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Corporate governance provisions and firm ownership: Firm-level evidence from Eastern Europe

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Abstract

We study differences in the use of two corporate governance provisions − cumulative voting and proxy by mail voting − in a sample of about 220 firms located in four Eastern European countries. After controlling for other firm characteristics, we find that firms that have a large, minority blockholder are more likely to allow cumulative voting. We do not find any significant relationship between the use of these corporate governance provisions and foreign ownership. We conclude that the use of cumulative voting is associated with the presence of large, minority shareholders.
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1. Introduction

On a national level, the laws that establish shareholder rights and the degree to which these laws protect investors differ significantly across countries, in part because of differences in legal origins and judicial efficiency (La Porta et al., 1998). Furthermore, shareholder protection may vary across firms within countries because provisions in investor protection laws may not

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be binding since firms have the flexibility in their corporate charters and bylaws to either choose to ''opt-out'' and decline specific provisions or adopt additional provisions not listed in their legal code (Easterbrook and Fischel, 1991; Black and Gilson, 1998). In addition, firms could improve investor protection rights by voluntarily choosing to increase disclosure, select independent boards, and impose disciplinary mechanisms to prevent management and controlling shareholders from engaging in expropriation of minority shareholders. Therefore, it is likely that firms within the same country will offer varying degrees of protection to their investors.

Recent literature has offered a number of explanations for why firms may find it beneficial to adopt stricter corporate governance provisions. La Porta et al. (1998) argue that greater investor protection increases investors' willingness to provide financing and will therefore enhance firms' access to external finance. Himmelberg et al. (1999) argue that some firms will find it easier to expropriate from minority shareholders due to the nature of their operations; therefore, these firms may find it optimal to impose ex-ante stricter governance mechanisms to prevent ex-post expropriation. However, since stricter corporate governance mechanisms may come at a cost to the majority shareholder, it is not clear a priori in what cases a firm may decide to adopt better corporate governance standards.

A number of recent papers have studied differences in firm-level corporate governance mechanisms (see Shleifer and Vishny, 1997; Maher and Andersson, 2000, for comprehensive surveys). Gompers et al. (2003) use differences in takeover defense provisions to create a corporate governance index of US firms and find that firms with stronger shareholder rights have better operating performance, higher market valuation, and are more likely to make acquisitions. Black (2001) finds that the governance practices of Russian corporations are strongly related to implied value ratios. Similarly, Black et al. (2004) find that governance of Korean firms is strongly related to firm performance. Klapper and Love (2004) use firm-level corporate governance rankings across 14 emerging markets and find that this corporate governance index is related to firm's performance and valuation.

Most of these papers have focused on the relationship between corporate governance, firm performance and corporate valuation. However, they do not analyze what type of firms is more likely to use specific corporate governance provisions, which is the focus of this paper. One exception is a recent paper by Doidge et al. (2005), who studied whether firm-level corporate governance scores (generated by an investment bank or a rating agency) are correlated with country and firm characteristics. They find that most of the variation in the governance scores can be attributed to country factors rather than firm characteristics, especially for firms in developed countries. Our paper differs from the paper by Doidge et al. (2005) because we study the actual use of specific governance provisions, rather than perceived scores of firm corporate governance based on ''expert'' opinions.

We use a unique firm-level dataset of the use of corporate governance provisions in four Eastern European countries – the Czech Republic, Hungary, Poland, and the Slovak Republic. We study differences in firms' use of corporate governance mechanisms aimed at the protection of minority shareholders. In a recent paper, Berglof and Pajuste (2003) argue that the protection of minority shareholders is becoming an increasingly important issue in Eastern European countries. They note that ownership and control are very concentrated in these countries and, as a result, the main agency conflicts arise between controlling shareholders and minority shareholders rather than between shareholders and firm managers. The latter relationship is the focus of a large body of literature that focuses on US firms (see, for example, Jensen and Meckling, 1976).

An additional advantage of focusing on firms in transition countries is that the privatization process of these firms may have offered a natural process for choosing an incentive-compatible corporate governance framework. In other words, privatization has enabled and spurred these firms to search for a governance framework that is in the interest of the main stakeholders of the firm. Our sample of firms, therefore, provides for a natural experiment to investigate the differences between the types of corporate governance provisions that firms decided to enact.

Most previous studies of corporate governance have constructed various corporate governance indices, which aim to comprehensively measure specific aspects of corporate governance. However, such studies often present a "black-box" index, which aggregates and obscures the understanding of specific governance provisions. For example, Klapper and Love (2004) show that corporate governance is related to performance and valuation, but they are unable to disentangle the value of specific governance provisions. This makes it more difficult to identify which provisions matter most.

In this paper we take a different approach and focus on two specific corporate governance provisions that are widely believed to be important mechanisms to improve the protection of minority shareholder rights: (1) cumulative voting and (2) proxy by mail voting. "Cumulative voting" provisions allow shareholders to cast all their votes for one candidate standing for election to the board of directors. "Proxy by mail" provisions allow shareholders to submit their votes by postal or electronic mail.

