Guest editorial

Law, culture and finance

Introduction

Many studies in economics, finance, law, management and international business have written about how law and culture shape financial market, organizational structures, firm practices and investment decisions (Brouthers, 2002; Berry *et al.*, 2010; Choi and Contractor, 2016; Cumming *et al.*, 2017; Miletkov *et al.*, 2017; Aitken *et al.*, 2015; Cumming and Zhang, 2018). Few studies up to date have examined the intersection and interaction of these two on firms and financial markets. The objective of this special issue of the *International Journal of Managerial Finance* (*IJMF*) is to promote both theoretical and empirical research on the intersection and interaction of law and culture on corporate financial decisions, firm values and financial transactions.

Academic research in finance area has traditionally studied legal perspectives on financial market development following the pioneering work of La Porta *et al.* (1998). However, more recently, there has been a growing interest in the role of culture in finance (Karolyi, 2016). Theoretically and empirically, law and culture can explain a number of firm and financial market events such as foreign investments, cross-listings, angel investor activities and innovation investments, among other things. One of the difficulties to implement studies on the intersection and interaction impact of law and finance is that regulations tend to change over time, but culture remains relatively stable. Also, culture and legal environments are highly correlated. To this end, we feel the need for new research in order to ascertain the relative importance of law vs culture in financial markets.

The remainder of this paper is organized as follows. In the next section, we briefly review the prior literature on law and finance. We then present an over review of the prior literature on culture and finance. After, we discuss some interdisciplinary studies that examine both law and culture on various finance topics. Follow, we provide a brief introduction to articles included in the special issue. Finally, we make concluding remarks and suggestions for future research.

Law and finance

There is a developed body of literature of law and finance examining how legal institutional environments impact economic growth and financial market development. Cross-jurisdictional studies categorize countries and financial markets by differences in legal origins and qualities. In their serial seminal papers, La Porta *et al.* (1997, 1998, 2006) and Glaeser *et al.* (2004) suggest that legal origin is influential in a nation's protection of outside investors who are not management or controlling shareholders, which the authors suggest is largely for the purpose of corporate governance. They also empirically confirmed the importance of legal environment for better investor protections (La Porta *et al.*, 1997, 1998, 2006), and legal rules that can protect investors from expropriation by insiders will also affect the investors' willingness to participate in the equity markets. The main legal variables used are legal families of common law, French law, German law and the Scandinavian law origins.

Better investor protection and more transparent financial markets in countries with stronger legal protection will lead to better resource allocations within the economy and such an environment is highly valued by investors (Renders and Gaeremynck, 2007; Fernandes *et al.*, 2010) and thus increases the participation of investors and predicts a stronger sentiment effect (Yuk Ying *et al.*, 2012). Cheng and Courtenay (2006) also find that

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better regulations and accounting standards positively impact the quality of voluntary reporting across countries.

Focus on exchange trading regulation, Cumming *et al.* (2011) argue that detailed exchange trading regulation could enhance investor confidence and provide greater dissemination of knowledge about prohibited trading behaviors, thus improve trading activities, reduce uncertainty and decrease trading cost in the financial market. They find that difference in exchange trading rules, over time and across financial markets has significant impact on financial market liquidity. Furthermore, Aitken *et al.* (2015) also find that more detailed exchange trading regulation over time significantly reduces the number of suspected insider trading activities.

Similar to those results found in the public equity market, better legal conditions will also facilitate better enforcement of private equity (PE) contracts, and the associated information asymmetries between PE investors, investee firms and outside investors during both investment and divestment periods can be alleviated in a more efficient way (Lerner and Schoar, 2005; Cumming *et al.*, 2006; Johan and Zhang, 2016a, b). Cumming and Walz (2010) show that performance outcomes of ownership concentration and retained ownership by PE investors may differ depending on the legal system and institutional characteristics of the PE industry in a specific country. Cumming and Johan (2013a, b) also find that fair valuation clauses in PE fund contracts are more likely to be enforced in countries with stronger and better legal environments. In addition, Cumming and Zhang (2018) find country-level minority investor protection can also substitute for the lack of direct contractual protection in angel deals, which further highlights the importance of legal protection on angel capital markets.

