RESEARCH ARTICLE

Grey Directors on Philippine Corporate Boards

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Independent directors on a firm's board are theorized to enhance corporate governance by mitigating agency conflicts. However, some independent directors, referred to as grey directors, have prior relationships with managers that may hamper this role. Using data for Philippine firms, we construct a measure that categorizes independent directors as truly independent or grey, based on the 12 criteria used to define board independence as stipulated in the 2017 Philippine Corporate Governance Code. This measure is used to examine which firms are more likely to appoint grey directors and how the presence of grey directors affects firm performance. Consistent with agency theory, we find that firms with higher ownership concentration are more likely to have grey directors. However, we find that the presence of these grey directors does not adversely affect firm performance. We conclude that while grey directors are common among Philippine firms, their presence does not appear to escalate agency problems.

Keywords: Corporate Governance, Board of Directors, Family Firms, International Finance

JEL Classification: G32, G38

The institutional environment in the Philippines is fundamentally different from that of developed Western economies in several respects, including weaker investor rights and a market more susceptible to the concentrated control of blockholders. Most of these blockholders are corporate groups subsumed under family empires, where ownership, management, and directorships are often intertwined (Unite & Sullivan, 2000). As a result, managerial actions have been largely shrouded in opacity because of inadequate monitoring by external parties. The protection of minority shareholders has also often been eroded by insider trading among controlling shareholders and by the dominance of large insider shareholders in corporations (Saldaña, 2000). Controlling shareholders also largely determine the appointment, term, and compensation of the chairperson of the Board, thereby ensuring that the chairperson is aligned to their interest (Saldaña, 2000). Against this background, the history of corporate governance in the Philippines is marred by weak investor protection, deficient auditing standards, and poor governance structures that are reinforced by the occasional corporate scandal rivaling the infamous collapse of Enron in the U.S.¹

Since the early 2000s, regulators in the Philippines and other emerging market countries have been striving to improve corporate governance standards. For example, the Philippine Securities and Exchange Commission (SEC) has continually amended its Corporate Governance Code with the intent of raising the corporate governance standards of Philippine corporations to be at par with their regional and global counterparts, including provisions to mandate an increased presence of independent directors on corporate boards.² Having independent directors on a corporate board of directors is a proposed solution to owner-manager agency conflicts (Crespi-Cladera & Pascual-Fuster, 2014) and is argued to enhance the monitoring and supervision of managerial behavior. However, past research demonstrates that the effectiveness of having these independent directors varies based on specific firm characteristics and the firm's country of origin (Liu et al., 2015). Emerging market countries, where family corporate groups are dominant and legal institutions to protect shareholders are weaker, may benefit more from greater board independence. In these countries, internal governance mechanisms become more important. For example, Husted and de Sousa-Filho (2019) demonstrated the importance of country context by investigating the board structure (i.e., board independence) of publicly-traded firms in Latin American countries where family-controlled groups are prevalent. They found that greater board independence increases the Environmental, Social, and Governance (ESG) disclosure of Latin American firms, consistent with their hypothesis that independent directors visibly improve managerial practices in countries with weak legal regulations. In contrast, Garcia-Sanchez et al. (2015) found that among countries with greater legal protection for investors, independent directors are more committed to fostering ethical behavior among managers compared to independent directors in countries with weaker investor protection.³ Therefore, the literature shows that independent directors seem to add value to firms in both emerging and developed markets, although such value-added may still be sensitive to institutional and country-specific differences.

In theory, independent directors are valuemaximizing for any firm because these directors provide an outside perspective and act to oversee and monitor board insiders, which limits managerial opportunism. Unlike inside directors who may not feel compelled to contradict the CEO, independent directors should have no qualms doing so, thereby putting them in a better position to monitor managerial activities (Choi et al., 2007). As such, it is expected that a more independent board will contribute positively to firm performance and valuation. However, such expectation has not been consistently demonstrated across a variety of country contexts. In the U.S., few studies report a positive relationship between board independence and firm performance and excess returns (Baysinger & Butler, 1985; Rosenstein & Wyatt, 1990), whereas others found an insignificant relationship (Hermalin & Weisbach, 1991; Bhagat & Black, 2002). For emerging markets, some studies also report a positive board independence-firm performance relationship: Choi et al. (2007) for Korean publicly listed firms, Pombo and Gutierrez (2011) for Colombian listed and non-listed firms, Liu et al. (2015) for Chinese listed firms, and Kao et al. (2019) for Taiwanese listed firms. Others, however, find an insignificant effect of board independence on firm performance: Unite et al. (2019) for Philippine publicly-listed firms and Yammeesri and Herath (2010) for Thai-listed firms. These results emphasize that the cross-sectional effect of independent directors on firm performance varies because boards may be endogenously determined (Hermalin & Weisbach, 2003) or because of the different market environments in which these firms operate.

In some cases, these independent directors may only be independent in name and may have a relationship with corporate insiders that compromises their independence; such directors are referred to as friendly or grey directors (Hermalin & Weisbach, 2003; Borokhovich et al., 2014). The question is whether these grey directors hamper the resolution of owner-manager agency conflicts that the presence of truly independent directors would otherwise foster. A contrasting view is that although grey directors do not act in a fully independent manner, they may actually enhance board functionality. The argument is that board insiders may be reluctant to share propriety information with truly independent directors, thereby circumventing the board's advisory role. In contrast, board insiders may have more trust in grey directors, which improves information sharing and may strengthen the board's advisory role. Based on this mutual trust, grey directors are more likely to obtain crucial information from top management on a timely basis and use this information to advise management on strategic issues (Hsu & Wu, 2014), thereby facilitating more efficient decision-making, especially during periods of crises.

Close ties with the management and with insiders, therefore, puts grey directors in a better position to perform their advisory role. Consistent with this premise, Hsu and Wu (2014) found that firms in the U.K. with more grey directors than strictly independent directors are less likely to fail. However, it may also be possible that different firms have different optimal levels of board independence. If a firm's optimal proportion of board independence is below the proportion recommended by codes of good governance, then the firm may appoint grey directors merely to satisfy the required proportion of independent directors suggested by these regulatory standards (Crespi-Cladera & Pascual-Fuster, 2014). In this case, grey directors act as window dressing for the firm and may have an insignificant or negligible effect on firm performance. Several studies support an insignificant grey director-firm performance relationship: Vafeas and Theodorou (1998) for U.K. firms, Yammeesri and Herath (2010) for Thai-listed companies, Choi et al. (2007) for Korean publicly-listed non-financial firms, and Crespi-Cladera and Pascual-Fuster (2014) for Spanish publicly-listed firms. In the Philippines, no study has yet been conducted on the firm performance impact of grey directors.

This study augments the limited literature on the value-added of grey directors in the context of an emerging market. We investigate how the presence of grey directors corresponds to ownership structure and analyze how the presence of grey directors affects firm performance. We perform this analysis using Philippine data, where high corporate ownership concentration and weak corporate governance are common. Our contribution to the literature is twofold: First, unlike studies (Choi et al., 2007; Yammeesri & Herath, 2010) that rely on informal or one-dimensional independence criteria (e.g., social and business ties to the firm) to classify directors as grey, our study uses a systematic, 12-point classification scheme to identify grey directors. This methodology allows us to

more rigorously distinguish grey directors from truly independent ones. Second, we control for endogeneity issues that may potentially influence the relationship between grey directors and firm performance by lagging all of our independent variables by one period to reduce the risk that our results are driven by reverse causality. We then estimate a model that disentangles the effects of grey directors from that of truly independent directors on firm performance. Overall, we find that firms with higher ownership concentration are more likely to have grey directors but that the presence of these grey directors does not significantly impact firm performance. We conclude that grey directors fulfill regulatory dictates of board independence while not disrupting an optimal board mix within the Philippine corporate environment. Agency problems do not seem to be exacerbated due to compromised board independence, and Philippine regulators do not need to address this situation immediately.

The rest of this paper is structured as follows. In Section 2, we discuss the institutional environment in the Philippines as it relates to board independence and corporate governance. In Sections 3 and 4, we review the theoretical arguments and empirical literature on how ownership structure affects the presence of grey directors and how these directors affect firm performance. Following that, we discuss the data, model specifications, and methodologies used in this study. We present the descriptive statistics and report our estimation results in Section 6, and we discuss the results of our robustness tests in Section 7. Finally, we summarize our results and conclude in Section 8.

