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Impact of Investor Protection on Firm Performance

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Abstract - The purpose of this paper is to measure the impact of investor protection on firm performance. The dataset consists of 49 companies over the period of 2001 to 2012, using a panel regression model. We use both accounting (ROA) and market based (Tobin's Q) measures of firm performance. ROA and TQ are dependent variables and investor protection is independent variable. This study found that investor protection positively associated with TQ. It indicates that better investor protection improve firm value. Investor protection is negatively associated with ROA.

Keywords:* *Corporate Governance, Investor Protection, Tobin's Q, Firm Performance

I. INTRODUCTION

The various shareholders who contribute their funds into an organization are the actual owners of the organization. Investors mainly consider two variables before taking investment decisions- the rate of return on invested funds and the risk related with the investment. Investor protection is the most important element of the securities market. Investor protection helps to enhance the mobilization of funds for market development.

Strong investor protection is the essential feature of good corporate governance. According to [20], 'Corporate governance is a set of mechanisms by which outsiders protect themselves against expropriation as a result of the insiders'. Expropriation is possible as a result of agency problems that are inherent in the formation and structure of corporation. A firm's investors or shareholders are many and scattered on various places and so it is not possible for them to manage the corporation. So the investors trust on the firm's management includes board of directors, senior executives such as CEO and CFO. In many instances, the objectives of managers are relatively different from those of the shareholders. Such mismatch of objectives results in agency problems. Investors do realize and accept a certain level of self-centered behaviors in managers. But when such self- indulgence by managers exceeds reasonable limits then principles of corporate governance come in to check such abuses and malpractices. Both managers and controlling shareholders can expropriate the investors in a variety of ways like insiders simply steal the earnings and under qualified family members are appointed to senior management positions with excessive pay and perks. In all these instances, it is clear that the insiders use the profits of the firm to benefits themselves instead of returning the money to outside investors to whom it legitimately belongs.

Minority investors are the backbone of the Indian capital market. Due to lack of proper investor protection, the capital market in the country has experienced a stream of market irregularities and scandals in the 1990s. The SEBI has developed and refined institutional mechanism and computer technology with the primary objective of investors protection only after the Ketan Parikh scam (2001) and UTI crisis (1998 and 2001).Yet there are still continuing concerns regarding the speed and effectiveness with which fake activities are detected and punished, which after all, should be major focus of the capital market reforms in the country.

SEBI has broad power to regulate the securities market and protect the interest of investors. SEBI as a statutory body has issued a number of circulars and guidelines on disclosure and investor protection after it was come into existence in 1992. SEBI has been amending the guidelines from time to time to meet and deal with the contraventions of the act and distortions and malpractice in the market to protect the interest of shareholders and investors. SEBI has been emphasizing on the importance of disclosure standards for corporate in disseminating important and correct information to the investors. These guidelines have been revised and consolidated in early 2000 as a compendium on SEBI (Disclosure and Investor Protection) Guidelines, 2000. Currently issue of securities is regulated by SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

In December 1991, the SEBI issued a consultative paper containing draft Insider Trading Regulations in which it recommended strict measures to control the practice of insider trading and deterrent punishment to those who would indulge in it. The SEBI had framed the Insider Trading Regulations with the approval of the central government under the Securities and Exchange Board of India Act, 1992. With a view to strengthening the existing Insider Trading Regulations and to create a framework for prevention of insider trading, a committee was constituted by SEBI under the chairmanship of Shri Kumar Mangalam Birla. The recommendations of the committee were considered by the SEBI board and the amended regulations notified in the gazette on 20th February 2002. These regulations were renamed as SEBI (Prohibition of Insider Trading) Regulations, 1992 by the SEBI (Insider Trading) (Amendment) regulations, 2002. Broadly speaking, the

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regulations are based on the United Kingdom's the Company Securities (Insider Dealing) Act, 1985. The regulations are applicable only to the dealings in securities of listed companies; these regulations do not apply the dealings in securities of private and unlisted public companies.

