

## **Institutions, Governance and Finance in a Globally Connected Environment**

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## **1. The background**

The last two decades have witnessed the globalization of markets, leading to the internationalization of firms at an unprecedented scale across different countries. The governments in many countries have removed different types of barriers to entry in business, allowed greater degree of foreign ownership in FDI, eased up capital controls and relaxed rules for participation of foreign institutional investment in the capital market. All these moves have helped the markets to become globally connected. Such policies in turn have encouraged many firms to internationalize themselves via various means, including exporting their products to global markets, cross-listing at international exchanges with significantly stricter legal, monitoring and governance regimes, acquiring firms across borders and issuing securities like ADR etc.

Simultaneously, the shift towards International Financial Reporting Standards (IFRS), reforms in the internal corporate governance laws and the creation of new financial markets or adapting the existing ones to conform to global norms have certainly contributed to the uniformity of standards for judging and comparing the performances of firms over a period of time both within and across economies. All these had a direct impact on a firm's choice of corporate governance structure from a weak to stronger legal regimes as well as altering global investors' feasibility sets for the allocation of portfolio investments. The firms found opportunities to align themselves to better governance systems and to migrate to better monitoring regimes, which reduced information asymmetry and improved their stock market valuations in many cases. On the other hand, the integration of access to capital markets by global investors reduced fragmentation and led to reductions in the cost of capital and better access to financing in the world capital markets. The latest trend towards bringing about the uniformity of global standards in auditing and the market micro-structure of trading contribute to this overall trend.

While the huge body of early work on corporate governance shows that the internationalization of firms in globalized markets brings about changes in the governance, valuation and functioning of firms, the results are not uniform across countries. This could be

due to the fact that internationalization, globalization and the attendant forces that bring uniformity in markets do not operate in a vacuum. They rather interact symbiotically with the institutions like the political systems, income or wealth distribution, and indigenous institutions peculiar to a country's history (e.g., family firms, financing network, efficiency of bankruptcy procedures, financial institutions catering to specific communities). Such factors, however, are not easily malleable and may not have the inner flexibility to change along with the speed of changes brought about by the integration of global financial or product markets.

In response to these developments, research in the general field of corporate finance has been continuously making inroads into new areas while expanding the frontiers of many traditional territories. New methodologies, novel sources of data and broader themes have continued to shed new light on conventional areas of finance related to agency costs, informational asymmetry and the incompleteness of contracts etc. Simultaneously, new and emerging areas linking finance to political environments, cultural dimensions or the importance of the role of gender (e.g. in boardrooms) have entered the arena of mainstream of corporate finance. The new empirical methodologies often exploit exogenous shocks to economies or institutions. They have deftly addressed concerns on endogeneity problems, omitted variable biases and other potential econometric problems that often plague empirical work (see, for example, the contribution of Roberts and Whited, 2013). These novel empirical methods in combination with unique datasets have helped researchers look into older questions in numerous fields (like determinants of firm value, dividend policy, financial structure, IPO, M & As, and so on) as well as introduce new themes with a higher degree of accuracy and precision and enriching almost every branch and sub-branch within the corporate finance literature.

At the 2015 International Finance and Banking Society (IFABS) Corporate Finance Conference held at the Saïd Business School of the University of Oxford on 12-13 September, 2015, three key themes emerged as participants strove to understand the interactions of internal and country specific systems and institutions with the forces of globalization of markets and firms' bids for internationalization: 1. interactive institutions and markets, 2. structure of CEO compensations and 3. governance mechanisms in firms.

This special issue reflects some key contributions made at the conference to the debate above. It presents 17 papers that tackle the three themes mentioned above, keeping in mind the limitations of making a seamless blend of a wide range of papers under the umbrella of multiple but related themes. Each paper makes a significant contribution to the literature and we hope to draw out the unifying themes for the reader.

## **2. Institutions and markets**

The papers in this category mostly deal with topics ranging from the contributions of both the younger venture capitalist (VC) and matured buyout (BO) firms segments of private equity and the restoration of credit rating agencies' credibility in the post-crisis scenarios to the issues of IPO and capital structure in the context of both emerging and developed markets.