These provisions are two of the six provisions included in the anti-director rights index constructed by La Porta et al. (1998). The other four provisions are: whether ordinary shares are required to carry one vote per share; whether firms are required to deposit their shares prior to Shareholder Meetings, therefore preventing the sale of these shares for a number of days; whether minority shareholders have the right to challenge management decisions in court or require management to purchase shares in the case of ownership changes; and whether shareholders have the preemptive right to buy new issues of shares. The reason for focusing on these two provisions is that they are the only two of the six provisions considered by La Porta et al. (1998) that are not mandatory by national law in any of the four countries that we study at the time of our survey (see Pistor, 2000). Therefore, if we find that a particular company allows for any of these two provisions, we can assume that the choice was driven by firm-level considerations and not because it was prescribed by a country-level law. Note that La Porta et al. (1998) focus on cross-country variation in the extent to which the Company Law or Commercial Code of a country allows these corporate governance mechanisms, while we study within-country variation in the actual use of these corporate governance mechanisms.

Previous literature has suggested that these two governance provisions, particularly cumulative voting, are important mechanisms to protect minority shareholders. For example, Bhagat and Brickley (1984) find empirical evidence that firm value is enhanced with the adoption of cumulative voting. Black and Kraakman (1996) review the literature and conclude that "A critical feature of [a] self-enforcing [corporate law] model is a cumulative voting rule for election of directors. Cumulative voting allows large outside shareholders to elect representatives to the board. As long as outside shareholders hold stakes large enough to elect their own representatives, cumulative voting enhances information flow and ensures that at least some directors will be true shareholder representatives. An insider majority will still control non-related-party transactions under this rule, but outside representation makes it harder for insiders to ignore or deceive minority shareholders. Although other voting rules, such as class voting, can also ensure minority representation on the board of directors, a cumulative voting rule is flexible enough to encompass a wide variety of ownership structures."

Black and Kraakman (1996) consider the one share–one vote rule to be another important component of good corporate governance but show that this rule is conventional in many jurisdictions. Mandatory cumulative voting, on the other hand, is a much less common provision. Next they argue that "One share, one vote and cumulative voting are only part of the architecture of a voting system for emerging economies. Ancillary rules are also needed to govern the form of shareholder proxies (or ballots), how shareholders can nominate candidates for election to the board or introduce other proposals for shareholder vote, and how shareholder votes are counted." In particular they stress the importance of the ability to vote in some manner, either through a written ballot or by appointing a proxy, hence, the importance of proxy voting by mail.

Another advantage of our data is that in addition to information on governance provisions, it also contains detailed ownership data, which includes the country of origin of the five largest shareholders (in addition to their ownership stake). This allows us to study whether the corporate governance provisions stipulated by law in the "home country" of large shareholders are correlated with the governance provisions adopted by foreign-owned firms in the "host country". This touches upon an important policy-relevant question of whether foreign shareholders export better corporate governance standards to their host countries. Previous work by Boycko et al. (1996) and Dyck (2001), among others, has argued that foreign investors are a source of better governance.

We find that the use of cumulative voting is positively related to the presence and ownership stake of a second large shareholder (i.e. beyond the largest shareholder). This result survives when we control for other firm characteristics. We neither find a robust relationship between the presence of a "majority" shareholder (i.e. a shareholder who owns 50% or more of the firm's equity) and the use of cumulative voting, nor do we find a significant relationship between the ownership stakes of large shareholders and the use of proxy voting by mail.

While this result is consistent with the notion that large minority shareholders benefit most from stronger voting rights, our analysis does not allow drawing conclusions regarding causality of the effect, i.e. whether the adoption of voting provisions is caused by the presence of large, minority shareholders or whether minority shareholders prefer to invest in firms that allow such voting provisions. On the one hand, a second large blockholder may prefer cumulative voting in order to acquire increased power in electing directors or to increase board representation. By participating in board meetings, such minority shareholders may be able to reduce diversion by the main shareholder. On the other hand, large investors may be attracted to and more willing to invest in firms that allow cumulative voting, because they consider this a positive signal that the firm takes an interest in the protection of minority shareholder rights. As a result, firms may adopt the provision in order to attract outside investors.

To summarize, we find that firms with a second large blockholder are more likely to allow cumulative voting. We do not find any relationship between the use of proxy voting and ownership structure. These results suggest that the large blockholders attach value to cumulative voting provisions. We also find that foreign owners do not behave differently from domestic owners with a majority stake with respect to the two governance provisions that we study in this paper. We do not find any significant relationship between foreign ownership and the use of these provisions, regardless of whether the foreign owners come from countries with or without these provisions in their "home country" legal codes.

The paper proceeds as follows. Section 2 presents our methodology. Section 3 presents the data. Section 4 presents the empirical results. Section 5 concludes.

