



Ownership structure and board composition in a high ownership concentration context



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ABSTRACT

Few articles have addressed the relation between the ownership structure and the composition of the boards. The results of the analysis performed on a sample of Spanish listed companies for the period 2004–2011, show that in markets where corporate ownership is highly concentrated, it is necessary to devote special attention to blockholders and to differentiate the figure of the independent directors from the group of outsiders. The results confirm a negative and decreasing relation between blockholders and the percentage of independents while insiders' ownership is only significant if one looks at the percentage of outsiders as a whole, in which case it shows a U-shaped quadratic relation.

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Introduction

Differences in corporate governance across countries appear to be the result of variations in corporate organizational structure, particularly the ownership patterns and the composition of boards of directors (Li, 1994).

With regards to the ownership structure, a conventional classification distinguishes between two broad categories of corporate ownership structure. In the first category are the countries of Continental Europe and Japan, in which the ownership of firms is often concentrated within a small number of other firms, banks, and families. In the second category, which includes the UK and the United States, ownership is more dispersed and cross-shareholdings are rare.

The problem of corporate governance that companies face in each of these contexts is different and the board of directors, as the highest governing body of a company, must adapt its composition and functioning to solve the prevailing problem of corporate governance in each case.

In countries where ownership is dispersed, the predominant problem is the agency problem between shareholders (principals) and managers (agents) as a result of the separation of ownership and control (Jensen & Meckling, 1976). In this case, the board of directors must be configured primarily as a tool for supervision

and control, aimed at aligning the interests of those who manage the company with the interests of those who provide the resources and hold the risk. On the other hand, in contexts such as Spain where equity ownership is highly concentrated, the corporate governance problem is accentuated on the relationship between small and large shareholders (Shleifer & Vishny, 1997; Villalonga & Amit, 2006). Here the board should broaden the scope of its supervisory function to safeguard the interests of small shareholders, thereby preventing that the divergence of large and small shareholder interests results in harm to, or the expropriation of, small investors.

In 74% of the listed companies in Spain the blockholders, or significant shareholders,¹ hold more than 50% of the capital. In a quarter of the listed companies, a single individual or legal entity holds the majority of the capital (data from the Annual Corporate Governance Report of 2011 published by the Spanish National Stock Market Commission (CNMV)). Therefore, the problem of the lack of incentives for shareholders to monitor managers is minimized; however, the problems between large and small shareholders are accentuated. Issues such as the limited legal protection afforded to investors – extensible to continental European countries in general (La Porta, López de Silanes, Shleifer, & Vishny, 2000), limited activism, the reduced participation of institutional investors in the capital of the companies and the weight of the large shareholders all make it

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¹ Blockholders are defined as holding 5% or more of the stock capital. Although RD 1362/2007, of 19 October, establishes the first threshold for informing of significant shareholdings at 3% instead of the previous 5%, the 5% limit was maintained here to ensure that the variable was homogeneous during the period analyzed.

difficult for small shareholders to make their proposals heard (Castriello & Marcos, 2007)² fostering a predominately passive attitude among these shareholders. In this situation, it is the board of directors that should act to protect small shareholders (Mínguez & Martín, 2003), and its composition must reflect this, sending a signal to the market that the interests of small shareholders are properly safeguarded and that they will not be expropriated by the large shareholders (Peasnell, Pope, & Young, 2003).

When the relationship between ownership structure and board composition has been analyzed in the academic world, the studies published (most of them performed in Anglo-Saxon countries) have focused their attention on the influence of managerial ownership on the percentage of either outsiders or independents on the board (Li, 1994; Bathala & Rao, 1995; Denis & Sarin, 1999; Mak & Li, 2001; Peasnell et al., 2003; Donnelly & Kelly, 2005; Boone, Field, Karpoff, & Raheja, 2007; Coles, Daniel, & Naveen, 2008, or Linck, Netter, & Yang, 2008, among others), deeming the supervision of the management team to be the fundamental mission of the board. However, the control function performed by the board should also be made extensive to the conflict of interests between large and small shareholders in contexts of highly concentrated ownership.

