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Corporate Governance Culture Transmission in Mutual Funds: Directors as Vector of Transmission

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Abstract *The purpose of study is to investigate the unique dimension of corporate governance of mutual fund that how culture of good and bad governance transmits from corporate industry of Pakistan to Mutual funds? Independent directors who are working in other industries and same time are independent directors of mutual fund are transmitting good or bad corporate governance culture of other industries into the mutual fund industry as well. Furthermore, it is investigated that how females and foreign director on board of mutual fund effect the culture of corporate governance in the mutual funds. We have applied fixed effect panel regression and results revealed that independent directors transmit shareholder friendly culture into mutual fund industry in Pakistan that called expertise effect, whereas if dependent directors of fund are connected with outside industry it is not good for governance of mutual fund due to cronyism effect. Moreover, foreign and female directors on board are not helping in promoting a good culture of corporate governance in the Mutual fund industry.*

Key words Fund governance, governance transmission, mutual funds, cronyism effect, expertise effect, independent directors

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1. Introduction

The mutual fund industry helps the economy, individual investors and institutional investors by different means, e.g., diversification, economy of scale, divisibility, liquidity and benefit of professional management (Edelen, 1999). Mutual fund industry also plays a pivotal role in the economic growth of a country as they mobilize the savings form general public and institutions to make it productive for economy.

Independence of the board of directors is always viewed as a tool to mitigate the agency problem between shareholders and managers of firms. This phenomenon does not restrain to any single industry, but also widespread in the mutual fund industry. Since the new code of corporate governance is implemented in Pakistan in year 2012 all mutual fund companies have tended to include more independent directors on their board. The prime focus of this paper is to investigate the fund governance in new perspective. This study adopted a new approach to investigate whether outside mutual fund directors transmit the governance culture from firms where they employed to mutual fund where they are independent or dependent directors. Normally the board of directors is high profile executive in their respective firms and they transmit the governance culture. If the mutual fund director also working in outside industry and engage in shareholder unfriendly practices, that shareholder unfriendly culture can be spilled over to other industry via director working in more than one place.

There are two aspects of fund governance contagion; one is positive and second is negative. If outside directors coming up with efficient information, they will be better able to manage the fund. Furthermore, these directors also equipped the mutual funds employees with new skills and competencies that are known as expertise effect and second aspect is negative that is cronyism means director are transmitting shareholders unfriendly practices into fund. Investors prefer to invent in better managed funds where long-term returns are high (Berk and Green, 2002) as better governance give superior return to investors.

The major contribution of this paper is that it measures new dimension of corporate governance beyond the simple mitigating agency problem. In best knowledge of researchers, it is first study in Pakistan that measures the transmission of mutual fund governance. Previous studies specifically look into agency problem perspective of fund governance. For example (Tufano and Sevick, 1997); (Del Guercio *et al*., 2003); (Cremers and Petajisto, 2009); (Ferris, 2007); (Qian, 2011). When board of director join fund, s/he certainly come up with mind set and governance practice with him from his previous workplace. For example, if any firm have bad governance record and his independent directors are may by beneficial in term if mitigating the agency problem for that company but side by side they are contaminating the other organizations where they are outside directors, with transmission of bad governance practices.

2. Literature review

The mutual fund industry has been playing a significant role in the economic growth of Pakistan. Though first mutual fund started it operation in 1962, it grew rapidly grew after 2003. Currently, 30 Assets Management Companies (AMCs) are working in Pakistan and there are 120 are mutual funds traded. AMCs have jointly created a mutual fund association of Pakistan (MUFAP) to protect the interest of both, AMCs and investors.