Meggison et al. (2018) in this special issue explore whether the contribution of VCs to their client firms persists beyond the initial public offering (IPO) phase and investigates whether such IPOs exhibit lower risk profiles in post-IPO scenarios compared to non-VC backed entities. In addition to uncovering channels via which VCs exert such influences, the paper also explores the sources of systematic differences between VC and non-VC backed IPOs. Resolving these issues is non-trivial because theoretical arguments could go in favour of either VCs or sponsored firms. For example, VCs' special expertise in screening applicants might lead to a selection of firms with better ability of risk management in the post-IPO period. On the other hand, the certification effects of being selected by a VC might prompt other banks and financiers to lend to these firms more aggressively and contribute to their financial distress. Due to these multiple and contrasting trade-offs, the resolution to these questions is purely empirical.

The paper, with the aid of a dataset spanning 1990 to 2007 covering a sample of 1,593 US IPOs (with 27.5% VC backed IPOs) finds (after controlling for other key variables such as size and age) that the VC backed IPOs display a lower financial distress risk than non-VC backed firms, as the former as a group performs better within all standard measures of financial

distress risks (such as Z"-, ZM- and O-score). These results proved to be robust with OLS regressions that tested for financial distress risks for both VC and non-VC firms.

Moreover, the differential effect shows up in lower costs of debt for the VC backed IPO firms. Another interesting finding of the paper is that IPOs with bank-affiliated VCs turn out to be less risky than their counterparts backed by independent VCs. The last finding is consistent with the fact that some VCs (especially those with corporate affiliations) are not constrained under the pressure of raising funds as they have access to internal parental organizational funding; hence, they can afford to choose firms that are less risky but with better longer-run prospects.

The paper contributes to our understanding of the literature on VCs in multiple dimensions. First, it extends the earlier analysis which shows that VC backed firms exhibit lesser under-pricing in IPO (Megginson and Weiss 1991) and also confirms that such firms display lower risk profile in post IPO scenarios. These findings call for further attention towards the analysis of the dynamic impact of VCs' contribution on sponsored firms' financial and investment policies in post-IPO period. Second, the finding of differential performances of IPO firms for independent and bank-affiliated VCs also provides input for further analysis that might explain why seemingly similar activities (exit via IPO) performed by different forms of organization yield altogether very dissimilar outcomes.

In a similar vein, Michala (2018) in this special issue combines both the younger (VC) and matured (buyout firms) arms of private equity (PE) sponsored firms to study their comparative economic and financial performances in the post-IPO scenarios.<sup>1</sup> Broadly speaking, this paper investigates whether PE firms, in general, time their IPOs in hot markets to inflate valuations for the purpose of "loading lemons" to uninformed investors. This paper deals with questions often flagged by the media, with a comparative analysis of (a) degree of underpricing in IPOs and (b) probability of financial distress of such firms in post-IPO scenarios.

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<sup>1</sup> While there are some overlapping of functions between buyouts and VCs, many other important aspects like age profiles, mechanisms of control, security design, etc. vary between them (see Metrick and Yesuda 2011), although both often use IPOs as an exit route.

The paper finds that although PE sponsors do time their target firms to enlist IPOs in hot markets, they do not do so with a frequency which is higher than stand-alone firms. Another related finding of the study is that the degree of underpricing tends to be smaller in BO backed firms compared to their benchmarks. Thus, according to the study, PEs in contrast to media and public perceptions, do not necessarily have the tendency to rush their clients into premature IPOs in comparison to benchmark firms. The paper also finds that BO and VC backed IPOs default less than others. The paper complements the study by Megginson et al. in this volume by extending their work on financial distress to BO firms. These two papers also employ different data sets and empirical methodologies. While the first paper uses different measures of financial distress, Michala's paper uses multi-period logit regression framework for prediction in IPO pricing and post-IPO business failures leading to bankruptcies.

A major feature of the PE firms is that they write elaborate contracts with their investee firm which often explicitly specify key features such as termination date (being a partnership organization), compensation structure for all stakeholders and fund size, among other attributes. Several theoretical and empirical studies show (see the references in Metrick and Yasuda, 2011) that very often such multi-dimensional contracts are in response to agency and information asymmetry problems.