2. Methodology

Our empirical test is straightforward. Controlling for country-specific effects, we investigate what firm-specific characteristics are associated with two provisions – cumulative voting and proxy by mail voting – being included in the company's charter or not. Our regression model therefore takes the following form:

$$\text{Provision}_{ij} = C_j + \beta F_{ij} + \varepsilon_{ij}, \quad (1)$$

where Provision is either a dummy variable indicating whether or not the firm has enacted cumulative voting in the company's charter or a dummy variable indicating whether or not the firm allows proxy by mail voting; i indicates firm i and j indicates country j; C_j is a country dummy variable; F_{ij} is a vector of firm-specific variables; and ε_{ij} is an error term. We focus on two categories of firm-specific variables: the first set contains ownership structure and privatization variables and the second set contains financial variables.

As presented in the following data section, the firms in our sample have very high concentrations of ownership (which is consistent with the previous evidence in Berglof and Pajuste, 2003). Our empirical analysis tests whether the use of governance provisions is related to the ownership structure of the company. Our first variable is a dummy variable for whether or not the largest shareholder has an ownership stake of more than 50%, in which case we refer to the largest shareholder as the ''majority'' shareholder. Although a majority shareholder controls a majority of the votes and thus potentially many firm-level decisions, the provision of cumulative voting would allow minority shareholders to elect representatives to the board of the company, thereby curtailing some of the majority shareholder's power. Since cumulative voting gives greater oversight to minority shareholders (and may reduce the ability of majority shareholders to expropriate from the firm), we expect to find that firms with a majority shareholder are less likely to allow cumulative voting provisions.

However, the bargaining power of the largest shareholder will depend on whether there are other large shareholders as opposed to the case where the remainder of the shares is widely held. Clearly, in a firm without a majority shareholder, the other large blockholders (i.e. excluding the largest owner) would prefer to have cumulative voting, which may give them power to elect some of the directors. Even in the case that the largest shareholder currently owns more than 50%, one would still expect that the ability to participate on the board – even as a minority voice – would make other large blockholders prefer to have cumulative voting. We therefore expect that firms with other large blockholders are more likely to allow cumulative voting.

To test this hypothesis we include either (1) the cumulative ownership stake of the five largest shareholders, or (2) the ownership stake of the largest shareholder, the ownership stake of the second shareholder, and the cumulative ownership stake of the third through the fifth largest shareholders. We aggregate the third through fifth shareholders because almost all firms do not have more than five blockholders. Even in the case that other large shareholders hold significantly smaller stakes relative to the largest shareholder, these smaller shareholders might act in agreement and combine their shares during votes to counterbalance the largest shareholder. We do not explicitly model the bargaining process or the minority shareholder collusion effort. We also test whether the identity of the owners has any effect on the presence of the governance provisions, with special attention to the role of foreign shareholders. We create a dummy for whether the majority shareholder is a foreigner and include it in the regression model in

addition to our "majority dummy" to test if foreign controlling shareholders behave differently than domestic shareholders.

We create similar dummies for whether the shareholder is a bank or the government, but find no significant relationship between the presence of bank or government ownership and the use of the governance provisions considered and therefore do not report the results in the tables.

The period during which the firm was privatized may also affect whether the firm allows cumulative voting or proxy voting. On the one hand, one may expect early privatizers to adopt these provisions to signal good corporate governance to potential investors; on the other hand, late privatizers may be more likely to adopt these provisions because the importance of good corporate governance became more prominent during the second part of the 1990s because of corporate scandals during the early wave of privatization. We therefore control for the period in which the firm was privatized, by creating several dummy variables splitting the privatization into three general "waves": wave 1 contains companies privatized during the period 1989–1991, wave 2 is the period 1992–1994 and wave 3 is 1995 and after.

Our second focus is on the set of financial characteristics that could explain variation in the degree to which firms enact certain corporate governance provisions. La Porta et al. (1998) argues that greater investor protection increases investors' willingness to provide financing and will therefore enhance firms' access to external finance. This may suggest that firms that are in need of external finance are more likely to enact governance provisions to improve shareholder rights in order to attract external financing.

To test this premise we use several firm characteristics measuring access to different sources of finance and the need for funds. We use size (measured by the log sales in US dollars) to control for a potential size effect. We also use the ratio of equity to total assets to see if there is a correlation between financial leverage and the adoption of governance provision.

In a recent paper, Klapper and Love (2004) study firm-level determinants of an aggregate corporate governance index and find that firms that are faster growing and are less capital intensive are more likely to adopt stricter governance provisions, as well as firms that issue ADRs. We therefore also explored other financial ratios included in the study by Klapper and Love (2004), such as the ratio of fixed assets to total assets, the return on assets, and sales growth, but do not find any of these variables to enter significantly (not shown). Alternative measures of firm performance, such as book-to-market values, stock returns, or Tobin's Q also do not enter significantly. One explanation for the difference in the results could be that they only focus on an aggregate governance index and are not able to differentiate between specific governance provisions as our data permit in this paper.

