International Review of Economics and Finance 32 (2014) 159–174

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

Affiliation and professionalism: Alternative perspectives on decomposing the board structures of financial institutions

Yin-Hua Yeh [a,*], Pei-Gi Shu [b], Tsui-Lin Chiang [c]

[a] Graduate Institute of Finance, National Chiao Tung University, 1001 Ta-Hsueh Rd., Hsinchu City 30010, Taiwan, ROC
[b] Department of Business Administration, Fu Jen Catholic University, 510, Zhongzheng Rd., Xinzhuang Dist., New Taipei City 24205, Taiwan, ROC
[c] Graduate Institute of Business Administration, Fu Jen Catholic University, 510, Zhongzheng Rd., Xinzhuang Dist., New Taipei City 24205, Taiwan, ROC

ARTICLE INFO

Available online 24 January 2014

JEL classification:
G21
G34

Keywords:
Board structure
Affiliation
Professionalism
The incentive alignment effect

ABSTRACT

Most financial institutions around the world are under concentrated ownership. To protect rents and the private benefits of control, controlling owners prefer to include more affiliated members on their boards. This study empirically examines financial institutions in Taiwan—a country that harbors both firms with controlling shareholders and pyramidal groups—and its results verify the aforementioned postulation. We find that board affiliation is positively associated with control rights, cash flow rights and the control/cash flow deviation associated with controlling owners. In contrast, professionalism can disentangle controlling owners' motives, as it is positively associated with the controlling-owner cash flow/control rights ratio and negatively correlated with the control/cash flow deviation. The results support the incentive effect associated with controlling owners. Moreover, the information argument provides auxiliary explanations for how boards are structured. Family is a catalyst for the bias toward lower levels of board professionalism. Finally, whereas board professionalism is positively correlated with stock returns during a financial crisis, board affiliation has a negative correlation.

1. Introduction

Forming concentrated ownership allows controlling owners to obtain decision rights and protect rents from proprietary knowledge (Christie, Joye, & Watts, 2003; Jensen & Meckling, 1992). Fan and Wong (2002) indicate that concentrated ownership is a solution for preventing information leakage that may result in competition and social sanctions. Controlling owners proactively pursue private benefits of control through either the "psychic" value of simply being in control (e.g., Aghion & Bolton, 1992; Harris & Raviv, 1988) or the perquisites they enjoy exclusively (Jensen & Meckling, 1976).[1] This also results in concentrated ownership. Moreover, the degree of ownership concentration is affected by the size of the control benefits (Bebchuk, 1999; Dyck & Zingales, 2004). The literature has documented that ownership concentration is widely evidenced in regions where legal systems are weak or corporate governance mechanisms are ineffective (Dyck & Zingales, 2004; La Porta, Lopez-de-Silanes, & Shleifer, 1999; Shleifer & Vishny, 1997).

Industry factors such as high leverage and strict regulation are related to ownership concentration. Leverage amplifies the size of private benefits of control in the sense that controlling owners use other people's money to leverage personal influence or

* Corresponding author. Tel.: +886 3 513 129.
E-mail addresses: yhyeh@nctu.edu.tw (Y.-H. Yeh), 036047@mail.fju.edu.tw (P.-G. Shu), vivianc60@yahoo.com.tw (T.-L. Chiang).

[1] Note that the existence of private benefits of control is not necessarily inefficient. Dyck and Zingales (2004) indicate that private benefits of control may be the most efficient way for a company to capture some of the value created. Furthermore, the existence of private benefits of control may be socially beneficial, as they make value-enhancing takeovers possible (Grossman & Hart, 1988).

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http://dx.doi.org/10.1016/j.iref.2014.01.013

pursue social capital. According to Demsetz and Lehn (1985), regulation may lower control potential. Following this thread, ownership structures in a highly regulated financial industry are expected to be diffusive. However, when the legal protection of public investors is ineffectual, controlling owners may concentrate ownership in hand, allowing them to engage in political lobbying and rent-seeking activities. This is consistent with a study by Caprio, Laeven, and Levine (2003), who find that with a few exceptions due to strong shareholder protection laws, the financial institutions in most countries are not widely held but tend to be ultimately controlled by families or the state.

In this paper, we portray the important effect of ownership structures on boards, through which controlling owners may protect rents and seize control benefits. If the one-share-one-vote rule is adhered to, owners may only arrange affiliated members in proportion to their cash flow rights. However, devices such as pyramidal structures, cross-shareholdings and dual-class share arrangements that result in control/cash flow deviation could provide owners with the leeway to arrange more affiliated members in disproportion to their cash flow rights. Due to attractive rents and the private benefits of control, controlling owners in the financial industry opt to arrange more affiliated board members whenever possible.

Studies have attached much importance to board independence, indicating that independent board members counterbalance the potential entrenchment of controlling owners. However, the empirical findings of these studies have been mixed.[2] This may be a result of identification rather than the notion of independence. For example, *resume*-independent members who do not have familial, employment or financial relationships with a company and its directors may be closely connected to a controlling owner. Moreover, the practice of including independent directors in most Asian countries is still in its infancy. In most cases, companies include the minimum number of *resume*-independent board members when legally required to do so. Either way, the relationship between board independence and the governing mechanism can become blurry.

In this study, we use board affiliation to consider the core sense of control. To determine a board affiliation, we meticulously trace the ownership structure of each financial institution to locate the controlling owner who possesses the most voting rights. Affiliation is recognized when a controlling owner ultimately controls board members via family ties or as representatives of his/her controlled firms or institutions. The notion of affiliation is different from family ties not only because the ultimate/controlling owner could be a family or the state, but also because nonfamily representatives from controlled firms or institutes are included. Board affiliation is defined as the percentage of affiliated members on a board. Although board affiliation superficially resembles the flipside of board independence, they are not necessarily equivalent. For example, using the affiliation framework, we do not have to make judgments on the status of dubious board members who are representatives of legal persons and may or may not be linked to a controlling owner.

Because board control is the top priority of controlling owners, we hypothesize that board affiliation is positively correlated with controlling owners' control rights from either direct cash investment or indirect wedges such as pyramidal structures, cross-shareholdings and dual-class shareholdings.

To understand the roles that a board can play and how effectively it can play them, it is crucial to understand how directors are chosen (Hermalin & Weisbach, 1998). Other than affiliation, we investigate another factor that is useful in disentangling controlling owners' motives: board professionalism. Professional members potentially contribute to a firm's operations, and this is especially true for a financial industry that is highly sensitive to market movements. In this study, we consider board members to be professional if they are certified accountants or attorneys or have prior management experience from other financial institutions. Board professionalism refers to the proportion of professional members on a board.

The higher cash flow rights associated with a controlling owner motivate that owner to accommodate more professional board members who can provide more value-added opinions (i.e., the *incentive alignment* hypothesis). In contrast, a deviating voting/cash structure that results from cross-shareholdings, pyramidal structures or dual-class shareholdings decreases the positive incentive of a controlling owner and thus lowers the level of board professionalism. Therefore, a controlling owner's motives, manifested in the ownership structure, dictate the level of board professionalism.

The predicted relationship between ownership structures and board professionalism is also reconciled with the information hypothesis. Controlling owners who are entitled to higher cash flow rights appreciate a positive signal associated with a professional board that warrants the informativeness and creditability of a firm's financial reports. The flipside of the information argument is that controlling owners who operate according to a deviating control/cash flow structure prevent the possible leakage of proprietary information to competitors and avoid unwanted political or social scrutiny, resulting in a lower level of board professionalism.

In this study, we examine the financial industry in Taiwan from 2003 to 2006. Taiwan is an ideal setting for examination because it features relatively weak shareholder protection, a predominance of controlling shareholders and an extensive use of pyramidal groups and cross-shareholdings, characteristics that are commonly seen in many countries (Caprio et al., 2003; Claessens, Djankov, & Lang, 2000; Faccio & Lang, 2002; La Porta et al., 1999).[3] Our results basically verify the aforementioned postulations. A controlling owner's cash flow and control rights are both positively correlated with board affiliation, implying that the rents and private benefits of control embedded in a highly leveraged structure are attractive enough for controlling owners to

[2] For example, Rosenstein and Wyatt (1997) find a positive market reaction to the addition of outside directors, and Byrd, Fraser, Lee, and Williams (2002) find that the thrifts that survived the thrift crisis had more independent directors than those that failed. In contrast, Baysinger and Bulter (1985), Hermalin and Weisbach (1991), Mehran (1995), and Bhagat and Black (2002) find no significant correlation between the proportion of independent directors on a firm's board and either accounting or long-term stock performances.