The committee chaired by N.K. Mitra submitted its reports on investor protection in April, 2001 with following recommendations- (1) Need for a specific act to protect investors; (2) Establishment of judicial forum and award for compensation to investors; (3) Investor education and protection fund should be shifted to the SEBI Act and administered by SEBI; (4) SEBI should be the only capital market regulator; (5) SEBI Act, 1992 and the Securities Contract (Regulation) Act, 1956 should be amended.

The Parliament of India constitutes the Joint Parliamentary Committee in 2002 on the basis of petition filed by Investor Grievances Forum in 2000. This committee recommended that the measures to be taken to protect the funds of small investors be examined by the Government Regulatory Authorities and be implemented with the positive perspective. The report further recommended that proper efforts should be made by Securities & Exchange Board of India (SEBI) and the Department of Company Affairs (DCA) in co-ordination with Stock Exchanges for timely detection of misleading and manipulative practices.

Before the enactment of SEBI Act, 1992, the securities markets were full of fraudulent trade practices. The investors and shareholder lost their confidence in the market and moved to withdraw their funds. In the beginning years of SEBI, to stop fraudulent trade activities from securities market was major task. Due to the lack of knowledge of legal provisions, investors were not able to know the market trend. It was essential to stop those practices in securities market to take back the assurance of investors and to protect the rights of investors.

In order to promote fairness in the capital market and to protect the interest of small investors, SEBI has framed regulation, providing for acquisition of shares and takeover of listed companies normally known as "Takeover code". Corporate governance is an important instrument of investor protection, and it is therefore a main concern on SEBI's agenda. The development of capital market is depending on good corporate governance without which investors do not show the confidence in the companies. It is very important for the companies to maximize the shareholders value and wealth.

The purpose of this paper is to measure the impact of investor protection on firm performance. Investor protection is defined as the rights of minority shareholders and creditors get to be protected against expropriation by controlling shareholders or managers. These rights are enforced through law and regulations, but the level to which investors actually are protected differs among countries [21].

The paper commences with a review of literature on relationship of investor protection and firm performance. We than describes the hypothesis, data and methodology used in the study, followed by analysis and summary of the results.

II. REVIEW OF LITERATURE

Investor Protection

Investor protection is important element for development of capital market in a country. Small investors are the backbone of the Indian capital market. Earlier empirical finding suggest that shareholder protection level is positively related with development of stock market. Various researchers have measured the relationship between investor protection and firm performance [22, 9, 3]. Better investor protection motivates the investors to invest the funds at lower cost. Generally, investor rights provide the investor the ability to extract the returns on their investment. This is mainly important when managers have the ability to act in their own interest at the expense of their investors [23]. Differences in the investor rights, allow managers to divert firm's value at a degree depending on the level of investor protection [7]. Thus, managers who work in countries where the investor protection is low, have the chance to divert resources of the firm more easily [5].

Firm Performance

Earlier studies have used both accounting and market based measures for firm performance [19, 10, 28]. Ma et al. (2010) [27] and Himmelberg et al. (1999) [6] used the accounting measure of return on assets (ROA) and the Tobin's Q for measuring firm performance in their study. Bertrand et al. (2008) [12] has used the ROA in their study about the firm performance of family firms in Thailand. Claessens et al. (2002) [25] and Himmelberg et al. (1999) [6] have used the Tobin's Q as a measure of firm performance in their study. On the basis of earlier studies we have taken ROA and Tobin's Q as firm performance measures.

Relationship between Investor Protection and Firm Performance

Various studies found that there is a relationship between investor protection and firm performance. They found firms that have stronger investor protection have higher firm performance and firms with poor investor protection have lower firm performance [15, 11]. Shleifer and Wolfenzon (2002) [4] found that the Tobin's Q is used as a measure for firm performance and the level of dividend paid is higher in countries with good investor protection. La Porta et al. (2002) [22] found the similar results for countries with poor levels of investor protection and Tobin's Q is lower if investor protection is low. Earlier empirical findings

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suggest that shareholders protection level is positively related with development of stock market.

