A Survey of Research on the Corporate Governance of Korean Firms

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We thank Dohan Kim, Wook Sohn, and other participants of the 2021 Korea Finance Association (KFA) Fall Conference for their valuable comments. Also note that this article constitutes a part of the 2020 Knowledge Database Project initiated by the Korea Finance Association (KFA), and financially supported by KFA and NH Investment & Securities Co. Ltd.

Abstract

This article reviews research conducted from 2011-2020 on the corporate governance of Korean firms. The purpose is to promote academic interest in Korean corporate governance research especially among non-Korean scholars and to provide guidance to young Korean scholars who are working in this area. We begin with the institutional features that are unique to Korea. We explain how they allowed researchers to develop interesting hypotheses that cannot be studied elsewhere, to establish causality that is not possible in other country settings, or to obtain data that are not available elsewhere. Then, we review the studies that examine the control (ownership) and governance structures of Korean firms. We pay attention to their determinants and their consequences. Lastly, we raise methodological concerns in existing studies and also discuss research topics for future research.

Keywords: corporate governance, Korea, control structure, ownership structure, business groups, family firms, related-party transactions

JEL Classifications: G30, G32, G34, G35

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I. Introduction

The definition of corporate governance in Shleifer and Vishny (1997) focuses on the interest of (outside) investors and how they might align themselves with the interests of insiders (managers). Since U.S. public firms are primarily owned by dispersed shareholders, academic discussion on corporate governance evolved around how to motivate professional managers, who do not have much of an ownership stake in the firms they manage, to care about shareholder value.

As described in La Porta, Lopez-de-Silanes, and Shleifer (1999), corporate structures outside the U.S. are quite different from those found in the U.S. Specifically, non-U.S. firms are typically characterized by: 1) family control and (2) business groups. Korea is no exception. The main mechanism through which families retain control over a large amount of assets is through inter-corporate shareholdings of public member firms that create a pyramidal business group. This structure creates a deviation between cash flow and the control rights of the controlling shareholder, which is not observed often in the U.S. (i.e., except for a small subset of firms with dual class shares.) While this structure may aggravate the agency problem between minority shareholders and controlling shareholders (Morck, Wolfenzon, and Yeung, 2005), legal enforcement is generally not in place to effectively curb the pursuit of various private benefits of control. Extreme forms of private benefits, such as wealth transfer or *tunneling* from the minority shareholders to the heirs of the controlling families, are observed quite often and are deemed legal in many cases.

The purpose of this review is to survey the academic literature that covers corporate control and governance issues of Korean firms. While our primary objective is to promote academic interest in Korean corporate governance research, especially among non-Korean scholars, we would also like to provide guidance to young Korean scholars who are working in this area. We also explain corporate governance institutions unique to Korea so that non-Korean scholars can better understand the research setting.

This survey paper constitutes a part of the 2020 Knowledge Database Project initiated by the Korea Finance Association, and is an extension of an earlier study on the same subject that covers publications from 1999-2010 (Yang, 2011). In this survey, we review academic research published from 2011-2020 on corporate governance of Korean firms. Our search resulted in 108 articles, 74 from 14 international journals and 34 from Korean journals. following journals. [1]

In the process, we not only cover the traditional governance mechanisms widely studied in the U.S. including managerial compensation, board of directors, institutional activism, and the market for corporate control, but also the implications of family control, business groups, and the deviation between cash flow and control rights. We also highlight the empirical challenge inevitable in corporate governance research since both (family's) control structure and (investors') governance mechanism are sometimes treated as the dependent variables and sometimes as independent variables. In fact, some studies use the governance variable as both a dependent and independent variable at the same time.

The remainder of the paper is organized as follows. In Section II, we describe, in detail, the institutional features that shape the ownership and control structures of Korean firms and how they are different from U.S. firms. In Section III, we review the studies that consider control and governance structure as dependent variables, namely studies that examine the

[1] 14 international journals include Journal of Finance, Journal of Financial Economics, Journal of Corporate Finance, Journal of Banking and Finance, Financial Management, Pacific-Basin Finance Journal, Corporate Governance: An International Review, Emerging Markets Review, Emerging Markets Finance and Trade, Asia-Pacific Journal of Financial Studies, Journal of Business Finance and Accounting, Journal of International Economics, and the Journal of International Money and Finance. We also cover studies published in the following local journals (in Korean): Asian Review of Financial Research (재무연구), Korean Journal of Financial Studies (한국증권학회지), Journal of Money and Finance (금융연구), and the Korean Journal of Financial Management (재무관리연구).

determinants of control and the governance mechanism. Sections IV and V cover studies that treat control and the governance mechanism as explanatory variables, respectively. That is, Section IV reviews studies that examine the consequences of control structures, including business groups, while Section V reviews those that examine the consequences of various governance mechanisms similar to those in the U.S. Section VI provides a brief conclusion including some directions for future research.

II. Unique Corporate Governance Institutions in Korea

Many corporate governance studies in Korea owe greatly to the institutions that are unique to Korea. They allow researchers to develop interesting hypotheses that cannot be studied elsewhere, to establish causality that is not possible in other country settings, or to obtain data that are not available in other countries. In this chapter, we discuss the regulatory settings (firm and group levels) and the data sources that enabled these studies.

1. Regulatory Settings: Firm-level Regulation

1.1 Board Structure Reform

Researchers are fond of utilizing exogenous rule changes. It helps them overcome selection bias and obtain unbiased treatment effects. This is also the case for corporate governance studies, where corporate governance reform measures are used as exogenous shocks. Here, we outline board structure reform that took place in Korea and discuss the studies that made use of it to establish causality in their studies.

Before the financial crisis of 1997, few Korean firms had outside directors. These included a few banks and state-owned enterprises (SOEs). However, things changed after the financial crisis. In 1998, the Korea Stock Exchange (KSE) amended its listing rule to require all listed firms to have at least a 25% outside director ratio. Starting in July 1999, discussions ensued to legally mandate large publicly traded firms to have at least a 50% outside director ratio Initially, it was recommended that listed firms with a total asset size above one trillion Korean won (approximately, one billion U.S. dollars) be subject to the rule requirement. [2]

However, when the recommendation was actually drafted in November for the purpose of amending the Securities Transaction Act, the asset size threshold requiring a 50% outside director ratio was raised from one trillion Korean won totwo2 trillion Korean won. The amendment, which took place in December 1999, introduced additional reform measures. For listed firms above the two trillion won threshold, the law required a minimum of three outside directors, an audit committee, and an outside director nomination committee. The audit committee had to be chaired by an outside director and maintain a minimum outside director ratio of two-thirds. The outside director nomination committee had to maintain a minimum outside director ratio of one-half. [3]

After the 1999 reform, there were four additional board-related reform measures, none of which are fully exploited yet in governance research. In 2003, the National Assembly amended the Securities Transaction Act to mandate listed firms above the two trillion won threshold to elect *more than half* of the board members as outside directors. In addition, in the same amendment, the National Assembly required at least one audit committee member to be an expert in finance or accounting. Moreover, in January 2020, the government amended the Enforcement Decree of the Commercial Act to impose a six-year limit on the length of years an outside director can serve in one company. For outside directors serving in multiple firms

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[2] Black and Kim (2012) and Black, Kim, Jang, and Park (2015) made use of this announcement to assess the effect of board independence on firm value. They conducted a series of event studies where June-August of 1999 is used as the event period for firms with a total asset size above one trillion Korean won (see Section V.2.1 for their research findings).

[3] Black and Kim (2012) made use of this amendment to assess the effect of board independence on firm value. They employed difference-in-differences (DiD) estimation, where listed firms above the two trillion won threshold are classified as treated firms. They supplemented this by an instrumental variable (IV) approach and regression discontinuity analyses (see Section V.2.1 for their research findings).

within the same business group, the combined length of service cannot exceed nine years. [4]

In December 2020, the National Assembly amended the Commercial Act to require firms above the 2 trillion won threshold to elect at least one audit committee member separately from the other directors. This is a significant rule change that made the 3% voting rights restriction imposed on large shareholders effective for at least one audit committee member. Prior to this amendment, audit committee members were elected sequentially. They had to be first elected as directors and then as audit committee members. Since the 3% voting rights restriction applied to the second stage, but not the first stage, the candidates put to a vote in the second stage were all under the influence of the controlling shareholder, undermining the purpose of the voting rights restriction. However, with the 2020 amendment, at least one audit committee member had to be set aside from the others to go through a single election where membership to the board and audit committee is determined simultaneously and the 3% voting rights restriction is applied. [5]

1.2 Disclosure of Executive Compensation

To conduct empirical research on executive compensation, it is desirable to have access to compensation data at the individual executive level. Prior to 2013, this data was available only for share-based compensation in Korea. For cash-based compensation, companies disclosed figures aggregated at the group level. Specifically, the three groups included: 1) all inside directors not serving on the audit committee, 2) all outside directors not serving on the audit committee, and 3) all audit committee members (i.e., the statutory auditor in case the

[4] Very few countries have tenure-related regulations (CFA Institute, 2020). Among this handful of countries, Korea has the strictest regulations.

[5] Doo and Yoon (2020) study the setting that existed prior to the 2020 amendment. They investigate firms below the two trillion won threshold that were given the option to choose between the internal auditor system and the audit committee system (see Section III.2.1 for their research findings).

company does not have an audit committee). [6]

The disclosure rule went through a major change in April 2013 when the National Assembly amended the Financial Investment Services and Capital Markets Act to require any director (or statutory auditor) whose total pay exceeds 500 million Korean won in a given fiscal year to disclose their total pay, its components, and the criteria/methods used to set the pay in the company's business reports. According to the detailed disclosure guidelines set by the financial authorities, total pay is composed of labor income (i.e., salary, bonus, and incentives), retirement income, and other income including realized gains from stock option exercises. [7]

However, this new regime received criticism for its vulnerability to disclosure evasion. Two avoidance strategies were pointed out. One is director *deregistration*. That is, registered board members stepping down from the board, but retaining a non-registered executive position. Another is *pay cut* involving a registered board member deliberately setting their pay below the disclosure threshold of 500 million Korean won. In response to these criticisms concerning the vulnerability to disclosure evasion and many actual incidents of director deregistration by family executives, the National Assembly amended the Financial Investment Services and Capital Markets Act in 2016 to expand the scope of executives subject to mandatory disclosure. In addition to registered board members receiving more than 500 million Korean won a year, it required non-registered executives to disclose their pay as long as they are among the top five highest paid executives in the company and receive more than 500 million Korean won a year. This new rule came into effect in 2018. To date, no study has explored the effect of this rule change.