Fang (2018) in this special issue extends this literature to emerging markets, where the PEs in recent times have started becoming quite active in China and India. The central question of the paper is: why such PE funds in emerging markets often tend to have a shorter life span, with their structure of compensation being tied to it? To answer this question, the paper uses a setup where the manager of a PE fund, due to agency problems, has an incentive to burn money by undertaking risky but inefficient projects unless he is "in the money." Such "risk shifting" incentives, under a long-fused contract, lead the manager to opportunistically time her investments and burn money when early investments fail (i.e., when she is "out of the money"). Minimizing agency costs in this setup are shown to require both (a) a short fuse, which restricts the manager's timing to engage in opportunism, and (b) a low-powered incentive compensation that mitigates the money-burning tendency. However, such a (constrained) optimal financing arrangement can force the manager to concede rents to

investors in the fund due to the induced trade-off between rents to investors and curbing agency costs. So, the paper predicts that the equilibrium financing arrangement would be short-fused and leave some rents for investors in the presence of greater degree of agency costs due to a lack of strong enforcement mechanisms and institutional monitoring. The opposite holds true in developed markets due to the presence of stronger regulatory institutions. Thus, the paper draws parallel predictions on managerial behaviour, fund structure, and investment performance for both short-fused emerging-market and long-fused developed market PE structures and thus provides the basis for a comparative empirical study for the validation of these findings.

Due to lack of co-ordination among themselves, small investors often tend to hold different opinions about the IPO firms even when they have same sources of information (e.g. IPO prospectus); see Chemmanur and Fulgheri (1999). A large body of literature documents that the presence of large shareholders (PE or institutional shareholders) can reduce the degree of such heterogeneous belief. This can be achieved if small investors could observe the magnitude of IPO stockholding and the price paid by large shareholders. This is consequent to the fact that the latter would buy equity shares of a relatively unknown company only if their expected returns exceeded the costs of production of information about the quality of such IPO firms. However, the quantity of shares purchased and the price paid by large shareholders are often conducted privately through negotiated settlements unless legal mandates explicitly call for the transparency of such transactions. Hence, legal regimes that mandate allocation of shares and the process of price setting (fixed price or auction), to be in the domain of public information help the price discovery process in IPO markets more efficient.

Samdani (2018) in this special issue investigates whether changes in the regulatory rules in India, purported to create a direct impact on the book building process, helped to narrow the gap between investors' belief about IPO stocks in the country. The setup here is a 2009 legal mandate whereby the Securities Exchange Board of India (SEBI, the regulatory body in the Indian stock market) allowed anchor or large qualified institutional investors to receive a guaranteed share allocation at a fixed price in the pre-market price discovery phase. The new law revived the book building process by reversing its earlier decisions and gave underwriters

more discretionary power to allocate shares to preferred large investors but ensured that both price and quantity of shares settled in such transactions are announced in the public domain.

The law passed by the SEBI served an almost similar purpose to that of a quasi-natural experiment, which the author exploits to determine whether it reduces the heterogeneity of investors' beliefs associated with above-market-average earnings, finding that the mandated transparency, thrust upon anchor investors before public filing, reduced the degree of dispersion among investors' beliefs associated with reported earnings, and thereby improved the price discovery process. The enacted law also sped up the time by which new information was reflected in market prices and the result is independent of accounting standards and financial reporting quality. The paper's findings illuminate the role and contributions of regulatory institutions toward the process of fair price determination, however further research should investigate potential costs of such transparencies, which might have a negative impact on participation by large (anchor) investors.

The next two papers deal with the effectiveness of grades on bonds issued by rating agencies, which have been battered badly by the media and regulatory institutions in the aftermath of the financial crisis. The US congress and the Securities and Exchange Commission (SEC) have undertaken a series of pro-active steps in the aftermath of a chain of business failures of firms (like World.com, Enron), whereby many had earned investment grades from rating agencies just before filing the chapter 11 code of bankruptcy. Such efforts by lawmakers resulted in the legislation of the Credit Rating Agency (CRA) Reform Act in 2006. Later further legal measures to promote the transparency and timeliness of ratings have been adopted, especially in the post sub-prime crisis era of 2009, when many loss-making structured products also received inflated ratings; see Griffin and Tang (2012). By now, we have sufficient data to address the question of whether such legal mandates and measures together with reputational considerations of the CRAs have improved the timeliness and accuracy of ratings and restored their credibility to users.

For example, Berwart et al. (2018) in this special issue look for the existence of any lead-lag relationship between *issuer verses investor* paid ratings to investigate this question. Other than the fact that in the former the issuer pays the CRA fee upfront, while mostly the investor



pays it upfront (in most cases) in the latter, there are other innate differences between the two forms of rating that have a direct bearing on the quality of information dissemination of issued grades. While issuer-sponsored ratings could suffer from an upward bias (as the objective of the issuer is to receive the highest rather than the most accurate ratings) and competition between CRAs could even lead to a “race to the bottom” of rating inflation, the investor-initiated ratings could suffer from both free rider problem across the investors and default on payments from the issuer inflicted by lower ratings. However, regulatory intervention could cost the CRAs their reputation and damage investors' confidence in the reliability of ratings, which potentially could outweigh the short-term gains from the increased issuer fees from inflated ratings. However, to what extent such concerns could bring back the timeliness of ratings and restore the credibility of the CRAs is an empirical question to which this paper turns its attention.

