

In this paper we review existing international corporate governance research. The first generation of this research is broadly patterned after the large body of evidence on governance mechanisms in US firms. These first generation studies examine governance mechanisms that have been studied in the US – particularly board composition and ownership structure – for one or more non-US countries.

The first generation of international corporate governance research examines individual countries in depth and establishes that there are important differences in governance systems across economies. Early international research focused primarily on Germany, Japan, and the UK. Even across these very developed economies, significant differences in ownership and board structure were observed. As international research expanded into other countries, the differences in corporate governance systems mounted. Of particular note are the very distinct differences in ownership structure across countries. The typical large US corporation, with its diffuse equity ownership structure and its professional manager, appears to be typical only of the US and the UK. Ownership concentration in virtually every other country in the world is higher than it is in these two countries. In many countries, majority ownership by a single shareholder is common.

It is also common in many countries that major shareholders' control rights exceed their cash flow rights. The realities of ownership and control are such that the primary agency conflict in the US – that between professional managers and their widely dispersed shareholders – is relatively unimportant in many other countries. In its place, however, there is a different agency conflict, that between controlling shareholders and minority shareholders. Evidence suggests that the private benefits of control of companies can be significant and that they are value-reducing.

The typical first-generation international corporate governance study examines one particular country. Taken together, these studies reveal differences in governance systems across countries. Such a fragmented approach, however, does not yield much understanding of why we observe the differences we do. To be able to explain these

differences, examination of many countries in a unified framework is required. This task is taken up in the second generation of international corporate governance research.

An important insight generated from the second generation research is that a country's legal system – in particular, the extent to which it protects investor rights – has a fundamental effect on the structure of markets in that country, on the governance structures that are adopted by companies in that country, and on the effectiveness of those governance systems. This insight, along with newly-developed measures of the strength of countries' legal protection of investors, will continue to generate a rich body of comparative corporate governance studies.

Strong legal protection for shareholders appears to be a necessary condition for diffuse equity investment. The relatively diverse ownership of US firms can be attributed, at least in part to the relatively strong legal protection available to potential investors in the US. The general lack of a relationship between ownership structure and firm value could simply mean that the strong legal protection in the US allows US firms to pick and choose among a menu of potential governance mechanisms to achieve optimal structures. In countries with weak protection, however, it appears that only ownership concentration can overcome the lack of protection.

While there is a large body of evidence on individual corporate governance mechanisms in the US, there is much less published evidence addressing the interrelationships among them and the factors that determine the optimal governance structure for a particular firm. In addition, the recent evidence on the importance of legal structure poses new questions even for the US. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) argue that, while protection of shareholder rights in the US is the strongest in the world, such protection is not particularly strong anywhere. Would greater protection in the US improve corporate governance, and with it firm values? Clearly there are limits to the value of protection. For example, a system in which shareholders have the right to approve or disapprove every decision made by managers would be neither practical nor valuable. But what are these limits? Does the US have an optimal level of shareholder protection, or is there room for improvement?

Governance structures around the world are evolving, as governments, private parties, and markets seek to strengthen their economies and firms. Such evolution will

provide opportunities for rich new data. For many countries in the world, there is relatively little empirical evidence on governance mechanisms other than legal protection and ownership structure. Such issues as board structure, compensation, and changes in control have been extensively studied in the US but have been studied much less – if at all – for many other world economies. This may reflect the dominant role of ownership structure in these economies, a dominance that appears to be driven at least in part by weaknesses in legal systems. Evolutions in legal structure provide for natural corporate governance experiments. What aspects of legal systems evolve? What are the effects of such changes on the role of other firm-specific governance mechanisms? What, ultimately, are the effects of such changes on the strength of economies and on the actions and value of companies within them? Answers to these questions will increase our understanding of the role of corporate governance throughout the world.

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