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[6] Studies using group-level compensation data include Garner and Kim (2013) and Kim and Kim (2020), among others (see Section V.2.3 and III.2.2.1 respectively for their findings).

[7] A number of studies took advantage of this new disclosure rule. These include Kim, Lee, and Shin (2017), Kim and Han (2018), and Cheong and Kim (2019) (see Section III.2.2.1 for their findings).

1.3 Disclosure of Block Ownership and Pre-meeting Vote Disclosures

Disclosure of significant interests in listed companies' voting securities is a regulation that is indispensable for researchers of shareholder activism. For example, many U.S. studies assess the effect of shareholder activism via the extent of abnormal returns that take place around the Schedule 13D filing date.

This empirical strategy became possible for Korean firms beginning in 2005. The National Assembly amended the Securities Transaction Act mandating block holders to disclose the purpose of their holdings. According to the new rule, block holders with the purpose of influencing control must file a detailed long form within five days after the acquisition and check at least one of the ten potential areas of engagement. [8]

Another rule change regarding the 5% rule took place in February 2020. The Enforcement Decree of the Financial Investment Services and Capital Markets Act was revised to specify certain engagement activities not be classified as those influencing corporate control. These activities include: 1) exercising the right to injunction or requesting the court to remove directors if they are in violation of any statute or the articles of incorporation, 2) dividend payouts related engagement activities, and 3) public pension funds who propose amending the articles of incorporation following their pre-disclosed principles and guidelines for the sole purpose of improving corporate governance.

This amendment was made with the intention of removing the hurdles the National Pension Service (NPS) had to face when carrying out its stewardship responsibilities. According to the Financial Investment Services and Capital Markets Act and its Enforcement Decree, any public pension fund owning a block of shares greater than 10% with the intention

[8] A number of studies took advantage of this new rule. These include Kim, Kim, and Kwon (2009) and Kim, Sung, and Wei (2017), among others (See Section V.2.3 for their findings). Also note that 5% block holding data is readily available from KRX (https://find.krx.co.kr).

of influencing corporate control is subject to the short-swing profit rule. That is, returning profits to investee companies if profits are made from purchases and sales occurring within a six-month period.[9] As one of the largest asset owners in the world, NPS owns such blocks in most of the major companies listed on KRX. However, thanks to the new 5% rule, NPS can now participate in certain engagement activities without triggering short-swing profits. To date, we have not found any study exploring the revised 5% rule.

In close-call votes, large institutional investors can have a significant influence over the voting outcomes of shareholder meeting resolution items. More so if they disclose their voting decisions prior to the meeting and other shareholders follow their pre-disclosed votes. In July 2018, NPS decided to do exactly this and delegated the implementation details to the Special Committee on Responsible Investment & Governance. In February 2019, the Committee decided that firms whose share ownership by NPS is greater than 10% or whose weight in the NPS domestic equity portfolio is greater than 1% should be subject to pre-meeting disclosure. The first pre-meeting disclosure took place in the 2019 proxy season.[10]

1.4 Shareholders' Meeting Dates

Korean public firms tend to hold annual general meetings (AGM) of shareholders on the last Friday of March. This significantly limits the shareholders who own shares of multiple firms from physically attending all of the meetings, which is especially troublesome if firms do not allow electronic voting.[11]

Regulation is partly responsible for these clustered AGM dates. Prior to 2021, Korean

[9] NPS maintains an external management system where private asset managers trade under the name of NPS, but make independent trading decisions. Under this system, there is no guarantee that the shares registered under the name of NPS will be held for more than six months.

[10] Ko and Kim (2020) study the stock price reaction to NPS dissenting votes disclosed before the shareholders' meeting (See Section V.2.3 on their findings).

[11] According to the Korea Securities Depository (KSD), from 2016-2020, 85.5% of public firms in Korea held their AGMs during the last ten days of March.

public firms had to set dividend record dates at fiscal year-end and hold the AGM not more than 90 days after the record date. Given that most Korean public firms use a calendar year from January 1 to December 21 as their fiscal year, this regulation, in effect, required firms to hold AGMs by the end of March. In addition, Korean public firms had to submit audit reports at least one week before the AGM. Since it is extremely challenging to prepare the audit report by February, most Korean public firms inevitably held their AGMs in March. However, this may not be the only story. Gam, Gupta, Im, and Shin (2021) explore whether Korean firms deliberately schedule their AGMs on highly clustered dates to prevent shareholders from attending AGMs.

The regulation responsible for the AGM clustering was lifted with the amendment of the Commercial Act in 2020. Korea public firms no longer need to set their dividend record dates at fiscal year-end. In the case of firms using a calendar year as their fiscal year, they can set their record dates after December 31 and hold AGMs not only in March, but also in April or May. With the goal of inducing firms to hold their AGMs in April or May, the government amended the Enforcement Decree of the Commercial Act and obligated public firms to submit their annual business reports at least a week prior to the AGM. Note that Korean public firms must submit their annual business reports not more than 90 days after the fiscal year-end and have typically submitted them on the last day of March. One interesting topic for future research is investigating the types of firms that opt to move the dividend record date to hold AGMs in April or May and the types firms that opt not to do so, but continue to hold AGMs on the clustered dates.

2. Regulatory Settings: Group-level Regulation

2.1 Control-enhancing Mechanisms

Control-enhancing mechanisms or anti-takeover devices are popular corporate governance research topics in many countries. However, this is not the case in Korea where we find only a handful of research in this area. This is partly due to the fact that Korean firms are banned from issuing multiple voting shares or poison pills that take up a large part of the research in this area.

In the absence of multiple voting shares and poison pills, Korean firms make use of alternative devices that are not commonly found in other countries. One good example is the use of treasury stocks. Unlike firms in other countries, Korean firms seldom retire the shares they repurchase. They keep them in the form of treasury stocks for an extended period of time. One motivation behind this is to sell them to white knights in times of proxy fights.[12]

Another example is the use of death spirals (i.e., floating-priced warrants or convertibles) as a control-enhancing mechanism. Unlike the death spirals in the U.S. that allow exercise prices (i.e., conversion prices in the case of convertible bonds) to adjust in both directions, Korean death spirals allow exercise prices to adjust only downward. This is a very attractive feature to whoever wishes to exercise control over the firm as any downward movement in the share price triggers a downward spiral of share prices by lowering the exercise price and increasing the number of shares that a warrant holder can purchase.[13]

Among smaller Korean firms, various types of charter-based anti-takeover provisions (ATP) are popular. These include: 1) supermajority requirements for dismissing directors, 2) an upper limit on the maximum number of directors that can be dismissed per year, 3) golden parachutes, 4) supermajority requirements for mergers, 5) supermajority requirements for

[12] Kim and Lim (2017) investigate this motivation of holding and reselling treasury stocks (see Section V.1.1 for their findings).

[13] Over time, the Korean government introduced a series of regulations regarding the private issuance of bonds with detachable warrants. For example, in 2002, immediately after the Doosan Corporation incident, it banned issuing firms from redeeming the bonds with more than two-thirds of the maturity remaining. In 2013, it completely banned the private issuance of bonds with detachable warrants in listed firms. Kim, Kim, and Kim (2013) study the control enhancing or the control transferring motive behind the issuance of death spirals (see Section V.2.2 for their findings).

amending any of these control-related charter provisions, and 6) delaying the effective date of any control-related charter amendments. [14]

As previously mentioned, Korean firms cannot issue multiple voting shares. This does not mean, however, that Korean firms are completely deprived of forming a dual class share (DCS) structure. With the amendment of the Commercial Act in 2012, they can issue no-vote common shares that can serve a similar purpose. This is the same type of shares issued by Alphabet Inc. (i.e., its Class C share with a ticker GOOG) and Snap Inc. (i.e., its Class A share with a ticker SNAP). At the time of this writing, no Korean firm has yet issued no-vote common shares. The 2012 amendment also allowed Korea firms to issue convertible preferred stocks where conversion is at the discretion of management. This is a close cousin of the poison pill. Upon hostile takeover attempts, management can convert preferred stock held by friendly investors into common stock thereby increasing its control over the firm. [15]

Finally, the tax system in Korea can work as a barrier to hostile tender offers. This is because for shareholders owning stocks worth less than one billion Korean won, capital gains from over-the-counter trades (e.g., selling shares to a tender offer bid) are taxed, while gains from on-exchange trades are not. Under this unique tax regime, raiders must offer a higher bidding price to induce shareholders to tender their shares. To date, we have not seen any study utilizing this unique feature in the Korean tax system.

2.2 Related-party Transactions

Tunneling, which is defined as the transfer of assets and profits out of firms for the benefit of their controlling shareholders, is an important theme in corporate governance research. In

[14] Hwang and Kim (2012) study the motivation behind the adoption of ATPs and the consequences of adopting them (see Section V.2.4 for their findings).

[15] Kim, Hwang, and Kim (2020) explore the motivation behind the issuance of these convertible preferred stocks and the consequences of adopting them (see Section V.2.4 for their findings).

business group settings, this expropriation is often realized by related-party transactions (RPTs) that take place between member firms under common family control. To discourage unfair RPTs, a number of approaches are taken around the world. These include independent or disinterested director approval, majority of the minority (MoM) approval, *ex post* fairness review by courts, and the involvement of government agencies.

In Korea, KFTC plays an important role in regulating unfair RPTs among large business group firms. Authorized by the Monopoly Regulation and the Fair Trade Act (FTA), it requires large scale RPTs to be approved by the board and be disclosed immediately upon approval. It also prohibits assistance to related parties if it harms competition and its terms are substantially preferential. From 2013, it also bans large business group firms from providing undue benefits to controlling families. This regulation is not only applicable to provisions that benefit controlling families directly, but also to provisions that benefit them indirectly through member firms where controlling families have substantial equity stakes.[16] A virtuous feature of this new regulation lies in the fact that it can be applicable even when the provision does not harm competition. The types of undue benefit provisions include: 1) RPTs that are carried out in substantially beneficial terms, 2) RPTs that funnel a substantial amount of business even if they are carried out in market terms, and 3) business opportunities that provide substantial benefits. To date, we have not found any study that investigates the effect of these regulations.