[3] According to La Porta et al. (1999), only three out of six legal protections for investors are included in Taiwanese law. The number is comparatively smaller than five in the U.S. and four in common law countries. However, it is equivalent to the average of the full sample of La Porta et al.

arrange more affiliated persons on a board. Moreover, a deviating control/cash flow structure is also positively associated with the proportion of affiliated board members. The positive correlation between firm size and board affiliation indicates that larger firms embed higher private benefits of control. The results support the argument that controlling owners prefer to arrange more affiliated board members to entrench their board control.

The board-professionalism result indicates that controlling owners have a positive incentive to enhance board professionalism when they are entitled to higher cash flow rights in proportion to control rights. In contrast, they may indulge in self-dealing actions and a lower level of board professionalism when the control/cash flow deviation is large. The information hypothesis agrees with the empirical result, as the inclusion of more professional board members sends a positive signal to outsiders that the financial reports are informative. In contrast, a less-professional board allows the controlling owner to guard against the revelation of proprietary knowledge. Finally, family-controlled firms are associated with less-professional boards. Our findings advance the understanding that board professionalism is more important than independence in detecting a controlling owner's motives as they are manifested in the ownership structure. The following sections are arranged as follows. Section 2 develops testable hypotheses. Section 3 describes the data and method. Section 4 presents the empirical analysis. Section 5 concludes the paper.

2. Hypothesis development

The listed firms in East Asia are typically owned by large shareholders. This concentrated ownership is usually obtained through the arrangement of stock pyramids and cross-shareholdings. In this section, we develop hypotheses to test the possible relationships between ownership and board structures. First, we discuss the force that shapes a concentrated ownership structure. We then discuss the two factors that dictate board composition, i.e., interest alignment and information effects. Finally, we elaborate on how financial institution boards are structured, with a focus on board affiliation and professionalism.

2.1. Concentrated ownership

The literature on property rights (see Eggertsson (1990) for a survey of the literature) has indicated that the owner of a company's shares is entitled to asset deployment (control or voting rights), income sharing (cash flow rights) and the transferability of shares. Ownership structures affect the degree to which corporate contracts are enforced, especially in economies in which the state provides insufficient protection of property rights.

Controlling owners can have the privilege of privately enforced property rights, especially in less-developed countries and countries in which property rights are not well defined and/or protected by judicial systems (Shleifer & Vishny, 1997). This is one of the probable reasons for forming a concentrated ownership.

2.2. Incentive alignment effect of concentrated ownership

Concentrated ownership transforms targeted agency problems from manager-shareholder conflicts into conflicts between controlling owners and minority shareholders. Gaining control over a firm enables a controlling owner to determine how profits are shared among the shareholders. An increase in ownership stake gives a controlling shareholder a stronger motive to ensure the firm is run properly. This incentive alignment effect also serves to restrain the controlling owner from expropriating minority shareholders, because if he/she did so the minority shareholders could discount the stock price to at least the extent of expropriation (Gomes, 2000). Therefore, the incentive alignment effect predicts that increasing an owner's company shares beyond the minimum level required for effective control improves the alignment of interest between the controlling owner and minority shareholders.

However, the alignment effect may be suppressed if the controlling owner possesses control rights that deviate too far from his/her cash flow rights. A misalignment of interest may result in a controlling owner's opportunistic wealth exploitation (e.g., profits transferred to other companies that he/she controls or de facto expropriation (e.g., not pursuing profit-maximizing actions in return for personal utilities). The misalignment problem is exacerbated if stock pyramids and cross-shareholdings are used.[4]

2.3. The information argument

The financial industry has been characterized as extraordinarily complex and opaque in nature (Morgan, 2002). Concentrated ownership allows financial institutions to avoid unwanted political or social scrutiny and to limit the information revealed to prevent the leakage of proprietary information to competitors. Jensen and Meckling (1992) and Christie et al. (2003) indicate that firms with proprietary knowledge and specific human capital tend to concentrate their ownership and decision rights on the individuals who possess the required knowledge. Furthermore, preventing the revelation of information may relate not to proprietary knowledge but to political rent-seeking activities, which are prevalent and highly profitable in Asian countries. For example, Fisman (2001) portrays the value of political connections by illustrating the significant drop in the value of firms that were connected to Suharto when news of his illness was announced. Morck (1996) argues that closely held firms are better able

[4] A simple pyramidal structure is illustrated as follows. Assume that the controlling owner owns 40% of the stock in publicly traded Firm A, which in turn owns 25% of the stock in Firm B. The controlling owner, under the most modest terms, controls 25% of Firm B, the weakest link in the chain of voting rights. He/she simultaneously holds about 10% of the cash flow rights of Firm B, which is the product of the two ownership stakes along the chain. In this circumstance, the controlling owner would only be penalized $10 for every $100 expropriated from Firm B.

to engage in political lobbying than widely held firms. Concentrated ownership allows opacity in decision making, perfectly matching the secrecy required to maintain connected politicians' reputations of integrity. However, a controlling owner is more secure in his/her position in such a firm, and thus has more credibility with which to trade favors with the government.

The flipside of the information argument is that it signals to outsiders that the revealed information is trustworthy and informative. People tend to be suspicious of a firm that is closely controlled by a small number of persons. Controlling owners of firms with concentrated ownerships, therefore, have a desperate need to send positive signals to outsiders. The informativeness of a firm's financial reports is positively associated with its market valuation, which is also strictly tied to the controlling owner's wealth, especially when he/she possesses high cash flow rights. Therefore, enhancing board professionalism seems to be a plausible and conveyable vehicle for abating outsiders' suspicions.

2.4. Board professionalism

Board professionalism refers not merely to the formal representation of board members in meetings, but to the value maximization by which those members are obliged. Professionalism requires board members to act in the best interests of shareholders in general, without any obligation to particular parties. Their sophistication in the financial industry can discourage managers from engaging in self-dealing activities at the expense of minority parties. More importantly, it can enable managers to make better decisions and therefore increase the value of financial institutions. A financial institution's value can also increase in the sense that a sound governance structure is taken seriously by the public. Xie, Davidson, and DaDalt (2003) indicate that board members with corporate or financial backgrounds are associated with small discretionary current accruals.

2.5. Ownership structure and board affiliation

Just as a share ownership structure delineates a firm's agency problem, it also influences board composition. When an owner effectively controls the board, he/she also controls the firm. We argue that the factors that dictate board composition are jointly determined by the incentive and information effects.

Given that ownership structures in the financial industry are concentrated and serve as substitutes for weak legal shareholder protection, controlling owners may pursue their control potential through direct involvement in their boards by arranging more affiliated persons. The temptation to internalize a board is magnified by the highly leveraged capital structure of the financial industry. A hypothetical example is illustrated as follows. Assume that a controlling owner is entitled to 25% of the cash flow rights in a financial institution comprising 90% debt. The leverage effect of 40 ($1 / [0.25 * 0.1]$) is so attractive that it may convince the controlling owner to seize control (Bennedsen & Wolfenzon, 2000; Burkart, Gromb, & Panunzi, 1997; Grossman & Hart, 1988; Stulz, 1988). The literature has portrayed gaining control both positively and negatively. For example, Akerlof and Romer (1993) and La Porta, Lopez-de-Silanes, and Zamarripa (2003) discuss cases of insider expropriation of bank resources in the United States and Mexico. In contrast, Klein (1998a) shows that the proportion of inside directors on finance and investment committees is positively related to stock market performance measures. This is consistent with Fama and Jensen's (1983) assertion that insider directors provide valuable information to boards about firms' long-term investment decisions. Klein (1998b) further indicates that most affiliated directors are not puppets of management, but are placed on boards to serve the specific or strategic needs of firms. Regardless of the impetus behind gaining control, we surmise it is the top priority for anyone to whom the opportunity is bestowed. Given that gaining control over a firm is equivalent to gaining control over its board, we further surmise that a controlling owner would arrange as many of his/her affiliated persons on the board as possible. Moreover, voting rights may emerge directly from cash flow investments or indirectly from the wedges of cross-shareholdings or pyramid structures. As such, we postulate that board and ownership structures are related as follows.

Hypothesis 1. *Board affiliation is positively related to a controlling owner's control rights.*

Hypothesis 2. *Board affiliation is positively related to the divergence of a controlling owner's control over his/her cash flow rights.*

2.6. Ownership structures and board professionalism

The following passages discuss the relationship between ownership structures and board professionalism, and are based on the premise that a controlling owner has predominant control over his/her board. The functional role of the board becomes the owner's concern.