Our final set of tests considers the effect of the home country of the foreign owners. It has been argued that in countries with weak governance standards, foreign owners from countries with higher corporate governance standards are likely to export their higher standards and apply them to firms they take over in the host country (see, for example, Dyck, 2000). One reason may be that foreign owners face reputational or legal risks if they do not apply the same governance standards in the host country as they apply in their home country. They would also be more familiar with the implementation of these provisions and have the experience and legal expertise to address issues arising as a result of such provisions. Therefore, we also investigate whether firms in our sample are more likely to allow proxy by mail voting and/or cumulative voting if they are owned by a foreign firm from a country where either proxy voting or cumulative voting is prescribed by the law of the country of origin. Since our data only represent a cross-section of firm-level characteristics, we cannot distinguish between several alternative hypotheses. For example, foreigners could induce changes in governance provisions after they

invest in these firms, or, foreigners may be more likely to invest in the firms that already have desirable governance provisions (although firms may voluntarily improve their governance in order to attract foreign investors).

Most of the foreign-owned firms in the four countries we investigated are owned by firms incorporated in either Western European countries, the US or Canada. In Western Europe, the country laws typically do not prescribe cumulative voting and proxy voting, while they do in Canada and the US. Exceptions are France and Norway, where the law prescribes proxy voting by mail and Spain, where the law prescribes cumulative voting (La Porta et al., 1998).

We run the following regression to test whether or not foreign owners from countries that prescribe proxy voting and cumulative voting by law tend to "export" these rules to their host countries:

$$\text{Provision}_{ij} = C_i + \beta F_{ij} + \gamma G_{ij} + \varepsilon_{ij}, \tag{2}$$

where F_{ij} is a vector of firm-specific variables, including a dummy variable for a majority owner and G_{ij} is a set of two "home-rule" variables: first, a dummy equals to 1 if the law of the home country of any of the foreign owners prescribes proxy voting or cumulative voting (we construct separate variables for cumulative voting and for proxy voting) and second, a dummy equals to 1 if none of the foreign owners come from a country with "home rules".

Since our dependent variables are binary variables, we estimate all of the above models with a Probit procedure. The numbers reported in the tables are marginal effects. Hence, in the case of dummy variables, the figures indicate the probability of changing the outcome if the dummy variable changes from 0 to 1. We report White (1980) heteroskedasticity-consistent standard errors, although the results are very similar when we do not adjust for heteroskedasticity.

3. Data

Our unique set of data on corporate governance provisions enacted by firms comes from Aspekt, a private Czech data provider recognized by the Czech public authorities to offer company data to the public. Aspekt consultants collected this information on a company-by-company basis via interviews and company public filings in late 2001. We follow the same definition of cumulative voting and proxy voting as in La Porta et al. (1998) and construct variables identical to the ones used in their study, although we construct these variables at the firm-level while they constructed them at the country-level. Cumulative voting equals 1 if the charters allow shareholders to cast all of their votes for one candidate standing for election to the board of directors, and zero otherwise. Proxy by mail equals 1 if the corporate charters or bylaws allow shareholders to submit their proxy vote to the firm by postal or electronic mail, and zero otherwise.

We complemented our corporate governance data with firm-level financial data and ownership data provided by Aspekt. For a few firms, Aspekt could not provide the financial statements. In these cases, we resort to data from the Worldscope database, when available, and otherwise the Amadeus database. Worldscope is a database that includes financial statements of listed firms around the world and Amadeus is a database that includes financial statements of all registered listed and private firms in 35 European countries. Our ownership data have several limitations. While we have detailed data about direct ownership stakes, we cannot trace ultimate control rights. This is particularly problematic in the case of business groups or pyramidal ownership structures. We also cannot distinguish between control rights and cash flow rights. Our final sample of firms includes 224 publicly traded firms for which data is available.

The data are well distributed among the four Eastern European countries in our sample: 74 firms from the Czech Republic, 56 firms from Hungary, 56 firms from Poland, and 38 firms from the Slovak Republic. All firm-level data are for the year 2000.

Columns (2) and (3) in Panel A of Table 1 show that there is a lot of variation within and across the countries in our sample in terms of the use of both governance provisions. Only 12% of companies have enacted proxy voting in their company's charter, but over 39% of firms have enacted cumulative voting provision. Among the four countries studied, cumulative voting is most prominent in Poland and the Slovak Republic. Proxy voting provisions can be most frequently found in Hungary and Poland, while its use is virtually absent in the Czech Republic and totally absent in the Slovak Republic. The percentage of firms with either of the two provisions is lowest in the Czech Republic.

One explanation for these cross-country differences may be related to how firms respond to weaknesses in regulatory oversight. For example, while Poland and Hungary established an independent securities and exchange commission early on during the reform process, the Czech Republic followed suit only in 1998 (Pistor, 2000). According to Coffee (1999), the lack of attention that was paid in the Czech Republic to securities market regulation can be attributed to a combination of ideological bias against regulation and domestic political obstacles. Glaeser et al. (2001) show that in Poland, where the securities law was strictly enforced by the regulator, firms frequently issued new stock and the stock market developed rapidly. In the Czech Republic, on the other hand, laissezfaire regulation resulted in a moribund stock market. Such differences in regulatory oversight and enforcement of regulation could possibly explain why voting provisions became popular in countries like Poland but not in countries like the Czech Republic.