Besides using legal origins, or exchange trading rules, as explanatory variables, many scholars also adopted the World Bank's ease of doing business index to proxy the legal environment in that this index ranks economies on their ease of starting a business, getting credit, protecting minority investors and/or enforcing contracts (Ho and Wong, 2007; Groh *et al.*, 2009). A high ease of doing business ranking means the regulatory environment is more conducive to the starting and operating a business, and therefore investors investing in firms situated in these countries with better legal and business environments might potentially benefit as this enables investors not only to more effectively provide advice during the investment process, but also to affect organizational changes to ensure efficient exits from the same firms (Cumming and Johan, 2007, 2008, 2013a, b). There is another minority shareholder protection index that can be used to capture legal environments and this legality index is the weighted average of ten key legal provisions identified by legal scholars as being most relevant to the protection of minority shareholder rights (Guillén and Capron, 2015)[1]. Higher values indicate more effective legal systems providing better minority shareholder protection. This legal index is dynamic over the years to capture a more comprehensive legal environment with more countries and years covered.

Culture and finance

A large literature have documented the importance of national culture that could shape the behaviors and decision-making processes of individuals and organizations (Salter and Niswander, 1995; Schwartz, 1999, 2014; Tung and Verbeke, 2010; Hofstede, 2010; Ronen and Shenkar, 2013; Boubakri *et al.*, 2016; Beugelsdijk *et al.*, 2017; Devinney and Hohberger, 2017; Kirkman *et al.*, 2017; Griffin *et al.*, 2017; Mingo *et al.*, 2018). These international studies have also shown that culture is one of the key variable that explains institutional differences (Tung and Verbeke, 2010; Hofstede, 2010; Schwartz, 1999, 2014; Ronen and Shenkar, 2013; Beugelsdijk *et al.*, 2017). Since the pioneering studies of Grinblatt and Keloharju (2001) and Stulz and Williamson (2003) linking culture with stock holdings and investor protections, the literature develops a strand of studies focusing on explaining different financial

decisions based on cultural differences. In this section, we will briefly review some studies to highlight the cultural impact on various finance topics.

One set of culture and finance studies are discussing the financial flows across nations as well as international investments where cultural distances between two nations would hinder financial flows in between (Aggarwal and Goodell, 2009; Siegel *et al.*, 2011). Beugelsdijk and Frijns (2010) also find that home bias is higher in foreign countries with a higher cultural distance relative to the home country by investigating cross-border M&A flows. Cultural distance also has a negative effect on the profitability given the cumulative abnormal returns are lower for UK companies when their acquisition is made in countries with higher cultural distance (Conn *et al.*, 2005).

Another set of studies are discussing the stock market functionality by relating various cultural index. Chui *et al.* (2010) relates the momentum effect to Hofstede's individualism index where such strategies are strong in US stock markets but weak in many Asian countries. Schmeling (2009) extends this result to investigate whether the tendency of national stock markets to be prone to "over-reaction and herd-like behaviors." Clement *et al.* (2003) show that the individual experience of financial market analysts has more leverage on the forecast accuracy in individualistic countries than in collectivistic countries.

In addition, at the national level, prior evidence has shown that firms in an ambiguity-averse culture are more likely to prefer bank-oriented financial systems (Aggrawal and Goodell, 2016), and riskier start-ups rely less on equity incentives (Cumming *et al.*, 2014). Boubakri *et al.* (2016) show that culture can significantly affect privatization around the world. They show that a continued role of government in privatized firms is more likely in countries with higher levels of collectivism cultural. In turn, this continued role of government in privatized firms negatively affects a firm's economic performance, including valuation, risk taking and efficiency. In the entrepreneurial finance and PE literature, researchers also consider national culture as one of the important factors affecting entrepreneurs' and start-ups' business decisions (Shane, 1993; Hayton *et al.*, 2002; Cumming *et al.*, 2014). One of the six Hofstede's (2001) six cultural dimensions of uncertainty avoidance has been documented to be linked to entrepreneurs' risk-taking behaviors and proactiveness as well as having impacts on the PE investment and divestment activities (Kreiser *et al.*, 2010; Holm *et al.*, 2013; Johan and Zhang, 2016a, b; Cumming and Zhang, 2018).

