

Does granting minority shareholders direct control over corporate decisions increase shareholder value?

A natural experiment from China

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The debate

- The expropriation of minority shareholders by management and/or controlling shareholders is a worldwide corporate governance problem
- One solution is to give minority shareholders increased control over corporate decisions. Good idea?
 - Yes because it is necessary to combat widespread managerial agency problems
 - No because
 - minority shareholders either lack the requisite knowledge and expertise to make effective decisions or have incentives to make value reducing decisions;
 - Minority shareholders may not have incentive to exercise the power; or they may not be able to effectively exercise the power.
- The debate will eventually have to be settled empirically
- There is little empirical research on the issue

Our setting

- Prior to the split share reform in 2005, most listed firms in China had two types of shares: non-tradable and tradable
 - On average, non-tradable shares account for about 70% of total shares outstanding
 - Non-tradable shares are typically owned by controlling shareholders
- Generally tradable shareholders (referred to as minority shareholders) could not affect corporate decisions
- Minority shareholders' interests are frequently expropriated by management/controlling shareholders in China
- On Dec 7, 2004, CSRC issued a new regulation (segment voting rule)
 - Requires several types of major corporate decisions to seek **separate** approval by both tradable and non-tradable shareholders
 - Represents a significant shift of control power from management/controlling shareholders to minority shareholders

Research Questions

- What is the effect of the 2004 CSRC regulation on corporate decisions and shareholder value?
 - Does the quality of managerial decisions (equity financing proposals) improve after the regulation?
 - Do minority shareholders veto value-decreasing equity offering proposals submitted by management?
- How does the effect of the regulation vary with minority shareholder composition?

Main Findings

- The regulation helps deter management from submitting value-decreasing equity financing proposals
 - The effect is more pronounced for firms with higher mutual fund ownership
- Minority shareholders are more likely to veto value-decreasing proposals in firms with higher mutual fund ownership

Test 1: Does the Regulation deter management from submitting value decreasing equity offering proposal?

- We compare the quality of *equity offering* proposals submitted before and after the regulation
 - Equity offerings are important decisions
 - Equity offerings are often used to expropriate minority shareholders
 - Segment voting rules for other corporate decisions are relatively easy to circumvent and the sample is biased.
 - Majority of the proposals are equity offering proposals.
- We ask two specific questions
 - How does the regulation affect management's incentive to submit value-increasing (high quality) and value-decreasing proposals (low quality)?
 - Does the average quality of submitted proposals improve after the regulation?

Measure the Quality of SEO Proposals

- We measure the quality of proposals using market reaction (CAR) to the announcement of the proposals
 - CAR reflect market's collective wisdom about a proposal's quality
 - We use relatively long window [-2,+10] to allow the market to fully capture the proposal quality
 - A share market has price movement limit $\pm 10\%$
 - Equity offering is a complex business decision
 - $CAR > 0$ = high quality; $CAR < 0$ = low quality
 - Average quality = average CAR

SEO Proposal Submission

- We estimate a multinomial logit model
 - $\Pr(\text{SUBMISSION}=\text{J}) = a+b*\text{AFTER} + \text{CONTROLS}$
 - J=0 if not submit (benchmark);
 - J=1 if submit at least one *value increasing* (CAR>0) proposal;
 - J=2 if submitted at least one *value decreasing* (CAR<0) proposal
- Sample periods: monthly observations from Jan 2004 to Jun 2005
- Firms that are not eligible to submit equity financing proposals are excluded
- Manually collect all equity offering proposals (228 proposals)

The Main Effect

$$\Pr(\text{SUBMISSION}=\text{J}) = a + b * \text{AFTER} + \text{CONTROLS}$$

Table 2, Panel A. Main effects model

	SUBMISSION=1 (value increasing)	SUBMISSION=2 (value decreasing)
	Coefficient (<i>p-value</i>)	Coefficient (<i>p-value</i>)
AFTER	0.1882 (0.322)	-0.4643 (0.016)

The Effect of Minority Shareholder Composition

- Focus on the top10 tradable shareholders
 - These shareholders have a stronger monitoring incentive than other tradable shareholders
- Partition the top10 tradable shareholders into
 - Mutual funds (MUTUAL_OWN)
 - Other institutional shareholders (OTHERINST_OWN)
 - security firms, national social security trust funds, insurance companies, other domestic institutions (e.g., private funds, lease and financial companies), foreign institutions
 - Individual shareholders (INDIVIDUAL_OWN)

