Dividend Policyand Corporate Governance Reform : The importance of Personal Liability in Enforcement.

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Motivation:

Reputation Argument of DPR and Substitution Hypothesis

- With weaker CG environment, firms are motivated to pay higher DPR to establish a reputation of being fair to minority investors (Easterbrook, 1984; La Porta et al., 2000; Glendening et al., 2016; *JIBS*).
- Higher DPR is associated with a reputation that may help firms achieve easier access to external capital (La Porta et al., 2000, *JF*), and be rewarded with higher market valuation in a weaker investor protection regime (Pinkowitz et al., 2006, *JF*).
- However, higher DPR is a costly strategy, this reduces the internal funds available for financing value-enhancing corporate investments (DeAngelo et al., 2006, JFE; Caton et al., 2016, *JCF*; Glendening et al., 2016, *JIBS*).
- Alternatively, CGR with mandatory provisions reduces agency problem
- CGR should substitute DPR *(Substitution Hypothesis)*

Motivation…

Emerging markets: Ideal setup to test substitution hypothesis between CGR and DPR.

Two Stylized Features of EM

- greater conflicts of interest between controlling insiders and minority outsiders
  - Weaker IP regime (*Bekaert and Harvey, 2003, JEF; Claessens and Yortuglu, 2013, EMR*), associated higher private benefits at the disposal of corporate insiders (Bertrand et al., 2002, QJE)
  - Makes reputational role of dividends particularly relevant in these emerging markets (*Pinkowitz et al., 2006, JF*)
- Weaker market forces of corporate scrutiny (*Aggarwal et al., 2008, RFS*).
  - Mandatory CGR should be an policy tool to improve corporate governance practices
  - Shift in the CG environment through mandatory CG enforcement could make the reputational role of high DPR less relevant.

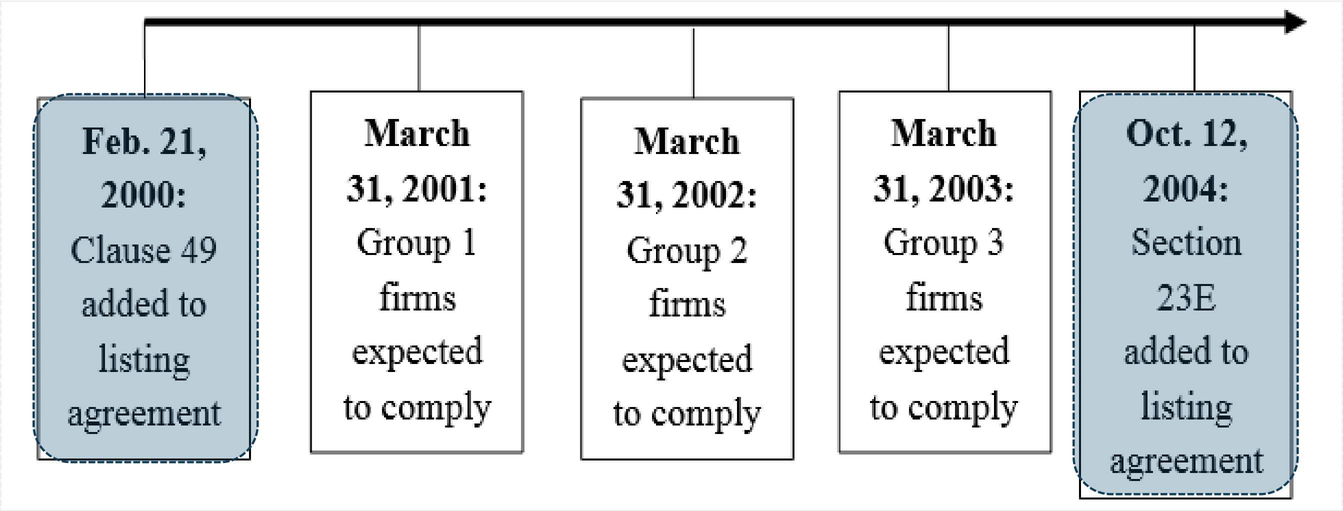
Motivation…

CGR in India (Clause-49)

- Emerging economy *(context)*.
- *Provides two reform-shocks to test the adequacy CGR of sanctions in examining Substitution Hypothesis*.

- The setting has been used in previous empirical studies in law and finance (*Dharmapala and Khanna, 2013, JLEO*)

CGR in India



Any firm listed before 2000 who did not meet the paid-up capital or net worth criteria are in Control Group. Rest are in Treatment Group.

Hypotheses Development

1. CGR- DPR *Substitution Hypothesis*

H_1: Following the introduction of Clause-49 in 2000, affected firms reduce their DPR more than the unaffected firms.