Law, culture and finance

Although investors' rights and protections, along with the legal origins as well as rules of law and enforcement, have been extensively discussed in the law and finance studies and used to investigate various financial issues ranging from the quality of corporate governance to the development of financial markets (La Porta *et al.*, 2006), Stulz and Williamson (2003) and Licht *et al.* (2005) show how financial laws can correlate with certain enduring and stable underlying socio-cultural characteristics, thus casting doubt and raising the debate about whether changes to the letter of the law can have effective consequences in practice. Thus, it is important to shed more light on the intersection and interaction of law and culture on finance. In this section, we will review some interdisciplinary papers in the literature that consider both the impact of law and culture on finance, or finance-related outcomes.

Although Aggarwal *et al.* (2012) focus on the four Hofstede's cultural dimensions impact on international aggregate flows of debt and equity, their study also consider the commonality of legal origins impact on those financial flows across nations. Beugelsdijk and Frijns (2010) support their proposition on the role of culture in international asset allocation while controlling the legal environment as a key institutional variable. In similar settings, Chui and Kwok (2008) identify the negative relationship between life insurance consumption and Hofstede's three cultural dimensions of collectivism, masculinity and power distance.

Kwok and Tadesse (2006) confirm that national culture plays a significant role in shaping the financial markets while using legal origins to capture the legal systems across countries. They find that countries characterized by higher uncertainty avoidance are more likely to have a bank-based system. Licht *et al.* (2005, 2007) analyze the relationships between indices of investors' legal rights and national cultural profiles and find the method of grouping countries according to legal families provides partial depiction of the universe of corporate governance regimes. The three basic social norms of governance, namely, rule of law, corruption and democratic accountability, correlate systematically and strongly with national scores on cultural dimensions and differ across cultural regions of the world. Their findings have implications for understanding the diversity and convergence in corporate governance call for systematic analysis of the interface between law and social institutions.

In addition to those studies focusing on the important relationship of law and culture on financial issues, some recent entrepreneurial finance studies also shed some lights on the intersection of law and culture impact on entrepreneurial startup and angel financing. Cumming *et al.* (2014) examine the role of law and culture in terms of the impact of entrepreneurship on economic outcomes, such as GDP/capita, exports/GDP, patents per population and unemployment. They uncover institutional impediments to the positive impact of entrepreneurship on each of these economic outcomes. The impact of entrepreneurship is significantly mitigated by excessively strong creditor rights and cultural attitudes that limit entrepreneurial risk-taking. Further, they find evidence that access to equity finance enables more efficient and higher growth entrepreneurship, particularly where it is available from top tier venture capital funds. Top tied venture capital funds enhance the impact of entrepreneurship on GDP/capita by providing superior due diligence, screening, monitoring, value-added strategic, finance, administrative and human resource advice, as well as a network of contacts for entrepreneurs. The reputation of top tier venture capital funds further enables more successful IPO exits (Nahata, 2008), although cultural forces in different countries may inhibit this impact (Nahata *et al.*, 2014). Some recent studies have also shown that institutional factors such as opportunity perception, legal framework and culture influence the emergence of angel investments (Edelman *et al.*, 2017). Cumming and Zhang (2018) find that relative to PE and VC funds, angels invest in smaller, more active entrepreneurial firms which tend to be located in countries characterized by less effective legal environments with higher levels of individualism and risk-taking. Their study not only considered national cultural dimensions as factors impacting angel investments, it also echoed and confirmed that cultural differences are more region-specific than country-specific to further consider cultural impact at the supra-national/regional level (Beugelsdijk *et al.*, 2017).

Introducing this issue

This issue of the *IJMF* focuses on both theoretical and empirical research on the intersection and interaction law and culture on financial market development, corporate decision, firm value and financial transactions. A brief summary of each paper is listed next and more detailed information of each paper can be found in Table AI.