The interest alignment effect implies that an increase in equity ownership beyond the minimum level for effective control would encourage a controlling owner to pay more attention to the total value of the firm as it relates to his/her personal wealth. Furthermore, as the owner's control over shareholders' cash flow rights increases, his/her wealth expropriation gradually becomes costlier ceteris paribus (Burkart, Gromb, & Panunzi, 1998; Jensen & Meckling, 1976). Finally, controlling owners of financial institutions in Taiwan tend to be founders who are emotionally connected to the institutions. This emotional identification further enhances the interest alignment effect.

The interest alignment effect posits an increase in board professionalism because professional members are more likely to provide value-added, constructive opinions. Moreover, the existence of professional board members, who are likely to monitor a controlling owner's actions, may prompt the owner to be self-restricted and not exploit the company's wealth (Yeh & Woidtke,

2005). Semkow (1994) finds that firms filled with senior management and non-family professional board members demonstrate traditional "structural family" characteristics.

In terms of the information argument, board professionalism sends a positive signal to outsiders that a firm's financial information is creditworthy and informative. Firms with professional boards incur fewer discounts on valuation. Therefore, we expect board professionalism and cash flow rights to be related as follows.

Hypothesis 3. *Board professionalism is positively related to a controlling shareholder's cash flow rights.*

When a controlling owner's control is leveraged mainly through pyramids or cross-shareholdings, resulting in a divergent control/cash flow structure, the positive incentive effect is muffled. We expect that board professionalism is negatively related to control/cash flow divergence. A controlling owner intent on self-dealing is less likely to be questioned and scrutinized by boards that are mainly composed of inexperienced members who are incapable of detecting the owner's misconduct or misrepresentation of financial reports. Because of its complex and opaque nature, the financial industry especially demands board member professionalism (Morgan, 2002). As Spira (1999) indicates, an audit committee without financially sophisticated members may indeed be largely ceremonial. The abatement of the incentive alignment effect may divert the controlling owner's attention from value creation to a broad range of expropriations such as theft, transfer pricing, asset stripping, and the allocation of credit in a manner that enriches insiders but hurts the organization as a whole or other "perquisites" (Caprio et al., 2003). For example, Gorton and Rosen (1995) present evidence that managers who pursue wealth exploitation make more risky loans and fewer safe loans.

In terms of the information argument, it is easier to prevent information from being revealed when the board members involved are inexperienced. A controlling owner who pursues the double-leverage advantage from capital and ownership structures would prefer a novice on the board to a sophisticate.

Hypothesis 4. *Board professionalism is negatively related to the divergence of a controlling shareholder's control over his/her cash flow investments.*

2.7. Board affiliation, professionalism and firm performance

Concentrated ownership arises when investor protection is weaker to help solve the managerial agency problem. Controlling shareholders ultimately have the power and incentive to discipline management (e.g., Grossman & Hart, 1988). However, concentrated ownership creates the conditions for a new agency problem because the interests of controlling and minority shareholders are not perfectly aligned (e.g., Bebchuk, Kraakman, & Trianis, 2000; Claessens, Djankov, Fan, & Lang, 2002). In such instances, corporate boards could play an important role in limiting the power of controlling shareholders to expropriate the interests of minority shareholders by ratifying and monitoring important decisions (Fama & Jensen, 1983). However, board composition is likely to be influenced by controlling shareholders in such instances. Therefore, a firm's board structure could serve as an important indicator of whether the controlling shareholder is committed to good corporate governance or is entrenched (Yeh & Woidtke, 2005).

We explore the effect of board structures on firm value in the banking industry, which is associated with characteristics such as opacity, complexity and regulation. These special attributes make it difficult to apply the usual corporate mechanisms directly to the financial industry (e.g., Ciancanelli & Reyes, 2001; Levine, 2004; Macey & O'Hara, 2003; Prowse, 1997). We portray the issue in terms of board affiliation and professionalism. As stated, affiliated directors are mainly arranged for the purpose of controlling a board. This is more prominent in the banking industry than in other industries (see Akerlof & Romer, 1993; La Porta et al., 2003). Moreover, the problem of information asymmetry is more aggravated for the financial industry than for other industries (Furfine, 2001; Levine, 2004; Morgan, 2002). Bank opacity and complexity makes it difficult for stakeholders to monitor their banks. Furthermore, complexity makes it easy for controlling owners to modify investment risks and obtain perquisites (Levine, 2004). If obtaining control is the most important issue for a controlling owner, arranging more affiliated members through any approach would be deemed a detriment to firm performance. In contrast, professional directors with academic, attorney or finance backgrounds devote all of their work, time and energy to corporate board activities. We postulate that firms with higher proportions of such individuals are able to provide valuable advice to their incumbent management (Adams & Ferreira, 2007; Helland & Sykuta, 2004) and detect possible wealth expropriations by their controlling owners.

Hypothesis 5. *Board affiliation is negatively correlated with firm performance, and board professionalism is positively correlated with firm performance.*

3. Data and methodology

The sample comprises panel data from 41 financial institutions that were publicly listed in Taiwan from 2003 to 2006.[5] The data on board composition, control rights (or voting rights) and cash flow rights were collected from company prospectuses and

[5] Five financial institutions were excluded from the sample due to data unavailability (Taiwanese Business Bank, China United Trust & Investment Corporation) or inconsistency with the sample period (Taiwan Cooperative Bank, Yanta Core Pacific Securities, and Taiwan International Securities Corporation). The 41 financial institutions include 14 financial holding companies, 14 banks, five security houses, and eight insurance companies.

"Business Groups in Taiwan," a book published annually by China Credit Information Service, Ltd. Other company information was collected from the Taiwan Economic Journal (TEJ) database.

According to the concept of ultimate control given in a study by La Porta et al. (1999), cash flow rights measure a controlling owner's percentage of the profits, losses and dividends of his/her firm. A higher ownership percentage provides a strong incentive to maximize the value of the firm and minimize agency misconduct. If there are multiple chains of ownership, then the cash flow rights along each chain are products of all of the ownership rights in the intermediate companies in that chain. The total cash flow rights are then equal to the sum of all of the cash flow rights from all of the ownership chains.

"Voting rights" refer to both direct and indirect voting rights. Direct voting rights are the shares registered under the names of the controlling shareholder and affiliated individuals. Indirect voting rights refer to shares that are registered under other companies or institutions that are controlled by the same controlling shareholder. To identify the controlling owner, we trace the ownership structure through various sources[6] and calculate the cash flow and voting rights according to the aforementioned definitions. When the controlling owner is a family, which is defined as a group of people related through blood or marriage ties, the cash flow and voting rights of the family members are summed. The same algorithm is also applied to the calculation of the cash flow and voting rights when the controlling owner is the state.

Take SinoPac Holding as an example. The diagram of SinoPac Holding in Fig. 1 illustrates separate calculations of the cash flow and control rights when cross-shareholdings and pyramids are used. Following the methodology used by Claessens et al. (2000), the direct control rights are based on the proportion of shares registered to the ultimate owner, and the indirect control rights are based on the weakest link in the chain of shares held by entities that are, in turn, controlled by the ultimate owner. As shown in the diagram, the control rights of the controlling owner, Ming-Hon Hon, are 11.60% (3.86% + 0.07% + 1.89% + 5.78%), and his cash flow rights (6.16%) are summed from the direct cash flow rights of 5.82% (100% * 3.86% + 0.07% + 100% * 1.89%) and indirect cash flow rights of 0.34% (5.82% * 100% * 5.78%), resulting in a cash-flow-right control deviation of 5.44%.

We further classify the qualifications of board members based on their relation to a controlling owner and their backgrounds. The corporate boards in Taiwan are similar to those in Germany, which comprise two separate organizations—a board of directors and a supervisory board—with minimum composition numbers of three and one, respectively. Whereas directors are responsible for managing the companies, supervisors are responsible for monitoring the directors. However, unlike the German boards, the Taiwanese boards of directors and supervisors are parallel, meaning that supervisors have the right to review and audit the reports provided by directors, but do not have the right to approve the directors' decisions.

Although Taiwan's Corporate Law stipulates that no current employees or directors may serve as supervisors, it does not prohibit family members of current employees or directors from serving in supervisory posts. Moreover, because the law allows institutional shareholders to assign representatives to a board, a controlling owner is able to enhance his/her influence over a board by founding nominal investment companies that have seats on the board in turn. As a result, it is not uncommon for legal representatives to be ultimately controlled by a controlling owner to whom they are only superficially related. This is why board independence is difficult to define technically. Instead, we consider board affiliation by identifying the board members who are controlled by a controlling owner according to the representatives from the owner's affiliated firms or institutes. Government representatives on boards are recognized as affiliated members when the controlling owner is the state.