In addition to the FTA, the National Tax Service (NTS) also plays a role in regulating RPTs in Korea. Since the amendment of the Inheritance Tax and Gift Tax Act in 2012, NTS collects gift taxes from controlling shareholders of firms with significant sales to related-

[16] Prior to the 2020 FTA amendment, the minimum ownership by controlling families in beneficiary firms was 30% for publicly traded firms and 20% for privately held firms. In December 2020, the FTA was amended to expand the scope of beneficiary firms. The minimum ownership was unified to be 20% for all firms regardless of their listing status. Also, firms in which these aforementioned beneficiary firms own more than 50% of shares are classified as beneficiary firms.

party firms. The rationale behind this is that when a firm benefits from excessive related-party sales, the resulting profits are deemed to have been donated to the controlling shareholders of the firm.[17]

3. Data Sources

3.1 Business Group Data

Korea is not the only country with family-controlled business groups. However, Korea is one of the most heavily studied countries when it comes to family-controlled business groups. This is attributable to the government-compiled business group data that is readily available to the public (https://egroup.go.kr).

For regulatory purposes, the Korea Fair Trade Commission (KFTC) has been designating large business groups (or more popularly known as *chaebols* in Korea) every year since 1987. To be designated as a large business group, the sum of the member firms' assets (i.e., net assets in the case of financial firms) must be within the top 30 prior to 2002, above 2 trillion Korean won from 2002-2008, or above 5 trillion Korean won since 2009.

Together with the list of large business groups, the KFTC announces the names of those who control each of the groups and the list of firms under these . A person in control could be a natural person or a legal person. When identifying member firms, KFTC considers not only the shares directly owned by the controlling persons, but also the shares they indirectly own through their related parties including their relatives, non-for-profit entities under their control, and other member firms they control. It also considers channels of influence that do not rely on share ownership. In other words, KFTC uses the concept of *de facto* control.

[17] Chung, Choi, and Jung (2019) examine whether this new gift tax succeeded in deterring excessive related-party sales (see Section V.2.4 for their findings).

What makes the Korean business group data distinctive is the detailed ownership data of non-listed member firms. This feature allows researchers to compute a controlling person's cash flow rights more precisely by considering the control chains that go through non-listed firms in addition to listed firms. From 2022, KFTC mandates large business groups to disclose detailed control chains that go through overseas subsidiaries as well. This will allow researchers to compute cash flow rights even more precisely. Many studies have used KFTC data in their business group research. We summarize these studies in Section IV.2.

3.2 Corporate Governance Ratings Data

Corporate governance indices or ratings are heavily used in corporate governance research. This is no exception for studies of Korean companies thanks to the ratings data compiled by the Korea Corporate Governance Service (KCGS). KCGS is a non-profit organization set up in 2002 by the Korea Stock Exchange (KSE), the predecessor of the Korea Exchange (KRX), for the purpose of promoting corporate governance in Korea.

Since 2003, KCGS has been conducting annual ratings of all the KOSPI-listed companies. Over the past few years, it expanded its ratings coverage to include KOSDAQ 150 stocks, the remaining KOSDAQ-listed firms that are members of large business groups, and all financial companies subject to the Act on Corporate Governance of Financial Companies regardless of their listing status. Since 2011, it added ratings on environmental and social practices. When rating governance, it focuses on four distinct areas (i.e., shareholder rights protection, board of directors, auditing body, and disclosure) that have their own separate ratings. Procedurally, it goes through five steps: 1) the preparation stage where raw data is collected from publicly available sources, 2) the initial evaluation stage, 3) the feedback stage where revision requests are taken from rated companies, 4) the interview stage, if necessary, and 5) the final rating stage. Note that the overall governance rating has seven grades (S, A+, A, B+, B, C, and D) and is available to the public from its homepage (http://www.cgs.or.kr). Detailed ratings data, including the four sub-ratings, however, are available only through data vendors. We discuss the paper utilizing KCGS governance ratings rata in Section V.1.

3.3 Related-party Transactions Data

Related-party transaction data is available from two sources in Korea. One source is from financial statements. All public firms and privately-held firms subject to external audit must disclose in the footnotes of their financial statements the amounts of purchases (sales) of goods and services from (to) related-parties, the amounts of payables (receivables) owed to (by) related-parties, and the amounts of debt (credit) owed to (by) related-parties. The data is available from the Data Analysis, Retrieval and Transfer System (DART) database (http://newdart.fss.or.kr) managed by the Financial Supervisory Service (FSS), the financial regulatory agency in Korea, and from the Korea Investor's Network for Disclosure System (KIND) database (https://kind.krx.co.kr) managed by the Korean Exchange. [18]

Another source of related-party transaction data is from KFTC. Although the data it provides is confined to the member firms of KFTC-designated large business groups, it provides the data in greater detail. One example is the transaction of trademark royalties. For each business group, it provides the names of licensing firms, the names of licensee firms, the amount of royalties received or paid, and the formula used to calculate the royalties. For the convenience of users, this KFTC related-party transaction data is available through DART. To date, we know of only one working paper making use of this data. We expect to see more studies utilizing this data in the years to come.

[18] Black, Kim, Jang, and Park (2015), Hwang and Kim (2016), and Kim and Kim (2020) made use of this data in their research on related-party transactions (see Sections V.1.2, IV.1.1, and III.2.2.1 on their findings).

3.4 Financial Statements Data of Unlisted Firms

In most countries, financial statement data is available only for publicly traded firms. This is especially problematic given that a large fraction of business group firms are privately held. However, this is not the case in Korea. Thanks to the Act on External Audit of Stock Companies, any stock company above a certain size threshold must receive external audits and disclose their financial statements to the public. [19]

This rule dates back in 1981 when the act was first introduced. The size threshold was initially set to three billion Korean won in total assets. Over time, the threshold was gradually raised. At the time of this writing, any stock company that has total assets above 50 billion Korean won or total sales above 50 billion Korean won must receive an external audit. In addition, any stock company that has total assets above 12 billion Korean won, total debt above seven billion Korean won, total sales above ten billion Korean won, and a total number of employees above 100 must receive an external audit. [20]

III. Determinants of Control Structure and Governance Mechanism

In this section, we review studies that examine the determinants of corporate ownership and control structures, as well as governance mechanisms.

1. What Determines Ownership and Control Structure?

[19] Separate from the Act on External Audit of Stock Companies, the FTA also obligates unlisted firms to disclose their financial information. However, this is limited to the member firms of large business groups (group total assets greater than five trillion Korean won) and the financial information disclosed is highly constrained. Balance sheet data includes current assets (cash and cash equivalents as a separate item), fixed assets, total assets, current liabilities, long-term liabilities, and book equity (paid-in capital as a separate item). Income statement data includes total sales, operating income, other income, other costs (interest expense as a separate item), and net income.

[20] A number of studies we cover in this review make use of this data of unlisted firms. Kim, Kim, and Yang (2015) use it to investigate how business groups establish new member firms. Hwang and Kim (2016) use it to investigate how member firms privately owned by heirs benefit from related-party sales (see Sections III.1 and V.1.1 for their findings).

The law and finance literature broadly suggests that concentrated corporate ownership found in non-U.S. countries is generally attributable to poor investor protection. In these economies, controlling shareholders do not sell their shares or issue new equity that would reduce their proportional ownership for fear of losing various forms of private benefits of control that they currently enjoy. According to Roe (2006), the existence of strong labor unions in Europe may explain the prevalence of family firms. Although this perspective is useful in understanding cross-country variations, it has limited implications as to how the control structure may vary within an economy dominated by concentrated ownership, such as Korea.

Studies that examine the control structures of Korean firms primarily focus on the nature of business groups or pyramidal structures. Almeida, Park, Subrahmanyam, and Wolfenzon (2011) study the evolution of Korean chaebols (i.e., business groups) and find that chaebols grow vertically (as pyramids) when the controlling family uses well-established group firms (i.e., “central firms”) to acquire firms with low pledgeable income and high acquisition premiums. In contrast, chaebols grow horizontally (i.e., through direct ownership) when the family acquires firms with high pledgeable income and low acquisition premiums. In this setting, central firms trade at a relative discount due to shareholders’ anticipation of value-destroying acquisitions. This study is important since a widely accepted explanation for setting up pyramids was to tunnel from firms located in the bottom. In contrast, they argue that the underperformance of pyramidal firms is not due to tunneling, but rather through selection. Highly profitable firms that require little capital are directly owned by the family, while less profitable firms are largely owned by affiliated firms.

Kim, Kim, and Yang (2015) confirm this finding by comparing the size and profitability of private firms newly established by individuals against those set up by another member firm. Korean accounting regulations require even private firms that exceed a certain size threshold to be externally audited and file their financial statements rendering this type of study feasible. They find that firms set up by individuals are smaller and more profitable compared to firms set up by other firms, consistent with the selection hypothesis. However, they also suggest that profitability may not be exogenously determined based on the inherent characteristics of the business as suggested by Almeida et al. (2011), but rather determined endogenously based on related party transactions with other member firms in the business group.

Some studies point out incentives to avoid inheritance taxes in the process of transferring control to the next generation may induce certain organizational changes. Yang (2016) examines how inheritance tax structure may affect the creation of pyramids. The Korean inheritance tax code, adopting a weighted average of the net asset value of the most recent year (40%) and three-year average net income (60%) as firm value for inheritance taxation, implicitly leads controlling shareholders to vertically split or insert an intermediary to control subsidiaries, both of which yield a pyramidal control structure within family business groups. Inheriting unlisted firms via intermediaries reduces inheritance taxes and its tax savings effect is maximized when intermediary firms are much smaller than the subsidiaries.

Similarly, Shin (2020) argues that avoidance of inheritance taxes may facilitate intragroup mergers. In 1999, Korea initiated a tax reform that bumped up personal inheritance taxes by 25 percentage points. In the post-tax-reform period, he finds that family firms increase stock-for-stock intragroup mergers involving targets owned by heirs. Specifically, in business groups where heirs face heavy inheritance taxes, intra-group mergers occur between public member firms and private member firms largely owned by heirs.

Kim, Kim, Kim, and Byun (2010) examine what may determine foreign ownership in Korean firms. They find that foreign investors allocate a disproportionately higher share of their funds to firms with foreign outside directors. They interpret this finding as evidence that improvements in corporate governance attract more foreign investments.

Kim, Hwang, and Kim (2020) take advantage of a regulatory change in Korea that allowed firms to adopt two new classes of shares: preferred stocks convertible to voting stocks at the discretion of management and preferred stocks redeemable at the discretion of investors. They find that firms adopt the former for managerial entrenchment purposes, while the latter is adopted in times of financial constraint. They also determine that adoption of both classes results in lower firm value suggesting that changes in control or ownership structure are less likely to be motivated by value maximization.

2. What Determines Governance Mechanism?

In this subsection, we review studies that examine various governance mechanisms in Korean firms. By governance mechanisms, we are referring to all mechanisms designed to reduce agency problems between managers and shareholders. We follow the standard classification of a governance mechanism. An internal mechanism including board of directors and managerial incentives and external mechanisms including institutional activism and market for corporate control.