The Effect of Minority Shareholder Composition

$$\Pr(\text{SUBMISSION}=J) = a_0 + (a_1 * \text{MUTUAL_OWN} + a_2 * \text{OTHERINST_OWN} + a_3 * \text{INDIVIDUAL_OWN}) + b_0 * \text{AFTER} + (b_1 * \text{MUTUAL_OWN} + b_2 * \text{OTHERINST_OWN} + b_3 * \text{INDIVIDUAL_OWN}) * \text{AFTER} + \text{CONTROLS}$$

Table 2, Panel B: Interaction effects model

	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value decreasing)	
	coefficient	p-value	coefficient	p-value
AFTER*MUTUAL_OWN	1.1437	(0.595)	-10.4375	(0.003)
AFTER*OTHERINST_OWN	-1.3320	(0.414)	-2.0158	(0.380)
AFTER*INDIVIDUAL_OWN	-18.2770	(0.141)	-38.8125	(0.037)

The Effect of Minority Shareholder Composition

Table 2, Panel C. Ai and Norton (2003) Marginal interaction effects

Interaction effect of	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value decreasing)	
	Mean marginal effect	Mean Z-statistics	Mean marginal effect	Mean Z-statistics
AFTER*MUTUAL_OWN	0.0122	(0.597)	-0.0875	(-1.818)
AFTER*OTHERINST_OWN	-0.0113	(-0.757)	-0.0145	(-0.607)
AFTER*INDIVIDUAL_OWN	-0.1598	(-1.240)	-0.3390	(-1.803)

Market Reaction to Announcement of Proposal Submission

Table 3, Panel A. The market reactions to announcements of equity offering proposals in the pre- and post- regulation periods

	CAR in the pre- regulation period	CAR in the post- regulation period	Two-tailed p value on the test of the difference	
			t-test	rank-sum test
	-0.014 (-0.018) [0.068]	0.014 (0.018) [0.066]	0.003	0.004
Two-tailed p value of one-sample t-test	0.012	0.069		
Two-tailed p value of one-sample rank- sum test	0.005	0.119		

The Effect of Minority Shareholder Composition

$$\text{CAR} = a_0 + (a_1 * \text{MUTUAL_OWN} + a_2 * \text{OTHERINST_OWN} + a_3 * \text{INDIVIDUAL_OWN}) + b_0 * \text{AFTER} + (b_1 * \text{MUTUAL_OWN} + b_2 * \text{OTHERINST_OWN} + b_3 * \text{INDIVIDUAL_OWN}) * \text{AFTER}$$

Table 3, Panel B: Interaction effects model

	Coefficient (two-tailed p)
AFTER*MUTUAL_OWN	0.3677 (0.002)
AFTER*OTHERINST_OWN	0.0323 (0.602)
AFTER*INDIVIDUAL_OWN	0.3549 (0.615)

Alternative explanations

Could our results for Tables 2/3 be explained by confounding factors?

- (1) Anticipation of split share reform?
- (2) A gradual improvement in investor protection over time, especially the competing contemporaneous regulations?

Alternative explanation (1)

- Split share reform
 - Convert the non-tradable shares into tradable shares.
 - Non-tradable shareholders negotiate with tradable shareholders to determine the compensate ratio of conversion.
 - Pilot program starts April 2005 (4 firms in April 2005; 42 firms in May 2005).
 - Expanded to all listed firms in August 2005
 - After August 2005, CSRC effectively ceased to process new equity issue.

Alternative explanation (1)

- The anticipation of the split share reform could have the following two effects:
 - Management would stop submitting both value increasing and value decreasing proposals.
 - With the increased liquidity of non-tradable shares after the reform, we expect controlling shareholders to have a weak incentive to expropriate minority shareholders. Therefore the decrease in likelihood of submitting bad proposals should be stronger when nontradable shareholders hold more.
 - We find no support for either prediction
 - Dropping the 46 firms in the pilot reform does not affect the results in table 2 and 3.

Alternative explanation (2)

- Could our results in Tables 2 and 3 be explained by:
 - A gradual improvement in investor protection?
 - In particular, competing contemporaneous regulations?
 - strengthening the role of independent directors by requiring material related party transactions and the hiring and dismissal of the company auditor subject to the approval of at least one half of the independent directors;
 - improving investor relations by encouraging management to improve the quality of corporate disclosures and investor communications;
 - encouraging listed firms to adopt a regular dividend policy and prohibiting listed firms that have not distributed cash dividends in the past three years from issuing new equity;
 - holding controlling shareholders and company executives to the standard of fiduciary duty for minority shareholders and increasing the administrative penalties for violation of such fiduciary duty.