S. No.	Author	Year	Country	Objective	Techniques	Conclusion
1	La Porta et al. [22]	2002	27 wealthy economies	To evaluate the effect of investors protection and ownership by controlling shareholder on corporate valuation	Regression analysis	Better shareholder protection and higher cash flow ownership by controlling shareholder improve valuation
2	Lele and Siems [18]	2006	UK, US, Germany, France, India	Construct shareholder protection index for five countries and code the development of law	Quantitative methodology	Improvement in shareholder protection US shareholder protection law is weak than other four countries Minority protection against majority shareholders is stronger in France, Germany and India Legal differences between five countries does not confirm distinction among common law and civil law
3	Huang and Wu [9]	2010	USA	To investigate the effect of individual shareholder rights provisions on cost of equity capital	Stepwise regression method	Four provisions (fair price, control share cash out, poison pill and golden parachute) are most significant determinant of cost of equity capital Investors charges lower cost of equity capital if firm has fair price provision
4	Cormier et al. [8]	2010	Canada	To investigate the impact of governance on information asymmetry between managers and investors	Multivariate analysis	Corporate governance disclosures, board and audit committee size and voluntary governance disclosure reduce information asymmetry
5	Madan et al. [3]	2012	India	To make assessment of adoption of code of CG and implementation of Non-mandatory recommendations with mandatory recommendations	Chi –square test and Z test	Fair adoption of CG, adoption of non- mandatory recommendations with mandatory recommendations effect firm performance

III. HYPOTHESIS

The main objective of this study is to analyze the effect of investor protection on firm performance. To achieve this objective, following research hypothesis has been formulated:

H_{01}: There is no relationship between investor protection index and firm performance.

IV. DATA AND METHODOLOGY

Data

This study use data of BSE- 500 listed companies for the period of 2001 to 2012. The firm level data have been collected from "Prowess" a database of Indian companies, maintained by the Centre for Monitoring the Indian Economy (CMIE). Annual reports of the companies are taken from the company's websites. This paper sample excludes all banking and financial services companies because they are governed by other Regulation Act. The final sample set after removing outliers and companies with inadequate financial data consist of 49 companies over a period of 12 years.

Investor Protection Index

Investor protection is not possible without reliable and adequate corporate information. Several other rights provided to them under the law cannot be exercised by shareholders unless companies in which they have invested in share with them such information. Minority shareholders have the same rights as majority shareholders. The basic rights of the shareholders include the right to share transfer, obtaining relevant information on the company on regular and timely basis, participating in shareholder meetings and sharing in profits of the company. There are various rules and regulations that are considered to protect investors. The objective of corporate governance reforms is to protect the rights of outside investors including both shareholders and creditors. Investor protection is important constituent of corporate governance. Therefore rules and regulations are designed to protect investors. In India, for instance, rules protecting investors come from the Department of Company Affairs of the Ministry of Finance, the SEBI, the Listing Agreements of Stock Exchanges, Accounting Standards of ICAI and sometimes decisions of the Superior

 DOI : 10.18231/2454-9150.2018.1193

Court of the country. Investor protection index is based on the following attributes:

1. Shareholder Information

(A) Appointment and Re-appointment of Director- In case of appointment of new director or re-appointment of existing director, information containing a brief resume, nature of expertise in specific functional areas and companies in which the person hold directorship and committee membership, must be provided to the benefit of shareholders. The effectiveness of the board is determined by the quality of the directors, thus the shareholders show a greater degree of interest and participation in the appointment of the directors.

(B) Quarterly Results- This is the specific recommendation of sharing information of quarterly results presentation made by the company through company's websites.

(C) Annual General Meeting Details- Firm should provide the annual general meeting details like time, place and date of meeting to shareholders.

2. Shareholder Right-

(A) Half -Yearly Financial Reports - Half-yearly declaration of financial performance including summary of the significant events in six months should be sent to each of the shareholders.

(B) Right of Share Transfer- The board should delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents with a direction to the delegate authority to attend to share transfer formalities at least once in fortnight.