The first article in the issue, "Legal Family, Cultural Dimensions, and FDI," by Tanja Steigner, Marian Riedy and Antonina Bauman of Emporia State University, Kansas, USA, investigates the relationship among legal origins of law, cultural dimensions and flow of foreign direct investment (FDI). They find that FDI flows from civil law countries to common law countries are greater. Furthermore, cultural distance impacts FDI flows depending on the legal origin of the source country. More FDI flows from civil and common law countries when the host country has a higher (lower) power distance (individualism) score. Civil law countries send more FDI into countries with higher masculinity, uncertainty avoidance and indulgence scores, and with lower value on long-term orientation.

The second article in the issue, "Do Culture and Governance Structure Influence Extent of Corporate Risk Disclosure?," by Ben Agyei-Mensah of SolBridge International School of Buesinss, and Samuel Buertey of Hannam University, Korea, examines the relationship among culture, corporate governance variables and corporate risk reporting practices in Nigeria and South Africa. They find that power distance is negatively associated with the corporate risk disclosure. The study also finds that both institutional ownership and profitability can explain a firm's risk disclosure practices.

The third article in the issue, "An International Study of the Response of Corporate Payout Policy," by Indrit Hoxha and Edward Hoang, studies the payout policy for public firms in 94 countries between 1990 and 2015. Their study finds that corporate payout policy is influenced by investment and debt policies and cannot be determined independently. Furthermore, they find that geographic/cultural/institutional variation influence the response of payout policy to other corporate decisions.

The fourth article in the issue, "Region, National Culture and Cross-country Differences in The Use of Trade Credits: Evidence from European SMES," by Markus Mättö and Merv Niskanen of Business School at University of Eastern Finland, Finland, investigates whether national culture or religion can explain cross-country difference in trade credits. They find that Hofstede's cultural dimensions, such as power distance and uncertainty avoidance, are positively associated with trade credits. In addition, they find that trade credit are higher in Catholic countries than in Protestant ones. Overall, their study shows that both national culture and religion are important determinants of trade credit.

The last article in the issue, "Individualism, Synchronized Stock Price Movement, and Stock Market Volatility," by Feng Zhan of Boler Collee of Business, John Carroll University, USA, examines the impact of national culture on herding behavior across international financial markets. His study finds that nations with lower values of individualistic culture are more likely to have a higher number of synchronized stock price movements. Further, the correlation between stock price movements apparently increases stock market volatility. This positive relationship between synchronized stock price movements and stock market volatility is stronger for emerging markets during the financial crisis from June 2007 to December 2008.

Conclusions and future research directions

This paper reviews the research on the relationships between legal systems and finance as well as culture and finance. We aim to promote both theoretical and empirical research on the intersection and interaction of law and culture on corporate financial decisions, firm valuations and financial transactions.

Future research is needed on the role of different cultural layers (regional/national, organizational and individual) on the financial decision-making process within a firm or by individuals, and how legal systems interact with those different layers of cultures to have differential impact on finance. Some interesting research questions can be asked:

RQ1. To what extent are regulatory changes in different countries affected by national culture (Stulz and Williamson, 2003)?

RQ2. What is the role of angel investors, venture capital, innovation centers and incubators in different economies around the world (Cumming and Johan, 2013a, b), and how does it depend on national culture and financial regulation?

RQ3. What is the relative importance of culture and legal institutions for emerging vs developed markets?

RQ4. Are agency problems associated with state-owned enterprises affected by the legal and cultural settings in which they operate?

RQ5. How is contagion influenced by law vs culture in global financial markets?

RQ6. What are the identification strategies/methodologies that can provide causal insights between cultural and legal institutions and financial markets?

RQ7. How do legal and cultural institutions affect firms' innovation investment and long-term financial performance?

RQ8. How do legal and cultural forces interact in ways that exacerbate or mitigate the risk-taking behavior of firms and individuals?