Background

The Philippine Business Environment

The Philippine economy has been historically marred by rampant corruption and ineffective regulatory institutions (Unite & Sullivan, 2000; dela Rama, 2012). Consequently, much of the economic activity has revolved around business groups that insulate and sustain business activities in this uncertain environment (La Porta et al., 1999). Claessens et al. (2000) demonstrated the resulting economic ownership concentration in the Philippines by showing that the largest 10 family groups control over half of the country's corporate assets. Tan (1993) showed that these large business groups are centered around a commercial bank that interlock with other companies in the same conglomerate. These conglomerates are so large that they span across several industries, and this degree of agglomeration allows these business groups to become effective lobbying institutions or entities used to acquire political favors. Unite and Sullivan (2000) also demonstrated this high degree of ownership concentration, where the single top owner averages 37% ownership of publicly listed firms, and the top 10 shareholders average 73% ownership. Similarly, in this study, we find that high ownership concentration has continued, averaging 54.85%.

Thus, unlike the market-based corporate governance of the U.S., the government-based corporate governance of China and Singapore, and the bank-based corporate governance of Japan and Germany, corporate governance in the Philippines is best described as family- or group-based. Such high ownership concentration among corporate groups makes it difficult to mount a takeover attempt without the support of these families (Mak & Li, 2001), which explains why hostile takeovers in the Philippines occur infrequently.

Board Independence Guidelines in the Philippine Code of Corporate Governance

In the Philippines, guidelines for corporate governance have been formalized with the Code of Corporate Governance that was first issued in 2002 by the SEC (Securities and Exchange Commission, 2002a). One of the Code's provisions mandates that publicly listed firms have a board of directors consisting either of 20% independent directors or a minimum of two independent directors, whichever is less (Securities and Exchange Commission, 2002b).⁴ Additional guidelines include the definition, nomination procedures, and election process of independent directors. Furthermore, the Code's guidelines list specific criteria that disqualify a director from being classified as independent.

The 2002 Code of Corporate Governance was revised in 2009 (Securities and Exchange Commission, 2009a). The revised Code mandates that all covered companies have at least two independent directors or such a number of independent directors that constitutes 20% of the board, whichever is less, but in no case must the number be fewer than two. The revised Code also added two new criteria for board independence and mandates that the equity ownership of independent directors may not exceed 2% of the covered company, which is lower than the 10% threshold stipulated in the 2002 Code (Securities and Exchange Commission, 2009a, 2009b). Additional guidelines introduced rules related to term limits of independent directors in listed, public, and mutual fund companies (Securities and Exchange Commission, 2011).

Effective January 2017, the SEC issued a new Code of Corporate Governance for Publicly Listed Companies that adopts the "comply or explain" approach (Securities and Exchange Commission, 2016). This Code recommends that all covered companies must have at least three independent directors or such a number of independent directors that constitutes 30% of the board, whichever is higher. It also retains and improves several criteria of independence from past guidelines and adds three new criteria for board independence. The 2017 Code also recommends that board committees be expanded to support various tasks, including audit practices, risk management, and compensation and remuneration.

Throughout multiple amendments to the Code, the standards set by the SEC for the classification of independent directors in publicly listed companies have become much more stringent. However, the improvement in the criteria that define an independent director does not necessarily correspond to compliance from those for which the Corporate Governance Code is intended. See Appendix A for the detailed evolution of the Code of Corporate Governance.

Theoretical Framework

There are different agency problems depending on the firm's ownership structure. For widely held firms, the prominent agency problem is between managers and shareholders. This conflict arises because it is difficult for diffused shareholders to coordinate and properly monitor the actions of managers. In these cases, appointing independent directors provides a monitoring function to limit managerial opportunism (Millstein & MacAvoy, 1998). For firms with high ownership concentration, the prominent agency problem is between controlling and minority shareholders (La Porta et al., 1999; Hermalin & Weisbach, 1991; Molz, 1988). In this case, independent directors can monitor the actions of the controlling shareholders and represent the interests of minority shareholders. Therefore, independent directors can enhance the firm's value, regardless of ownership structure, through their industry expertise and monitoring function.

However, the benefit that independent directors provide in mitigating agency problems may be compromised in cases where these independent directors have a relationship with corporate insiders. In widely-held firms, powerful managers may compel the appointment of grey directors to reduce board monitoring. Meanwhile, for firms with high ownership concentration, controlling shareholders may compel the appointment of grey directors to enhance their control and give them more flexibility in running the firm. Thus, instead of fulfilling their purpose on the board as monitors and value-enhancers, these grey directors may aggravate agency conflicts and allow for some degree of opportunism or wealth expropriation that may negatively affect firm performance.

On the other hand, Crespi-Cladera and Pascual-Fuster (2014) proposed the optimal board independence theory, arguing that a one-size-fits-all policy for board independence is not best for shareholder interests.5 Different boards have different optimal degrees of board independence; for some firms, having too many truly independent directors may be disadvantageous and may only compel top managers to withhold information to avoid excessive meddling. Therefore, in this scenario, when the firm's optimal (unobservable) level of board independence is below the level of independence recommended by governance codes, firms may simply appoint grey directors to act as window dressing and to satisfy regulatory requirements on independent directors while maintaining their current optimal level of board independence (Crespi-Cladera & Pascual-Fuster, 2014). If this theory holds, appointing such directors will not negatively affect firm value; in fact, it is likely that these grey directors will not materially affect firm performance in any direction at all. However, if the firm's optimal level of board independence is above the level of independence recommended by the governance code, then appointing grey directors might even positively impact firm performance because such directors are being appointed to reach the firm's optimal mix of independence. Consistent with the optimal board independence theory, Adams and Ferreira (2007) showed there is an optimal level of board independence that induces managers to divulge enough information to the board to function in a firm value-maximizing manner.

Therefore, agency and optimal board independence theories offer contrasting predictions related to the presence of grey directors. Consistent with agency theory, high ownership concentration results in a greater presence of grey directors. However, if the appointment of grey directors amplifies agency problems, firm performance may suffer. In contrast, consistent with the optimal board independence theory, grey directors are a useful or negligible substitute for truly independent directors, and the presence of grey directors will not negatively affect firm performance.

Literature Review and Hypotheses Development

Empirically, several studies support the idea that independent directors improve board performance through the monitoring of insider directors and managers and through the provision of outside expertise and unbiased counseling (Baysinger & Butler, 1985; Rosenstein & Wyatt, 1990; Greenbury, 1995; Bonn et al., 2004; Anderson & Reeb, 2004; Black et al., 2006; Choi et al., 2007; Chen & Nowland, 2010; Kim & Lim, 2010; Pombo & Gutierrez, 2011). However, there is also empirical evidence that board independence has an insignificant or negative effect on firm performance (Agrawal & Knoeber, 1996; Dalton et al., 1998; Bhagat & Black, 2002; Fuzi et al., 2016; Cavaco et al., 2017; Unite et al., 2019). Moreover, some studies found that the effect of board independence may be moderated by the ownership structure of the firm (Leung et al., 2014; Liu et al., 2015). Some attributed the varying results to the fact that boards are endogenously determined (Hermalin & Weisbach, 2003), whereas others posited that results vary due to the different market environments these firms operate in (Choi et al., 2007; Liu et al., 2015). The differing empirical results in the literature bring to question the effectiveness of a one-size-fits-all policy for independent directorships, suggesting that the benefits of continuous increases in board independence may have been over-emphasized in the literature.

Consistent with the agency theory, Bartholomeusz and Tanewski (2006) reported that Australian publicly listed family firms are more likely to have fewer independent directors and more grey directors, suggesting that firms with high ownership concentration tend to substitute outsider monitoring with interested bystanders. There is also empirical evidence that firms with more grey directors suffer from owner-manager agency conflicts. Core et al. (1999) showed that publicly traded U.S. firms with more grey directors are associated with higher CEO compensation, indicating that grey directors are less independent of the CEO and are, therefore, less effective monitors who will structure the CEO's compensation package to maximize the CEO's selfinterest. Borokhovich et al. (2014) provided additional insights into the self-seeking motivations of grey directors: after the unexpected death of a top executive, grey directors tend to behave like insiders and avoid casting dissenting votes against the appointment of a perceived successor to the position, thereby protecting their business ties with the company even if they know that the successor is not the most qualified replacement. Finally, Beasley (1998) observed that the U.S. publicly traded companies with at least one reported instance of material financial statement fraud have more grey directors than no-fraud companies.