Columns (4)–(6) in Panel A show the distribution of firms over the "waves" of privatization described in Section 2. Column (7) shows the number of years since privatization. We find that the majority of firms in all countries were privatized during the second wave and that on average it has been about 8 years since the firms were privatized. One notable difference is that firms in Hungary and Poland were privatized throughout the 1990s, whereas firms in the Czech Republic and Slovakia were privatized primarily during the second wave.

Panel B presents the ownership structure of firms in our sample. Column (1) shows that almost half of the firms in our sample have a significant presence of foreign ownership. Foreign ownership, defined as stakes by foreigner shareholders of more than 20% of the company's outstanding shares, is most prominent in Hungary (were about 70% if all listed firms have significant foreign ownership) and is least prevalent in the Slovak Republic (where only about 26% of firms have foreign ownership). Column (2) shows that the Czech Republic has the highest remaining government presence (27% of our sample firms have over 20% government ownership stakes), while Hungary and Poland have very few government-controlled firms among listed firms. Banks have large ownership stakes in over 10% of firms in all countries, except Poland, plus smaller stakes in many more firms (column 3). In line with Berglof and Pajuste (2003), we find that ownership in our sample is very highly concentrated. On average the largest shareholder owns over 50% of shares in all countries except Poland (in which they have about a 40% stake, as shown in column 6), while the five largest shareholders represent over an 80% stake (again in all countries except Poland, as shown in column 5). We also find across all countries with the exception of Poland that the majority of firms have a controlling shareholder with an ownership stake of over 50% of the shares in the company (column 8). However, in quite a few firms there are other large shareholders and their combined shares are not trivial. For example, the four largest shareholders beyond the largest

Table 1
Summary statistics of shareholder rights and ownership structure

	Number of firms	% of firms with		Privatization: % of firms in			
		Cumulative voting	Proxy voting	Wave 1	Wave 2	Wave 3	Average years
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Panel A. Shareholder rights and privatization							
Czech Republic	74	26	4	12	74	14	7.87
Hungary	56	20	18	24	36	23	7.67
Poland	56	66	25	38	41	21	8.39
Slovak Republic	38	55	0	10	70	16	7.73
All sample	224	39	12	21	57	18	7.97

	% of firms with ownership by			Average % of firm shares held by			% of firms with largest shareholder owning over 50%
	Foreigners	Government	Bank	Foreigners	Largest shareholder	Five largest shareholders	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Panel B. Ownership structure							
Czech Republic	47	27	11	38	69	89	70
Hungary	70	7	18	43	52	96	52
Poland	32	11	4	19	39	64	25
Slovak Republic	26	18	11	17	62	82	68
All sample	46	17	11	31	56	83	54

		Equity	Sales	Tangibility	ROA
		(1)	(2)	(3)	(4)
Panel C. Financial ratios					
Czech Republic	Mean	0.53	18.18	0.77	0.03
	Std	0.21	1.64	0.55	0.10
Hungary	Mean	0.60	17.85	0.62	0.04
	Std	0.21	1.79	0.42	0.08
Poland	Mean	0.51	18.01	0.54	0.02
	Std	0.21	1.54	0.49	0.10
Slovak Republic	Mean	0.47	17.45	0.67	0.00
	Std	0.24	2.05	0.38	0.07
Total sample	Mean	0.54	17.95	0.66	0.03
	Std	0.22	1.72	0.49	0.09

Panel A reports the summary statistics on the shareholder rights and privatization variables. Columns (2) and (3) report the percentage of firms with shareholder rights' provisions; columns (4)–(6) report the percentage of firms privatized in Privatization wave 1 (1989–1991), wave 2 (1992–1994) or wave 3 (1995 and after); column (7) reports sample average of number of years since privatization. Panel B reports the summary statistics on the ownership variables. Ownership indicators in columns (1)–(3) in Panel B are defined for firms with 20% or more of each type of ownership. Panel C reports the summary statistics of the financial firm characteristics. *Equity* is the ratio of equity to total assets; *Sales* is log of sales in US dollars; *Tangibility* is the ratio of fixed assets to sales and *ROA* is the ratio of net income to total assets.

shareholders together own on average about 30% of the shares across all countries (with the highest concentration of 40% on average in Hungary).

Panel C shows summary statistics by country for the key financial ratios of firms in our sample. Surprisingly, the financial characteristics of the firms are quite similar across the four

countries studied – the average and standard deviation of the financial leverage, firm size, asset tangibility, and profitability are very similar and the country means of the variables are not statistically different across these countries.

4. Empirical results

Tables 2 and 3 present the results when we regress our two governance provisions on firm characteristics, including country effects to control for differences across countries. Table 2 presents results for cumulative voting and Table 3 presents results for proxy by mail voting.