Alternatively, the term "corporate governance" or "governance mechanism" often implies a completely different concept in Korea. Specifically, the media typically uses the term to refer to the inter-corporate control structure of a business group from the perspective of the controlling families. This leads to substantial confusion of the key concepts and issues as the Korean perspective does not clearly reveal the inherent agency problem between the controlling shareholders, with low cash flow rights, and the vast majority of the minority shareholders. This misperception is reinforced through the media who often refer to the controlling families as "owners" implying that they are principals rather than agents. In this paper, we refer to inter-corporate shareholdings from the family's perspective as the "control structure" to distinguish it from the standard governance mechanism.

2.1 Board of Directors

While the board of directors, composed of at least some outside independent directors, is a key governance mechanism, it is relatively new in Korea. As is the case for most other governance mechanisms, it was instituted only after the 1997 Asian Financial Crisis. Even today, outside director candidates are largely approved by the controlling family before formally being voted on at the shareholders meeting. This practice makes it difficult to find research on what determines the structure of the board members precisely as they are largely dependent on the will of the controlling family.

Doo and Yoon (2020) investigate whether and how a regulatory change in the appointment procedure of audit committees affects firms' choice of an auditor or a voluntary audit committee. In Korea, mid-sized public firms may choose between an internal auditor or a comptroller, similar to that of German corporate law, or an audit committee under the board, similar to the U.S. system. Korean regulations traditionally put a strict limit on the maximum number of votes shareholders can exercise when they elect auditing bodies. Specifically, controlling shareholders are allowed to exercise up to 3%. The new law at the time, however, allowed the board members to be elected first, after which audit committee members are elected with the binding 3% constraint. The authors find that mid-sized companies voluntarily switched from a traditional German style comptroller system, where they are subject to the binding 3% constraint, to the American style audit committee system effectively postponing the 3% constraint to the second stage. They also find that audit committees do not necessarily improve financial reporting suggesting that these changes in the auditing mechanism largely reflect agency motives rather than monitoring incentives.

2.2 Managerial Incentives

2.2.1 Compensation

Disclosure of executive compensation was not mandatory until 2014 in Korea. It is only after that point that we are able to find studies based on individual compensation data. Kim and Han (2018) examine executive compensation in Korea with a focus on family business groups, and find that family CEOs of Korean business groups are paid 60% more than professional CEOs. Moreover, this discrepancy is not based on performance-contingent payments, but rather generated by differences in fixed payments. They also note that the operation of internal capital markets, CEO talent, CEO stock ownership, and family board membership do not explain the excessive compensation of family CEOs indicating that rent extraction through executive compensation is prevalent in Korean family business groups.

Cheong and Kim (2019) empirically test the prediction that family pay discounts documented in the U.S. do not hold in a business group setting and this is attributable to the lack of monitoring by other family members. They find that family executives receive higher compensation than non-family executives (i.e., the family pay premium) in business group firms in Korea (chaebols). They also determine that the pay offered to family executives tends to be high when the proportion of shares held by other family members is low, which is typically the case in business group firms.

Kim and Kim (2020) examine how executive compensation may be influenced by other member firms within the same business group. They find that a member firm's executive cash compensation is positively linked not only to its own stock performance, but also to other member firms. This positive link suggests that managers may be rewarded for their decision to benefit the controlling family at the expense of the firm they manage. Specifically, the sensitivity of executive pay to other member firms' performance exists only in respect to firms where the cash flow rights of the controlling family exceed those of the subject firm.

2.2.2 Managerial Turnover

Most controlling shareholders in Korea are often the CEOs themselves. As such, it is not trivial to fire the CEO even if their performance is poor as they are effectively entrenched through concentrated ownership. This is probably one of the reasons why the literature on what determines CEO turnover is relatively scant. A substantial number of CEOs still retain their position even if they are formally convicted of a criminal offense.

Johnson and Yi (2014) investigate the consequences of fraud for CEOs and how they depend on CEO power. They find that CEO power can reduce the likelihood of director turnover, as well as CEO turnover, even after fraud is detected. They also find that CEO power is negatively related to long-term stock performance after fraud detection and this negative relationship is particularly strong for powerful CEOs when the board has low overall turnover. These results imply that powerful CEOs may entrench themselves and survive by potentially working with board members who are favorable to them.

2.3 Institutional Activism / Market for Corporate Control

Both institutional activism and the market for corporate control were also introduced only after the 1997 Asian Financial Crisis. Previously, institutional investors were subject to a "shadow voting" system where you are allowed to exercise your voting rights only in direct proportion to the outcome of the remaining votes. The market for corporate control also did not exist as no one other than the controlling shareholder at the time of the IPO can hold more than 10% of the voting rights in any publicly traded firm. An important milestone in institutional activism was the adoption of the stewardship code by the National Pension Fund of Korea (NPF) in 2018, the largest institutional investor in Korea.

Kim, Park, and Jung (2020) analyze the characteristics of institutional investors who adopted the Korea stewardship code that was introduced in 2016. They find that institutional investors tend to participate more actively in the stewardship code if they invest a larger amount of money in stocks, pay more dividends in cash, and showed a higher level of negative votes before code participation. They also conform that institutional investors with foreign origin or those belonging to financial groups are more likely to adopt the stewardship code. They also note that institutional investors who have introduced the code tend to vote negatively, especially when the invested firms have more severe agency problems. These results suggest that the introduction of the stewardship code may lead to more active monitoring by domestic institutional investors.

Kim and Kim (2020) examine how credit ratings may affect M&A activity in Korea. They find that credit ratings are negatively correlated with the probability of being a target indicating that target firms in Korea may be in distress. They also determine that acquiring firms with high credit ratings exhibit low cumulative abnormal returns consistent with agency problem arising from free cash flow.

2.4 Overall Governance / Index

The Korea Corporate Governance Service (KCGS), a non-profit organization sponsored by the Korea Exchange (KRX), has been compiling firm-level corporate governance indices since 2003. Many Korean researchers have relied on this index as the dependent variable and other times as an explanatory variable in their empirical studies.

Lee and Chung (2015) find that a firm’s corporate governance index increases with the duration of institutional stock ownership emphasizing that investors’ investment horizons may be an important determinant of corporate governance. Bereskin, Kim, and Oh (2015) confirm that firms near rating upgrades or downgrades are associated with improved corporate governance implying that managers' concerns over their firms' credit ratings may affect corporate governance.

3. What Determines Governance Mechanisms and How Does It Affect Corporate Outcomes (Firm Value)?

Park and Ryu (2020) take into account the possible joint determination of corporate governance and firm value and present a theoretical model focusing on the effect of private equity trading platforms. Electronic platforms where unlisted stocks are traded have become popular among retail investors in Korea recently and provided the motivation behind this study. The authors argue that these platforms may increase the liquidity in the unlisted stock market by easing regulations on the trading of these stocks further enhancing firm values and the corporate governance of the corresponding firms. Specifically, in an unlisted firm, a potential dual agency problem exists where the manager, who is also a blockholder, invests less than the external shareholders' profit-maximizing levels. Managers have the incentives to increase a firm's investment when the liquidity in the unlisted stock market improves with the growth of the private equity trading platform implying that these platforms potentially enhance the corporate governance of unlisted companies and promote their growth simultaneously.

Byun, Lee, and Park (2012) empirically test whether member firms in a business group (chaebol) behave differently from stand-alone firms in their decisions regarding internal corporate governance given product market competition. They find chaebol member firms maintain better internal corporate governance in a non-competitive environment, while stand-alone firms do so in a competitive environment. They next use corporate governance as an explanatory variable and determine that the positive effects of internal corporate governance on firm value are stronger in a non-competitive environment for stand-alone firms, but not for member firms. They ascribe the detected differences in corporate behavior and performance to differences in the level of competitive pressure to which firms are exposed.

Goh, Lee, and Cho (2016) examine how the controlling shareholders' control-ownership wedge may be determined by firm characteristics and how it affects firms' investment decisions. They find a non-monotonic relation between the controlling shareholders' control-ownership wedge and a firm's overinvestment in their piecewise linear regressions. Specifically, the relation between the controlling shareholders' wedge and overinvestment is significant for certain wedge levels.

Hwang, Kim, Park, and Park (2013) take advantage of unique survey data and examine how business group membership may affect corporate governance that may, in turn, affect payout policies. They find that business group (chaebol) firms have overall stronger governance practices, but weaker shareholder rights and lower dividend payout ratios than independent firms. They also note that the adverse effect of chaebol firms' weak shareholder rights on dividend payout ratios appears to intensify with the onset of the global financial crisis in 2008. The positive correlation between corporate governance practices and dividend payout ratios is weaker among chaebol firms. Their interpretation is that the entrenched control by chaebol families places less weight on protecting minority shareholders resulting in smaller distributions of dividend payments.

IV. Consequences of Corporate Control Structure

Corporate control by insiders and corporate governance for outside investors are not only determined by various firm, industry, market characteristics, but they also may affect various corporate outcomes including firm value. In this section, we review the literature on the effect of corporate control on corporate outcomes. In Section V, we continue with those studies exploring how governance mechanisms may affect firm decisions.

1. The Effect of Family Ownership

1.1 Percentage Cash Flow Rights or Dollar Amount Wealth Invested

Traditional literature on managerial ownership or family firms begin by examining how the family's proportional claim on a firm's cash flows, or cash flow rights, may affect corporate outcomes. Hwang and Kim (2016) focus on the ownership of the second and third generation heirs of the founding families and investigate how related-party sales may be used to financially support those firms owned largely by these heirs. They implement a series of difference-in-differences tests and find that these firms experience greater related-party sales, benefit in terms of earnings, and gain importance in controlling other firms in the group. These findings suggest that families', especially heirs', ownership may determine the direction and magnitude of related-party transactions within a business group.

Kang, Anderson, Eom, and Kang (2017) propose a new measure of controlling family's relative dollar value interest in a given member firm. It is defined as the value of the controlling shareholders' stake in an affiliate divided by their stake in all affiliates. This measure, which they refer to as the controlling shareholders' value, is designed to capture differences in the magnitude of the family's interest in different member firms that is not captured in conventional cash flow rights defined at the firm level. Using data on Korean family-controlled business groups, they find that this new measure has greater explanatory power for firm performance than traditional cash flow rights. Chae, Kang, Lee, and Lee (2020) use the same measure to explore family business groups' risk taking behavior in each affiliate. They determine that the affiliates in which the controlling family has greater (less) investment take less (greater) risk. Their results indicate that the controlling family decides the riskiness of each affiliate based on the family's interests at both the firm level and the business-group level.