3. General Body Meetings Detail- The general body meetings give an opportunity to the shareholders to deal with their concerns to the board of directors and comment on and demand any justification on the annual report or on the general functioning of the company. So, company should disclose the information related to the location and time of general meeting held in last 3 years, details of special resolution passed in last 3 years and details of resolution passed in last year through postal ballot.

4. Prohibition for Insider Trading- Insider trading is the dealing in the securities of a listed company by a director, officer, an employee of the firm or by any other person such as internal auditor, statutory auditor, agent, advisor, analyst, consultant, etc., who has knowledge of material `inside' information not available to the general public. The dealing in securities by an `insider' is illegal when it is predicated upon the utilization of 'insider' information to profit at the expense of other investors who do not have access to the same information. The insider trading practices needs to be checked to keep investor assurance in the integrity of the securities market. If any person deal in the securities on the basis of the unpublished price-sensitive information shall be liable to a penalty of twenty-five crore rupees or three times the amount of earnings made out of insider trading, whichever is higher.

5. Whistle Blower Policy- A company may set up a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also give for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the chairman of the audit committee in exceptional cases.

These attributes highlight that today's domestic as well as international investors are keep away from the countries that do not guarantee investor rights and do not provide adequate corporate disclosures. Thus, we have construct investor protection index on the basis of shareholder rights and information, insider trading and whistle blower policy and measure its impact on firm performance.

The information's used in construction of the investor protection index are compiled from the publically available sources as disclosed by the listed companies. If that particular information is available then value one is assigned, otherwise zero is assigned. Appendix shows the attributes used in construction of investor protection index of listed Indian companies.

Variables

To measure the relationship between investor protection and firm valuation, we have used both market and accounting measures of performance such as Tobin's Q and ROA as dependent variables in this study. Tobin's Q represents the market's perception about the future profitability of firms. We use market measure such as Tobin's Q which is computed as the ratio of the market capitalization plus total debt divided by total asset of the company. Accounting measure such as Return on Assets (ROA) which is computed as the ratio of EBITDA divided by the total assets. ROA is a sign of managerial competence to measures the capability of management to change the assets of the company into net earnings. Klapper and Love (2004) [11] found that good corporate governance and hence shareholder protection leads to higher operating performance (ROA) and higher Tobin's Q. Some empirical studies used control variable for estimating the relationship between investor protection and firm performance. We used Sales growth, size, leverage and beta as control variables in this study. These control variables affects the firm performance in both positive and negative way.

We have used panel data analysis in this study because panel data sets are able to identify and estimate effects that are not measurable in pure cross-sectional or pure time-series data. This paper sample comprises data of 49 companies for the period of twelve years so it required panel data analysis.

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V. RESULTS

Descriptive Statistics

A brief description of the variables is provided in this section. Descriptive statistics of dataset of 49 companies are illustrated in table 1. Average of Tobin's Q is 1.29. Average ROA is 0.15. The mean value of sales growth is 0.17.The mean size of firms, as measured by Natural logarithms of total assets are 10.18. Leverage the ratio of total debts to total assets.

Table: 1 Descriptive statistics of investor protection and firm performance

Variables	Minimum	Maximum	Mean	Std. Deviation
IPI*	2	10	6.49	1.52
TQ	0.13	6.25	1.29	0.84
ROA	0.01	0.75	0.15	0.07
Sales Growth	-0.55	2.77	0.17	0.25
Size	6.92	13.79	10.18	1.36
Leverage	0.00	0.73	0.27	0.16
Beta	0.21	1.89	0.92	0.29
N = 588				

* = Investor protection index

shows a mean of 0.27 which indicates that for each unit of total assets; Indian firms on average have 0.27 units of total debts. Beta used as a proxy to measure firm risk has mean value 0.92 with standard deviation 0.29. Investor protection index score range between 2 and 10 with standard deviation 1.52.