Column (1) of Table 2 shows that cumulative voting is significantly negatively correlated with the presence of a majority owner. Column (2) also includes a variable that indicates whether the majority owner is a foreign shareholder or not. This variable does not enter significantly. This suggests that the relationship between cumulative voting and majority ownership does not depend on whether the majority shareholders are domestic or foreign. In addition, government and bank majority ownership is also insignificant (not shown). Interestingly, column (3) shows that the combined stake of the five largest owners is positive and significant, even when controlling for the presence of a majority shareholder. This suggests that the use of cumulative voting may be related to the presence of other large shareholders beyond the largest shareholder. In columns (4) and (5), we therefore split the total ownership of the five largest shareholders into the stake of the largest shareholder, the stake of the second largest shareholder, and the combined shareholdings of the third through the fifth largest shareholders. We continue to include the majority ownership dummy, because the effect may depend on whether the largest shareholder has a majority stake or not. Column (4) shows that the effect of majority ownership loses significance once we control for the shareholding of the second largest shareholder. Most of the effect now comes from the second blockholder, i.e. firms where the second largest shareholder holds a relatively large stake are significantly more likely to have cumulative voting. In column (5), we add the combined shareholdings of the third through the fifth largest shareholders but this does not change the results.

In Table 2, columns (6) and (7), we show that our results are robust to controlling for firm size (as measured by the log of total sales) and financial leverage (as measured by the book value of equity to assets). In addition, we do not find that asset tangibility, profitability, and sales growth are correlated with the use of these two governance provisions (not shown). We also do not find that a significant foreign ownership presence (of at least 20% or more of the total stake) has a statistically significant effect on the use of cumulative voting (not shown). Finally, we do not find a significant effect of the privatization wave on whether firms allow cumulative voting or not.

The results for proxy voting presented in Table 3 are generally much weaker. Again, we find that firms with a majority shareholder are less likely to have proxy provisions, although the effect is statistically significant only at 10%. We no longer find a statistically significant effect of the presence of a second shareholder or other large shareholders. The weaker results for proxy voting may suggest that cumulative voting is a more important provision for minority shareholders than proxy voting. For example, proxy voting may not be effective without cumulative voting, especially if the firm's largest shareholder holds a majority stake. The weaker results for proxy voting are also reflected in the number of firms in our sample that has adopted the provision: only 12% of firms allow proxy voting, while 39% of firms allow cumulative voting.

In both Tables 2 and 3 we also find significant country effects, which are consistent with the summary statistics presented in Table 1. In particular, we find that firms operating in the Czech

Table 2
Determinants of cumulative voting

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Majority	−0.127 [0.073]*	−0.155 [0.084]*	−0.222 [0.080]***	−0.179 [0.123]	−0.203 [0.124]	−0.151 [0.127]	−0.203 [0.140]
Majority foreign		0.115 [0.092]					
Share 1−5			0.710 [0.315]**				
Share 1				0.329 [0.291]	0.482 [0.327]	0.268 [0.301]	0.413 [0.330]
Share 2				0.748 [0.354]**	1.078 [0.438]**	0.818 [0.371]**	0.952 [0.431]**
Share 3−5					−0.218 [0.134]		
Privatization-1							−0.031 [0.134]
Privatization-2							0.072 [0.117]
Sales						0.033 [0.023]	0.033 [0.026]
Equity						0.523 [0.186]***	0.551 [0.207]***
Czech Rep	−0.213 [0.103]**	−0.241 [0.104]**	−0.260 [0.104]**	−0.247 [0.102]**	−0.233 [0.105]**	−0.264 [0.103]**	−0.232 [0.120]*
Hungary	−0.297 [0.088]***	−0.341 [0.085]***	−0.378 [0.084]***	−0.318 [0.085]***	−0.327 [0.084]***	−0.381 [0.076]***	−0.322 [0.091]***
Poland	0.131 [0.122]	0.099 [0.123]	0.221 [0.126]*	0.206 [0.125]*	0.163 [0.127]	0.201 [0.127]	0.314 [0.137]**
Observations	205	205	205	205	205	198	170
Pseudo-R^2	0.18	0.19	0.20	0.20	0.21	0.24	0.24

Dependent variable is cumulative voting, which is a dummy variable that takes a value of 1 if the firm allows cumulative voting, and zero otherwise. *Majority* is a dummy equal to 1 if the largest shareholder holds more than 50% of total shares; *Majority foreign* is a dummy equal to 1 if there is a foreign shareholder who holds more than 50% of total shares; *Share 1−5* is the percentage of shares held by the five largest shareholders with shareholdings greater than 5% (normalized by 100); *Share 1*, *Share 2*, and *Share 3−5* are the percentage of shares held by the first, second, and the sum of the third, fourth and fifth largest shareholders, respectively (normalized by 100); *Privatization-1* is a dummy indicating the first privatization wave, 1989−1991; *Privatization-2* is a dummy indicating the second privatization wave, 1992−1994; and *Privatization-3* is a dummy indicating the third privatization wave, 1995 and after (the omitted category); *Sales* is the log of total sales in US dollars; *Equity* is the ratio of the book value of total equity to total assets; *Czech Rep*, *Hungary*, and *Poland* are country dummies. Regressions are estimated using a Probit model and the reported numbers are marginal effects. White (1980) heteroskedasticity-consistent standard errors are reported between brackets. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Table 3
Determinants of proxy by mail