Kim and Wee (2019) examine how managerial ownership may affect corporate giving. They find that low managerial ownership is associated with greater corporate giving, especially when the controlling shareholder is the CEO, and conclude that this corporate giving may be motivated by the controlling shareholders' pursuit of personal gain.

Kim, Jung, and Kim (2018) examine how the complexity of group ownership structure may affect capital structure decisions. They find that controlling shareholders of cross-shareholding business groups are more likely use debt for tunneling purposes than those of pyramidal business groups.

Park and Jung (2015) empirically investigate the relationship between controlling shareholders' ownership and the risk-taking behavior of savings banks in Korea. They find that the risk of savings banks increases with higher ownership of the controlling shareholders. These findings suggest that regulatory scrutiny may be required to curb potential excessive risk taking in savings banks with more concentrated ownership.

1.2 Importance in Business Group Control: Centrality

Almeida et al. (2011) propose a new measure of corporate control that they refer to as "centrality." Although this measure is defined at the firm level, it measures how important this firm is in terms of maintaining control over other firms within the business group. Some studies utilize this measure and examine how centrality may affect corporate outcomes.

Choi, Gam, and Shin (2020) explore a potential causal relationship between firms' ownership structure and the likelihood of corporate fraud related to illegal related-party transactions (RPTs) regulated by the KFTC. They determine that central firms that control other member firms are subject to more corporate frauds than are non-central firms. They argue that central firms commit fraud by expropriating non-central firms, where controlling shareholder's cash flow rights is low by providing financial assistance to non-central firms that are suffering from financial distress. Exploiting the 2001 regulatory reform that imposed the ceiling on the amount of equity investment a member firm can make in domestic affiliates, they also find that the frequency of corporate fraud drop more significantly in central firms than in non-central firms as central firms' ability to provide financial assistance to non-central firms drop and the controlling owner's cash-flow rights in non-central firms increase.

1.3 The Effect of Control-Ownership Disparity or "Wedge"

In a typical stand-alone style U.S. firm, we do not observe a wedge between cash flow rights and control rights unless there are dual class shares. Alternatively, in non-U.S. economies, where corporate pyramids and cross-shareholdings prevail, cash flow rights held by the controlling shareholding may be much smaller than the control rights they may exercise, separating cash flow rights from control rights. This divergence is commonly referred to as the control-ownership disparity or "wedge" and has been used as a measure of the degree of the agency problem in non-U.S. firms. Theoretically, the disparity between control and ownership rights gives rise to the risk of tunneling by the controlling shareholder, and is prevalent in many emerging market economies and present in some developed countries. However, in Korean business groups, where all member firms are tightly controlled by the controlling shareholders, the degree of de facto control does not vary much among member firms. Under this circumstance, the differences in cash flow rights, rather than disparity, may better explain wealth transfer among member firms.

Kim, Sung, and Wei (2011) study whether the difference in the degrees of control-ownership disparity in investors' home countries affects their portfolio choice in an emerging market. Their key finding is that investors from low disparity countries do not favor high disparity stocks in Korea, but investors from high disparity countries are indifferent. Moreover, investors from low disparity countries became averse to the disparity only after the Asian financial crisis. These results suggest that the nature of corporate governance in international investors' home countries affects their portfolio choices abroad.

Choi, Cho, and Sul (2014) investigate how the disparity or wedge may influence foreign investors' shareholdings in Korean firms. They find that foreign shareholders invest less in companies with high ownership-control disparity suggesting that aggravated agency problems created by the wedge negatively affects foreign investors' shareholdings.

Kang, Lee, Lee, and Park (2014) examine whether related-party transactions (RPT) are used as a mechanism for tunneling among firms belonging to large business groups (chaebols). First, they test whether the control-ownership wedge affects RPTs and then explore whether RPTs affect firm value. They find the control–ownership wedge to be positively associated with the magnitude of RPTs. RPTs increase as voting rights increase, while RPTs decrease as cash flow rights increase. They also note that RPTs of Korean chaebol firms, on average, reduce firm value, but this value destruction is observed only when the control-ownership wedge is high and is more pronounced in the top five chaebol firms. Overall, their results imply that RPTs occur when the agency problem is severe and are used as a means of tunneling thereby destroying firm value.

2. Business Group Membership or Affiliation

One important defining characteristic of the Korean corporate sector is that many public firms belong to a business group that consists of multiple public firms. This is not typically found in the U.S. Many studies have taken advantage of this characteristic and have compared business group member firms with non-member firms or stand-alone firms in various dimensions.

Most of these studies resort to the business group classification provided by the Korea Fair Trade Commission (KFTC). A key issue with this approach is that the KFTC only designates "large" business groups that exceed a certain size threshold. As a consequence, member firms in many smaller business groups that are not designated by the KFTC are incorrectly identified as stand-alone firms. Since the KFTC designated groups are large business groups, it is difficult to disentangle a pure business group effect from a potential size effect based on this classification.

Another confounding issue is that while many of these large business groups are controlled by families, some are not. Two prominent examples, POSCO and KT, the largest steel producer and telecom provider, respectively, are widely held public firms after being privatized a while ago. However, both firms are members of a larger entity, the POSCO group and the KT group, each of which consists of multiple public firms. Although these are also designated by KFTC as large business groups, they are not referred to as chaebols since there are no controlling families. With these caveats in mind, we review the literature on Korean business groups.

2.1 The Bright Side of Business Groups

Proponents of business groups emphasize that they may substitute for weak market mechanisms in emerging economies, especially underdeveloped capital and labor markets. In these economies, business group member firms may pool resources at the group-level optimizing group-level outcomes. During a crisis, member firms that are better off may provide a financial buffer for less fortunate member firms allowing the latter to survive difficult times.

Kim (2011b) investigates the impact of business group structure on investment activities by group affiliated companies and finds that during a global economic crisis, chaebol-affiliated firms increased investments, while a set of matched control firms significantly decreased their investments. The investments of chaebol member firms were not financed through internal capital markets, but through external capital markets. However, the relatively greater decreases in Tobin's Q for chaebol firms suggest that investment efficiency of group-affiliated firms is worse than that of the control firms. However, as previously mentioned, this result may be driven by the size effect rather than the business group effect.

Kim (2012) next investigates the long-term value implication of business group affiliations. He finds that the long-term performance of chaebol-affiliated firms is superior to that of the matched control firms although the two groups are very similar at the beginning of the sample period. The differential performance between the two groups has been caused by changes in firm characteristics over time. Difference-in-difference estimators on important firm characteristics indicate that over time, chaebol-affiliated firms become larger and more profitable, grow faster with more investments, have higher debt, and have more foreign ownership leading to a larger overall firm size.

Almeida, Kim, and Kim (2015) document similar results to that of Kim (2012) based on a rigorous empirical approach. They examine capital reallocation among firms in Korean business groups in the aftermath of the 1997 Asian financial crisis and the consequences of this capital reallocation for the investment and performance of chaebol firms. They show that chaebols transferred cash from low growth to high growth member firms using cross-firm equity investments. This capital reallocation allowed chaebol firms with greater investment opportunities to invest more than the control firms after the crisis. These firms also showed greater profitability and lower declines in valuation than the control firms following the crisis. Their results suggest that chaebol internal capital markets helped them mitigate the negative effects of the Asian crisis on investment and performance.

Jung, Lee, Rhee, and Shin (2019) examine how business group affiliation affects a firm's labor investment decisions. They find that chaebol-affiliated firms make more efficient labor investments than nonaffiliated firms. The positive relation between chaebol-affiliated firms and labor investment efficiency is attributed to the mitigation of underinvestment in labor. Chaebol affiliates have higher labor productivity than stand-alone firms. They further determine that labor sharing among affiliated firms and easy access to external financing lead to more efficient labor investments for chaebol firms when compared to stand-alone firms.

Kim, Park, and Kim (2012) also emphasize a potentially positive role of the internal labor market in business groups focusing on CEO turnover. They find that CEOs are more likely to be replaced, without a new appointment within the business group, when firm performance is poor. CEOs in chaebol member firms often relocate to other member firms within the business group, but this relocation is not driven by firm performance. The authors interpret this finding as being consistent with the existence of an internal labor market within a business group.

Byun, Choi, Hwang, and Kim (2013) examine the relation between business group affiliations and the cost of debt capital. Business group membership may affect the cost of debt in two different ways. The co-insurance effect associated with business groups can reduce the cost of debt, while expropriation by controlling shareholders can raise the cost of debt. They find that firms affiliated with chaebols enjoy a substantially lower cost of public debt than independent firms, consistent with the co-insurance argument.

Bae, Kwon, and Lee (2011) investigate the valuation effects of diversification activities by chaebols. They find that unrelated diversification by Korean firms erodes firm value, but related diversification does not decrease firm value, which is more pronounced for large business group firms. Their findings suggest that stronger internal factor markets in large business group firms enables them to take advantage of the synergic benefits associated with related diversification.

2.2 The Dark Side of Business Groups

Alternatively, business groups may provide the controlling families the incentive and the ability to expropriate minority shareholders of public member firms. In addition, an external shock may have a greater impact on business group member firms that are tightly linked through inter-corporate shareholdings and debt guarantees.

Park, Jung, and Kim (2018) analyze the stock price behavior of firms engaging in intra-group mergers, which have been a key channel of tunneling in business groups. Due to the severity of conflicts of interest in these transactions, U.S. law requires a very strict “entire fairness” doctrine in non-arms’ length mergers. However, Korean regulations mechanically apply a formula based on the historical prices of the acquirer and the target in setting merger ratios, even if they are from the same business group. As such, the controlling families have incentives to inflate the market value of the firms in which they have larger cash flow rights prior to an intra-group merger regardless as to whether the firm is the acquirer or the target. The authors find that firms where the controlling families have larger cash flows exhibit greater price increases leading up to a merger announcement.

Joh and Kim (2013) examine the effect of firm characteristics of member firms engaging in intra-group equity investment and the subsequent stock market's response. They find that member firms with more financial slack and less ownership by the controlling family tend to invest more in the equities of other member firms. The stock market responds negatively when the investing firm is diversifying and has considerable cash. Their findings suggest that idle cash of a firm largely owned by minority shareholders is the source of funds in the internal capital market and these funds are directed to poorly performing affiliated firms that are under the influence of the same controlling shareholder.