Using a Granger causality analysis and an ordered-probit framework (due to ordinal nature of rating), the paper finds that, in the wake of reforms, prior changes in ratings by the investor-paid ratings would significantly increase the probability of similar actions by the other type of agencies in a window of six months. However, this causality turned bi-directional after 2002, indicating some degree of recovery of investors' trust by the CRAs. However, the paper also finds that investor-paid downgrades become associated with more negative, statistically significant abnormal stock returns than issuer-paid downgrades. Together, these results imply that although the market's confidence in the ratings paid for by the issuer was building up, the pace was slow and gradual.

In a similar vein, Driss et al. (2018) in this special issue focus on the CRAs but address the general perception of the negative image of the CRAs from the perspective of lenders, who would be wary of lending to firms even when receiving high grades on their current bonds from CRAs. To analyse the issue, the authors are utilizing an event called “credit watch”, whereby a CRA, upon receipt of a negative signal, issues a warning of the future possible ratings downgrade unless the firm undertakes (costly) action to reverse the situation. Typically, CRAs either confirm the original rating after the end of the watch period or the firm is downgraded. Thus, a “credit watch” could serve as an early warning system and it could

affect a firm's financial and investment policies if the lenders place some importance on the abilities of the CRAs. The “credit watch” event, in that case, disseminates information about the recipient firms and also calls for a greater monitoring of their activities by CRAs and lenders inside the watch period.

Using a dataset of Moody's watch assignments spanning the period from 1992 to 2014 (with 27% confirmation in the sample), the paper finds that those firms on an average received confirmed initial ratings after the watch period, had their financial constraints relaxed (indicated by the WW-index of Whited and Wu (2006) and the measures of cash flow-investment gap as in Rajan and Zingales (1998)), procured a higher level of long-term debt financing, and increased their physical investment and experienced growth of assets in the four quarters after the end of the watch period. Of course, the endogeneity issues often cloud empirical findings because the firms who avoided downgrades could be the better ones and their performances might not be related to the early warning and monitoring by the CRAs. To address these issues, the authors properly matched both confirmed and non-confirmed firms along similar lines of relevant attributes such as size, Tobin's Q, etc. and also ran differences and differences regressions on outcomes before and after the watch period to weed out potential endogeneity germane in such problems. Finally, the paper also employed a switching regression model with the endogenous switching of grades to deal with the biases due to the omitted variables problem. To sum up, both studies attempt to determine whether media outcry and public intervention in the post-Enron scandal and financial crisis have triggered any substantive changes in CRAs' behaviour. The paper by Driss et al addressed this issue from the banks' point of view and the previous paper by Berwart et al looked at the same problem from the sources of payments of different types of ratings. The emerging theme in both is that the CRAs have gained only a partial restoration of their creditability in the post-crisis period, signifying that once it has been damaged, it takes time for a reputation to be fully restored.

Kale et al. (2018) discuss how the presence of the “outside option” of employees in a firm weakens the debt's power to discipline them and thus impacts capital structure. By issuing debt, companies can threaten their workers with bearing part of the bankruptcy costs, which reduces their ex ante bargaining power. However, such a threat is vacuous if workers

have the option to quit the organization. By using US data from between 1978 and 2007, this study documents that outside options weaken the impact of leverage on labour productivity. To control the endogeneity problem and its confounding impact on causal relationships between leverage and employee productivity due to time-varying unobservable attributes, the authors used proper instrumental variables (relating to firm's incentives to avoid taxes from the exogenous government policies rather than leverage-induced tax shields) and also conducted two-stage least squares methods. Finally, the paper also used the implementation of NAFTA as an exogenous shock (which also serves as a quasi-natural experiment) to verify the robustness of the results. The ideas contained in the paper can thus be extended to situations like cyclical movements of the economy, which is related to voluntary quits by the workers.

The 1997–98 Asian financial crisis prompted a series of reforms aimed at restructuring the regional bond markets (i.e., Asian Bond Funds in 2003 and 2005, ABF and ABF-2 respectively). However, not all countries have joined such a policy intervention. These reforms supposedly had several effects on a range of issues, including liquidity expansion in domestic bond markets, liberalization of foreign exchange markets, tax reforms for foreign investors and regulatory improvement (see Packer and Remolona, 2012).