Supporting the optimal board independence theory, Hermalin and Weisbach (1998) found that the presence of truly independent directors may not be desirable when the firm is performing well. Bhagat and Black (1999) also concluded that there is no empirical support that U.S. firms with "supermajorityindependent boards" are more profitable than other firms, suggesting instead that the optimal mix of insider, grey, and independent directors varies from firm to firm. Crespi-Cladera and Pascual-Fuster (2014) found empirical evidence that grey directorships have no significant effect on the performance of Spanish publicly listed firms, whereas Cavaco et al. (2017) suggested that these grey directors among Spanish firms are primarily appointed to satisfy regulatory requirements. Using a sample of U.K. firms, Vafeas and Theodorou (1998) found that having more grey directors does not have any discernible effect on firm performance. Similarly, Yammeesri and Herath (2010) found in their sample of Thai-listed companies that grey directors do not significantly affect firm value, whereas Choi et al. (2007) also found an insignificant grey director-firm performance relationship among Korean publicly-listed firms. Furthermore, Coles et al. (2008) questioned the conventional wisdom that smaller and more independent boards are more effective, and argued that the effectiveness of board composition on firm performance is driven by the heterogeneities between simple and complex firms.

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Based on the foregoing discussions, we hypothesize that:

- H₁: If the agency theory holds, ownership concentration is positively related to the presence of grey directors on the board.
- H₂: If the agency theory holds, the proportion of grey directors will have a negative effect on firm performance.
- H₃: If the optimal board independence theory holds, the proportion of grey directors will have an insignificant or positive effect on firm performance.

Data and Empirical Models

Sample and Data Collection

Data used to construct our board structure, ownership structure, firm size, and firm age variables are hand-collected from the Annual Reports, Public Ownership Reports, and Annual Corporate Governance Reports (ACGR) submitted by our sample firms to the Philippine SEC and the Philippine Stock Exchange (PSE). The SEC began requiring all listed companies to submit their ACGRs in 2013. The ACGR is a more accurate source of information to properly classify board members as independent directors and to verify whether the declared independent director satisfies the 12 criteria of strict independence or is considered, for our purposes, as a grey director. Firm-level financial data required to construct our measures of firm leverage and growth opportunities are obtained from the Annual Reports and the Thomson Reuters financial database.

Our initial panel dataset includes all Philippine publicly listed firms whose common shares were traded in the PSE from 2012 to 2015. We exclude firms that did not trade or were suspended and firms with missing information. The resulting unbalanced panel spans the period 2012 to 2015 and consists of 926 firm-year observations. Table 1 summarizes our sample elimination process.

Definition of Grey Directors

The 2017 Philippines' Code of Corporate Governance for Publicly Listed Companies lists the criteria for members of corporate boards to be classified as independent. This regulation came as a response to

| | 2015 | 2014 | 2013 | 2012 | Total |
|--------------------------|------|------|------|------|-------|
| Initial sample | 263 | 260 | 255 | 255 | 1033 |
| Firms that did not trade | (0) | (16) | (18) | (19) | (53) |
| Firms with missing data | (16) | (11) | (13) | (14) | (54) |
| Total | 247 | 233 | 224 | 222 | 926 |

 Table 1. Sample Data Elimination

international developments in corporate governance and as an attempt to align with international best practices and standards. Hermalin and Weisbach (1988) classified outside directors who have business relationships with the firm as grey directors and those without as strict independent directors. Choi et al. (2007) defined grey directors as "outside directors who appear to have current or potential business ties with the firm by virtue of their professions, such as lawyers, accountants, consultants, or bank executives" (p. 946), whereas Vafeas and Theodorou (1998) described grey directors as "non-executive directors having a fiduciary relationship with the firm, such as management consultants, executives in financial institutions, and the firm's legal counsel" (p. 386). Core et al. (1999) classified grey directors as "those who or whose employer received payments from the company in excess of his board pay" (p. 380). We follow Crespi-Cladera and Pascual-Fuster (2014), who investigated Spanish firms, and Cavaco et al. (2017), who investigated French firms, and defined those directors that do not meet all 12 criteria listed in the 2017 Code as grey directors. These criteria are enumerated in Appendix A.

Model 1: Presence of Grey Directors and Ownership Concentration

Based on the agency theory, firms with high ownership concentration are expected to be more prone to appointing grey directors to fulfill regulatory mandates of greater board independence while giving management greater flexibility in running the firm. Therefore, similar to Crespi-Cladera and Pascual-Fuster (2014), we test whether the presence of grey directors is related to a firm's ownership structure while controlling for factors shown to affect board composition by estimating Model (1). $GREY_{i,t} = \beta_0 + \beta_1 TopOwn_{i,t} + \beta_2 Fsize_{i,t} + \beta_3 Dual_{i,t} + \beta_4 Bsize_{i,t} + \beta_5 Busy_{i,t}$

$$+\beta_6 Interlock_{i,t} + \sum_{z=1}^{Z-1} \vartheta_z Indus_{z,i,t} + \sum_{t=1}^{T-1} \delta_t Year_t + \epsilon_{i,t}$$
(1)

The dependent variable, the presence of a grey director (GREY), is a dummy variable that takes the value of 1 when at least one grey director sits on the board and 0 otherwise. Our independent variable of interest is the firm's ownership concentration (TopOwn), defined as the percentage of outstanding common shares owned by the firm's largest shareholder.6 We include control variables that have been shown to affect the presence of grey directors. The first set of control variables proxy for managerial power and include CEO duality (Dual), board size (Bsize), board busyness (Busy), and interlocking directorates (Interlock). Dual is a dummy variable that takes on the value of 1 when the Chair and CEO are the same person and 0 otherwise. Bsize is the natural logarithm of the number of directors on the board. Busy is the ratio of the number of busy non-executive directors to the number of directors on the board, where busy directors are defined as those having three or more directorships (Fich & Shivdasani, 2007). Interlock is measured as the ratio of the number of interlocked executive directors to the number of directors on the board. An interlocking executive director is defined as an executive director who serves as a non-executive on another firm's board, with an executive director who serves as a non-executive director on the first firm's board (Hallock, 1997). We also include the variable, Fsize, the natural logarithm of the firm's market capitalization, to control for potential effects related to the size of the firm. Industry (Industry) and year (Year) dummies are included to control for industry-wide and macroeconomic effects that may affect the presence of grey directors on a firm's board.7

| Model 1 | | Model 2 | | | |
|--|--|---|---|--|--|
| Dependent Variable | | Dependent Variables | | | |
| | | Return on assets (ROA) | Net income plus interest expenses net of tax effects (<i>EBIAT</i>) divided by the previous period's book value of total assets | | |
| Presence of grey directors (<i>GREY</i>) | A dummy variable equal to 1 if there is at least one grey director on the board; 0 otherwise | Return on equity (ROE) | Net income plus interest expenses net of tax effects (<i>EBIAT</i>) divided by the previous period's book value of equity | | |
| | | Negative profit (<i>NEGPROF</i>) | A dummy variable equal to 1 if a firm's <i>EBIAT</i> is negative; 0 otherwise | | |
| Independent Variab | bles | Independent Variables | | | |
| Variable of Interest | | Variables of Interest | | | |
| Top ownership (<i>TopOwn</i>) | Percentage of outstanding common shares owned by the | Proportion of grey directors (<i>PGREY</i>) | Number of grey directors on the board divided by the total number of directors on the board | | |
| | largest shareholder | Top ownership (<i>TopOwn</i>) | Percentage of outstanding common shares owned by the largest shareholder | | |
| Control Variable | | Control Variables | | | |
| | | Firm size (Fsize) | Natural logarithm of the firm' market capitalization | | |
| Firm size (<i>Fsize</i>) | Natural logarithm of the firm's market capitalization | Growth opportunities (Fgrowth) | Market-to-book asset ratio, defined as the sum of the market value of common equity, book value of preferred shares, and book value of total debt less deferred tax liabilities, all divided by the book value of total assets | | |
| | | Firm leverage (Flev) | Long-term debt divided by the book value of total assets | | |
| | | Firm age (Fage) | Natural logarithm of the number of years since the firm's date of incorporation | | |

 Table 2. Variable Definition and Measurement

| Corporate Governance Variables | | Corporate Governance Variables | | | |
|--|--|--|--|--|--|
| CEO-Chairperson duality (<i>Dual</i>) | A dummy variable equal to 1 if the CEO is also the Chairperson of the Board; 0 otherwise | CEO-Chairperson duality (<i>Dual</i>) | A dummy variable equal to 1 if the CEO is also the Chairperson of the Board; 0 otherwise | | |
| Board size (Bsize) | Natural logarithm of the number of directors on the board | Board size (Bsize) | Natural logarithm of the number of directors on the board | | |
| Board busyness (Busy) | Number of non-executive directors with 3 or more directorships in their portfolio divided by the total number of directors on the board | Board busyness (<i>Busy</i>) | Number of non-executive directors with 3 or more directorships in their portfolio divided by the total number of directors on the board | | |
| Interlocking directorates (<i>Interlock</i>) | Number of interlocked executive directors divided by the total number of directors on the board, where an interlocked executive director is defined as an executive director who serves as a non-executive on another firm's board with an executive director who serves as a non-executive director on the first firm's board | Interlocking directorates (<i>Interlock</i>) | Number of interlocked executive directors divided by the total number of directors on the board, where an interlocked executive director is defined as an executive director who serves as a non-executive on another firm's board with an executive director who serves as a non-executive director on the first firm's board | | |
| | | Proportion of executive directors (<i>ED</i>) | Number of executive directors divided by the total number of directors on the board | | |
| | | Executive director ownership (EDown) | Percentage of outstanding common shares owned by all executive directors | | |
| | | Non-executive director ownership (<i>NEDown</i>) | Percentage of outstanding common shares owned by all non-executive directors | | |

Table 2 summarizes the variables used in Model (1), along with their corresponding measurements.