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Majority	−0.073 [0.037]*	−0.073 [0.041]*	−0.074 [0.043]*	0.003 [0.053]	0.002 [0.053]	0.003 [0.057]	0.014 [0.058]
Majority foreign		0.033 [0.052]					
Share 1−5			0.005 [0.127]				
Share 1				0.197 [0.131]	0.194 [0.140]	0.173 [0.144]	0.150 [0.139]
Share 2				0.020 [0.145]	0.007 [0.189]	0.001 [0.147]	0.097 [0.148]
Share 3−5					0.006 [0.064]		
Privatization-1							0.015 [0.054]
Privatization-2							−0.042 [0.052]
Sales						−0.006 [0.011]	−0.009 [0.010]
Equity						−0.039 [0.087]	−0.035 [0.082]
Czech Rep	−0.073 [0.036]***	−0.108 [0.037]***	−0.097 [0.037]***	−0.077 [0.038]**	−0.076 [0.038]**	−0.074 [0.044]*	−0.071 [0.045]
Hungary	0.097 [0.044]	0.004 [0.046]	0.010 [0.051]	0.017 [0.047]	0.017 [0.047]	0.028 [0.053]	0.023 [0.056]
Observations	205	191	205	205	205	198	170
Pseudo-R^2	0.12	0.12	0.12	0.14	0.14	0.13	0.17

Dependent variable is proxy voting by mail, which is a dummy variable that takes a value of 1 if the firm allows proxy voting by mail, and zero otherwise. *Majority* is a dummy equal to 1 if the largest shareholder holds more than 50% of total shares; *Majority foreign* is a dummy equal to 1 if there is a foreign shareholder who holds more than 50% of total shares; *Share 1−5* is the percentage of shares held by the five largest shareholders with shareholdings greater than 5% (normalized by 100); *Share 1*, *Share 2*, and *Share 3−5* are the percentage of shares held by the first, second, and the sum of the third, fourth and fifth largest shareholders, respectively (normalized by 100); *Privatization-1* is a dummy indicating the first privatization wave, 1989−1991; *Privatization-2* is a dummy indicating the second privatization wave, 1992−1994; and *Privatization-3* is a dummy indicating the third privatization wave, 1995 and after (the omitted category); *Sales* is the log of total sales in US dollars; *Equity* is the ratio of the book value of total equity to total assets; *Czech Rep* and *Hungary* are country dummies. All regressions include dummies indicating 1-digit SIC industry codes. All regressions exclude Slovakia as there are no cases in our sample in which proxy by mail is stipulated in the charter. Regressions are estimated using a Probit model and the reported numbers are marginal effects. White (1980) heteroskedasticity-consistent standard errors are reported between brackets. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Republic are much less likely to allow cumulative voting and proxy voting than firms in the other three Eastern European countries. However, country effects explain only about 10% of the variation in the adoption of these provisions.

The results presented so far are consistent with the hypothesis presented in Section 2 that majority shareholders prefer no voting provisions (i.e. weak shareholder rights) while large minority shareholders prefer firms that allow cumulative voting. We should stress that the relationship between the use of provisions and the presence of majority shareholder turns insignificant once we control for the presence of other large shareholders, so we can only conclude that the use of cumulative voting is correlated with the presence of a second large shareholder. Also, we cannot infer causality from the regression results. While the results are consistent with the notion that corporate governance provisions such as cumulative voting are enacted in response to pressure from existing shareholders, they could equally well support the idea that firms adopt corporate governance provisions to make themselves more attractive to outside providers of capital (as in La Porta et al., 1998). Nevertheless, we think these results are useful as a first step toward understanding the relationship between specific governance provisions and firm ownership.

Next, we study whether the home country of foreign owners is related to the use of voting provisions. Firms in the Central European countries that we study have large foreign ownership stakes. Almost half the firms in our sample have foreign ownership in excess of 20% and together these foreign shareholders own about 31% of shareholder capital (Table 1, Panel B). Column (1) of Panel A in Table 4 shows that more than 60% of the firms in our sample have any foreign ownership, ranging from a low of 42% on average in the Slovak Republic to a high of 80% on average in Hungary. The remaining columns of Panel A in Table 4 show the percentage of firms with foreign owners from countries with legislated cumulative and proxy voting. We find that 9% of firms in our sample have foreign owners from countries with mandatory cumulative voting and 13% of firms in our sample have foreign owners from countries with mandatory proxy voting.

These foreign-owned companies may be required or compelled to adhere to higher standards of corporate governance and would therefore be more likely to invest in companies with stricter governance provisions and/or, once they have invested locally, are more likely to put pressure on the firm to enact stricter governance provisions. The reputational concerns of foreign firms are expected to be particularly prominent for foreign firms from countries where the law prescribes a greater set of corporate governance provisions than the host country. We therefore test whether firms that are foreign owned by a firm incorporated in a country where the law prescribes cumulative voting and/or proxy by mail voting are more likely to allow cumulative voting and/or proxy voting. We use the data from La Porta et al. (1998) and Gelfer et al. (2000) to assess whether the laws of the home country of the foreign owners prescribe proxy voting and/or cumulative voting.