Future research could also examine the differential role of law and culture on finance for public vs private firms. In addition to the traditional institutional environment considered, future research could examine the extent to which the political environment could mediate any connections between law, culture and financial market functionality. These topics are likely to be the subject of active research in the forthcoming years.

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Note

1. The detailed definitions of those ten legal provisions are in Guillén and Capron (2015) Table 1: power of the general meeting for *de facto* changes; agenda-setting power; the anticipation of a facilitated shareholder decision; prohibition of multiple voting rights; independent board members; feasibility of director dismissal; private enforcement of director duties (derivative suit); shareholder action against general meeting resolutions; mandatory bid; and disclosure of major share ownership (see also Lele and Siems, 2007; Siems, 2008).

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Appendix

Author(s)	Data source(s)	Country samples	Time period	Dependent variables	Main explanatory variables	Main findings
Tanja Steigner, Marian Riedy and Antonina Bauman	OECD database (stats.oecd.org)	OECD countries	2003–2012	FDI	Cultural dimension (Hofstede, 1980, 2010); Legal Index (LLSV, 1999)	FDI flows from civil to common law countries are greater than vice versa. Further, cultural distance impacts FDI flows depending on the legal origin of the source country. More FDI flows from civil and common law countries when the host country has a higher [lower] power distance [individualism] score. Civil law countries send more FDI into countries with higher masculinity, uncertainty avoidance and indulgence scores, and with lower- (long) term orientation scores
Ben Agyei-Mensah and Samuel Buertey	Annual report of 163 companies listed in Lagos and Johannesburg stock exchange	Nigeria and South Africa	2013	Corporate risk disclosure index: the disclosure index = total corporate risk information disclosed/maximum (32) items disclosed for each company	Cultural dimension (Hofstede, 1991, 2001); corporate governance (institutional ownership, ownership concentration, independent directors)	The results indicate that power distance is negatively associated with the corporate risk disclosure. This implies that organizations where power distance is high are characterized by lower corporate risk disclosure and vice versa. From the analysis, two factors, namely, institutional ownership and profitability, were found to explain sample firms' risk disclosure practices as they are positively and statistically related to corporate risk disclosure
Indrit Hoxha and Edward Hoang	Compustat Global	94 countries	1990–2015	Corporate payout	Legal Index (World Bank; LLSV, 1999)	Corporate payout policy is influenced by investment and debt policies, and cannot be determined independently. Furthermore, we find that geographic/cultural/institutional variation influence the response of payout policy to other corporate financing decisions
Markus Mättö and Merv Niskanen	Amadeus database	35 European countries	2007 to 2011	Trade credits	Cultural dimension (Hofstede, 1991, 2001; Schwartz value survey, SVS 1998–2005); religion	Religion and national culture are associated with trade credit. The paper finds that the levels of trade credit are higher in Catholic countries than in Protestant ones and that people's religiousness has an impact on trade credit only in Catholic countries. It also finds that Hofstede's cultural

(*continued*)

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Author(s)	Data source(s)	Country samples	Time period	Dependent variables	Main explanatory variables	Main findings
					(World Fact book of CIA)	dimensions, such as power distance and uncertainty avoidance, are positively associated with trade credit. Overall, its findings indicate that religion and national culture are important determinants of trade credit management, and that the association between commonly used cultural values and trade credit depends on the religious, legal, and financial environment
Feng Zhan	Datastream	47 countries	2003–2012	Stock market volatility and synchronized stock price movements	Cultural dimension (Hofstede, 2010); Legal Index (LLSV, 1999)	This paper finds that nations with lower values of individualistic culture are more likely to have a higher number of synchronized stock price movements. Further, the correlation between stock price movements apparently increases stock market volatility. Nations with high individualistic culture have a lower number of synchronized stock price movements and thus have lower levels of stock market volatility. The positive relationship between synchronized stock price movements and stock market volatility is stronger for emerging markets during the financial crisis from June 2007 to December 2008. Rather than due to the different levels of economic development, the empirical results here indicate that a portion of the difference in market level volatility is attributed to the investor bias of different cultures