We estimate this binary response model using three alternative logit models to check for the robustness of our results: (a) a pooled logit regression model (LOGIT) with robust standard errors clustered by firms, (b) a random effects panel data logit model (RELM) with robust standard errors, and (c) a generalized estimating equations (GEE) panel data logit model. The GEE estimation technique, developed by Zeger and Liang (1986) and Liang and Zeger (1986), is a semiparametric technique that uses quasi-likelihood estimation rather than maximum-likelihood estimation. This method is akin to the feasible generalized linear models (Crespi-Cladera & Pascual-Fuster, 2014). In specifying the GEE model, we set the distribution of the dependent variable as binomial, the link function to the logistic function, and the correlation structure to an autoregressive structure to account for the persistence of the presence of non-strict independent directors in the board over time.⁸

Model 2: Firm Performance, Grey Directors, and Ownership Structure

To analyze the effect of grey directors and ownership structure on firm performance, we estimate Model (2).

$$Perf_{i,t} = \alpha_0 + \alpha_1 PGREY_{i,t-1} + \alpha_2 TopOwn_{i,t-1} + \alpha_2 TopOwn_{i,t-1} + \alpha_3 (TopOwn_{i,t-1} \times PGREY_{i,t-1}) (2) + \Phi C_{i,t-1} + \sum_{t=1}^{T-1} \delta_t Year_t + \sum_{z=1}^{Z-1} \vartheta_z Indus_{z,i,t} + \epsilon_{i,t}$$

where the elements of the vector $C_{i,t}$ are variables that control for firm characteristics and $\epsilon_{i,t}$ is the stochastic disturbance term.

These control variables include firm size (*Fsize*) as measured previously, firm growth opportunities (Fgrowth) as proxied by the market-to-book asset ratio, leverage (Flev) as the ratio of long-term debt to total assets, and firm age (Fage) as the natural logarithm of the number of years since the firm's date of incorporation.9 Moreover, we control for a firm's corporate governance structure through a set of variables including CEO duality (Dual), the proportion of executive directors on the board (ED), board size (Bsize), executive director ownership (EDown), non-executive director ownership (NEDown), board busyness (Busy), and interlocking directorates (Interlock). CEO duality, board size, board busyness, and interlocking directorates are as defined in Model (1). ED is the ratio of the number of executive directors to the number of total directors on the board. EDown is the percentage of outstanding common shares owned by executive directors, whereas NEDown is the percentage of outstanding common shares owned by non-executive directors (NEDs). Dual and ED are both measures of managerial power (Crespi-Cladera & Pascual-Fuster, 2014), whereas Bsize is a measure of board coordination problems (Yermack, 1996). EDown and NEDown both represent the ownership stake of the board. Busy controls for NEDs with commitment issues (Fich & Shivdasani, 2007), whereas Interlock represents the monitoring effort of NEDs (Hallock, 1997). We also include industry (Industry) and year (Year) dummies in the model to account for industryspecific effects and market-wide effects that vary over time. All independent variables are lagged by one period to mitigate endogeneity issues (Hermalin & Weisbach, 2003).¹⁰

Three alternative accounting-based measures for firm performance are employed: return on assets (ROA), return on equity (ROE), and negative profit (NEGPROF).¹¹ ROA is computed as net income plus interest expenses net of tax effects (EBIAT) divided by the book value of assets (BVA) of the preceding period. ROE is computed as EBIAT divided by the book value of equity (BVE) of the preceding period. *NEGPROF* is a dummy variable that takes the value of 1 if a firm's EBIAT is negative and 0 otherwise. Similar to Crespi-Cladera and Pascual-Fuster (2014), PGREY is the ratio of the number of grey directors to the total number of directors on the board. TopOwn is as defined in Model (1). We include an interaction term between ownership and the proportion of grey directors (*TopOwn* \times *PGREY*) to investigate whether there is a differential effect of grey directors on firm performance based on the firm's ownership structure. Table 2 summarizes the variables used in Model (2), along with their corresponding measurements.

We acknowledge that empirical research of corporate governance is problematic because of the endogeneity between corporate governance variables and firm performance measures, making inference difficult because resulting parameter estimates may be biased or inconsistent (Adams et al., 2010; Liu et al., 2015). Similar to the approach of Dittmann et al. (2010) and Joecks et al. (2013), we address the issue of endogeneity by using one-period lagged explanatory variables as regressors (with the exception of the firm and year dummies) to estimate the effects of our explanatory variables on future performance. In addition, Model (2) is estimated using two-way fixed effects and random effects regression models with Huber-White robust standard errors (robust standard errors clustered by firm).

Results and Discussion

Descriptive Statistics

In Table 3, we show that 51.35% of the declared independent directors can be classified as grey directorships and that 66.63% of our firm-year observations have at least one grey director. This compares to the findings of Crespi-Cladera and

| | 2015 | 2014 | 2013 | 2012 | Overall |
|---------------------------------------|--------|--------|--------|--------|---------|
| All Independent Directors | 608 | 569 | 546 | 534 | 2,257 |
| Grey Directors | 331 | 307 | 263 | 258 | 1,159 |
| Truly Independent Directors | 277 | 262 | 283 | 276 | 1,098 |
| % Independent positions that are Grey | 54.44% | 53.95% | 48.17% | 48.31% | 51.35% |
| Firms with Grey Directors | 168 | 161 | 143 | 145 | 617 |
| % Firms with Grey Directors | 68.02% | 69.10% | 63.84% | 65.32% | 66.63% |
| Number of Firms, top owner > 50% | 154 | 143 | 134 | 131 | 562 |
| Firms with Grey, top owner $> 50\%$ | 106 | 103 | 90 | 91 | 390 |
| % Firms with Grey, top owner $> 50\%$ | 68.83% | 72.03% | 67.16% | 69.47% | 69.40% |
| Number of Firms, top owner $< 50\%$ | 93 | 90 | 90 | 91 | 364 |
| Firms with Grey, top owner $< 50\%$ | 62 | 58 | 53 | 54 | 227 |
| % Firms with Grey, top owner $< 50\%$ | 66.67% | 64.44% | 58.89% | 59.34% | 62.36% |

Table 3. Data on Grey Directorships

Pascual-Fuster (2014) of 56.3% and 69.8% for Spanish firms. We also report the distribution of grey directors across firms based on the top shareholder owning a majority of outstanding shares. In cases where the top shareholder has more than 50% ownership, we find that 69.4% of these firms have a grey director on the board. This compares to 62.36% for the other firms in our sample, suggesting that firms with high ownership concentration may be more likely to appoint grey directors.

In Table 4, we report descriptive statistics for the other variables used in this study. The high degree of ownership concentration in the Philippines is demonstrated by our finding that the top shareholder averages 54.85% ownership. This is much higher than the 36.39% figure reported by Crespi-Cladera and Pascual-Fuster (2014). We also find that the typical board has nine directors, 13.13% of which are grey directors. This is lower than the 18.31% figure found by Crespi-Cladera and Pascual-Fuster (2014). On average, 31.03% of board members in our sample are executive directors, all of whom own 8.96% of the firm's outstanding common shares. This is higher than the average ownership of 2.66% for non-executive directors. Furthermore, 39.3% of firms have CEOs who also serve as the Chair of the board, 53.41% of the board, on average, are non-executive directors with three or more directorships in their portfolio, whereas 2.62% of the board are executive directors with interlocking board positions.