Alternative explanation (2)

- If these alternative explanations are *true*, then we should observe:
 - Similar findings even prior to the 2004 regulation (increasing trend in proposal quality)
 - No evidence (figure 2; Table 6)
 - The results in Table 2/3 are driven by firms do not pay dividends prior to 2004-12.
 - No evidence; the results of table 2/3 are largely unaffected when dropping firms that do not pay cash dividends before 2004.
 - A similar decline in another form of managerial expropriation, which is not affected by segment vote ([inter-corporate loans](#) (Jiang et al. 2009)), around the 2004 regulation
 - No evidence (Table 7)

Test 2:

Do minority shareholders veto
Value decreasing proposals?

Minority shareholders' participation in the voting

Table 8 Panel A. Descriptive statistics on minority shareholders' voting participation

Variable	N	Mean	S.D.	25%	50%	75%
PARTICIPATE_ALL	80	0.161	0.129	0.061	0.133	0.235
PARTICIPATE_TOP10	76	0.550	0.277	0.365	0.628	0.780
PARTICIPATE_NONTOP10	76	0.089	0.104	0.015	0.044	0.135
PARTICIPATE_MUTUAL	56	0.635	0.358	0.456	0.656	1.000
PARTICIPATE_OTHERINST	64	0.476	0.416	0.000	0.488	0.912
PARTICIPATE_INDIVIDUAL	51	0.270	0.307	0.000	0.183	0.409

PARTICIPATE_ALL = number of tradable shares vote/ number of tradable shares outstanding

PARTICIPATE_TOP10 = number of tradable shares owned by top10 shareholders and vote/ number of tradable shares owned by top 10 shareholders

PARTICIPATE_NONTOP10 = number of tradable shares owned by top10 shareholders and vote/ number of tradable shares owned by top 10 shareholders

PARTICIPATE_MUTUAL = number of tradable shares owned by mutual funds among the top10 shareholders and vote/number of tradable shares owned by mutual funds among top10 shareholders

A caveat about the voting analysis

- Due to deterrence effect, we may not observe negative association between veto and proposal quality.
 - If controlling shareholders correctly anticipate that minority shareholders will veto bad proposals, they will not submit.
 - In equilibrium, we should not observe veto.
 - If veto exists, it must be out of equilibrium cases.

Table 9 Proposal quality and the likelihood of veto

Panel A. Logit regression results	Model 1 (main effects)	Model 2 (interaction effects)
	Coefficient (p-value)	Coefficient (p-value)
CONSTANT	-1.576 (0.000)	-1.759 (0.077)
DCAR (=1 if CAR>0)	-0.799 (0.255)	4.313 (0.129)
MUTUAL_OWN		0.116 (0.084)
OTHERINST_OWN		-0.026 (0.389)
INDIVIDUAL_OWN		-0.178 (0.544)
DCAR*MUTUAL_OWN		-0.634 (0.035)
DCAR*OTHERINST_OWN		-0.172 (0.107)
DCAR*INDIVIDUAL_OWN		-1.037 (0.313)
Pseudo R-square	0.023	0.254
Test of Hypotheses		
MUTUAL_OWN+DCAR*MUTUAL_OWN		-0.518 (0.075)
OTHERINST_OWN+DCAR*OTHERINST_OWN		-0.198 (0.053)
INDIVIDUAL_OWN+DCAR*INDIVIDUAL_OWN		-1.215 (0.213)
Panel B. Mean Ai and Norton marginal effect (mean Z-statistic)		
DCAR*MUTUAL_OWN		-0.063 (-1.785)
DCAR*OTHERINST_OWN		-0.015 (-0.444)
INDIVIDUAL_OWN		-0.086 (-0.425)

Our contributions

- Provide timely information to government regulators around the world who are debating about the costs and benefits of granting minority shareholders direct control over corporate decisions
- Contribute to the international corporate governance literature
 - Illustrate the effect of a specific investor protection mechanism on shareholder value
 - Overcome the common methodological limitations in this line of research
- Contribute to the mutual fund proxy voting literature
 - A narrow focus on mutual funds' actual voting behavior may have missed the governance role of these institutions
- Contribute to our understanding of the governance role of institutional investors in weak investor protection countries