The professionalism of a board member is recognized when he/she possesses an accounting or law qualification or management experience from another financial firm. Board professionalism is indicated by the number of board members who have the aforementioned qualifications divided by the total number of board members. This definition is based on the premise that board members with more qualifications are able to exert a better monitoring function than those with fewer qualifications. However, the counterargument indicates that double counting a member's qualifications is inappropriate because only one person is monitoring. We alternatively define board professionalism as the percentage of professional members who satisfy the aforementioned qualifications. Although the results from the two definitions are qualitatively similar, the total assets and family-control dummy lose their significance when an alternative definition is used. For the sake of brevity, we report only the results from the former definition. The results from the latter may be provided upon request.

3.1. Ownership structure

Panel A in Table 1 presents the ownership structure measures in the sample. The results indicate that the mean control rights and cash flow rights are 27.42% and 17.99%, respectively. The wedge, defined as the control rights less the cash flow rights, is 9.43%. These numbers are comparatively lower than those of non-financial companies.[7] The cash flow/control rights ratio is 63.83% on average. The devices that facilitate ownership leverage include pyramidal structures and cross-shareholdings. The statistics show that 54% and 35% of our sample firms are associated with the use of pyramids and cross-shareholdings, respectively.

[6] We identify the business entities that are affiliated with the major shareholders from "Business Groups in Taiwan," an authoritative local source published by China Credit Information Service, Ltd. We supplement the business affiliation information with data from other sources, such as company prospectuses and annual reports, in which the relative associations between the top managers, directors, and supervisors are discussed. We gather data on indirect ownership (registered under other companies or institutions controlled by the controlling shareholder) from the "invested businesses," "major shareholders," and "trades with affiliated persons" sections of the company prospectuses or annual reports. Finally, we also use data provided by the Central News Agency to confirm the interrelationships between the large shareholders.

[7] According to Yeh and Woidtke (2005), the average control rights and cash flow rights for non-financial companies are 30.33% and 21.68%, respectively.

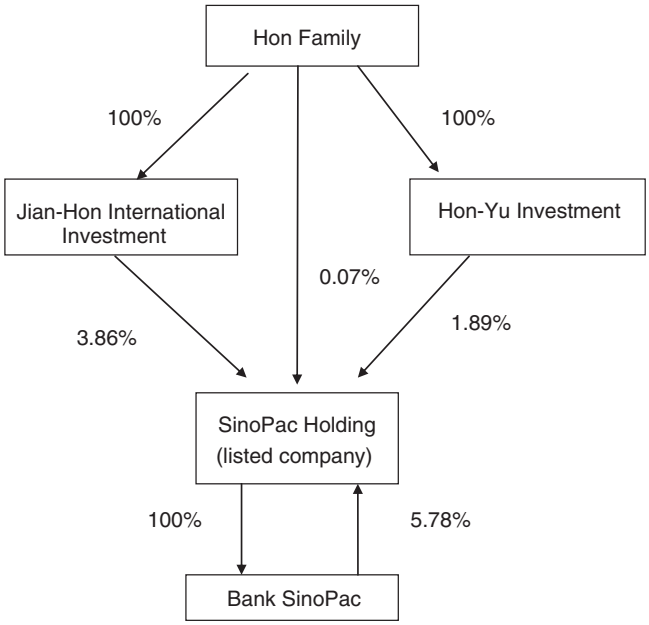

Fig. 1. SinoPac Holding ownership structure.

3.2. Board structure

Claessens et al. (2000) find that the managers of approximately 80% of Taiwanese listed firms are members of the firms' controlling families. Board affiliation, which is defined as the proportion of board members who are the controlling owners themselves, their identifiable relatives and representatives from their controlled firms/institutes, is an indicator of the motives of

Table 1
Summary statistics.
The sample consists of 41 financial firms in Taiwan in 2003–2006 sampling period. This table reports the summary statistics, including the mean, standard deviation, and quartiles of the main variables for ownership structure (Panel A), board structure (Panel B), and company characteristics (Panel C). "Control" is the proportion of shares or votes controlled by the largest shareholder group. "Cash flow" is the proportion of shares or cash flow rights owned by the largest shareholder group. "Wedge" is a measure of the excess control of the largest shareholder group and is defined as the divergence between control and cash flow rights. The pyramidal (cross-shareholding) dummy equals 1 if the controlling shareholder group leverages control through a pyramidal structure (cross-shareholding arrangement) and 0 otherwise. "Affiliated directors/supervisors" denotes the proportion of directors/supervisors made up by the firm's controlling shareholder, the controlling shareholder's identifiable relatives, or the legal representatives of other companies or entities controlled by the controlling shareholder. "Professional directors/supervisors" represents the proportion of directors/supervisors who have related working experience or certificates in a finance, accounting, or legal field. "Total assets" represents the book value of total assets in billions of NT dollars. The participation dummy equals 1 if the largest shareholder member serves as either the chairman of the board of directors or the general manager and 0 otherwise. The family-control dummy equals 1 if the largest shareholder group is a family or group of families and 0 otherwise.

	Mean	S. D.	Q1	Q2	Q3
Panel A: ownership structure					
Control (%)	27.42	16.17	13.37	26.72	36.65
Cash flow (%)	17.99	13.60	5.20	15.95	25.77
Wedge (%)	9.43	10.59	1.41	5.68	14.56
Cash flow/control (%)	63.83	28.96	43.96	64.56	93.63
Pyramidal dummy	0.54	0.50	0.00	0.00	1.00
Cross-shareholding dummy	0.35	0.48	0.00	0.00	1.00
Panel B: board structure					
Number of directors	11.31	4.03	9.00	11.00	14.75
Number of supervisors	3.35	1.02	3.00	3.00	4.00
Affiliated directors (%)	66.31	24.49	50.96	66.67	83.33
Affiliated supervisors (%)	58.78	32.74	33.33	60.00	100.00
Professional directors (%)	59.64	32.72	33.33	62.02	84.58
Professional supervisors (%)	68.37	52.01	33.33	66.67	100.00
Panel C: company characteristics					
Total assets (in billions of NT dollars)	625.81	753.08	75.01	254.64	1118.78
Second largest shareholder shareholding (%)	5.17	6.86	1.15	2.46	6.42
Participation dummy	0.92	0.27	1.00	1.00	1.00
Family-control dummy	0.73	0.45	0.00	1.00	1.00
Financial holding dummy	0.33	0.47	0.00	0.00	1.00

the controlling owners. The results in Panel B illustrate that the mean numbers of directors and supervisors are 11.31 and 3.35, respectively. As reported in a study by Yeh and Woidtke (2005), board affiliation in the financial industry (66.31%) is higher than in the non-financial industry (52.83%). Moreover, the leveraged capital structure associated with the financial industry allows controlling owners to wield major influence over corporate decisions. Klein (1998b) illustrates that the boards of large U.S. firms have more outside directors with business relations when their information needs are higher. Moreover, Park, Selvili, and Song (2008) indicate that the amount of outside blockholders is positively correlated with the market's reaction to partial acquisitions. Professional board members are either appointed by outside blockholders to watch a controlling owner closely or by the controlling owner to provide professional opinions about the firm's major decisions. The statistics show that the average ratio of professional directors (supervisors) is 59.64% (68.37%).

3.3. Other firm characteristics

Panel C includes other control variables. Ownership concentration may decrease as a firm's assets increase, and this may affect board member selection. The average asset size is NT$625.81 billion. The average shareholding of the second largest shareholder, who counterbalances the controlling owner's power and mitigates the agency problem, is 5.17%. The effect of the controlling owner becoming involved in management practices has received mixed support in the literature.[8] The majority of the sample cases (92%) include statistics on the management involvement of controlling owners, and the results imply that the large private benefits of control associated with the financial industry encourage controlling owners to become personally involved in management practices. The statistics also show that approximately 73% of the sample firms are family controlled and that 33% are financial holding companies.

4. Empirical results

4.1. Univariate test

In Table 2, we further divide the sample based on the sample median of the wedge of excess control (Panel A) and the cash flow/control rights ratio (Panel B). A parametric *t*-test is used to test the differences in the variables. The results show that the financial institutions with higher cash flow/control divergences invite fewer professional directors (supervisors) to their boards. On average, the proportion of professional directors (supervisors) for the low-divergence group is 69.81% (81.20%), comparatively higher than the 49.47% (55.53%) proportion for the high-divergence group. In contrast, the firms in the high-divergence group are associated with a higher ratio of affiliated directors (70.40%) than that of the low-divergence group (62.23%). Moreover, the firms in the high-divergence group are associated with lower cash flow rights, higher control rights and higher odds of participating in management than the firms in the low-divergence group. The results support our postulation that financial firms with higher cash flow/control divergences are inclined to organize boards of directors (supervisors) with higher levels of affiliation and lower levels of professionalism.