Performance-wise, our sample firms have an average ROA of 4.44% and an average ROE of 10.72%; 23.87% of them have negative profitability. The typical firm has a market capitalization of 43 billion Php, a market-to-book asset ratio of 7.66, a leverage ratio of 9.58, and has been operating for 41 years since its date of incorporation.

Model 1 Results and Discussion

In Table 5, we report the results of estimating Model (1) where the dependent variable is the presence of grey directors on the board. Contrary to the findings of Crespi-Cladera and Pascual-Fuster (2014), our GEE and RELM estimation results show a positive relationship between ownership concentration and the likelihood of the presence of a grey director. This finding supports the presence of agency problems where firms with high ownership concentration appoint grey directors to fulfill regulatory requirements of board independence while simultaneously reaching the desired level of "friendliness" in the board that will allow management to gain greater control over the firm. Similarly, Bartholomeusz and Tanewski (2006) found that Australian publicly listed family firms are likely to have more grey directors than non-family firms, consistent with the theory that controlling family shareholders will want to appoint friendly directors who have existing loyalties to them, potentially creating agency costs. To establish whether these grey director appointments truly result in poorer firm

Table 4. Summary Statistics

| | Mean | Std. Dev. | Minimum | Maximum |
|--|----------|-----------|------------|-----------|
| Firm Performance | | | | |
| Return on assets (ROA) | 4.4400% | 16.6725% | -68.4785% | 91.9308% |
| Return on equity (ROE) | 10.7206% | 29.6419% | -108.3176% | 155.9719% |
| Negative profit (<i>NEGPROF</i>) | 23.8661% | 42.6495% | | |
| Board Independence | | | | |
| Presence of grey directors (<i>GREY</i>) | 66.6307% | 47.1786% | | |
| Proportion of grey directors (<i>PGREY</i>) | 13.1290% | 12.2228% | 0% | 72.7273% |
| Ownership Structure | | | | |
| Top ownership (TopOwn) | 54.8475% | 22.3059% | 0.2823% | 99.9359% |
| Firm Characteristics | | | | |
| Market capitalization (in Php millions) | 43,216 | 97,246 | 11 | 693,840 |
| Market-to-book asset ratio (Fgrowth) | 7.6554 | 40.4615 | 0.3716 | 350.0882 |
| Firm leverage (Flev) | 9.5775 | 14.8283 | 0 | 117.6723 |
| Firm age (in years) | 41.3326 | 24.6005 | 1.0376 | 112.3867 |
| Corporate Governance Struct | ure | | | |
| CEO-Chairperson duality (<i>Dual</i>) | 39.3089% | 48.8700% | | |
| Number of directors on the board | 9.4752 | 2.2591 | 5 | 15 |
| Proportion of busy directors (<i>Busy</i>) | 53.4090% | 21.8206% | 0 | 93.7500% |
| Proportion of interlocked executive directors (<i>Interlock</i>) | 2.6235% | 6.1277% | 0 | 44.4444% |
| Proportion of executive directors (<i>ED</i>) | 31.0252% | 16.3134% | 6.6667% | 81.8182% |
| Executive directors' ownership (EDown) | 8.9573% | 18.5169% | 0 | 91.2183% |
| Non-executive directors' ownership (<i>NEDown</i>) | 2.6618% | 7.9788% | 0 | 75.1915% |

| Variable | GEE Panel Data Logit Model | Random Effects Panel Data Logit Model | Pooled Logit Model | |
|---------------------|-------------------------------|--|-------------------------------|--|
| TopOwn | 0.0020 * (0.0010) | 0.0019 ** (0.0009) | 0.0016 (0.0011) | |
| Fsize | -0.0151 (0.0122) | -0.0203 ** (0.0092) | -0.0116 (0.0116) | |
| Dual | -0.0439 (0.0367) | -0.0176 (0.0370) | -0.0143 (0.0460) | |
| Bsize | 0.2752 *** (0.0998) | 0.3025 *** (0.0855) | 0.2125 ** (0.1061) | |
| Busy | 0.0043 *** (0.0010) | 0.0040 *** (0.0010) | 0.0056 *** (0.0011) | |
| Interlock | -0.0036 (0.0027) | -0.0028 (0.0028) | -0.0036 (0.0036) | |
| LR Test | | 294.12 *** | | |
| Chi2 Statistic | 38.73 *** | 31.68 *** | 37.94 *** | |
| Industry | Yes | Yes | Yes | |
| Year | Yes | Yes | Yes | |
| No. of Observations | 901 | 926 | 926 | |

 Table 5: Results for Model 1 (Presence of Grey Directors)

The dependent variable is the presence of grey directors (GREY), a dummy variable that takes the value of 1 if at least one grey director is on the board and 0 otherwise. The control variables are TopOwn as measured by the percentage of outstanding common shares owned by the largest shareholder; Fsize is the natural logarithm of the firm's market capitalization; Dual is a dummy variable that takes the value of 1 if the CEO is also the Chair of the board and 0 otherwise; Bsize is the natural logarithm of the number of directors on the board; Busy is the ratio of the number of busy non-executive directors to board size; and Interlock is the ratio of the number of interlocked executive directors to the number of directors on the board. The LR Test shows the results of the likelihood ratio test (i.e., random effects logistic model is more appropriate than the logit model). The Chi2 is a Wald test of the statistical significance of all independent variables used in the model. The coefficient estimates for all these regressions are the average marginal effects, and robust standard errors are shown in parentheses. *** denotes significance at the 1% level; ** denotes significance at the 5% level; and * denotes significance at the 10% level.

The GEE regression uses only 901 observations instead of the full 926 observations because this model requires at least two consecutive years in the sample. We exclude 6 firm-years for having non-consecutive observations and 19 firm-years due to having only one observation.

performance or whether they enable an optimal level of information sharing, we investigate how the presence of grey directors affects firm performance and discuss these results in the next section.

We also find evidence that larger and busier boards are more likely to have grey directors, consistent with Crespi-Cladera and Pascual-Fuster (2014)'s findings. This supports the idea that board monitoring problems exist due to lack of commitment or where responsibilities are unclear among board members (Yermack, 1996). Finally, we find some evidence that larger firms are less likely to appoint grey directors, possibly because of reputation costs that the firm may incur (Fich, 2005).

Model 2 Results and Discussion

In Table 6, we report the results of Model (2), estimating the effect grey directors have on three alternative measures of firm performance. When using *ROA* and *ROE* as the measures of firm performance, we find that the proportion of grey directors does not

| | R | OA | ROE | | NEGPROF | |
|------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------------|--------------------------------|
| PGREY | -0.1006 (0.0953) | -0.3341 (0.2741) | -0.0706 (0.1785) | -0.5410 (0.4466) | -0.0036 ** (0.0017) | 0.0004 (0.0038) |
| TopOwn | 0.1562 (0.1500) | 0.1240 (0.1634) | 0.4321 (0.2943) | 0.3672 (0.3204) | -0.0001 (0.0009) | 0.0007 (0.0011) |
| PGREY x TopOwn | | 0.0043 (0.0045) | | 0.0086 (0.0070) | | -0.0001 (0.0001) |
| Fsize | -2.5866 (1.7041) | -2.5921 (1.6980) | -3.2390 (3.2608) | -3.2501 (3.2410) | -0.0642 *** (0.0119) | -0.0640 *** (0.0119) |
| Fgrowth | 0.1453 * (0.0784) | 0.1451 * (0.0779) | 0.0733 * (0.0390) | 0.0728 * (0.0371) | -0.00004 (0.0004) | -0.00004 (0.0004) |
| Flev | 0.2514 * (0.1373) | 0.2408 * (0.1425) | 0.1217 (0.2221) | 0.1002 (0.2213) | -0.0012 (0.0014) | -0.0012 (0.0014) |
| Fage | 3.1975 (9.7646) | 1.4779 (9.5929) | -15.7159 (20.8185) | -19.1808 (21.2180) | -0.0007 (0.0297) | 0.0013 (0.0297) |
| Dual | -2.8625 (4.1806) | -2.5992 (4.1980) | -7.9195 (6.1400) | -7.3890 (6.2115) | 0.0442 (0.0345) | 0.0430 (0.0345) |
| ED | 0.1629 (0.1031) | 0.1604 (0.1023) | 0.1333 (0.2015) | 0.1283 (0.2010) | -0.0035 ** (0.0015) | -0.0034 ** (0.0014) |
| Bsize | -11.5757 (16.4001) | -11.6469 (16.5305) | -25.7593 (21.4472) | -25.9028 (21.7119) | -0.0876 (0.0879) | -0.0929 (0.0891) |
| EDown | 0.2403 (0.1802) | 0.2411 (0.1766) | 0.2349 (0.2526) | 0.2365 (0.2461) | 0.0009 (0.0010) | 0.0009 (0.0010) |
| NEDown | 0.3307 (0.2190) | 0.3349 (0.2211) | 0.5823 * (0.3092) | 0.5908 * (0.3086) | -0.0006 (0.0025) | -0.0007 (0.0025) |
| Busy | 0.1813 (0.1201) | 0.1859 (0.1194) | 0.1685 (0.2143) | 0.1777 (0.2132) | -0.0014 (0.0011) | -0.0014 (0.0011) |
| Interlock | -0.1757 (0.1374) | -0.1710 (0.1385) | -0.0816 (0.3313) | -0.0720 (0.3323) | -0.0019 (0.0030) | -0.0019 (0.0030) |
| Wald's Test | 2.78 *** | 2.78 *** | 2.10 *** | 2.10 *** | 0.76 | 0.81 |
| BPLM Test | 34.70 *** | 34.78 *** | 43.80 *** | 43.79 *** | | |
| LR Test | | | | | 87.70 *** | 87.18 *** |
| Hausman Test | 152.22 *** | 151.69 *** | 35.31 *** | 36.52 *** | | |
| F-statistic or Chi2 | 1.30 | 1.26 | 1.58 * | 1.83 ** | 63.70 *** | 66.56 *** |
| Appropriate Model | Fixed Effects | Fixed Effects | Fixed Effects | Fixed Effects | Random Effects | Random Effects |
| Industry | No | No | No | No | Yes | Yes |
| Years | Yes | Yes | Yes | Yes | Yes | Yes |
| No. of Observations | 669 | 669 | 669 | 669 | 669 | 669 |