Kim, Lim, and Yoon (2017) examine how controlling shareholders of business groups may pass on the costs of IPO underpricing to minority shareholders. Based on a sample of

IPOs taken place in the Korea Exchange, they find that sale of secondary shares in Korea, in general, does not reduce underpricing as it does in the U.S. However, they do find less underpricing or even overpricing when the offered shares are directly sold by the controlling shareholders. Alternatively, the sale of secondary shares held by affiliated firms leads to a negative market reaction for the selling firms implying a direct wealth transfer from shareholders of the affiliated firms to the IPO subscribers. Their findings suggest that minority shareholders in certain affiliated firms, or scapegoats, may bear the cost of underpricing, while controlling shareholders of the business group remain effectively protected.

Park and Jung (2011) study how the withdrawal of an existing member firm from a business group affects the remaining member firms. They find that the remaining firms realize a positive announcement return, while the departing firm realizes negative announcement returns, especially when the controlling shareholder's ownership in the leaving firm is high. This result suggests that the leaving firm has been supported by other member firms as a member, consistent with the tunneling hypothesis.

The influence of large business groups sometimes extends well beyond the private sector and may affect decisions made in the public sector including the judiciary. Choi, Kang, Kim, Lee, and Park (2016) examine whether executives from chaebol member firms are treated favorably in criminal cases. They find that the probability of actually incarcerating a suspect is much smaller if the indicted are associated with large business groups. This finding is consistent with the public's perception of a general legal leniency toward the wealthy, a tendency referred to as "with money no crime, without money yes crime" in Korea.

Choi, Kang, and Lee (2018) extend the work of Choi et al. (2016) and explore what may drive this judicial bias. They present two possible explanations. The first is that the larger the chaebol, the greater the judicial bias implying that the chaebol bias is stronger for the top business groups than for other chaebols. An alternative explanation is that intra-group transactions account for much of the bias. This suggests that the judiciary widely accepts the defense of chaebol offenders that intra-group transactions are in the interest of the entire business group and not in the interests of the offenders or the controlling family.

Kwon and Han (2020) examine how payout policies may be affected in business groups. They compare family firms against non-family firms and find that family firms have a lower payout ratio than non-family firms, which is more pronounced in family business groups or chaebols. Kim, Kim, and Kim (2013) study the motives for issuing floating-priced convertibles or warrants, known as death spirals, in Korean business groups. They find that unlike in the U.S. where these securities are generally issued as last resort financing, Korean firms seem to issue them directly or indirectly to the next generation family members to facilitate control transfers.

Kwon, Han, and Lee (2016) examine the negative spillover from one group-affiliated firm to another in the same business group using credit rating downgrade announcement data in Korea. They hypothesize that the existence of controlling shareholders and internal capital markets is a major cause of the negative spillover. Consistent with their conjecture, they find the financial constraints of a group-affiliated firm negatively affect the value of other group affiliates. Similarly, Kwon, Jung, Sunwoo, and Yim (2019) study the spillover of the stock price crash within business groups. They find that the crash risk of a firm is positively associated with the crash risk of other member firms in the same business group, and this is more pronounced in firms with more RPTs.

2.3 Business Groups and Asset Pricing

Some studies extend the implications of business group membership beyond corporate finance and explore how these memberships may affect asset prices and information transfers.

Kim, Kim, and Lee (2015) examine stock return comovement within business groups in Korea and find that stocks of companies belonging to the same business group commove with each other more than stocks in the same industry. The within-group correlation in excess of the within-industry correlation has become more pronounced over time, especially following the 1997-1998 Asian crisis. The increase in correlation appears to be driven more by non-fundamental factors, such as correlated trading, rather than fundamental factors, such as related-party transactions.

Kim and Wang (2019) examine how arbitrage may contribute to rather than remove temporary price deviations between two related securities. Based on a unique sample of stock-for-stock tender offers by a member firm for another member firm within Korean family business groups, they find that arbitrage opportunities exist in more than three quarters of the sample, consistent with Lamont and Thaler (2003). Prices of the two securities tend to diverge away from each other leading up to the tender offer, which may be impacted by the controlling families who benefit from a larger deviation. This deviation is more likely to be sustained when there is more short-selling during the arbitrage possible period. Their results suggest that, under certain circumstances, arbitrage may support temporary deviations in the relative prices of two related securities.

Kim, Kim, and Park (2012) examine the effects of a series of regulatory changes that facilitated business groups in Korea to switch from a complex circular shareholding or "loop" structure to a more simplified and transparent pure holding company structure. They find that firms that transform into holding companies exhibit a significant decrease in beta subsequent to structural change that is reflected in positive market reactions at the initial announcement. However, for other subsidiary member firms, they do not observe these patterns. The results suggest that these structural changes alleviate business and financial interdependence among member firms and that the benefits, if any, mostly accrue to (the shareholders of) the apex holding companies.

Ducret and Isakov (2020) examine how chaebols may affect the “Korea Discount,” a phenomenon that refers to a claim that stocks of Korean firms are undervalued and trade at a discount relative to comparable foreign firms. They find that Korean stocks exhibit significantly lower price-earnings ratios than their global peers, but chaebols are not specifically driving this discount.

Bae and Goyal (2010) test whether business group membership can explain the extent to which firms benefit when countries liberalize their equity markets. They use chaebol membership as a proxy for poor corporate governance since the deviation between cash flow and control is more severe in business groups. They find that non-chaebol firms experience higher abnormal returns than chaebol firms suggesting that better governed firms experience significantly greater stock price increases upon equity market liberalization.

2.4 Financial Companies in Business Groups

Some Korean business groups, or chaebols, have a large stake in securities firms that issue analysts’ reports on their member companies. Song, Mantecon, and Altintig (2012) investigate the informational content of earnings forecasts, stock recommendations, and target prices made by the chaebol-affiliated analysts. They find that chaebol analysts tend to make more optimistic earnings forecasts for member companies. The chaebol analysts also assign more favorable recommendations by almost one level out of five and set target prices higher for member companies after controlling for company and analyst characteristics. These results are consistent with the hypothesis that chaebol analysts’ reports are biased by conflicts of interest.

Park and Kim (2012) examine the performance of chaebol-affiliated asset management companies when they invest in other member firms. They find that chaebol-affiliated asset managers outperform other asset managers when investing in their group member firm stocks implying information transfers between member firms within a business group.

3. Political Connections

Firm-level corporate governance is inherently influenced by the institutional environment under which the firm operates. One of the institutional factors is the effect of potential political connections. Since Korea's economic growth was largely driven by the government, the magnitude of this effect may not be trivial.

Schoenherr (2019) finds that politicians can increase the amount of government resources allocated through their social networks to benefit private firms connected to these networks. After winning the election, the new president appoints members of his networks as CEOs of state-owned firms that act as intermediaries in allocating government contracts to private firms. In turn, these state firms allocate significantly more procurement contracts to private firms with a CEO from the same network. Contracts allocated to connected private firms are executed poorly and exhibit more frequent cost increases through contract renegotiations.

Similarly, Yu and Lee (2016) find that SOEs with a politically connected CEO perform well even during a financial crisis as the SOEs are able to obtain more favorable treatment. However, the results also indicate that politically connected CEOs perform poorly when government subsidies are excluded as they may lack the skills for successful management. These results suggest that political connections may directly benefit the firms being favored, but not the overall economy.

Alternatively, Cho and Song (2017) argue that political connections may be beneficial not only to the firm being favored, but also to the economy as a whole. Specifically, they find that firms with a politically connected audit committee exhibit higher earnings quality than those without these connections. They also note that the former have better access to equity financing, but only when their earnings quality is higher.

4. CEO Characteristics

Since many CEOs in Korean public firms are either founders themselves or descendants of the founders, studies on CEO characteristics, which would be more relevant for professional CEOs, are also relatively scant. Mun, Han, and Seo (2020) examine the effect of CEOs' educational background on the cash holdings policy and value of excess cash. They show that while firms with CEOs who majored in business have less cash holdings, the value of excess the cash holdings is higher than other CEOs. Similarly, Lim and Lee (2019) investigate the relationship between excess cash holdings of firms and CEO characteristics, such as ownership type, presence of stock options, inclusion in a chaebol, and CEO tenure, and find that professional CEOs have higher excess cash holdings than family managers.

Choi, Jung, and Kim (2020) investigate the relationship between the traumatic war experiences of chief executive officers (CEOs) and their corporate decisions. Using the Korean war as an event, they find that CEOs exposed to the war earlier in their lives are more conservative in their corporate policies. Among war-experienced CEOs, they also determine that those who have witnessed large scale massacres exhibit more conservative behavior. Moreover, war-experienced CEOs make more conservative decisions during a period of financial crisis or when they have ownership. Their results indicate that early life exposure to traumatic experiences significantly induces CEOs to be risk averse.

V. Consequences of Corporate Governance Mechanisms

In this section, we explore studies that investigate the consequences of various corporate governance mechanisms. We split these studies into two groups. The first group studies the overall level of governance, while the second group limits their attention to a single governance mechanism. The studies in the first group typically use KCGS governance ratings data to measure the strength of governance.

1. Corporate Governance in General

Corporate governance, in general, can influence a variety of outcomes. Some outcomes take place inside the company, such as corporate financial policies or the opportunistic behavior of corporate insiders (internal outcomes). Others outcomes take place outside the company, such as the reactions of stock market participants or credit rating agencies (external outcomes).

1.1. Internal Outcomes

We review those studies that focus on corporate financial policies, such as investments, leverage, managerial compensation, dividend payouts, stock repurchases, retirement of treasury stocks, and corporate pension plan funds. We also cover studies that investigate earnings management and insider trading.

Kook and Kang (2011) find evidence that stronger investor projection mitigates over- or under-investment problems. They confirm that stronger investor protection, measured by KCGS ratings, leads to lower earnings volatility in firms that are likely to overinvest (i.e., firms with high cash flow, but low growth opportunities). In contrast, they determine that stronger investor protection leads to higher earnings volatility in firms that are likely to underinvest (i.e., firms with high growth opportunities, but low cash flow). Kim, Jeon, and Kim (2014) present evidence that better governed firms make better dividend payout decisions. They note that the negative relationship between growth opportunities and dividend payouts strengthens with better corporate governance as measured by the KCGS ratings. Kim and Oh (2015) show that increases in outside director ratios and institutional ownership are related to increases in the amounts of stock repurchases and dividend payouts. However, they also note that the increase in stock repurchases and dividend payouts are related to reduced expenditures on research and development (R&D).