In Panel B, the firms are partitioned into two halves based on the cash flow/control rights ratio. Consistent with those in Panel A, the results indicate that the firms in the high-ratio group are associated with higher levels of professionalism in both their boards of directors and supervisory boards. The differences are significant at the 1% level.

In Table 3, the sample firms are classified into two distinct groups based on whether they are family controlled[9] (Panel A) and whether they belong to a financial holding group (Panel B). There are 30 family controlled firms, 11 non-family controlled firms, 14 financial-holding firms and 27 non-financial-holding firms. The results show that the family-controlled financial institutions are associated with a lower level of board professionalism than the non-family-controlled institutions. The average proportion of professional directors is 54.30% for the family-controlled firms and 74.03% for the non-family-controlled firms. The family-controlled firms also include fewer professional supervisors on their boards. The average proportion of professional supervisors for the family-controlled firms (59.56%) is significantly lower than that for the non-family-controlled firms (92.09%). The results also show that the controlling owners of the family-controlled firms wedge their controls to a greater extent than those of the non-family-controlled firms. The controlling owners of the family-controlled firms have cash flow rights of 12.89% on average, and further leverage their control rights to 24.31%, indicating an 11.42% wedge of excess control. In contrast, the controlling owners of the non-family-controlled firms have higher cash flow rights (31.72%) and control rights (35.78%). However, these firms are associated with lower excess control (4.07%). The non-family-controlled firms are associated with a higher proportion of affiliated supervisors than the family-controlled firms, partly because the state tends to control the non-family-controlled firms. The state is responsible for monitoring financial institutions closely and therefore assigns government officers with multiple professional qualifications to the supervisory posts. Compared with their non-family-controlled counterparts, the controlling owners of family-controlled firms are more likely to leverage their controls through

[8] Pi and Timme (1993) find that separating the roles of CEO and chairman is beneficial to a bank's performance. Simpsom and Gleason (1999) indicate that CEO/chairman duality lowers the probability of financial distress in banking firms. Byrd et al. (2002) also find that failed thrifts during the thrift crisis were more likely to have a CEO-chairman duality. In contrast, Baliga, Moyer, and Rao (1996) find no evidence that separating the CEO and chairman posts provides benefits to firms.

[9] A family-controlled firm is a firm of which the ultimate controller is a family.

Table 2
Comparisons between Financial Institutions with High and Low Divergence in Control and Ownership.
Measures are presented separately for financial institutions with high and low divergence in control and ownership. Panel A (Panel B) reports the test of differences in means based on the classification of the wedge between control and cash flow rights (the cash flow/control rights ratio) of the largest shareholder group. The variable definitions are given in Table 1.

	Low mean	High mean	*t*-Statistic
Panel A: control − cash flow			
Number of directors	12.32	10.29	−3.108[a]
Number of supervisors	3.54	3.17	−2.235[b]
Affiliated directors (%)	62.23	70.40	2.024[b]
Affiliated supervisors (%)	59.51	58.05	−0.266
Professional directors (%)	69.81	49.47	−3.911[a]
Professional supervisors (%)	81.20	55.53	−3.046[a]
Control (%)	22.39	32.44	3.912[a]
Cash flow (%)	20.73	15.25	−2.462[b]
ln (total assets)	15.08	14.60	−0.678
Second largest shareholder shareholding (%)	4.90	5.45	0.477
Participation dummy	0.88	0.97	2.218[b]
Panel B: cash flow/control			
Number of directors	10.69	11.92	1.834[c]
Number of supervisors	3.14	3.57	2.581[b]
Affiliated directors (%)	67.45	65.18	−0.554
Affiliated supervisors (%)	57.36	60.21	0.521
Professional directors (%)	51.28	68.01	3.163[a]
Professional supervisors (%)	52.82	83.91	3.746[a]
Control (%)	27.88	26.95	−0.344
Cash flow (%)	11.57	24.41	6.409[a]
ln (total assets)	14.80	14.89	0.131
Second largest shareholder shareholding (%)	4.81	5.53	0.626
Participation dummy	0.97	0.88	2.218[b]

[a] Significant at the 1% level.
[b] Significant at the 5% level.
[c] Significant at the 10% level.

cross-shareholdings than through a pyramidal structure, mainly due to the interwoven ownership structures associated with government-sponsored institutions.

Since the passage of the 2001 Financial Holding Company Act, which encourages integration among local financial institutions for the purpose of enhancing global competitiveness, numerous mergers and acquisitions have taken place, resulting in a

Table 3
Comparisons between financial institutions: family control and financial holdings.
This table presents separate measures for financial institutions that are either family controlled or not (Panel A) and financial institutions that are either ultimately controlled by a financial holding company or not (Panel B). The variable definitions are given in Table 1. The sampling period is from 2003 to 2006. In 2003, there were 30 family controlled firms, 11 non-family controlled firms, 14 financial-holding firms, and 27 non-financial-holding firms. A *t*-test is used for the test of differences in means.

	Panel A: family control dummy			Panel B: financial holding dummy		
Characteristic	No Mean	Yes Mean	*t*-Statistic	No Mean	Yes Mean	*t*-Statistic
Number of directors	12.54	10.85	2.269[a]	11.01	11.90	−1.270
Number of supervisors	3.85	3.17	3.934[b]	3.33	3.40	−0.342
Affiliated directors (%)	70.02	64.94	1.166	67.14	64.66	0.567
Affiliated supervisors (%)	70.73	54.35	2.727[b]	58.40	59.55	−0.197
Professional directors (%)	74.03	54.30	3.360[b]	52.89	73.14	−3.451[b]
Professional supervisors (%)	92.09	59.56	3.190[b]	59.10	86.91	−3.116[b]
Control (%)	35.78	24.31	3.974[b]	29.40	23.46	2.100[a]
Cash flow (%)	31.72	12.89	0.350[b]	18.74	16.47	1.024
Wedge (%)	4.07	11.42	−3.883[b]	10.65	6.99	1.976[a]
Cash flow/control (%)	88.18	54.79	7.142[b]	63.26	64.96	−0.324
Pyramidal dummy	0.69	0.49	2.234[a]	0.54	0.54	0.000
Cross-shareholding dummy	0.10	0.44	−3.930[b]	0.29	0.46	−1.994[a]
ln (total assets)	15.17	14.72	0.548	14.41	15.70	−1.717[c]
Second largest shareholder shareholding (%)	5.84	4.92	0.694	5.48	4.55	0.766
Participation dummy	0.95	0.91	0.763	0.91	0.96	−1.106

[a] Significant at the 5% level.
[b] Significant at the 1% level.
[c] Significant at the 10% level.

reshuffled market structure. A financial-holding company's ownership structure is even more complicated. The results from Panel B show that financial-holding firms are associated with a more extensive use of cross-shareholdings than non-financial-holding firms.[10] Moreover, the total assets of the financial-holding firms are larger than those of the non-financial holding firms.

4.2. Board affiliation determinants

We further examine the relationship between ownership structures and board affiliation. The results of regressing board affiliation on ownership structure variables are summarized in Table 4. A panel regression is used to control the fixed effect, which includes the yearly effect. The results support Hypotheses 1 and 2, as board affiliation is positively related to a controlling owner's cash flow rights, control rights and the wedge of excess control, which is significant at the 1% level. Controlling shareholders who pursue their control potential demand more affiliated persons to internalize the boards. Note that in the fourth to sixth regressions, we simultaneously include cash flow rights and the wedge of excess control in the regressions to mitigate the possible bias resulting from a spurious relationship among the variables or from omitting the most discerning variable. The results are basically intact. For example, cash flow rights and the wedge of excess control are both significant at the 1% level when both are included in the regression. Moreover, the explanatory power of the cash flow rights subsides when the control rights are included in the regressions, indicating that control rights are more important than cash flow rights in determining board affiliations. Therefore, a controlling owner's impulse to internalize the board is further intensified by the wedge that deviates from a cash investment.

The results also show that firm size is positively related to board affiliation. A firm size that implies the private benefits of control further impels a controlling owner to internalize the board. A controlling owner who is personally involved in management practices is prone to having more affiliated board members. As indicated by Uchida (2011), Japanese firms that are subject to pressures from small boards tend to adopt an officer system and thus do not substantially decrease the sizes of their management teams. The negative relationship between board size and director affiliation occurs mainly due to the existence of the second largest shareholder. This is verified by the negative correlation of board affiliation with the shareholdings of the second largest shareholder. In Panel B, we explore the determinants of board affiliation on a supervisory board. The results basically echo the findings in Panel A.