- With weaker external corporate governance, firms would be motivated to pay higher DPR to establish a reputation of being fair to minority investors.
- CG environment in India was largely informal prior to the adoption of Clause-49, the adoption should enhance external shareholders' confidence in accepting the improved corporate governance practices of affected firms.
- Should make the reputational role of DPR less relevant .

2. CGR-DPR Substitution

Expansion of harsher sanctions

H_2: Following the enforcement of Section-23E in 2004, the affected firms reduce their DPR to a greater extent than their control counterparts.

Economic rationale:

- Global convergence of CGR standards the quality of the legal and enforcement environments is the ultimate differentiating factor for CG effectiveness (*La Porta et al., 2006 JF; Martynova and Renneboog, 2011, JCF*).
- The effectiveness of regulatory intervention, particularly for evolving regulatory regimes of emerging markets, depends on the severity of sanctions (*Becker, 1968, JPE; Dutcher, 2005, ASLJ*).
- Expansion of personal liability in sanction improves effectiveness of CGR. Therefore substitution should be more effective following CGR with expansion of

Univariate Analysis

Panel A: (period of [t-3, t+3] for Clause-49 adoption)	Pre-Clause-49	Post-Clause-49	Difference	t-stat	No. of Obs.
DPR (Control)	0. 1492	0. 1443	-0.0049	1.0139	1944
DPR (Treated)	0. 1741	0. 1756	0.0015	0.1953	7749
Difference in Differences (DiD)			0.0064	0.5913	
Panel B: (period of [t-3, t+3] for Section-23E imposition)	Pre-Section-23E	Post-Section-23E	Difference	t-stat	No. of Obs.
DPR (Control)	0.1467	0.1396	-0.0071	1.65	2096
DPR (Treated)	0.1582	0.1310	-0.0272	-8.97***	10105
Difference in Differences (DiD)			-0.0201	-7.79***	

Multivariate Analysis

$$DPR_{it} = \alpha + \beta . Treat_i . After\_CL49_t + X_{i,t-1} . \delta + \gamma_i + \tau_t + g_i\, t + e_{it}$$

$$DPR_{it} = \alpha + \beta . Treat_i . After\_S23E_t + X_{i,t-1} . \delta + \gamma_i + \tau_t + g_i\, t + e_{it}$$

	Dependent Variable: Dividend Payout Ratio (DPR)			
	[1]	[2]	[3]	[4]
DiD_CL49 [$Treat_i . After\_CL49_t$]	0.02 (0.64)	0.03 (1.27)		
DiD_S23 [$Treat_i . After\_S23E_t$]			-0.03*** (-3.56)	-0.05*** (-4.17)
Size		-0.07*** (-6.69)		-0.05*** (-3.42)
Leverage		0.01 (0.17)		0.09 (1.63)
ROA		-0.02*** (-5.29)		-0.02*** (-5.30)
Tobin's Q		0.01* (2.25)		0.01* (2.13)
Volatility		-0.00 (-0.87)		-0.00 (-0.15)
Buy-back dummy		0.01 (0.24)		0.03 (0.75)
FII				0.12* (1.71)
DII				-0.03 (-0.82)
Year FE	YES	YES	YES	YES
Firm FE	YES	YES	YES	YES
Firm-specific trend	YES	YES	YES	YES
Adj. R^2 (within)	0.02	0.24	0.10	0.24
No. of Firms	1201	1201	805	805
No. of observations	7036	7036	3089	3089

Robustness Test

- Matched Firms
- False Experiments Test
- Shorter Period, (2003-2006)
- First Difference Regression
- Self-selection Issue

Exploring Firm's Heterogeneity:

	Payout Heterogeneity	Leverage Heterogeneity
	[1]	[2]
DIDID-High paying $[Treat_i \,.\, After\_S23E_t . High\_paying_i]$	-0.15*** (-6.67)	
DIDID-Leverage $[Treat_i \,.\, After\_S23E_t \,.\, \overline{Leverage_i}]$		-0.16*** (-2.89)
Size	-0.01 (-1.20)	-0.03** (-2.40)
Leverage	0.06 (1.22)	0.07 (1.10)
ROA	-0.018*** (-6.63)	-0.012*** (-5.82)
Tobin's Q	0.02* (1.95)	0.02 (1.62)
Volatility	-0.012** (-2.30)	-0.001 (-0.20)
FII	0.002** (2.56)	0.001 (1.02)
DII	-0.01 (-0.28)	-0.03 (-1.04)
Buy-back dummy	-0.01 (0.57)	-0.01 (-0.49)
Year FE	YES	YES
Firm FE	YES	YES
Firm specific trend	YES	YES
Adj. R^2 (within)	0.38	0.38
No of Firms	679	795
No of observation	2684	3069

Thank You