 Table 6. Results for Model 2 (Firm Performance and Grey Directors)

The dependent variable is firm performance, measured by ROA, ROE, or NEGPROF. ROA is computed as net income plus interest expenses net of tax effects (EBIAT) divided by the book value of assets of the previous period; ROE is EBIAT divided by the book value of equity of the previous period; NEGPROF is a dummy variable equal to 1 if the firm's EBIAT is negative and 0 otherwise. PGREY is the ratio of the number of grey directors to the total number of directors on the board; TopOwn is the percentage of outstanding common shares owned by the largest shareholder; Fsize is the natural logarithm of the firm's market capitalization; Fgrowth is the market-to-book asset ratio; Flev is the ratio of long-term debt to total assets; Fage is the natural logarithm of the number of years since the firm's date of incorporation; Dual is a dummy variable equal to 1 if the CED is also the Chair of the board and 0 otherwise; ED is the proportion of executive directors; NEDown is the percentage of outstanding common shares owned by executive directors; NEDown is the percentage of outstanding common shares owned by executive directors; NEDown is the percentage of outstanding common shares owned by executive directors; NEDown is the percentage of outstanding common shares owned by executive directors; NEDown is the percentage of interlocked executive directors to the number of directors on the board; and Interlock is the ratio of the number of interlocked executive directors to the number of directors on the board. The test statistics of the various specification tests are also reported. BPLM test is the Breusch-Pagan Lagrange Multiplier test used to test for mandom effects; Wald's test is used to examine whether there are fixed effects; the Hausman specification test is used to determine whether the random effects logistic model is appropriate for regression. The results of these tests indicate that the fixed effects from biased and inconsistent estimates; and the LR Test is analogous to the BPLM test but for logistic regressions. The

significantly affect firm performance, although there is some evidence that having more grey directors corresponds to a lower likelihood of negative profitability (NEGPROF). These findings support the optimal board independence theory, which posits that firms appoint grey directors merely to act as window dressing and satisfy the regulatory recommended levels of board independence; in some cases, such appointments may even help the firm reach its optimal levels of board independence. Grey directors may even allow an optimal level of information sharing between managers and the board because the CEO is not as reluctant to share firm-specific information with them as with strictly independent directors (Cavaco et al., 2017), thereby facilitating efficient decision-making and reducing the likelihood of accounting losses. Moreover, similar to the findings of Crespi-Cladera and Pascual-Fuster (2014), our results indicate that the appointment of grey directors does not exacerbate agency problems. It seems as if grey directors do not impair performance, at least among Philippine publicly listed firms, contrary to Borokhovich et al.'s (2014) suggestion that grey directors tend to behave like inside directors by abstaining from sharing valuable dissenting opinions when necessary, thus reducing firm value.

We also find that highly valued and fast-growing firms enjoy better performance, and that larger firms are less likely to have negative profits. These findings are consistent with the idea that larger and high-growth firms are better able to cope with corruption issues and an ineffectual regulatory environment inherent in the emerging Philippine economy, perhaps because of their broader pool of resources and their ability to exploit scale economies and easily access credit (Mansfield, 1962). There is also some evidence, albeit weakly significant, that highly leveraged firms can enhance their performance, possibly because banks and other creditors monitor the discretionary actions of management and prevent inefficient activities. For our corporate governance variables, we find evidence consistent with Vu et al. (2018) that greater nonexecutive director ownership corresponds to better firm performance as proxied by ROE, suggesting that as their stakes in the firm increase, non-executive directors will have stronger incentives to exercise more effective oversight and steer managers towards more judicious and value-maximizing tasks (Jensen & Meckling, 1976). Having more executive directors

on the board also leads to a lower likelihood of negative firm profitability, consistent with Jensen's (1993) theory that executive directors possess the expertise needed to efficiently participate in planning the financial aspects that affect corporate performance.

Robustness Tests

Alternative Measures of Firm Leverage

Other than using three alternative measures of firm performance, we also re-estimate Model (2) using two alternative proxies for firm leverage: the ratio of total debt to total assets (*Flevalt1*) and, following Schultz et al. (2013), the ratio of total debt to the sum of market value of common equity and total debt (*Flevalt2*). The tabulated regression results are available upon request.

Overall, the results of the firm performance regressions are robust to these alternative specifications. Regardless of the leverage measure used, having more grey directors still does not significantly affect *ROA* and *ROE*, although there is still some evidence of a negative and significant relationship between the proportion of grey directors and *NEGPROF*. There are, however, a few changes to the results of our control and corporate governance variables:

- 1. Using either *Flevalt1* or *Flevalt2* as the leverage proxies, we find that firm leverage does not significantly affect *ROA* anymore.
- 2. Using *Flevalt2* as the leverage measure, we find more consistent evidence that *NEDown* positively and significantly impacts firm performance, that is, the positive coefficients of *NEDown* became statistically significant in the *ROA* regressions and became even more statistically significant in the *ROE* regressions, supporting our earlier results.
- 3. Using *Flevalt2* as the proxy for leverage, we now find statistically significant evidence that greater firm leverage corresponds to lower *NEGPROF*, consistent with the aforementioned theory that banks and external creditors will tend to monitor the behavior of management to avoid value-degrading activities, thus preventing losses from occurring. Results for all other variables are the same as before.

System Generalized Method of Moments (GMM) Estimation Technique

Wintoki et al. (2012) noted that endogeneity issues often plague the relationship between corporate governance variables and firm performance, making the relationship biased and inconsistent. Hermalin and Weisbach (2003) further mentioned that board characteristics are not exogenous variables because boards are endogenously chosen by firms to suit their operating environment. In line with this, three endogeneity issues need to be addressed when analyzing the effects of board characteristics on corporate performance. First, firm-specific characteristics or unobserved heterogeneity may influence both board characteristics and firm performance and bias our results in the opposite direction, making it necessary to employ panel data fixed-effects or random-effects methods to account for such omitted and unobserved factors. Second, reverse causality or simultaneity implies that corporate performance affects contemporaneous board appointments, as much as board appointments affect contemporaneous corporate performance. Instrumental variable techniques are commonly used to address simultaneity issues, although identifying both a strong and valid instrument to proxy for any endogenous board variable is usually challenging (Bhagat & Bolton, 2013).¹² Finally, simultaneity issues may be dynamic in nature (Wintoki et al., 2012), that is, past realizations of firm performance may affect current board appointments. Consequently, the Arellano-Bover/Blundell-Bond system generalized method of moments (GMM) estimation technique is commonly used to address all three endogeneity concerns. Its method of first-differencing eliminates any potential unobserved firm-specific effects on firm performance, while its use of lagged instruments allows it to correct for simultaneity.¹³ In addition, it controls for dynamic endogeneity through the incorporation of lagged values of the dependent variable as additional independent variables while avoiding Nickell's (1981) dynamic panel bias.¹⁴ To test for the validity of the instrument set used in system GMM, results of the Arellano-Bond first- and second-order autocorrelation test and the Hansen test for overidentifying restrictions are commonly reported. Failure to reject the null hypotheses of the second-order autocorrelation test and the Hansen test implies that the moment conditions and instruments used are valid (Roodman, 2009).