4.3. Board professionalism determinants

The aforementioned results show that controlling owners prefer highly affiliated boards regardless of the control rights originating from direct cash flow investments, the wedges of cross-shareholdings or pyramidal structures. The relationship between ownership structures and board professionalism requires further investigation. The incentive alignment hypothesis posits that professional boards that are value added to financial institutions are connected to the high cash flow rights associated with the controlling owner, who has a stronger motive to ensure that the financial institution is run properly and prosperously. The results from Table 5 show that when control rights are controlled in the regression, the cash flow/control rights ratio is positively related to board professionalism for both boards of directors and supervisory boards at the 5% significance level. Further, value-added board professionalism sends a “structural family” signal (Semkow, 1994) to outsiders. This positive signal could enhance the credibility of a firm's financial reports. As such, Hypothesis 3 is supported.

When a controlling owner obtains predominant control rights through a wedge rather than cash investment, the incentive alignment effect is suppressed, diverting his/her attention from value creation to wealth exploitation. In such a situation, the controlling owner prefers a lower level of board professionalism to avoid having his/her actions questioned. The regression coefficient of the wedge of excess control is −0.928 for board-of-director professionalism and −1.096 for supervisory-board professionalism, and both are significant at the 1% level. Moreover, control rights are negatively associated with board-of-director professionalism. This result is consistent with Hypothesis 4, which states that an abatement of the incentive alignment effect results in a lower level of board professionalism. Note that the family-control dummy is negatively associated with board professionalism at the 1% and 5% significance levels, indicating that family controlling owners are reluctant to have professional boards because the arrangement of non-professional members allows them to make decisions that are biased in their favor. An alternative explanation is that the boards are structured as non-professional to prevent proprietary knowledge from leaking to competitors or to prevent the pursuit of private benefits of control that are not to be shared by others, and are thus less informative. Note that control rights and the wedge of excess control are both negatively correlated with board professionalism when cash flow rights are controlled in the regression. The results thus far illustrate that the level of board professionalism indicates the controlling owner's motives.

Note that cash flow rights receive weak support from the aforementioned analyses. One possible explanation is that the controlling owners' cash flow rights in financial companies are too low to reach the turning point of interest alignment, as illustrated by Morck, Shleifer, and Vishny (1988). However, we do find that the cash flow/control rights ratio is more sensitive

[10] Cross-shareholding among subsidiaries is explicitly noted in these financial-holding firms. They are required by regulators to substantially reduce cross-shareholdings among companies within the same holding entity within 3 years. The regulation also stipulates that the cross-shareholdings from mergers should be sold on the open market or relinquished to employees. Those who fail to comply with the rules are restricted in exerting their rights as shareholders, except for earnings sharing.

Table 4
Board affiliation determinant estimates.
This table presents coefficient estimates of the board membership proportions controlled by the largest shareholder group regression, estimated using a panel regression. The dependent variables in Panels A and B are the proportion of affiliated directors and the proportion of affiliated supervisors, respectively. The definitions of the independent variables are given in Table 1. The *t*-statistics are in parentheses.

	Panel A: affiliated directors (%)						Panel B: affiliated supervisors (%)					
Intercept	38.037	37.099	56.488	36.080	36.080	33.265	40.058	37.721	59.016	36.798	36.798	32.038
	(3.405)[a]	(3.119)[a]	(5.038)[a]	(3.124)[a]	(3.124)[a]	(2.601)[a]	(2.295)[b]	(2.075)[b]	(3.480)[a]	(2.039)[b]	(2.039)[b]	(1.604)
Control (%)	0.576			0.492		0.581	0.585			0.446		0.593
	(5.493)[a]			(3.060)[a]		(5.522)[a]	(3.569)[a]			(1.772)[c]		(3.609)[a]
Cash flow (%)		0.687		0.157	0.649			0.741		0.262	0.707	
		(4.465)[a]		(0.686)	(4.332)[a]			(3.151)[a]		(0.732)	(3.019)[a]	
Wedge (%)			0.550		0.492				0.508		0.446	
			(3.225)[a]		(3.060)[a]				(1.971)[b]		(1.772)[c]	
Cash flow/control (%)						0.050						0.084
						(0.770)						(0.829)
ln (total assets)	1.291	1.253	1.479	1.267	1.267	1.273	0.760	0.707	0.950	0.719	0.719	0.729
	(3.452)[a]	(3.233)[a]	(3.727)[a]	(3.367)[a]	(3.367)[a]	(3.391)[a]	(1.300)	(1.194)	(1.583)	(1.224)	(1.224)	(1.243)
Number of board members	−1.529	−1.660	−1.565	−1.545	−1.545	−1.549	−1.303	−1.434	−1.352	−1.329	−1.329	−1.337
	(−4.346)[a]	(−4.589)[a]	(−4.169)[a]	(−4.374)[a]	(−4.374)[a]	(−4.385)[a]	(−2.370)[b]	(−2.594)[b]	(−2.381)[b]	(−2.410)[b]	(−2.410)[b]	(−2.423)[b]
Participation dummy	24.369	27.919	22.595	25.075	25.075	25.284	24.426	28.174	22.901	25.602	25.602	25.964
	(4.126)[a]	(4.567)[a]	(3.554)[a]	(4.175)[a]	(4.175)[a]	(4.191)[a]	(2.647)[a]	(3.016)[a]	(2.382)[b]	(2.729)[a]	(2.729)[a]	(2.755)[a]
Second largest shareholder shareholding (%)	−0.984	−1.031	−0.979	−0.992	−0.992	−0.994	−0.772	−0.820	−0.770	−0.784	−0.784	−0.788
	(−4.229)[a]	(−4.295)[a]	(−3.943)[a]	(−4.249)[a]	(−4.249)[a]	(−4.258)[a]	(−2.123)[b]	(−2.236)[b]	(−2.052)[b]	(−2.151)[b]	(−2.151)[b]	(−2.162)[b]
Family-control dummy	−1.622	4.403	−3.369	0.341	0.341	0.067	−12.187	−5.243	−22.790	−8.917	−8.917	−9.348
	(−0.422)	(0.927)	(−0.925)	(0.071)	(0.071)	(0.015)	(−2.028)[b]	(−0.722)	(−3.737)[a]	(−1.189)	(−1.189)	(−1.350)
Financial-holding dummy	−1.520	−3.244	−3.369	−1.596	−1.596	−1.535	2.498	0.880	0.442	2.372	2.372	2.472
	(−0.441)	(−0.924)	(−0.925)	(−0.462)	(−.462)	(−0.445)	(.464)	(0.164)	(0.080)	(.440)	(.440)	(0.459)
R-square	0.417	0.379	0.339	0.415	0.415	0.416	0.204	0.189	0.154	0.201	0.201	0.202

[a] Significant at the 1% level.
[b] Significant at the 5% level.
[c] Significant at the 10% level.

Table 5
Board professionalism determinant estimates.

This table presents coefficient estimates of the professional-board-member proportion regression, estimated using a panel regression. The dependent variables in Panels A and B are the proportions of professional directors and supervisors on the board, respectively. The definitions of the independent variables are given in Table 1. The *t*-statistics are in parentheses.