Kim (2015) finds that firms with poor KCGS governance ratings tend to have higher debt ratios and shorter debt maturity than firms with high governance ratings. The study attributes this to the monitoring role of debt that can substitute for traditional governance arrangements. However, the study does not provide any direct evidence of debt holders playing a monitoring role. Song and Jung (2014) find evidence that KCGS governance ratings and executive compensation have a complementary relationship. They confirm that well governed firms are more likely to pay performance-based incentives to their executives than poorly governed ones.

Kim and Lim (2017) find evidence that poorly governed firms use treasury stocks to protect incumbent management. They show that Korean firms tend to resell most of the treasury shares that have been repurchased rather than retiring them. They also find this tendency to be stronger for firms with poor KCGS governance ratings. Kim and Wee (2020) investigate how corporate governance is associated with the funding decisions of defined benefit corporate pension plans. They show that funding ratios are higher in firms with higher KCGS governance ratings, higher managerial ownership, higher foreign investor ownership, or higher outside director ratios.

Kim and Kang (2011) investigate whether corporate governance can curb earnings management. They find that firms with better KCGS governance ratings engage less in real activity-based earnings management. Yoon (2013) investigates the relationship between corporate governance and insider trading. The study shows that insiders of well governed firms earn significantly smaller abnormal returns than insiders of poorly governed firms and this tendency is stronger after the Financial Investment Services and Capital Markets Act (FISCMA) was introduced in 2009.

1.2. External Outcomes

One of the key research topics in the corporate governance literature is studying the relationship between corporate governance and firm value. This research evolved in two directions. In one direction, researchers tried to address the endogenous nature of corporate governance to obtain its unbiased treatment effect. In another direction, researchers tried to identify the channels through which governance can affect firm value.

We focus on two studies regarding this second endeavor. Byun, Hwang, and Lee (2011) test whether corporate governance practices influence firm value by enhancing the value relevance of corporate financial decisions. Using KCGS governance ratings, they find that the value relevance of financing, investment, dividend, and cash-holding decisions increases with governance ratings. Black, Kim,, Jang, and Park (2015) explore whether the reduced incentive of tunneling serves as a channel through which governance can improve firm value. Their panel regression results are estimated from 1998-2004 and demonstrate that better governance moderates the negative effect of related-party transactions on firm value. Note that Black et al. (2015) use their own index to measure governance. This index, the Korea Corporate Governance Index (KCGI), utilizes the same raw data KCGS uses for its governance ratings, but is limited to elements that are time consistent and more meaningful.

Another popular research topic is studying the relationship between corporate governance and stock returns. Here, we have two lines of research. One investigates whether corporate governance can mitigate the degree stock prices will fall in a time of crisis. The second explores the return predictability of corporate governance. Cho, Shin, and Park (2016) examine the first issue. By investigating stock price reactions to the 2008 global financial crisis, they find that firms with independent boards and higher dividend payout ratios perform better than others. They deduce that these firms are better equipped to mitigate agency problems that can be greater in times of crisis. Sohn and Choi (2016) examine whether investment strategies based on corporate governance can generate alpha. In general, they find that corporate governance, measured by KCGS ratings, does not predict future stock returns. One exception is inside ownership. They determine that firms with low inside ownership exhibit higher stock returns. They suggest that investors are asking for higher return premiums from firms with dispersed ownership for fear that they will suffer more from agency problems. Jung and Park (2020) investigate whether better governed firms exhibit greater efficiency in stock pricing. They confirm that firms with higher KCGS governance ratings have higher variance ratios and shorter delays in stock pricing. They also show that better governed firms have lower idiosyncratic volatility and lower skewness of stock returns.

Credit rating agencies may also react to corporate governance. If stronger corporate governance lowers default risk, rating agencies should give higher ratings to well governed firms. Shin, Suh, and Park (2012) find that firms with stronger corporate governance, measured by the KCGS ratings, are more likely receive higher credit ratings. They also note that higher scores in disclosure and audit strengthen the positive association between earnings and credit ratings. Kang, Yoon, and Kim (2016) find similar results. They confirm that firms with stronger corporate governance are more likely to have higher bond ratings and have better chances of obtaining investment-grade ratings. They also find that this relationship is stronger for smaller firms that typically suffer more from information asymmetry problems.

2. Specific Corporate Governance Mechanisms

In this subsection, we review the studies on individual corporate governance mechanisms and their outcomes. Our discussion begins with internal mechanisms, such as corporate boards, executive compensation, and disclosure. Then, we move to external mechanisms including institutional investors, anti-takeover devices, product market compensation, and many others.

2.1. Corporate Boards

Inside corporations, corporate boards are the key to monitoring management. However, for it to be effective in carrying out its role as monitor, it is crucial that members of the board be independent from management and have the relevant skills and experience. Naturally, the studies on Korean corporate boards also focus on these two qualifications.

Most of the studies on board independence examine firm value as an outcome. For example, Black and Kim (2012) identify the causal relationship between board independence and firm value by making use of the 1999 board structure reform that required large firms to have a 50% outside director ratio and introduced audit committees with independent chairs (section II provides a detailed account of this reform). To identify the causal effect of this shock, they use multiple identification strategies including event studies, difference-in-differences (DiD) analyses, instrumental variable methods, and regression discontinuity design (RDD). They find that legal shock causes the share price of large firms to increase relative to mid-sized firms that were not subject to the reform. Black, Kim, Jang, and Park (2015) also make use of the 1999 board structure reform. To investigate whether reduced incentives for tunneling serves as a channel through which governance can improve firm value, they conduct a series of event studies around the event dates in June-August 1999 and show that large firms (total assets > one trillion Korean won) whose controllers have the incentive to tunnel (measured by the Expropriation Risk Index) earn stronger positive returns relative to mid-sized firms.

Joh and Jung (2012) and Byun, Lee, and Park (2013) also find a positive association between board independence and firm value. However, they suggest that this association can be moderated by other factors. They indicate that information transaction costs and the disparity between controlling shareholders' control rights and cash flow rights can weaken the positive link. Note that Joh and Jung (2012) measure board independence using the fraction of independent outside directors, while Byun, Lee, and Park (2013) use the average proportion of outside directors in each monitoring committee and whether the chairperson of the monitoring committee is an outside director. Kim and Shin (2016) investigate the effect of board independence in a different way. They examine the social ties of outside directors and show how they are associated with firm value. They confirm that strong social ties to executives result in significantly lower firm value, whiles their social ties with controlling shareholders do not.

We also review studies that investigate other outcomes. Kang Kook, and Yoon (2015) show that firms with a higher fraction of independent outside directors hold less cash and make more efficient use of it. In particular, they find that the tendency for low growth opportunity firms to increase dividend payouts strengthens with higher fractions of independent outside directors. They also note that the market value of cash is higher in these firms. Black, Kim, and Nasev (2021) determine that board independence leads to greater transparency. Using annual DiD within the framework of RDD, they find robust evidence that the 1999 board structure reform improved the disclosure practices of Korean firms.

Regarding the skills and experiences directors, we review studies on bureaucrat directors and academic directors. Lee and Chung (2017) examine the performance of former bureaucrats as outside directors. They find that firms where bureaucrat directors serve do not necessarily perform worse than firms without them in terms of ROA, ROE, and Tobin's Q. Cho and Chung (2019) examine the performance of professors as outside directors. They confirm that firms where academic directors with high research productivity serve perform better than other firms without them in terms of ROA, ROE, and Tobin's Q.

2.2. Other Internal Mechanisms

In addition to corporate boards, we cover studies focusing on executive compensation and disclosure. Executive compensation, if well designed, can help align the economic interests of managers and shareholders. However, if it is designed in the interest of managers, it can harm shareholder value. We focus on two studies that document the dark side of stock option grants using Korean data.

Lee, Lee, and Choi (2011) examine the effect of stock option grants on earnings management. Specifically, they show that firms with higher values of exercised options and higher option delta engage more in earnings management than other firms. They also confirm that this relationship intensifies with information asymmetry and in samples where executives sell stocks acquired from stock option exercises. Kim, Kim, and Sul (2011) study the announcement effect of stock option grants using a sample of Korean banks. They find that stock option grants generate significant and negative abnormal returns, but this effect is mitigated by the presence of foreign block holders and the ratio of outside directors that exceeds the legal minimum. They also note that the negative announcement effect is smaller when granting performance-based options rather than plain vanilla options.

Disclosure also plays an important role in corporate governance. It allows outside shareholders to obtain the information necessary to monitor management. Also, by reducing information asymmetry, disclosure mitigates the adverse selection problem. Han, Kim, Lee, and Lee (2014) investigate firms that are not faithful in their disclosures. They find that firms, designated as unfaithful disclosure firms by the Korea Exchange, exhibit significantly negative stock price returns upon designation. However, they note that this negative price reaction is mitigated in firms with high managerial ownership. Disclosure can also have unintended consequences. Kim, Lee, and Shin (2017) investigate the effect of the new executive compensation disclosure rule adopted in 2013. The new rule requires listed firms to disclose pay information for registered directors who earn more than 500 million Korean won per year (section II provides a detailed account of this rule). They find that executives receive higher pay after the new rule, and this is pronounced for executives who received suboptimal pay in prior years. They argue that this would not have taken place if it were not for the availability of the executive pay information of other executives. They also suggest that pay-performance sensitivity increased only in those firms with strong corporate governance.

2.3. Institutional Investors

The monitoring role of institutional investors is the most heavily studied external governance mechanism for Korean firms. The research questions are also diverse. We begin with those studies that ask whether voting decisions by institutional investors affect the share price of target firms. Kim and Yon (2014) find that dissenting votes cast by institutional investors result in positive stock price reactions. They also confirm that this is more pronounced for resolution items that are eventually disapproved. Kim, Sung, and Wei (2017) provide evidence for foreign institutional investors. They show that share prices react positively to 5% block holding announcements if foreign institutional investors declare themselves as activists and that the effect is greater if the activists come from countries with strong traditions of investor activism. However, the results for the National Pension Service (NPS) are mixed. Kim, Byun, and Lee (2014) find that target firm share prices do not react to dissenting votes cast by NPS in the short run. However, they suggest that these firms eventually exhibit higher firm value on the condition that they improve their internal governance *ex post*. Ko and Kim (2020) study the effect of NPS votes disclosed prior to the shareholders' meeting. They make use of the 2019 rule change that mandates the NPS to make pre-meeting disclosure of votes for firms in which the NPS owns at least 10% of the voting shares or firms whose weight is at least 1% of the NPS domestic equity portfolio (section II provides a detailed account of this rule). They find that the share prices of target firms react negatively to NPS dissenting vote announcements. They attribute this to the possibility that NPS dissenting vote disclosure, in effect, reveals negative private information to the public.