In Pakistan, some research work has been conducted on the mutual fund industry like (Nazir & Nawaz, 2010) have tried to explore the determinants of mutual fund growth. Authors have collected data of open ended mutual fund from Pakistan, ranges from 2005-2009. They applied fixed and f effect regression and came at conclusion that only assets turnover, management fee and expense ratio is positively significant relationship with growth of mutual fund. (Afza and Rauf, 2009) evaluated the performance of open ended mutual fund of Pakistan form 1999-2006. Authors' collected quarterly data for all those mutual fund listed on Mutual Fund Association of Pakistan. They concluded in their study that among all fund characteristic only liquidity and 12B-1 (type of load) are significant. But so far as per out knowledge managerial attributes are not yet considered as factor that can change the performance of mutual fund in Pakistan. So this study is unique in its kind and contributing in existing knowledge that how young mutual fund industry's performance is affected by managerial attributes. Literature provides some evidences regarding connection of fund and firm and discussing how these connections are beneficial for firm. The benefit is due to transfer of some crucial and positive elements like transmission of private information (Cohen and Schmidt, 2009), similarly information regarding assets flow and proxy voting is also important (Cohen *et al*., 2007); (Davis and Kim, 2007); (Butler and Gurun, 2012). Highlighting the importance of interlock and competition among firms,Hwang and Kim (2009) concluded that social networks of CEO influence the labor market and poor governance at one firm change the managerial behavior of other firm in same industry.

Lots of previous researches highlight the contagion effect in firm-to-firm setting and there are phenomena that are transmitting form one firm to other are mainly investment behavior,(Fracassi, 2012)adoption of poison pills,(Davis, 1991) backdating of financial derivatives, (John and Ryan, 2009) and governance culture and practices (Christa, 2011). Kelly (2013) finds evidence in his study that executive compensation and different remuneration policies are effected by firm-to-firm networks.

In previous researches there are different elements that are considered as vector of transmission of corporate governance from firm to fund. These vectors are board of director's interlocks (John *et al*., 2009) and geographical proximity (Kedia, 2011). These board interlock are responsible for making interactions between executives and thus propagate the corporate culture form one organization to other organization. Researchers having point of view these interlocks not only servers the monetary purpose through proxy voting of fund managers but private information also flow form director of firms to fund manager and sometime due to networks and interlock of directors, director vote in favor of firm to whom they are connect while proxy voting on behalf of investors. Similar nature of firms has more possibility to share the corporate governance. Like structure of firm is very important in transmission of governance. It is more plausible for same industry to apply similar nature of governance, thus it is more important to discuss governance contagion in similar nature of industry (Davis, 1991).

According to report 78% of director working 25 largest fund families are having financial background (Sterngold, 2012). Now in same industry it is more chances of interlocks. The important phenomenon that either transmission of culture and governance is bad or good is matter of grave concern. There is possibility the cronyism effect dominates when interlocks between boards occurred. Cronyism effect means that only bad practices of corporate governance are transmits into other firm like mutual fund industry(Jensen, 1993). But other side of coin is surely be considered that expertise effect can prevail when interlock occurs and across industry board connections built. Similarly Brick, Palmon, and Wald (2006) has provided empirical evidence in his paper that in corporate boardroom "mutual back scratching" exits and if director of board is taking high compensation he will give greater compensation to CEOs but it relates negatively with firm performance. Previous studies specifically look into agency problem and different perspective of fund governance. For example see (Tufano and Sevick, 1997); (Del Guercio *et al.*, 2003); (Cremers and Petajisto, 2009); (Ferris, 2007); (Qian, 2011). Effect of board ties and connection of one industry upon other industry is not researched.

3. Methodology of research

To investigate the mutual funds governance contagion from 2010 to 2014, data have been collected from the annual reports, websites of mutual fund firms and Mutual fund Assassination of Pakistan which is a portal for asset management companies in Pakistan. Dependent variable that is expense ratio is collected from annual reports of mutual fund companies. Expense ratio is proxy of corporate governance measurement. Furthermore, information about control variables, e.g. assets under management, age of manager, experience of the manger, fund age and qualification of manager is also collected. As our data is panel in nature, regression with fixed effect is used because of conformity with Husman test requirements. Our proxy variable is consistent with existing researches for example (Khorana *et al.*, 2007); *(Del Guercio et al.,* 2003); (Ferris and Yan, 2007). If corporate governance practices are good in mutual fund than expanses ratio must have inverse relationship with independent variables these variables are; percentage of independent director connected, percentage of independent director not connected and percentage of dependent directors are connected. 'P_independent connected' means that number of independent director connected with outside firms and they also working in mutual fund as independent director[1] divided by total number of independent directors on board of the fund. Similarly, to measure the impact of connection we segregated connection into independent director connected and independent directors not connected namely 'P_independent not connected'.