	Panel A: professional directors (%)						Panel B: professional supervisors (%)					
Intercept	53.491	41.683	39.755	43.582	43.582	33.150	93.761	76.814	81.423	79.098	79.098	66.229
	(3.099)[a]	(2.271)[b]	(2.489)[b]	(2.485)[b]	(2.485)[b]	(1.703)[c]	(3.232)[a]	(2.539)[b]	(3.023)[a]	(2.671)[a]	(2.671)[a]	(2.012)[b]
Control (%)	−0.493			−0.917		−0.472	−0.476			−1.102		−0.447
	(−3.044)[a]			(−3.751)[a]		(−2.944)[a]	(−1.747)[c]			(−2.672)[a]		(−1.649)
Cash flow (%)		−0.192		0.795	−0.122			−0.011		1.176	0.074	
		(−0.810)		(2.288)[b]	(−0.535)			(−0.028)		(2.006)[b]	(0.193)	
Wedge (%)			−0.928		−0.917				−1.096		−1.102	
			(−3.818)[a]		(−3.751)[a]				(−2.675)[a]		(−2.672)[a]	
Cash flow/control (%)						0.213						0.288
						(2.156)[b]						(1.976)[b]
ln (total assets)	1.520	1.423	1.359	1.398	1.398	1.442	0.655	0.504	0.499	0.474	0.474	0.549
	(2.631)[a]	(2.379)[b]	(2.404)[b]	(2.447)[b]	(2.447)[b]	(2.523)[b]	(0.674)	(0.511)	(0.523)	(0.492)	(0.492)	(0.568)
Number of board members	−0.283	−0.150	−0.361	−0.364	−0.364	−0.370	−0.017	0.121	−0.140	−0.138	−0.138	−0.135
	(−0.521)	(−0.268)	(−0.674)	(−0.680)	(−0.680)	(−0.688)	(−0.019)	(0.131)	(−0.155)	(−0.152)	(−0.152)	(−0.148)
Participation dummy	17.764	16.044	21.803	21.337	21.337	21.664	3.071	1.994	8.077	8.360	8.360	8.351
	(1.947)[c]	(1.701)[c]	(2.408)[b]	(2.339)[b]	(2.339)[b]	(2.359)[b]	(0.200)	(0.128)	(0.529)	(0.543)	(0.543)	(0.538)
Second largest shareholder shareholding (%)	−0.337	−0.302	-.378	−0.376	−0.376	−0.378	−0.875	−0.843	−0.930	−0.931	−0.931	−0.930
	(−0.938)	(−0.815)	(−1.069)	(−1.060)	(−1.060)	(−1.064)	(−1.448)	(−1.380)	(−1.560)	(−1.557)	(−1.557)	(−1.548)
Family-control dummy	−24.597	−22.220	−12.270	−14.659	−14.659	−17.398	−37.664	−32.050	−24.410	−22.958	−22.958	−27.920
	(−4.139)[a]	(−3.030)[a]	(−2.136)[b]	(−2.011)[b]	(−2.011)[b]	(−2.578)[b]	(−3.771)[a]	(−2.652)[a]	(−2.520)[b]	(−1.866)[c]	(−1.866)[c]	(−2.447)[b]
Financial-holding dummy	13.618	16.303	13.566	13.233	13.233	13.552	22.012	25.133	21.240	21.443	21.443	21.923
	(2.560)[b]	(3.008)[a]	(2.614)[a]	(2.525)[b]	(2.525)[b]	(2.582)[b]	(2.462)[b]	(2.814)[a]	(2.427)[b]	(2.424)[b]	(2.424)[b]	(2.470)[b]
R-square	0.259	0.212	0.285	0.286	0.286	0.283	0.171	0.153	0.195	0.195	0.195	0.189

[a] Significant at the 1% level.
[b] Significant at the 5% level.
[c] Significant at the 10% level.

than cash flow rights in illustrating controlling owners' motives. In an unreported result we use the alternative definition of board professionalism to investigate how it is affected by ownership structures. The result is basically intact.

As shown in Table 5, the family-control dummy is associated with low board professionalism. We further investigate the interactive effect of the family-control dummy with ownership structures. Table 6 reports the regression results.

The results show that cash flow rights become significant after including the family-control dummy. The regression coefficient of cash flow is 0.6 for the board of director affiliation and 0.887 for the supervisory board affiliation. However, the interaction between the family-control dummy and cash flow/control is significantly negative, which somewhat contradicts our postulation that family controlling owners may demand more affiliated board members when they have more cash flow investments. A close check of the regression result indicates that the regression coefficient of cash flow/control and that of the interaction between cash flow/control and the family-control dummy are equivalent in magnitude yet opposite in direction, resulting in an insignificant net effect on board affiliation.

Table 7 reports the regression results for board professionalism after the inclusion of the interactive effect between the family-control dummy and ownership variables. The board professionalism regression result shows that the interaction between the family-control dummy and control rights is significantly negative. Such is also the case for the interaction between the family-control dummy and cash flow rights, and the interaction between the family-control dummy and cash flow/control rights ratio. This implies that family controlling owners are reluctant to enhance board professionalism, even if it means increasing their control and cash flow rights and the cash flow/control rights ratio.

The results thus far illustrate that controlling owners are desperate to dominate their boards regardless of how and where they obtain the rights. If the controlling owners are not members of a family, they may accommodate more professional board members. However, such an intention is nullified when the controlling owners are family members.

Our postulation that controlling owners' motives are manifested in board structures may not apply to state-controlled banks, and the results from our sample consisting of private and state-controlled banks may be misleading to this effect. In unreported findings, we use only the subsample of private banks and the results are basically intact. These findings may be provided upon request.

Professional boards are more likely to act in the best interests of shareholders and to discourage managers from engaging in self-dealing activities at the expense of minority parties. This implies that financial institutions with professional boards are more

Table 6
The interaction between ownership structures and family control over board affiliations.
This table reports the coefficient estimates of the board membership proportion controlled by the largest shareholder group regression by adding the interactive terms of the ownership structure variables and the family-control dummy. The dependent variables in Panels A and B are the proportions of directors and supervisors controlled by the largest shareholder, respectively. The definitions of the independent variables are given in Table 1. The *t*-statistics are in parentheses.

	Panel A: affiliated directors (%)				Panel B: affiliated supervisors (%)			
Intercept	38.318 (3.834)[a]	42.510 (3.998)[a]	43.441 (4.116)[a]	53.126 (4.617)[a]	31.678 (2.030)[b]	33.685 (2.059)[b]	38.650 (2.417)[b]	45.403 (2.674)[a]
Control (%)	0.648 (5.712)[a]				0.896 (5.062)[a]			
Family-control dummy Control[c]	−0.108 (−1.014)				−0.380 (−2.290)[b]			
Wedge (%)		0.084 (0.204)				−0.018 (−0.029)		
Family-control dummy Wedge (%)[c]		0.345 (.834)				0.274 (0.430)		
Cash flow (%)			0.600 (4.875)[a]				0.887 (4.759)[a]	
Family-control dummy Cash flow (%)[c]			−0.005 (−0.028)				−0.384 (−1.445)	
Cash flow/control (%)				0.111 (1.796)[c]				0.240 (2.634)[a]
Family-control dummy Cash flow/control[c]				−0.129 (−2.395)[b]				−0.249 (−3.130)[a]
ln (total assets)	1.290 (3.461)[a]	1.537 (3.761)[a]	1.266 (3.252)[a]	1.444 (3.537)[a]	0.771 (1.326)	1.068 (1.699)[c]	0.741 (1.257)	0.885 (1.471)
Number of board members	−1.593 (−4.501)[a]	−1.303 (−3.402)[a]	−1.729 (−4.710)[a]	−1.752 (−4.559)[a]	−1.384 (−2.503)[b]	−0.912 (−1.547)	−1.554 (−2.794)[a]	−1.551 (−2.736)[a]
Participation dummy	23.729 (4.003)[a]	24.342 (3.727)[a]	27.363 (4.326)[a]	24.555 (3.692)[a]	22.494 (2.431)[b]	26.095 (2.597)[a]	25.188 (2.629)[a]	24.260 (2.473)[b]
Second largest shareholder holdings (%)	−0.988 (−4.275)[a]	−0.910 (−3.561)[a]	−1.047 (−4.357)[a]	−1.034 (−4.062)[a]	−0.748 (−2.072)[b]	−0.655 (−1.667)[c]	−0.801 (−2.202)[b]	−0.828 (−2.205)[b]
Financial-holding dummy	−1.332 (−0.389)	−4.067 (−1.081)	−3.520 (−1.003)	−5.429 (−1.473)	3.571 (0.668)	−0.634 (−0.110)	1.344 (.253)	−1.572 (−.289)
R-square	0.449	0.331	0.406	0.338	0.249	0.114	0.237	0.193

[a] Significant at the 1% level.
[b] Significant at the 5% level.
[c] Significant at the 10% level.

Table 7
Interaction between ownership structures and family control on board professionalism.
This table reports the coefficient estimates of the professional-board-member proportion regression by adding the interactive terms of the ownership structure variables and the family-control dummy. The dependent variables in Panels A and B are the proportions of directors and supervisors controlled by the largest shareholder, respectively. The definitions of the independent variables are given in Table 1. The *t*-statistics are in parentheses.