The aim of this study is to analyze the relationship between ownership structure and the composition of the board of directors for a sample composed of 173 non-financial Spanish listed companies for the period 2004–2011. Given the highly concentrated ownership context in which the study is performed, it is our understanding that the analysis needs to be adapted in two ways: firstly the focus cannot be exclusively on managerial ownership, but must take very much into account the role of significant shareholders or blockholders, as well as the importance that conflicts of interest between large and small shareholders have in this context. In this sense, few studies have analyzed the relationship between the concentration of ownership in the hands of blockholders and the makeup of the board of directors (Li, 1994; Mak & Li, 2001; Peasnell et al., 2003; Donnelly & Kelly, 2005; Lasfer, 2006 or Baglioni & Colombo, 2013).³

Secondly, and with respect to the composition of the board, in the Anglo-Saxon context, the terms outsiders and independents are used interchangeably. However in Spain, within the group of outsiders there are two distinct categories of directors – nominee and independent directors – each representing very different interests. Nominee directors represent the interests of the significant shareholders whereas independent directors represent the interests of the small shareholders or the free float. Although all of them are outsiders and as such should supervise the executive management, when the conflict between large and small shareholders is analyzed, the distinction between nominee directors and independent directors is crucial.

Based on the hypotheses derived from the Agency Theory that link ownership structure to the value of the firm (see for example De Miguel, Pindado, & De la Torre, 2004), in our study, and with the assumption that each firm chooses the structure of its board of directors that maximizes its value (Hermalin & Weisbach, 1988 and Hermalin & Weisbach, 1998; Bathala & Rao, 1995; Boone et al., 2007; Coles et al. 2008; Lehn, Patro, & Zhao, 2009), we formulate hypotheses concerning the influence of ownership structure on the composition of the board. We argue that the presence of outsiders on the board is explained by the need to supervise the management team and this need is linked (under the hypotheses

of alignment of interests and entrenchment) to the degree of managerial ownership. On the contrary, the presence of independent directors on the board is primarily determined by the need to solve problems between large and small shareholders and this need is linked (under the supervision and expropriation hypotheses) to the degree of ownership concentration.

Therefore, this article is the first in-depth study of the relationship between ownership structure and board composition in a context of highly concentrated ownership, clearly differentiating between the roles of independent and outside directors. Moreover, the study deepens the analysis of nonlinear relationships between ownership structure and board composition, an aspect scarcely analyzed in the literature, confirming a nonlinear U-shaped relationship between insider ownership⁴ and the percentage of outside directors and a decreasing nonlinear relationship between the concentration of ownership and the presence of independent directors on the board.

The paper is structured in the following manner. First, the ownership structure and board composition as corporate governance mechanisms are addressed and the hypotheses of the study are introduced. Subsequently, the sample to be analyzed and the analytical models are presented, as are the main findings of the study. The article closes with a summary and conclusions section.

Theoretical framework

The ownership structure and corporate governance problem

As observed by Berle and Means (1932), and even long before by Adam Smith in his book *The Wealth of Nations*, the distribution of capital among many shareholders in large companies allows managers greater freedom in the use of enterprise resources. The fragmentation of the ownership of companies can lead to a conflict of interests, or an agency conflict, between owners and managers over the allocation and distribution of corporate resources (Jensen & Meckling, 1976). The fundamental problem lies in the imperfect information that exists between managers and shareholders, which creates a moral hazard problem, since shareholders cannot verify whether good performance is due to luck or hard work (Rose, 2005).

The difficulties of coordinating small investors, together with the fact that each of them, taken individually, perceives their vote on any proposal as irrelevant, and as such unable to affect the final outcome, justifies the lack of participation of small shareholders in the management of the company. This is evidenced by the high level of absenteeism in the general shareholder's meetings (Stiglitz, 1985). Therefore, primarily in large enterprises and publicly traded companies, managers commonly enjoy a wide degree of discretion in the use of enterprise resources, discretion that they can exploit to their own advantage, creating an important agency conflict between the owners of the capital and the company executives.

Managerial ownership (Jensen & Meckling, 1976) and blockholder ownership (Kaplan & Minton, 1994) are two of the major governance mechanisms that help control agency problems. On one hand, the participation of the executives in the equity of the company leads to an alignment of their interests with those of the owners, reducing the agency conflict between the two. However, when managers have a substantial proportion of the shares, they can yield enough power and influence to pursue the satisfaction of their own interests in detriment to the interests of the other shareholders. Thus, with regard to insider ownership and its contribution to the resolution of the agency problem, the hypotheses formulated are a convergence of interests initially and, beyond a certain level of management participation in the company's equity, the entrenchment hypothesis (Peasnell et al., 2003).

² For example, Spanish law requires the representation of 5% of the capital in order to introduce items or modifications in the agenda of the General Shareholder's Meeting which is a difficult task even for small shareholders associations.

³ These studies use diverse variables to measure the concentration of ownership: some cases use ownership in the hands of the main shareholder (Peasnell et al., 2003), or the three major shareholders (Baglioni & Colombo, 2013), and other cases take as a reference the existence of shareholders with more than 3% or 5% of capital (Li, 1994; Mak & Li, 2001; Lasfer, 2006).

⁴ We have used insider ownership as a measure of managerial ownership.

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