It is observed that on panel of some of the funds there are foreign dependent or independent directors are working. For this purpose dummy variable is included in the study that carries value 1 if any mutual fund has a foreign director on its board otherwise 0. So, there is certainty that foreign directors have greater exposure of working in shareholder friendly practice and legal protection and corporate governance system is much better as compared to developing countries. Secondly, gender wise analysis is conducted that if female directors are on the panel of fund how fund governance is consistent with the literature we have included some control variables that are, assets under management, age of the manager,and experience of the manger, fund age and qualification of manager. Model of study is as follows:

$$Exp\_Ratio_{it} = \beta_1 \mathrm{p\_ind}_{it} + \beta_2 \mathrm{p\_depL}_{it} + \beta_2 \ \mathrm{p\_indnt\ connct}_{it} + \sum_{i=1}^{7} \beta \ control_{it} + \alpha_i + \varepsilon_{it} \tag{1}$$

Whereas Exp_Ratio_{it} is a dependent variable of study. Independent variables are given on the right hand side of the equation with β coefficients. Right hand side equation also included seven related control variable to measure the net effect of the independent variable of interest upon dependent variable, α_i is unobserved heterogeneity among mutual funds.

[1] Definition of independent director is varied across economies but common element that is being considered in Pakistan as well is Director who has not any stake or ownership liked with company other than remuneration, where he is employed.

4. Results and discussions

Table 1. Correlation Matrix

Correlations Table												
Variables	P_independent_connected	P_dependent_connected	p_independent_nonconnect	operating exp	AUM	exp_ratio	agemgr	exper	lnaum	mgtfee	fundage	Board_size
P_independent_connecte	1	-.257	-0.01	-.162	-.225	-.031	.039	-.504	-.108	-.037	-.198	.407
P_dependent_connected	-.257	1	.260	.002	.189	-.170	.074	.461	.218	-.197	.211	-.168
p_independent_nonconne	-1.000	.260	1	.158	.219	.034	-.040	.501	.105	.040	.192	-.414
operating exp	-.162	.002	.158	1	.540	.088	-.191	.333	.528	-.105	.648	.429
AUM	-.225	.189	.219	.540	1	-.237	-.082	.603	.630	-.208	.916	.521
exp_ratio	-.031	-.170	.034	.088	-.237	1	-.031	-.218	-.380	.266	-.225	-.128
agemgr	.039	.074	-.040	-.191	-.082	-.031	1	.296	-.315	.134	-.095	.046
exper	-.504	.461	.501	.333	.603	-.218	.296	1	.392	-.120	.529	.146
lnaum	-.108	.218	.105	.528	.630	-.380	-.315	.392	1	-.397	.666	.413
mgtfee	-.037	-.197	.040	-.105	-.208	.266	.134	-.120	-.397	1	-.256	-.212
fundage	-.198	.211	.192	.648	.916	-.225	-.095	.529	.666	-.256	1	.483
Board_size	.407	-.168	-.414	.429	.521	-.128	.046	.146	.413	-.212	.483	1

Correlation table given above shows that there is not serious issue of multicolinearity exists in independent variables of study.