In our case, the very short time period of our panel dataset makes it infeasible to accurately verify whether the moment conditions used are valid, that is, the maximum number of observations per firm (group) in our dataset is three and the average number of observations is 2.83. The second-order lagged differences of three observations do not exist and, thus, the Arellano-Bond second-order test statistics cannot be computed. Despite this uncertainty, we reestimated Model (2) using the system GMM estimation technique, treating all regressors as endogenous variables except for Fage and the industry and year dummies. We also augment Model (2) by including one lag of the dependent variable as an additional independent variable. In addition, we use the two-step GMM estimator, which is superior to the one-step GMM estimator, and report standard errors that are robust to both heteroskedasticity and within-firm serial correlation. The tabulated regression results are available upon request.

Overall, we find that the effect of having more grey directors on ROA and ROE remains insignificant, regardless of whether the effect is moderated by ownership structure (TopOwn). Unlike our earlier results, however, we now find no significant evidence of a relationship between PGREY and NEGPROF, although the coefficient of PGREY remains negative. These findings are still consistent with the optimal board independence theory, suggesting that Philippine firms tend to appoint grey directors merely to satisfy regulatory requirements of independence while maintaining their current optimal levels of independence. We also find that: (a) Flev does not significantly affect ROA anymore, although the coefficient remains positive; (b) contrary to our earlier results, the coefficient of Fgrowth is now negative and statistically significant in the ROA regressions, implying that because growth opportunities are related to management's discretionary investments (i.e. capacity expansion projects, new product lines), there is greater opportunity for management to exhibit opportunistic behavior by under-investing in positive net-present-value projects or by over-investing and empire-building when they make acquisitions (Hutchinson & Gul, 2004), reducing firm performance; (c) both *Fgrowth* and *NEDown* do not significantly affect ROE anymore; (d) the coefficients of Fsize and ED remain negative and statistically significant in the NEGPROF regressions, indicating that larger firms and those with more executive directors on the board are less likely to suffer from negative profits, consistent with our earlier results; and (e) there is some evidence that the coefficients of the one-period lags of *ROE* and *NEGPROF* are positive, albeit weakly significant, indicating only weak evidence that past performance positively affects contemporaneous performance.¹⁵ Results for all other variables are qualitatively similar.

Conclusion and Recommendations

Board independence is considered an important element of good corporate governance and provides benefits to both shareholders and the firm. Independent directors can protect minority shareholders from wealth expropriation by either management or large shareholders while providing industry expertise and a valuable alternative vision. Although we find that 51.35% of independent director positions are actually occupied by grey directors, and that the presence of grey directors is more likely for firms with higher ownership concentration, we do not find evidence that having grey directors adversely affects firm performance. That is, a greyer board does not seem to significantly affect firm performance at all; at best, having more grey directors may even correspond to a lower likelihood of negative firm profitability. As a whole, it appears that Philippine publicly listed firms do not appoint grey directors to mask agency problems but to satisfy regulatory board independence requirements. These results lead us to conclude that firms with higher ownership concentration are not motivated to appoint grey directors for self-serving reasons that eventually impair firm value, but instead, to provide top management with a degree of flexibility to govern the firm effectively while sharing proprietary information. We view this evidence as supporting the optimal board independence theory for firms with higher ownership concentration.

Although our results suggest that the proportion of grey directors does not negatively affect firm performance, the presence of grey directors may still expose minority shareholders to the risk of wealth expropriation. Because more than half of the declared independent directors among Philippine publicly traded firms are grey directors, the effectiveness of board independence as a corporate governance mechanism is diluted. Although the 2017 Philippine Code of Corporate Governance for Publicly Listed Firms requires firms to have policies protecting minority shareholder rights and privileges, the Code leaves the formulation of such policies to the firm.¹⁶ It is, therefore, worthwhile to analyze whether the declared level of board independence, among other corporate governance mechanisms, reduces tunneling behavior and minimizes the expropriation of minority shareholders' interests. Two immediate questions are: Will truly independent directors be necessary to mitigate expropriation activities? Will having more grey directors hamper any such effectiveness of truly independent directors?

NOTES

¹ See, for instance, the price manipulation scandal and the subsequent collapse of BW Resources in 1999. Hyped as a listing vehicle for former Philippine president Joseph Estrada's business interests, the price of shares of BW rose from Php 2.00 at the start of 1999 to Php 107.00 on October of the same year. By February 2000, the stock has dropped to Php 3.00 a share. It was, as political and financial pundits exclaimed, not just any ordinary bubble, but also a grand scheme of market manipulation and political corruption. Other noteworthy corporate governance failures include the Calata Corporation case in 2017 and the 2Go group's accounting scandal in 2017, the former of which involved stock price manipulation and insufficient disclosure, and the latter of which involved earnings management.

² A detailed discussion on the evolution of board independence requirements in the Philippine Code of Corporate Governance is presented in Appendix A.

³ However, it must be emphasized that their sample includes only firms from Canada, the U.S., and the U.K, all of which already have developed financial markets and stringent regulatory standards.

⁴ Companies not covered by the Code were only encouraged to appoint independent board members.

⁵ The optimal board independence theory was first conceptualized by Crespi-Cladera and Pascual-Fuster (2014) based on several theoretical and empirical studies that find inconsistent evidence of firm performance improving as a result of greater board independence. Independent directors may be effective at mitigating the agency problem and improving value in some situations, but they may also erode value in other instances.

⁶ This measure of ownership concentration captures the proportion of shares that have relational interest. For firms that are affiliated with a family or family corporate group, we use the total ownership of the family members or the total interest of the entities affiliated with the family.

⁷ Firms are classified according to the PSE sectoral classification system. The Mining and Oil sector is used as the base industry and 2012 as the base year.

⁸ We also use the quasi-likelihood under the independence model criterion developed by Pan (2001) as a guide to determine the most informative within-group correlation structure. Ballinger (2004) wrote a brief and insightful paper on the uses, weaknesses, and application of using GEE for longitudinal data.

⁹ The market-to-book asset ratio is the sum of the market value of common equity, book value of preferred shares, and book value of total debt less deferred tax liabilities divided by the book value of total assets. Adam and Goyal (2008) discussed and evaluated the performance of alternative proxies for a firm's investment opportunities and found that the market-to-book asset ratio contains the highest information content with respect to investment opportunities. We winsorize Fgrowth at the 1st and 99th percentiles to mitigate the effect of outliers.

¹⁰ We do not include any lagged dependent variable as an additional independent variable because (a) adding such variable introduces joint endogeneity problems between it and other independent variables, and (b) Nickell (1981) had shown that including a dynamic element to within-group estimators produces estimates that are biased and inconsistent. As a result of excluding such lagged dependent variable, we can use the fixed effects estimator to estimate Model (2).

¹¹ We winsorize ROA and ROE at the 1st and 99th percentiles to mitigate the effect of outliers.

¹² Almost any instrumental variable identified to be appropriate for a particular board-related variable will, in one way or the other, be related in theory or empirical evidence to at least another, possibly more, endogenous board or performance variable (Bhagat & Bolton, 2013).

¹³ The system GMM technique uses lagged firstdifferences as instruments for the equation in levels, in addition to the usual lagged levels used as instruments for the equations in first-differences proposed by Arellano and Bover (1995). This increase in the number of instruments allows for more informative moment conditions, which addresses the "weak instrument problem" caused by using only lagged levels as the instruments for endogenous firstdifferenced variables that are persistent in nature (Blundell & Bond, 1998).

¹⁴ For example, it may not be contemporaneous board appointments that are affecting firm performance, but rather the previous year's performance that could be playing a significant role. Lagged values of the dependent variable are, therefore, used as additional independent variables to control for this endogenous relationship.

¹⁵ Only three out of the six system GMM regressions of Model (2) yielded significant coefficients for the lag of the dependent variable: all three coefficients are positive and only weakly significant. The statistical significance of these coefficients disappears when we remove the industry variables and some of the board-related variables, indicating that the results are not robust to a variety of specifications. We take this to mean that there is no strong evidence of persistence in our performance variables during our fouryear sample period, supporting our earlier estimation technique of Model (2), which was to exclude the lag of the dependent variable to avoid the Nickell (1981) bias and use the fixed and random effects estimators.