Bose et al (2018) examine the implications of such initiatives on enhancing firms' access to external finance in the economies that joined such a policy compared to those opting not to participate. The study digs further by investigating whether particular segments of firms took more initiatives to take advantage of these initiatives to alleviate the lack of access to external finance. The study builds its research design around the argument that some of these components may prove more attractive than others. Thus, for instance, this provided firms with opportunities to switch from banks to external debt or equity markets or to issue more long-term debt.

A robust method is employed to analyse a panel dataset of 7286 firms from eight Asian economies.<sup>2</sup> The findings show that firms in their sample experience a decline in the

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<sup>2</sup> Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand and Taiwan

proportion of short-term debt to total debt after the introduction of the ABF2. However, post ABF2 the long-term debt to asset ratio seems to relatively increase. The reforms have improved firms' access to long-term debt. There is, however, a discrepancy of the effect, as among these firms the profitable and less risky firms seem to benefit significantly compared to others. The access to long-term sources of funds enabled profitable and less risky firms to finance their investments.

The policy implication of their result is that the ABF2 initiative was successful and achieved its goal of promoting the growth of the Asian bond market and contributed to the region's improved economic performance as well as provided a lesson to other emerging markets, including some countries in Latin America. The study indeed provides valuable insights for the literature and policymakers on multiple fronts. First, such an initiative seems to ease the pressure on the banks being the primary resource of funding in these economies. Second, *the* markets, as usual, tend to favour efficient firms (i.e., profitable and less risky). Therefore, these initiatives should also include more in-depth strategies to assist struggling firms in accessing finance (in particular long-term) or at least in improving their performance to appeal to the capital market.

Entrepreneurs' reputation information has attracted the attention of many studies ever since Diamond (1989), highlighting that an entrepreneur's acquisition of a reputation plays a vital role in facilitating the market between borrowers and lenders. However, the dilemma in observing reputation is that it requires repeated interaction between borrowers and lenders. In an environment of information asymmetry and incomplete contracts, such an issue seems to be further complicated for first-time issuers of debt.

Finally, this section ends with the paper by Li and Martin (2018). They examine the capital raising process in a crowdfunding setup by using data from Kickstarter. They collect records of entrepreneurs' activities related to promised deliveries, as well as their funding history, to sketch their reputation formation. The study uses daily data from the Kickstarter

website on 2826 initiated projects during the period 3-23 May 2013. The authors construct reputation-related proxies, entrepreneur characteristics, project characteristics, and reward characteristics from the first day of the funding period to avoid look-ahead bias. The final sample of the study is reduced to 1398 projects with funding goals over the median (\$5500), of which 36% have met their funding goals.

The findings provide evidence that entrepreneur reputation affects capital formation outcomes favourably regarding both degree and speed. Entrepreneurs who accumulated a positive reputation through previously delivery are 40% more likely to get funded. Those who acquired a negative reputation are 20% less likely to be financed. First timers with high skills are successful in attracting funds and tend to exceed their funding goal by 60%. The authors succeed in providing evidence to support their propositions. The study takes advantage of the fact that Kickstarter reports those entrepreneurs who fail to acquire funds and use it to examine various capital formations and contracting theories. The findings of the paper advocate that entrepreneur reputation in the capital formation process has a crucial effect. The results also send an encouraging message to financial institutions to rely on non-traditional social media data besides traditional approaches (i.e., funder characteristics, project characteristics, or timing of backing) for funding decision-making.

### **3. Structure of governance**

Recently, institutions ranging from regulatory bodies to stock exchanges across the globe have been consciously pushing reforms related to boardroom cultures, audit practices and compensation structures in order to bring about changes to the state of governance in firms.

The papers reviewed in this section address these issues at length and explore to what extent such legal mandates or the opening of global access impact the governance structure of firms and trace their consequences on firm value. These exogenous changes in legal and economic environments tend to perturb the equilibrium structures of board size, its structure and its composition (e.g., independent and non-independent directors) if firms ignored such constraints prior to imposition of such legal mandates. In that case, one would expect to

observe variations in outcome induced by the changes in policies and papers investigating the issues in detail. Two other themes relevant to this section are: 1. Do these changes in legal mandates or economic environments create governance externalities whereby *initial* changes in governance in one set of firms bring about similar changes in other passive sets of firms? 2. If they do, then what are the most important channels through which such changes take place? In the context of board setup, it implies that the pertinent channels could be either through board monitoring and CEO career concerns or via changes in the advisory role of the board, which often communicates with CEOs in an incomplete information setup (see the survey contribution by Adams, Hermalin and Weisbach, 2010).