Table 2. **Descriptive statistics**

Variable	Obs	Mean	Std. Dev.	Min	Max
P_ind_connected	91	61	28	0	100
P_dep_connected	91	35	30	0	100
P_ind_non_connected	91	39	28	0	100
Exp_ratio	91	0.050	0.05	0.0	0.36
Agemgr	91	35	6	24	47
Quali	91	1	0	0	1
exper	91	9	5	1	24
lnaum	91	21	2	18	25
mgtfee	91	3	3	0	20
fundage	91	8	11	1	52
Board_size	91	8	2	4	11
D_foreign	91	0	0	0	1
D_female	91	0	0	0	1

Descriptive stats are reported in Table 1 and it is obvious from results that the average numbers of independent connections of director are higher than that of dependent director (60%). Whereas, independent directors who don’t have any connection with outside industry is least among three types of directors (39%).Results are logical because independent directors are most of the time are field specialist and technocrats of market and serving in different firms so their chances to be non-connected are less. Dependent directors are those who have partially or fully have a monetary stake in the organization. So, they are mostly full time employees of the company. Though there is not any restriction upon them to work outside. Average age of manager is 35 years and fund age is 8 years. Average size of board is 8 directors.

Table 3. Independent Director Connections and Corporate Governance Contagion

Variable exp_ratio	Dependent variable				
	Coef.	**Std. Err.**	**Z-stats**	**P-value**	
p_independent_conn~d	-0.2119	0.00	-1.06	0.0291**	
Agemgr	-0.0251	0.00	-2.60	0.009***	
Quali	-0.0124	0.01	-1.18	0.24	
Lnaum	-0.0176	0.00	-3.76	0.00***	
Mgtfee	0.0186	0.00	0.84	0.40	
Fundage	0.0353	0.00	0.61	0.54	
board_size	0.0604	0.01	1.16	0.25	
d_foreign	-0.0172	0.01	-1.89	0.059*	
d_female	0.0456	0.01	6.80	0.00***	
_cons	0.4652	0.11	4.24	0.00***	
R^2	0.4568				
Observations	91				
sigma_u	0.020346				
sigma_e	0.043035				
Rho	0.182686	(fraction	of	variance	due

Exp_ratio is dependent variable and proxy for corporate governance. "p_independent_conn~d" is independent directors connected with outside industry. "agemgr" is age of manager, "quali" is categorical variable to measure the qualifiacion of board. "lnaum" natural log of assets under management, "mgtfee" is management fee, "fundage" is fund age, "board_size" is number of board members, "d_foreign" and " d_female" are categorical variable if board member of fund is belong to foreign country or female. '', '***' indicates significance at .05*

Connection of director and their independence matters a lot to mitigate the agency problem (Davis and Kim, 2007). It is generally believed concept that when independent directors are connected they transmits positive culture into fund due to diversity and exposure of different organizations. Secondly, they don't have any monetary ownership in firm or fund that is why they are not become influential in some matter. Same phenomenon is tested in Table 2. Results show that coefficient (-0.2119) of P_ind_connected is significant at 5% level and carrying negative sign. It confirms that connection with outside firm and industry generating expertise effect and contagion is positive for fund that is also proving out hypothesis of study. Our dependent variable is expense ratio as proxy of corporate governance and negative sign means that it is good for corporate governance.

Table 3. Dependent Director Connections and Corporate Governance Contagion

Exp_ratio	**Dependent variable**			
	Coef.	**Std. Err.**	**Z-stats**	**P-value**
p_dependent_connected	0.0353	0.00014	-2.52	0.012**
Quali	0.0910	0.00986	0.92	0.356
Mgtfee	0.0317	0.00223	1.42	0.155**
Fundage	-0.0387	0.00049	-0.79	0.43**
board_size	-0.2281	0.00522	-0.44	0.662*
d_female	0.0541	0.00682	7.94	0.00***
Constant	0.0628	0.03206	1.96	0.05
R^2	0.42			
Observations	91			
sigma_u	0.014468			
sigma_e	0.044393			
Rho	0.096019			

p_dependent_connected" is the percentage of dependent directors connected with outside industry. "quali" is categorical variable to measure the qualifiacion of board. "mgtfee" is management fee, "fundage" is fund age, *"board_size" is number of board members," d_female" are categorical variable if board member of fund is belong to foreign country or female. '*', '***' indicates significance at .05 and .01 percent level.*