Descriptive Statistics of Investor Protection Index

Table 2 analyzes our sample according to each of the 10 attributes of the investor protection index. Looking only at the year 2012, only 79.6 percent firms provided information to shareholders regarding to appointment and reappointment of directors. In the sample 98 percent firms published their quarterly results and provide right of share transfer to shareholders. All firms provide annual general meeting detail such as time, date and place to shareholders. Only 28.6 percent firms send half yearly reports to house of each shareholder. Only 73.5 percent firms have a policy against insider trading. And 46.9 percent firms have whistle blower policy mechanism. All firms show information on general meeting held in last 3 years in the annual reports. Information on special resolution passed in 3 years is shown by 83.7 percent firms. Only 14.3 percent firm's shows information related to resolution passed by postal ballot last year.

Table: 2 Investor protection index attributes descriptive statistics

(Values in percentage)

Attributes \ Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Appointment & Reappointment	55.1	61.2	67.3	71.4	73.5	71.4	79.6	73.5	75.5	77.6	83.7	79.6
Quarterly results	98	100	100	100	100	100	100	100	100	100	100	98
Right of share transfer	98	100	100	100	100	100	100	100	100	100	100	98
AGM* details	98	100	100	100	100	100	100	100	100	100	100	100
Half yearly reports	20.4	24.5	24.5	24.5	24.5	26.5	30.6	24.5	26.5	24.5	26.5	28.6
Insider trading	4.1	12.2	36.7	42.9	46.9	53.1	55.1	57.1	67.3	69.4	69.4	73.5
Whistle Blower policy	0	0	0	2	6.1	22.4	26.5	30.6	34.7	38.8	42.9	46.9
GM** held in 3 years	98	100	100	100	100	100	100	100	100	100	100	100
Special resolution passed in 3 years	16.3	18.4	18.4	22.4	30.6	77.6	87.8	85.7	81.6	89.8	87.8	83.7
Resolution passed by postal ballot	2	8.2	18.4	32.7	22.4	32.7	24.5	26.5	30.6	34.7	36.7	14.3

AGM* – Annual general meeting, GM**- General meeting

 DOI : 10.18231/2454-9150.2018.1193

Investor protection index is based on 10 attributes. The information is compiled from the publically available sources as disclosed by the listed companies. If that particular information is available then value one is assigned, otherwise assigned zero. The table 2 show the percentage of questions those answered with yes and assign values one. These questions are shown in appendix.

Relationship between investor protection index and firm performance

Our sample consist data of 49 firms and over the period of twelve years so it required panel data analysis. The model 1 has been used to measure the relationship between investor protection index and firm performance. This model is also used by [13].

$$D\,(TQ, ROA)_{it} =$$

$$\beta_0 + \beta_1\, INVESTOR\ PROTECTION\ INDEX_{it} + \beta_2\ FIRM\ \_SIZE_{it} + \beta_3\ SALES\_GROWTH_{it} + \beta_4\, BETA_{it} + \beta_5\ LEVERAGE_{it} + \epsilon_{it} \qquad \text{(Model 1)}$$

D stands for dependent variables taking values of Tobin's Q and ROA. Some control variables are used like firm size, sales growth, beta and leverage. It is generally believed that the firms with larger size perform better due to some advantages of economies of scale. So, it is important to control the impact of size on firm performance. Sales growth is related to future growth opportunities of the firm. Beta has been used as a measure of risk. And leverage is used to control for variations in capital structure. ϵ_{it} Denote error term respectively. We have used unit root test before applying panel regression. Levin, Lin and Chu unit root test provide result absence of unit roots by rejecting the null hypothesis.

We have applied panel regression model to find out the relationship between investors protection index and firm performance by controlling the heteroskedasticity. We have used redundant likelihood ratio test to verify the appropriateness of fixed effect model. If p-value less than 0.05, null hypothesis that independently pooled panels are more efficient was rejected, implying that fixed effects model was preferred to independently pooled panel model.