Aggarwal et al. (2018) attempt to address these issues by utilizing mandates that have affected the boardroom practices of 30% of the newly listed firms in the NYSE and NASDAQ from 2003 onwards. The paper finds that affected firms had lower values before the governance intervention by the exchanges and they indeed experienced a relative increase in value after its implementation. However, the gaps in value between the affected and unaffected firms (from the mandate) did not close completely. A closer inspection revealed that difference in corporate culture (defined by a set of measures of governance which included other key governance attributes not included by the mandate) between the control (unaffected) and treatment (affected) firms played a key role in explaining the gap. Thus, the paper finds that although the changes in governance mechanism external to the firm may create spillover effects in firms with relatively poor governance structure, the “old methods and practice,” which are not always shareholder friendly, nevertheless do not disappear immediately and there is a strong bias towards the persistence of governance gaps across the firm. An interesting research question could be to study the determinants of the trade-off of poor governance (leading to losses of share values affecting insiders as well) and other benefits that accrue to insiders from the persistence of low-level governance that might identify and narrow the sets of crucial factors resisting changes in methods of governance.

Similarly, in this special issue, the impact of changes in legal mandates are examined in Dahya et al. (2018). They focus on acquirers’ returns in the United Kingdom. Two reports published in UK with a gap of twelve years (the Cadbury Report 1992 and the Higgs Report

2004) explicitly called for the deployment of independent directors and other practices of governances. The Cadbury Report recommended at least three independent directors for publicly listed corporations and the code contained other prescriptions for good governance practices via changing norms for control, reporting functions of the board, tenures of members to functions and roles of auditors and extent of disclosures. This paper finds that firms there exist in a positive relationship between acquirers' returns and the fraction of the outside directors for the publicly listed firms rather than private firms. Hence, outside directors could potentially add greater value to publicly listed firms compared to a similar deal taking place between private firms. The result brings about the role of the reputation concerns of the director of the publicly listed firms because they face greater scrutiny from the financial markets, while such firms also have stronger disclosure requirements. The results also confirm the theoretical predictions stating that the main functions of the directors are advising and monitoring, and publicly traded firms employ directors with expertise on those areas so that the selection of targets and deals are thus more value enhancing in listed than in private firms.

Although the firm performance and other governance attributes (e.g., fraction of independent directors) are positively correlated, concerns for endogeneity often make it harder to draw inferences on the causal relationships between them. However, in recent times, there have been both government and exchange mandated calls for changes in governance structure; in practice, such laws often change the paradigms for governance and both papers have deftly used exogenous changes in legal norms and variations in observed outcome to draw conclusions on outcome as well as the prospective channels that make such outcomes happen more likely.

In recent years, the scale of cross-border acquisitions across the countries has experienced a surge and recent data show even larger buying sprees of the emerging markets' multinational firms in such a process. Such phenomena are new and have been made possible as governments in these countries have undertaken several reforms that relaxed constraints towards cross-border physical and financial movements of capital. Legal scholars have put forward a "bonding hypothesis", which asserts that such acquisitions tend to benefit emerging market firms. This is because such firms can use newly found opportunities of making overseas

investment to absorb improved corporate governance practices, not just as a legal compulsion but also for enhancing reputational considerations.

Col and Sen (2018) investigate whether acquiring firms from the emerging markets have been able to improve their standards of governance following cross-border acquisitions. They study a selected a group of Indian firms who had undertaken takeovers of the foreign firms located in the developed markets and report that both practices and attributes of the board change significantly after cross-border acquisitions, and the stronger the legal regime in the target country, the larger the effects on firm governances; consequently, the post acquisition values of these firms have increased significantly.

A major concern in such studies is the endogeneity problem, because decisions regarding takeovers and the choice of appropriate locations (i.e., from where to buy another firm) are not random. Hence, there is always a possibility that only good firms make those acquisitions and that choice of target countries may not matter much. The authors have tried to address these issues by choosing firms with a propensity score matching method, whereby the selected characteristics are likely to increase the probability of acquisitions and also conducted further analysis with the matching process to resolve the issue. However, a more complete analysis would have been to use some legal mandates relaxing cross-border investments in a specific country to examine the bonding hypothesis. Thus, more work needs to be done in these directions that would confirm such results on a firmer footing.