Next, to test the difference between the statuses of director in term of dependence we have analyzed the effect of dependent directors' connection upon the corporate governance of the fund. It is widely believed phenomenon that dependent director's connections are not good of corporate governance of firms. If dependent director are connected they bring into cronyism effect into base firms. Results of dependent director connections are reported in Table 4. It is worth noticing that sign of the coefficient of dependent director becomes positive that confirms that independent director's connection with outside firms are not fruitful for funds.

Table 4. Independent Director not connected and Corporate Governance Contagion

	Dependent variable			
exp_ratio	**Coef.**	**Std. Err.**	**Z-stats**	**P-value**
p_independent_nonconnected	0.000246	0.000288	0.85	0.0393**
agemgr	-0.00029	0.000988	-0.3	0.767
quali	0.008758	0.009597	0.91	0.362
exper	-0.00183	0.001451	-1.26	0.206
mgtfee	0.004025	0.002412	1.67	0.095
fundage	-0.0007	0.000739	-0.94	0.347
board_size	0.003584	0.00749	0.48	0.632
d_foreign	-0.01629	0.012054	-1.35	0.177**
d_female	0.045785	0.009413	4.86	0.00***
_cons	0.027283	0.064924	0.42	0.674
R2	0.36			
Observation	91			
sigma_u	0.023728			
sigma_e	0.044662			
rho	0.220134	(fraction	of	variance

p_independent_nonconnected*" is percentage of independent directors not connected with outside industry. "agemgr" is age of manager, "quali" is categorical variable to measure the qualifiacion of board. "exper" is experience of board member "mgtfee" is management fee, "fundage" is fund age, "board_size" is number of board members, "d_foreign" and "d_female" are categorical variable if board member of fund is belong to foreign country or female. '*', '***' indicates significance at .05 and .01 percent level.*

The nature of the work of the director is very important for firms. Dependent director has stake associated with firm and if they connect with outside firm it is a bad sign for firm. Similarly, the nature of work of independent director is that they work outside the firm and gets the diversity and work exposure from different type of culture and organizations who have diversity in corporate governance practices. So if independent directors are not connected this not well for fund too. The same phenomenon is tested and results are reported in Table-5 coefficient of variable independent director non-connected is significant and positive that confirms that independent director not connected are not good for corporate governance of fund.

Table 5. Female and Foreign directors and Corporate Governance Contagion

	Dependent variable			
exp_ratio	**Coef.**	**Std. Err.**	**Z-stats**	**P-value**
d_foreign	-0.09058	0.0126	-0.72	0.471
d_female	0.048059	0.0082	5.83	0.00***
mgtfee	0.003927	0.0024	1.61	0.108
board_size	-0.00098	0.0048	-0.2	0.839
exper	-0.00151	0.0013	-1.21	0.228
agemgr	-0.00066	0.0013	-0.49	0.625

_cons	0.080151	0.0628	1.28	0.202
R2	0.301			
Observation	91			
sigma_u	0.020249			
sigma_e	0.044374			
rho	0.172344			

d_foreign" and "female" are categorical variables if board member of fund is belonging to foreign country or female. "mgtfee" is management fee, "exper" is experience of board member ,"fundage" is fund age, "board_size" is number of board members," '', '***' indicates significance at .05 and .01 percent level.*