The regression results of these so-called home-rule tests are reported in Table 4, Panel B. We neither find that firms with foreign shareholders for which the law of the country of origin prescribes cumulative voting or proxy voting are more likely to allow for these provisions in the host country, nor do we find that firms with foreign shareholders in general are more likely to allow for these voting provisions. Our results may suggest that foreign owners do not cause a change in the specific corporate governance provisions that we studied. Or, alternatively, it could be that the presence or absence of these specific governance provisions is not guiding the decision to invest in the host companies.

Our results appear at odds with previous work by Boycko et al. (1996) and Dyck (2001), among others, who have argued that foreign investors are a source of better governance.

Table 4
Foreign ownership and home rule

Country	% of firms with				
	Any foreign ownership	Foreign owners from country			
		With cumulative voting	Without cumulative voting	With proxy voting	Without proxy voting
	(1)	(2)	(3)	(4)	(5)
Panel A. Proportion of foreign owners with and without home rule					
Czech Republic	61	5	55	14	47
Hungary	80	11	70	16	64
Poland	57	13	45	11	46
Slovak Republic	42	11	32	11	32
All sample	62	9	52	13	49

	Cumulative voting		Proxy by mail voting	
	(1)	(2)	(3)	(4)
Panel B. Regression results				
Majority		−0.141 [0.058]*		−0.064 [0.211]
Foreign from country with cumulative voting	−0.088 [0.433]	−0.086 [0.442]		
Foreign from country without cumulative voting	0.091 [0.223]	0.102 [0.179]		
Foreign from country with proxy by mail			0.093 [0.259]	0.103 [0.221]
Foreign from country without proxy by mail			−0.042 [0.426]	−0.035 [0.508]
Czech Republic	−0.302 [0.001]***	−0.305 [0.001]***	−0.195 [0.000]***	−0.170 [0.003]***
Hungary	−0.358 [0.000]***	−0.379 [0.000]***	−0.045 [0.372]	−0.032 [0.543]
Poland	0.100 [0.341]	0.036 [0.741]		
Observations	224	224	186	186
Pseudo-R^2	0.13	0.14	0.11	0.12

Panel A shows summary statistics of foreign ownership. Panel B shows regression results. The dependent variable is either a dummy variable for the use of cumulative voting (columns 1 and 2) or a dummy variable for the use of proxy voting (columns 3 and 4). *Majority* is a dummy variable equal to 1 if the largest shareholder holds more than 50% of total shares. The remaining independent variables are dummy variables indicating foreign shareholders from countries with or without cumulative voting (columns 1 and 2) and with or without proxy voting by mail (columns 3 and 4). Columns 3 and 4 exclude Slovakia as there are no cases in our sample in which proxy by mail is stipulated in the charter. Regressions are estimated using a Probit model and the reported numbers are marginal effects. White (1980) heteroskedasticity-consistent standard errors are reported between brackets. *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

However, our tests involve two specific governance provisions while previous research has focused on aggregate corporate governance measures. The lack of evidence on these specific governance provisions is insufficient to make definite conclusions about the overall role of foreign investors in improving corporate governance. There could be other ways in which foreign owners affect the corporate governance of firms that we do not explore in this paper. For example, we cannot rule out that foreign shareholders have positive spillover effects on overall corporate governance standards in the country because government authorities respond to the influx of capital by improving regulatory oversight. Our results highlight the importance of discovering the channels through which foreign owners may influence corporate governance, if, in fact, the causality of this relationship goes from foreign ownership to corporate governance.

5. Conclusions

We study differences in the use of two corporate governance provisions in four Eastern European countries: cumulative voting and proxy by mail. Although these provisions are not prescribed by the company law or the commercial code of these countries, we do find that many firms in these countries have chosen to voluntarily allow for such type of voting by enacting these provisions in their corporate charters. We find that some of the variation in the adoption of these governance provisions can be explained by cross-country variation. However, significant within-country variation remains after controlling for country fixed effects. Much of the variation in the use of cumulative voting can be explained by whether the firm has a second large shareholder (beyond the first largest shareholder). Some of the variation in the use of cumulative voting can also be explained by differences across firms in the use of equity as a source of external financing. We do not find a consistently significant relationship between the use of proxy voting and firm characteristics such as ownership structure and financial performance. We also neither find that these provisions are more common among firms with foreign shareholders, nor do we find that firms that allow cumulative voting or proxy voting are more likely to have controlling foreign owners whose country of origin prescribes these provisions by law.

While our results are consistent with the notion that large minority shareholders prefer stronger voting rights, we cannot infer causality. It could be that firms adopt voting provisions to make themselves more attractive to large, minority shareholders, or it could be that firms enact these voting provisions in response to pressure from existing, large minority shareholders. Identifying the direction of causality between changes in firm ownership and corporate governance reform is an important topic for future research.

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