Finally, the paper by Koch and Okamura (2018) discusses the features of the banks sued by the FDIC following their business failures and compares these with the ones not being sued and find that the former group indeed displayed “risk shifting tendencies” prior to proposed legal action by the FDIC. The sued firms exhibited faster asset growth and made larger short-term borrowing to the extent of endangering shareholders’ interests. An interesting find in the paper is the positive *ex ante* impact of the litigation on the standard of governance of the out of the sample peer groups. The study suggests that institutional and legal monitoring via the threat of lawsuits could have a dynamic impact on the bank governance process.

#### **4. CEO compensations**



A large volume of the literature already exists on this subject, capturing multiple dimensions of relevant topics in the field (see Frydman and Jenter 2010). A particular area of interest is the determination of size and composition of CEO pay. The recent increase in CEO compensation has been explained by both optimal contracting paradigms and the CEO power hypothesis. This literature primarily focuses on the process of determination of compensation contracts by the compensation committee set up by the board, which supposedly acts without outside influence of any sort. However, there is often outside interference (media, governments etc.) in the process of setting the limits to CEO compensation. The next two papers complement this literature by highlighting the role of direct or indirect intervention by the government and its impact on CEO compensation and firm value.

Hadley (2018) in this special issue investigates the magnitude and composition of CEO compensations in companies whose revenues mostly depend on government contracts for delivering supplies. Such firms provide interesting examples of case studies because they are often subject to both government scrutiny and media coverage. Hence, it is very natural that such firms would have a tendency to incur costs for deflecting the possibility of unwanted negative attention which could spell termination of future contracts and would thereby affect revenues adversely. The paper is exploring whether such politically sensitive firms change their compensation policy to reduce excess pay and also change its composition in order to avert negative reactions to them by the media and other watchdogs.

To address these issues, the author analyses a sample of data consisting of federal government contractors from 2000 to 2011 and finds that in order to defray political sensitivities, such firms indeed pay a lower number of excessive compensations, which interestingly take the form of cash rather than equity. The paper also finds that these firms also exhibit lower pay to performance sensitivities. However, some of these results get reversed for larger firms in the sample, which tend to pay the CEOs in excess, displaying a greater degree of bargaining power.

While this paper sets the agency issues and limits to CEO power and compensation in the context of governmental contracts for procurements of supplies, the paper by Raff and Siming (2018) examines the influence of prestigious government awards giving non-pecuniary

benefits to the CEOs (and other recipients of the prize) on the firm value and shareholders' return. The paper uses a century-old convention in New Zealand, where the country's government rewards titles of knighthoods and damehoods every year to selected citizens. A law abolished the custom in 2004 but it was reinstated in 2009 and thus provides the setup of a quasi natural experiment where it is possible to find out whether the program had an impact on firm value via any possible influence on the decision-making power of the CEOs. The paper shows that while abolishing the law certainly increased the operating margins of the treatment group vis-à-vis control groups (not affected by the law), such figures also declined after its reintroduction. The paper reports that announcement effects of both reforms on shareholders' returns were negative and indeed increased the enrolments of workers, to a possible detriment of shareholders' interests. Both papers in different setups thus highlight tensions in government objectives (e.g., maximizing employment) and shareholders' interests (increasing value of their shares), which influence CEO decision-making power via changes in both pecuniary and non-pecuniary benefits.

Fidrmuc and Xia (2018) investigate whether incentive (stock ownership) and severance payments (golden parachutes) impact the motivations of the CEOs of a target firm to initiate the M & A process. A CEO with significant ownership in a firm might try to sell his company earlier upon receipt of imminent bad news. The extant literature suggests a smaller premium from rational acquirers who might suspect adverse selection problems. Also, a target-initiated sale could reduce a CEO's bargaining power if the other party perceives her to be too impatient and in a hurry to sell the firm. However, this paper argues that while information or bargaining issues might lower the incentives for the CEO of the target company to engage in proactive negotiations with the buyer, CEO ownership and contractual arrangements (magnitude of stock ownership and severance payments) may alter the incentives and could play a countervailing role in the process. The paper finds that higher CEO ownerships show not only a more positive relationship with firm performance, it is also likely that the CEOs of these firms would take a proactive role in initiating deals to start the process of M & As.