¹⁶ The Corporation Code of the Philippines mandates that shareholders may cumulate their votes to increase the chances of their desired director being appointed, and that directors who fulfill the right to representation of shareholders may not be removed without cause (see Sections 23 and 27 of the Revised Corporation Code of the Philippines). Minority shareholders who band together to cumulate their shares increase their chances of board representation; however, the effectiveness of this practice still depends on the degree of ownership concentration of the majority owners. On August 2020, the SEC raised the minimum required public float of listed companies from 10% to 20%-33% for new entrants into the stock market (Dumlao-Abadilla, 2020). This improves the chances that minority shareholders who cooperate will have legitimate representation in board matters.

¹⁷ Unlike the 2002 and 2009 Codes of Corporate Governance, the 2017 Code of Corporate Governance adopts a "comply or explain" approach. Companies covered by the Code may opt not to comply with the recommendations set forth in the Code, but in so doing, they have to identify the areas of non-compliance and explain the reasons for such non-compliance in their Annual Corporate Governance Reports.

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Appendices

Appendix A: Evolution of Corporate Governance Codes in the Philippines

The Code of Corporate Governance in the Philippines was introduced by the SEC through SEC Memorandum Circular No. 2 Series of 2002 on April 5, 2002 (Securities and Exchange Commission, 2002a). A follow-up memorandum to this Code, SEC Memorandum Circular No. 16 Series of 2002, requires publicly-listed companies to have at least two independent directors or such a number of independent directors that will constitute 20% of the board size, whichever is less (Securities and Exchange Commission, 2002b). It also defines an independent director as meeting the following seven conditions.

2002 Code of Corporate Governance:

- 1. Is not a director or officer or substantial stockholder of the corporation or of its related companies or any of its substantial shareholders (other than as an independent director of any of the foregoing) (p. 2);
- 2. Is not a relative of any director, officer or substantial shareholder of the corporation, any of its related companies or any of its substantial shareholders. For this purpose, relatives include spouse, parent, child, brother, sister, and the spouse of such child, brother or sister (p. 2);
- 3. Is not acting as a nominee or representative of a substantial shareholder of the corporation, any of its related companies or any of its substantial shareholders (p. 2);
- 4. Has not been employed in any executive capacity by that public company, any of its related companies or by any of its substantial shareholders within the last five (5) years (p. 2);
- 5. Is not retained as a professional adviser by that public company, any of its related companies or any of its substantial shareholders within the last five (5) years, either personally or through his firm (p. 2);
- 6. Has not engaged and does not engage in any transaction with the corporation or with any of its related companies or with any of its substantial shareholders, whether by himself or with other persons or through a firm of which he is a partner or a company of which he is a director or substantial shareholder, other than transactions which are conducted at arm's length and are immaterial or insignificant (p. 2); and
- 7. Must not have beneficial security ownership exceeding 10% of the outstanding capital stock of the company where he is a director (p. 3).

The Code was revised in 2009 through SEC Memorandum Circular No. 6 Series of 2009 on June 22, 2009 (Securities and Exchange Commission, 2009a). To emphasize the need for independent directors, the 2009 Code now stipulates that publicly listed companies must still have at least two independent directors or such number of independent directors that will constitute 20% of the board size, whichever is less, "but in no case less than two." Furthermore, the 2009 Code now stipulates that an independent director can only own up to 2% of the subscribed capital stock of the company, or its subsidiaries and affiliates, where he is a director (p. 6). In a subsequent memorandum, SEC Memorandum Circular No. 9 Series of 2009, the SEC included two additional criteria that independent directors must satisfy (Securities and Exchange Commission, 2009b).

2009 Revised Code of Corporate Governance:

- 1. A regular director who resigns or whose term ends on the day of the election shall only qualify for nomination and election as an Independent Director after a two (2) year "cooling-off period" (p. 1); and
- 2. Persons appointed as Chairman "Emeritus", "Ex-Officio" Directors/Officers or Members of any Executive Advisory Board, or otherwise appointed in a capacity to assist the Board in the performance of its duties and responsibilities shall be subject to a one (1) year "cooling-off period" prior to his qualification as an Independent Director (p. 1).

In 2011, the SEC introduced term limits for independent directors through SEC Memorandum Circular No. 9 Series of 2011 on December 5, 2011 (Securities and Exchange Commission, 2011).

2011 Amendments to the 2009 Revised Corporate Governance Code:

- 1. There shall be no limit in the number of covered companies that a person may be elected as Independent Director (ID), except in business conglomerates where an ID can be elected to only five (5) companies of the conglomerate, i.e., parent company, subsidiary or affiliate (p. 1);
- IDs can serve as such for five (5) consecutive years, provided that service for a period of at least six (6) months shall be equivalent to one (1) year, regardless of the manner by which the ID position was relinquished or terminated (p. 1);
- 3. After completion of the five-year service period, an ID shall be ineligible for election as such in the same company unless the ID has undergone a "cooling off" period of two (2) years, provided, that during such period, the ID concerned has not engaged in any activity that under existing rules disqualifies a person from being elected as ID in the same company (p. 1);
- 4. An ID re-elected as such in the same company after the "cooling off" period can serve for another five (5) consecutive years under the conditions mentioned in paragraph 2 above (p. 1); and
- 5. After service as ID for ten (10) years, the ID shall be perpetually barred from being elected as such in the same company, without prejudice to being elected as ID in other companies outside of the business conglomerate, where applicable, under the same conditions provided for in this Circular (p. 1).

The Code of Corporate Governance for Publicly Listed Companies was introduced by the SEC on November 22, 2016 (Securities and Exchange Commission, 2016). This Code now recommends that the Board should have at least three independent directors, or such a number of independent directors that will constitute at least one-third of the board size, whichever is higher.¹⁷ The 2017 Code also consolidates the criteria for independent directors from the 2009 Revised Code of Corporate Governance and introduces new criteria for independence.

2017 Code of Corporate Governance for Publicly Listed Companies

- 1. Is not, or has not been a senior officer or employee of the covered company unless there has been a change in the controlling ownership of the company (p. 24);
- 2. Is not, and has not been in the three years immediately preceding the election, a director of the covered company; a director, officer, employee of the covered company's subsidiaries, associates, affiliates or related company's subsidiaries, associates, affiliates or related companies; or a director, officer, employee of the covered companies; or a director, officer, employee of the covered companies (p. 24);
- 3. Has not been appointed in the covered company, its subsidiaries, associates, affiliates or related companies as Chairman "Emeritus," "Ex-Officio" Directors/Officers or Members of any Advisory Board, or otherwise appointed in a capacity to assist the Board in the performance of its duties and responsibilities within three years immediately preceding his election (p. 24);
- 4. Is not an owner of more than two percent of the outstanding shares of the covered company, its subsidiaries, associates, affiliates or related companies (p. 24);
- 5. Is not a relative of a director, officer, or substantial shareholder of the covered company or any of its related companies or of any of its substantial shareholders. For this purpose, relatives include spouse, parent, child, brother, sister, and the spouse of such child, brother or sister (p. 24);
- 6. Is not acting as a nominee or representative of any director of the covered company or any of its related companies (p. 24);
- 7. Is not a securities broker-dealer of listed companies and registered issuers of securities. "Securities brokerdealer" refers to any person holding any office of trust and responsibility in a broker-dealer firm, which includes among others, a director, officer, principal stockholder, nominee of the firm to the Exchange, an

associated person or salesman, and an authorized clerk of the broker or dealer (p. 24);

- 8. Is not retained, either in his personal capacity or through a firm, as a professional adviser, auditor, consultant, agent or counsel of the covered company, any of its related companies or substantial shareholder, or is otherwise independent of Management and free from any business or other relationship within the three years immediately preceding the date of his election (p. 24);
- 9. Does not engage or has not engaged, whether by himself or with other persons or through a firm of which he is a partner, director or substantial shareholder, in any transaction with the covered company or any of its related companies or substantial shareholders, other than such transactions that are conducted at arm's length and could not materially interfere with or influence the exercise of his independent judgement (p. 24);
- 10. Is not affiliated with any non-profit organization that receives significant funding from the covered company or any of its related companies or substantial shareholders (p. 25); and
- 11. Is not employed as an executive officer of another company where any of the covered company's executives serve as directors (p. 25).
- 12. Others: Cumulative service of up to 9 years and can never be classified as an independent director thereafter (p. 25).