Table: 3 Regression results of the TQ and ROA as dependent variable

Independent variable	Fixed Effect (TQ)	Fixed Effect (ROA)
Constant	2.421***	0.467***
IPI	0.055**	-0.0038
Size	-0.129***	-0.019***
Sales growth	0.234***	0.052***
Beta	-0.318***	-0.022***
Leverage	-0.651***	-0.232***
F- Statistics	24.919***	10.061***
Adjusted R^2	0.726	0.501
Durbin- Watson Stat	1.128	1.373
Observation	588	588
Likelihood Ratio Test (Chi square)	632.517***	347.077***

*: p < 0.10; **: p < 0.05; ***: p < 0.01

Table 3 represent that the model explains 72.6 per cent variation in dependent variable (TQ) and 50.10 per cent variation in dependent variable (ROA). F statistics is significant at one per cent level. It denotes fitness of model. We have applied fixed effect model of panel regression as the redundant likelihood ratio test rejects the null hypothesis at one percent significance level. TQ and ROA are found to be negatively affected by firm size, beta and leverage at one per cent significance level. Sales growth is positively affected TQ and ROA at one percent significance level. Durbin – Watson statistics score value is 1.128 (TQ) and 1.373 (ROA). Investors protection index (IPI) positively affected TQ at five percent significance level. IPI affected TQ positively and significantly. It indicates that better investor protection improve firm value. Investor protection index has a negative and insignificant relationship with ROA. Our study rejects the hypothesis that is no relationship between investor protection index and firm performance.

Our findings of positive relationship between investor protection and firm performance measures (TQ) are similar to [22, 11]. Our results are contrary to [13]. And we find negative relationship between investor protection and firm performance measure (ROA) is similar to [13]. Klapper and Love (2004) [11] found that better shareholder protection leads to higher ROA.

Positive relationship of investor protection and firm performance indicates that better shareholder protection improve the firm valuation. Good corporate governance practices are important in minimizing risk and maximizing wealth for investors, attracting investment funds and improving the firm performance. La Porta et al. (2000), Klapper and Love (2004), Durnev and Kim (2005) and Djankov et al. (2008) [21, 11, 2, 26] have suggested that countries with better investors protection have more firm

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value and required lesser good corporate governance practices. Good governance is necessary for the countries those have no laws for protecting investors and therefore investor protection has positive effect on valuation. We find a positive effect of investor protection on valuation.

VI. CONCLUSION

The purpose of this paper was to measure the relationship between investor protection and firm performance by panel regression analysis for the period of 2001 to 2012. The results show that there is a positive relationship between Tobin's Q and investor protection index. The study concluded that better investor protection motivates the investors to invest the funds at lower cost. Those companies provide better protection to investors and shareholders' rights are more valued and have wide equity market and firm's valuation is also higher. On the other side those companies provide low protection to investors and their firm valuation is also lower. But ROA shows negative relationship between investor protection and firm performance. Future study could investigate other features that are not included in this study such as related party transactions, insider trading and other important disclosures which could affect the investor protection. We also suggest future researchers to make cross country comparison on the basis of similar provisions of investor protection and corporate governance.

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APPENDIX

Investor Protection Index is constructed on the basis of the following attributes and use binary coding for presence and absence of the attributes. One is assigned for presence and zero is assigned for absence of the attributes.

Investor Protection Index

Sr. No.	Attributes	Yes	No
1	Does the company provide Information's related to appointment of new director, new appointment of existing director and information related to brief resume, nature of his expertise, name of companies in which hold directorship and committee membership to shareholders ?.		
2	Does the company publish its quarterly results?		
3	Does the board allowed the shareholders to transfer their shares?		
4	Does the company provide annual general meeting details like time, place and date of meeting to shareholders?		
5	Does the company sent half yearly reports to household of each shareholder?		
6	Whether the company has adopted the policy against insider trading?		
7	Whether the company has adopted the policy for whistle blower mechanism?		
8	Does the company disclose the location and time of general meeting held in last 3 years?		
9	Does the company disclose the details of special resolution passed in last 3 years?		
10	Does the company disclose the details of resolution passed in last year through postal ballot?		

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