The authors conduct a further analysis and show that CEO incentives increase the odds of target deal initiation only in informal sales but not in formal, full-scale auctions. This result

suggests that managerial incentives to initiate deals are higher in private negotiations when the CEOs have greater power in negotiations than in other mechanisms, such as auctions, where much of the control lies in outside buyers. Finally, the paper shows that the CEO-initiated deals also fetch higher takeover premiums. To sum up, it shows that ownership by the CEO not only matter for the initiation of sales but is also specific to situations where they have control (negotiations) and not when a firm is likely to be put up for sale in a competitive auction market. This is certainly an interesting find which awaits a theoretical structure to explain why it is tied to method of sale.

A large volume of the literature documents that the cost of corruption is an antagonistic phenomenon that hinders economic growth and erodes efficiency at both the micro and macro levels (Mauro, 1995; Shleifer and Vishny, 1993). This paper examines the effects of corruption on efficiency at the firm level. Hanousek et al. (2018) in this special issue extend its scope to explore the role that key stakeholders play in firms operating within corrupt environments. Two interesting arguments seem to underline the foundation of this paper's research design. The first result confirms that firms operating in an environment perceived to be more corrupt will be less efficient than those operating in one which is regarded as less corrupt. The second result argues that heterogeneity in the perceptions of corruption may have a positive effect on firm efficiency. They trace the positive effect to the differences in perceptions of corruption, which may signal the presence of different "sub-environments". They claim that there is a possibility to find firms that operate freely in a corrupt environment due to their lower propensity to bribe. Thus, greater heterogeneity in perceptions of corruption may be associated, on average, with more efficiency. The study examines a number of firm attributes that are likely to be associated with a lower propensity to bribe. Two groups of stakeholders, namely owners and managers, are more likely to be responsible for bribing decision. Accordingly, investigating how the characteristics of owners and managers affect the efficiency-corruption relationship forms the core of their analysis.

The study obtains data on corruption and other business environment characteristics from the Business Environment and Enterprise Performance Survey (BEEPS) developed by the EBRD and the World Bank. The authors match BEEPS to the Amadeus database maintained by

Bureau van Dijk to complement the missing accounting data. Their final sample is composed of 76,552 observations and covers 14 countries in Central and Eastern Europe from 2000 to 2013. The study employs a stochastic frontier analysis to estimate technical efficiency.

The results indicate that foreign-owned firms are adversely affected by high levels of average corruption. Hence, foreign owners are likely to lack the knowledge of whom to bribe. Thus, they are at a disadvantage in relation to local owners. An interesting finding of the paper is that foreign-owned firms seem to mitigate this liability by locating in sub-environments where corruption is less common. The result also postulates that a female CEO who is less inclined to corruption tends to be disadvantaged by a high level of average corruption. The paper points towards the importance of both owners' and managers' awareness of the characteristics of the local operating environment. In other words, those who wish to run their business honestly still have the opportunity to avoid the antagonistic effect of a highly corrupt environment (on average), by locating their businesses in sub-environments with less corruption.

### **5. The challenges ahead**

The papers in this collection have addressed issues in governance structures, CEO compensations and interactions between institutions and markets in a fast changing global milieu. While institutions often gradually adapt to changes in external circumstances due to inertia or collective action problems, investors' reactions to such changes are far more rapid. A unifying element present in many papers in this volume is that such uneven and different speed of adjustment often create frictions and had impact on key variables such as reputation, firm value, leverage etc.

Recent phenomena like surge in shareholders' activism demand for greater diversity in boards and network building exercises done in both traditional connections and vibrant social media often are adding newer constraints in the decision making process of firms and thus raising new research questions for further dig up. Some of the plausible questions are: Does too much external intervention force the CEOs to adopt cautious policies (to minimize negative attention) at the costs of firm value?

The social media along with transactions in retail stores along with online companies often generate big data on prices and quantities that offer insights on consumer preferences or quality of supply chains and bring questions to the table. Do such findings have any influence on business, finance and investment policies adopted by such firms? New institutions like crowd funding often rely on networks from social media to raise financing especially in lesser developed financial markets. Is such huge flow of information and interactions in such systems of networks alleviating information asymmetry or making flow of information noisier for companies in these platforms?

Answering such questions involve not only careful processing of huge databases but also require resolving of multi-dimensional measurement issues in conceptual frameworks (diversity or network strengths), inherent biases due to endogeneity and related econometric problems, etc. Challenges in the future lie in building up appropriate methods specific to different types of problems for satisfactory resolution.

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