	Panel A: Professional directors (%)				Panel B: professional supervisors (%)			
Intercept	35.878 (2.342)[a]	26.947 (1.815)[b]	31.981 (2.003)[a]	6.279 (.381)	66.874 (2.593)[a]	55.854 (2.219)[a]	61.901 (2.338)[a]	31.987 (1.173)
Control (%)	0.120 (0.691)				0.465 (1.590)			
Family-control dummy Control[b]	−0.737 (−4.531)[c]				−1.133 (−4.134)[c]			
Wedge (%)		−0.443 (−0.767)				−0.215 (−0.219)		
Family-control dummy Wedge (%)[b]		−0.693 (−1.199)				−1.289 (−1.315)		
Cash flow (%)			0.359 (1.926)[b]				0.779 (2.523)[a]	
Family-control dummy Cash flow (%)[b]			−1.001 (−3.769)[c]				−1.401 (−3.181)[c]	
Cash flow/control (%)				0.341 (3.854)[c]				0.523 (3.568)[c]
Family-control dummy Cash flow/control[b]				−0.138 (−1.787)[b]				−0.268 (−2.094)[a]
ln (total assets)	1.545 (2.705)[c]	1.447 (2.534)[a]	1.488 (2.528)[a]	1.262 (2.160)[a]	0.693 (0.721)	0.671 (0.693)	0.593 (0.607)	0.359 (0.371)
Number of board members	−0.420 (−0.773)	−0.221 (−0.412)	−0.333 (−0.600)	−0.249 (−0.453)	−0.229 (−0.251)	0.149 (0.164)	−0.122 (−0.133)	−0.023 (−0.025)
Participation dummy	14.055 (1.547)	23.483 (2.574)[a]	9.255 (0.968)	19.830 (2.083)[a]	−2.630 (−0.172)	11.425 (0.739)	−7.402 (−0.467)	5.579 (0.354)
Second largest shareholder shareholding (%)	−0.285 (−0.804)	−0.342 (−0.958)	−0.223 (−0.613)	−0.349 (−0.958)[b]	−0.795 (−1.333)	−0.855 (−1.414)	−0.729 (−1.209)	−0.900 (−1.491)
Financial-holding dummy	15.761 (3.003)[c]	13.471 (2.564)[a]	18.051 (3.400)[c]	16.581 (3.142)[c]	25.295 (2.863)[c]	21.000 (2.358)[a]	27.640 (3.139)[c]	24.708 (2.828)[c]
R-square	0.275	0.269	0.238	0.239	0.187	0.168	0.171	0.168

[a] Significant at the 5% level.
[b] Significant at the 10% level.
[c] Significant at the 1% level.

Table 8
The impact of board professionalism and affiliation on the return of financial institutions.
This table reports the regression of 2008–2009 average annual return on board professionalism and affiliation. The dependent variable is annual raw return in Panel A and annual market-adjusted return in Panel B. The definitions of the independent variables are given in Table 1. The *t*-statistics are in parentheses.

	(1)	(2)	(3)	(4)	(5)
Panel A: raw return					
Intercept	124.525 (3.587)[a]	85.265 (2.590)[b]	103.670 (3.866)[a]	89.267 (3.019)[a]	158.700 (5.352)[a]
Professional directors (%)	0.274 (1.733)[c]				0.440 (3.248)[a]
Professional supervisors (%)		−0.022 (−0.249)			−0.067 (−1.004)
Affiliated directors (%)			−0.341 (−2.620)[b]		−0.578 (−4.157)[a]
Affiliated supervisors (%)				−0.026 (−0.306)	0.104 (1.263)
LN (asset)	−1.696 (−0.800)	0.247 (0.120)	−0.666 (−0.378)	0.023 (0.012)	−3.313 (−1.886)[c]
Growth of sales (%)	0.426 (3.053)[a]	0.458 (3.108)[a]	0.536 (4.047)[a]	0.468 (3.189)[a]	0.492 (4.427)[a]
Debt ratio (%)	−1.029 (−3.387)[a]	−0.800 (−2.591)[b]	−0.535 (−1.886)[c]	−0.794 (−2.567)[b]	−0.713 (−2.859)[b]
Adj. R-squared	0.505	0.446	0.565	0.447	0.739
Panel B: market-adjusted return					
Intercept	101.068 (2.344)[b]	83.810 (2.035)[c]	113.871 (3.531)[a]	87.323 (2.236)[b]	150.984 (4.623)[a]
Professional directors (%)	0.135 (0.761)				0.294 (2.149)[b]
Professional supervisors (%)		−0.022 (−0.232)			−0.054 (−0.813)
Affiliated directors (%)			−0.458 (−3.677)[a]		−0.714 (−5.112)[a]
Affiliated supervisors (%)				−0.046 (−0.507)	0.162 (1.950)[c]
LN (asset)	−2.180 (−0.802)	−1.401 (−0.529)	−3.009 (−1.418)	−1.621 (−0.624)	−4.635 (−2.321)[b]
Growth of sales (%)	0.435 (2.801)[a]	0.444 (2.820)[a]	0.540 (4.254)[a]	0.459 (2.941)[a]	0.512 (4.590)[a]
Debt Ratio (%)	−0.766 (−2.234)[b]	−0.634 (−1.915)[c]	−0.257 (−0.935)	−0.608 (−1.852)[c]	−0.385 (−1.505)
$D_{\text{Financial Holding}}$	5.342 (0.694)	6.580 (0.854)	8.713 (1.414)	6.344 (0.832)	8.394 (1.539)
Adj. R-squared	0.425	0.412	0.623	0.417	0.754

[a] Significant at the 1% level.
[b] Significant at the 5% level.
[c] Significant at the 10% level.

likely to help financial institutions when the overall market is in trouble. In contrast, affiliated boards allow controlling owners to engage in wealth-entrenchment activities, implying that financial institutions with affiliated boards are more likely to become trapped during a financial crisis.

In Table 8, we explore how board professionalism and affiliation affected the return[11] of financial institutions during the global financial crisis in 2008–2009. The results in Panel A of Table 8 indicate that the proportion of professional directors is positively correlated with the average returns during the period. In contrast, the proportion of affiliated directors is negatively correlated with the average return, implying that firms with affiliated boards are more likely to become trapped during financial crises and are therefore associated with lower average returns. The regression coefficients of both the professional and affiliated directors are significant at the traditional level. The results support Hypothesis 5, which states that whereas board affiliation is negatively correlated with firm performance, board professionalism has a positive correlation. In contrast, the proportions of professional and affiliated supervisors are less significant. In an unreported result, we find that both board professionalism and affiliation are insignificant when the average return of 2007 is used. This implies that both board professionalism and affiliation are better for contrasting firm performances during financial crises and normal periods. The result from the control variables indicates that returns are positively correlated with sales growth rate and negatively correlated with firm leverage. In Panel B, we use the market-adjusted return instead. Moreover, we include a financial-holding dummy variable. Although board professionalism is less significant when it is solely included in Model (1) in Table 8, the result is basically intact.

5. Concluding remarks

In this study, we examine whether the board structures of financial institutions are dictated by their ownership structures in regions where legal protections for investors are relatively weak. We find that controlling owners in the financial industry take leverage on ownership structures in which the private benefits of control are so attractive as to convince them to internalize their boards. Regardless of how and where they obtain the control rights, controlling owners internalize their boards by arranging more affiliated board members when possible. Empirical evidence shows that controlling owners' cash flow and control rights are both positively associated with the proportion of their affiliated board persons. A deviating control/cash flow structure is also positively associated with board affiliation. Further, we find that the incentive alignment and information effects provide satisfactory explanations for how board professionalism indicates a controlling owner's motives. We also find that family controlling owners are reluctant to invite professionals to their boards. Finally, we find that whereas board professionalism is positively correlated with stock returns during a financial crisis, board affiliation has a negative correlation.

This paper offers many potential contributions. First, in analyzing board structures, we use affiliation instead of independence to avoid bias and misclassifying *resume*-independent members who are indeed ultimately controlled by controlling owners. Moreover, our endeavor to connect controlling owners' motives and board structures indicates that internalizing boards that are composed of affiliated members is the top priority of controlling owners. Levels of board professionalism are another factor used to identify board structures and are also able to indicate controlling owners' motives. The result is intuitively appealing for investors, as examining how a controlling owner's board is structured allows them a better understanding of the owner's motives. As several M&A activities have taken place since the 2001 financial reform in Taiwan and are still on the rise, we do not trace the relationship between board structures and firm valuation in this study. Further studies could focus on this aspect to justify the value of affiliation and professionalism in board structures.

Acknowledgment

The authors are especially grateful to Prof. Sheng-Syan Chen and one anonymous reviewer for several useful comments. We would also like to thank the National Science Council of R.O.C. for the research support under contract no. NSC100-2410-H-030-027-MY3. We would also like to thank the great assistants of Ms Ching-I Chang. Any remaining errors are our own.

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[11] The exploration would be ideal if we focus on the target of financial crisis. However, there was no case of financial crisis for these financial institutions since the government of Taiwan provided blanket deposit insurance during this period. We therefore focus on the performance measure such as ROA, ROE, EPS and stock returns. The results from ROA, ROE, and EPS are as predicted, albeit the regression coefficients are less significant.

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