Another central research question is the role of institutional block holders on corporate investment decisions. These studies are usually motivated by the concern that foreign block holders are myopic and this can discourage firms from taking risky investments. Contrary to this expectation, Kim (2011a) finds that firms with higher foreign ownership exhibit greater cash flow volatility, a proxy capturing the riskiness of investments, and eventually grow faster. Similarly, Park and Yoon (2017) determine that business group firms with higher foreign ownership make more corporate investments and suffer less from external financial constraints. However, they do not find evidence that higher foreign ownership leads to greater risk taking. Studies focusing on research and development (R&D) provide mixed results. Kang, Chung, and Kim (2019) show that firms with higher foreign short-term block holdings spend significantly less on R&D expenditures than others. Alternatively, Joe, Chung, and Morscheck (2020) find that institutional block holders positively influence firm innovation and this positive effect is largely driven by foreign institutional block holders engaging in passive monitoring.

Another set of studies find that foreign ownership improves the workings of internal governance mechanisms and increases dividend payouts to shareholders. Garner and Kim (2013) determine that firms with higher foreign ownership tend to have higher pay-performance sensitivity, while their lower foreign ownership counterparts do not. Kim and Jang (2012) find a significant positive relationship between the changes in the ownership of long-term foreign investors and the changes in dividend payouts. Kim, Sung, and Wei (2017) show that target firms of foreign activist block holders peg dividend payouts, stock repurchases, and CEO turnover more closely to the changes in earnings, but only if they come from countries with strong traditions of activism.

Finally, a group of studies documents the role of institutional investors in curbing managerial rent diversion and earnings management. Lim (2011) is the first to show that tax avoidance lowers the cost of debt. The study attributes this to the possibility that tax avoidance is a substitute for the use of debt, but unlike debt not subject to default risk. The study then indicates that this negative relationship strengthens when the level of institutional ownership is high and this becomes even stronger after 1998 when the level of investor protection is significantly improved. The study attributes this to the role of institutional investors that lower the cost of debt even further by lowering the risk of managerial rent diversions. Liu, Chung, Sul, and Wang (2018) find evidence that institutional block holders deter opportunistic financial reporting, but that the effect comes solely from domestic institutional block holders.

2.4. Other External Mechanisms

In addition to institutional investors, there are many other external mechanisms that can shape the way firms are governed. In this review, we cover takeovers, anti-takeover devices, product market competition, shareholders' meetings, shareholder litigation, taxes, and dual listings.

In Korea, firms tend to takeover other firms by acquiring controlling minority blocks. The problem with this is that the remaining non-controlling shareholders of the target firm are vulnerable to expropriation by the controlling minority shareholders. This is what Byun, Kim, Lee, and Park (2019) find in their research. They confirm that the probability of embezzlement or breach of fiduciary duty is significantly higher in these targets than in targets with majority block acquisitions or in matched non-targets.

Korea does not allow poison pills. Nor does it allow the issuance of shares with multiple voting rights. However, this does not mean that Korean firms are completely stripped of anti-takeover devices. According to Hwang and Kim (2012), charter-based anti-takeover devices are popular among firms with low foreign ownership (see Section II.1.2.1 for details regarding these devices). They also find that these firms experience a fall in share prices upon adopting these provisions and during the post-adoption years, experience a rise in capital expenditures, a fall in profitability and dividend payouts, and a greater chance of delisting. Kim, Hwang, and Kim (2020) study the motivation and the effect of adopting convertible preferred stocks whose conversion rights are in the hands of the board. They find that firms adopt these types of stocks for managerial entrenchment purposes and destroy firm value upon adopting them.

It is well known in the literature that product market competition can be a substitute for internal or external governance mechanisms. We find similar results in the Korean literature as well. Park, Byun, and Lee (2011) show that the positive effect of internal corporate governance on dividend payouts and stock repurchases and the negative effect of internal corporate governance on investments are observed only in less competitive product markets, but not in the more competitive product markets. Similarly, Lee and Byun (2016) find that the negative effect of ownership disparity of the controlling shareholders on firm value is observed in less competitive product markets, but not in the more competitive product markets. Lee and Byun (2016) find that the negative effect of corporate governance on corporate risk-taking behavior exists only in less competitive product markets, but not in more competitive product markets. Finally, Byun, Lee, and Park (2018) investigate whether product market competition works as a disciplinary mechanism that reduces the incentives of controlling shareholders to pursue private benefits of control. Specifically, they find that member firms in more competitive markets have less disparity between the control and cash flow rights of controlling shareholders.

Tax enforcement can benefit shareholders by uncovering hidden earnings. In Korea, tax rules can benefit minority shareholders by discouraging unfair related-party transactions. Chung, Choi, and Jung (2019) examine the effect of the 2012 Inheritance Tax and Gift Tax Act amendment that required the National Tax Service (NTS) to collect gift taxes from controlling shareholders of firms with significant sales to related-party firms. By employing a difference-in-differences approach, they find that treatment group firms (i.e., firms whose controlling shareholders are likely to be subject to the gift tax) exhibit a significant drop in related-party sales during the post-amendment period, while there is no significant change in related-party sales for the control group firms (i.e., firms whose controlling shareholders are not likely to be subject to the gift tax).

The threat of shareholder litigation can prevent corporate directors from engaging in illegal activities. However, the threat can also increase liability insurance coverage for directors and officers. Park (2018) finds support for this conjecture. The study shows that firms increase liability insurance coverage after the introduction of shareholder class action lawsuits in 2004, and that this effect is more pronounced for firms operating in high litigation risk industries and firms with greater agency conflicts. Cross-listing can strengthen investor protection by bonding to the rules and regulations of another country. Choi and Choi (2015) provide supporting evidence on this for Korean firms. They find that cross-listed firms are worth more than other KRX-listed firms that are not cross-listed. They also note that cross-listed firms improve their governance after cross-listing.

Shareholders discipline management by exercising their rights at the shareholders' meetings. However, this is a challenge for shareholders in Korea, where AGM dates are highly clustered (see Section II.1.4 for details). Are firms deliberately scheduling their AGMs on highly clustered dates? Gam, Gupta, Im, and Shin (2021) confirm this. They find that firms that never held AGMs on clustered dates in previous years, but then held an AGM on one of the clustered dates are more likely to face a corporate fraud investigation in that same year.

VI. Conclusion

In this survey, we have reviewed academic studies that examine the determinants and consequences of Korean corporate control structures and governance mechanisms. In addition to the studies covering traditional mechanisms, such as boards of directors or managerial compensation, we also cover studies that focus on the implications of non-U.S. style corporate control structures, such as family control and business groups.

At this point, the results of the empirical research suggests both bright and dark sides to the Korean corporate control structure. While family-controlled business groups or chaebols may mitigate labor and capital market frictions through internal labor and capital markets, they have also caused inefficiencies, as well as wealth transfers.

Regarding empirical methodology, we find that various efforts have been made to tease out causality by taking advantage of certain regulatory changes as exogenous shocks. These methodologies include event studies, matched sample analyses, instrumental variable (IV) regressions, difference-in-differences (DiD) regressions, and regression discontinuity analyses. However, we also find studies that lack a clear identification strategy. Some even use corporate governance mechanisms as both the right hand side and the left hand side variables. These studies generally focus on certain characteristics that may affect corporate governance, which, in turn, may ultimately affect firm value. Although this approach may document correlations between certain firm characteristics and corporate governance or between corporate governance and firm value, it is difficult to tease out causality in such a framework.

There are some other methodological concerns in the Korean studies. One has to do with the measurement of concentrated ownership. In a business group structure, not all member firms are directly owned by the controlling family. Some are controlled indirectly through other member firms without any direct family ownership. For the latter type of firms, one should compute the controlling family's cash flow rights to correctly measure how greatly they are economically exposed to each member firm. However, we find some studies that do not make such an effort. We dropped these studies in this survey.

Another concern has to do with the definition of chaebol firms. Some studies do not clearly state whether they only include family-controlled business groups, or also widely-held ones in their definition of chaebol firms. POSCO, the largest steel manufacturer in Korea, has many subsidiary firms. As such, it is clear that POSCO and its member firms constitute a business group. However, POSCO itself is widely held with no family standing behind it. Thus, if the chaebol affiliation dummy is not clearly defined, it is not clear whether it is picking up the business group effect or the family effect.

Related to this, it should also be noted that the business groups designated by the Korea Fair Trade Commission are not any business group, but only "large" business groups that exceed a certain size threshold. Accordingly, firms outside of these large business groups not only include stand-alone firms, but also smaller business groups. Thus, using a chaebol affiliation dummy that takes a value of one for all KFTC-designated business groups and zero otherwise would fail to pick up the business group effect, but would pick up the business group "size" effect. Unfortunately, we find some Korean studies doing exactly this even when their intension was to identify the business group effect.

It has been only a quarter of a century since Korean firms have been subject to any form of corporate governance. Prior to the 1997 Asian Financial Crisis, there were virtually no constraints on controlling families' power to expropriate corporate resources or to make empire building decisions. Since 1998, there have been many regulatory changes, both at the group level and also at the firm level to constrain the power of controlling families. However, these regulatory changes did not fully deliver the intended effects. Controlling shareholders, who still consider themselves as principals rather than agents, are primarily responsible for this. More recently, the National Pension Fund adopted its own Stewardship Code that provided the groundwork for active monitoring or engagement by institutional investors in Korea. We are hoping that such empowerment would change the way controlling shareholders perceive themselves in the future.

On the direction of future research, we would like to highlight the importance of utilizing various governance-related reform measures. These policy experiments help researchers to establish causality more rigorously. In Section II, we have mentioned four board related reforms and other regulatory changes on the disclosure of executive compensation, 5% blockholdings, and related-party transactions.[21] We hope to see more research that takes advantage of the unique Korean setting, especially the regulatory changes.

[21] (i) 2003 Securities Exchange Act (SEA) reform on outside director ratio, (ii) 2003 Securities Exchange Act (SEA) reform on audit committee's financial/accounting expertise, (iii) 2020 Commercial Code Enforcement Decree reform on outside directors' length of tenure, (iv) 2020 Commercial Code reform on audit committee member election, (v) 2016 Capital Markets Act (CMA) reform on executive compensation disclosure, (vi) 2019 Capital Markets Act (CMA) Enforcement Decree reform on 5% rule, (vii) 2019 NPS reform on pre-meeting vote disclosures, (viii) 2020 Commercial Code and its Enforcement Decree reforms on shareholders' meeting dates, (ix) 2013 and 2020 Fair Trade Act (FTA) reform on related-party transactions.

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