Finally, it is observed that on panel of some of the funds there are foreign dependent or independent directors are working. For this purpose dummy variable is included in the study that carries value 1 if any mutual fund has a foreign director on its board otherwise 0. So, there is certainty that foreign directors have greater exposure of working in shareholder friendly practice and legal protection and corporate governance system is much better as compared to developing countries. Secondly, gender wise analysis is conducted that if female directors are on the panel of fund how fund governance is? It is confirmed by the results given in Table 6 that having a foreign director on board has not any effect on betterment of corporate governance. The possible explanation of this effect is that the corporate governance system of developed countries is very much different from system of developing countries like Pakistan. Legal protection system is not strong in developing countries and legal protection system is a basic and essential element for good governance. By contrast, gender has a different effect upon the corporate governance system as compared to having a foreign director on board. A dummy variable is included in study to capture the gender effect that is coded 1 if any female board of director working with board otherwise zero. Coefficient of 'd_female' is significant, but positive that shows that female director is not helpful for good corporate governance practices in Pakistan. In a male dominated society like Pakistan, these results are very much rational and not too odd. A possible reason of positive results is that most mutual funds are owned by families and families sometime give director level post and representation to their females on board of director. Now these females are not technical persons and don't have enough expertise to take sensitive decision that can enhance corporate governance practice in the country.

Table 7. Robust Check using management fee as an alternative measure

mgtfee (Dependent variable)	Coef.	Std. Err.	P.value
p_dependent_connected	0.0204	0.029017	0.0482**
p_independent_nonconnected	0.5401	2.644485	0.838
p_independent_connected	-0.5160	2.635273	0.045**
Agemgr	-0.0031	0.1501	0.983
fundage	-0.0707	0.10197	0.488
exper	-0.0581	0.223121	0.795
quali	-1.544	1.508296	0.306
_cons	-46.246	264.3938	0.861
sigma_u	3.14123		
sigma_e	2.32086		
Rho	0.64688		

In line with Khorana *et al*. (2007) for the robustness, we used alternative proxy for corporate governance of mutual fund. Excluding other element for expense ratio of mutual fund management fee is used only as an alternative measure and results are reported in Table 7. The results given in Table 7 are consistence with result given in the previous tables. Almost result are telling the same story and dependent directors, if connected and independent directors, if not connected are caused increase in management fee that means that dependent director connectedness and independent director non connectedness are both bad for corporate governance of mutual fund. Results of alternate proxy measurement of corporate governance confirm that our results are not biased and reliable measurement has been used in study.

5. Conclusions

Since the new code of corporate governance is implemented in Pakistan in year 2012, all mutual fund companies have tendency to hire more independent directors on their board. The prime focus of this paper is to investigate the fund governance in new perspective. We took and new approach to investigate whether mutual fund directors transmit the governance culture from firms where they employed to fund where they are independent or dependent directors. Normally the board of directors are high profile executives in their respective firms and they are the transmitting the governance cultures. If the mutual fund director also working in outside industry and engage in shareholder unfriendly practices, shareholder unfriendly culture can be spilled over to other industry via director working in more than one place.

The study finds that independence of directors is essential element for good governance in Pakistan. Using expense ratio as a proxy of corporate governance fist we find that independent director connection and ties with industry is good for corporate governance of mutual fund. It confirms the expertise effect that means independent directors working with different organizations that have different CG practices. This diversity gives greater exposure and independent director transmit the good practices into funds in Pakistan. Similarly, independent directors, if not connected to outside industry is bad omen for the mutual fund industry.

The study confirms that independent directors connected it good for corporate governance and if not connected is bad for corporate governance. Moreover, dependent connected directors have a positive sign with proxy of corporate governance and it's confirmed that dependent director connection and ties make the corporate governance worse. Finally, gender and the foreigner effect on corporate governance is tested and results show that foreigner on board of director are helpful in making the corporate governance good but not significantly. This is due to differences in culture, practice and legal protection system of foreign countries that these directors belong. Last but not least effect of presence of female director is tested and results are shown that the presence of females as a director on board is not fruitful for betterment of corporate governance. There are some future research avenues for interested researcher. We have only included open ended mutual fund that has condensed the dataset. Currently there are 120 mutual funds operating in Pakistan so taking into account these entire fund the research can be expanded more to clear the picture. It only possible to gauge the net impact of CG that investment objective of these 120 funds must be fixed.

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