Does granting minority shareholders direct control over corporate decisions increase shareholder value? A natural experiment from China

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Overview

- Examines the effect of granting minority shareholders the right to vote on corporate decisions on firm value
- Examines whether the above effects depend on the identity of the minority shareholder
- Uses a natural experiment: introduction of segment voting regulation in China since December 7th, 2004

Data

- Equity offerings in 7218 firm quarters for the period January 1, 2004 till June 30, 2005.
- Of these 3999 firm quarters are deemed eligible to propose equity offerings
- Ownership details of top 10 holdings of all tradable shares in each firm namely, percentage owned by mutual funds (4.6%), other institutions (6.3%), and individuals (2%)
- Uses CAR to proxy for "quality" of proposal: CAR > 0 → value increasing proposal; CAR <= 0 → value decreasing proposal
- Voting behavior of minority shareholders on equity offering proposals brought in by the management

Methodology

- Looks at three indicators
  - Propensity of management to bring in value increasing and value decreasing proposals on equity offerings
  - Voting behavior of minority shareholders on proposals brought forward by management
  - Market reaction after regulation
- Using
  - Mutinomial Logit model (no proposals, value increasing proposal, value decreasing proposals)
  - Logit model for voting “NO” (veto) on proposals brought forward
  - Event study methodology for stock market reaction

Results

- Granting minority shareholders the right to vote on corporate decisions reduces the likelihood of the management to bring in value decreasing proposals
- No effect on the likelihood of bringing in value increasing proposals
- Effect strongest for individual investors followed by mutual funds
- The quality of the proposals , proxied by CAR increases in the regulation period but only for firms with higher mutual fund ownership but not for individual ownership
- Minority shareholders are more likely to veto value reducing proposals in firms with higher mutual fund ownership, but not with high individual or institutional ownership
- Stock market reaction to the announcement of regulation increases with mutual fund ownership

Importance of the Question

- Address an important question of whether granting minority shareholders right to vote on corporate decisions is justified
  - Might increase firm value due to reduction of agency cost
  - Might reduce firm value due to lack of expertise to take informed decisions; objectives of different types of minority shareholders may also differ
- Contributes to the literature on effect of legal environment on financial market development and firm value; looks at specific mechanisms through which law might work
- Looks at the deterrence effect of managers voluntarily reducing bad corporate governance proposal in presence of significant minority shareholder presence as opposed to looking at voting behavior
- Clear results
  - results are robust to other confounding events; general improvement in the corporate governance environment
  - Quality classification and event study results are robust to event window definition; cluster standard errors also address econometric issues

How can we strengthen these findings?

- Making the results more robust through additional specifications
- Getting additional evidence by finer classification of investors' incentives to vote and investors' ability to influence outcome, and quality of proposals brought for voting
- Ruling out other methods of governance by institutional investors

Results: additional specification

- It would be nice to use accounting measures to quantify long term effect on firm value. Stock market may be inefficient
  - Market-to-book, Tobin's Q, Return-on-assets
- Regression
  - Regression ought to have "aggregate" ownership stakes of institutional investors to capture coordination
  - Could incorporate quarter fixed effects to control for unobserved time (regulation effects)
  - Should report the number of observations for each regression
  - It may be useful to report the odds ratio along with the coefficients

Results: additional specification

- Do other corporate governance mechanisms influence the incentive of the management to bring in value decreasing proposals?
  - Board and audit committee independence
  - CEO-duality
- Management can behave strategically regarding which proposals they bring for voting
  - Is there a selection model on top of the "voting" model? Should we have a inverse Mills ratio in the voting regression?
  - Also, shareholders already observe the market outcome and simply follow it while voting. No independent expertise or corporate governance role.
- What happens if a firm brought in both a value increasing as well as a value decreasing proposal
- Why can't we make "proposal" as the unit of observation instead of the "firm-quarter"? Can take ownership and firm characteristics to be unchanged for proposals within the same quarter

Getting additional evidence?

- Management's tabling of proposals as well as voting behavior of investors depend on
  - Incentive to vote
    - How important is the firm in the investors portfolio
    - Does the mutual fund have holdings in other member firms
    - Does the mutual fund, institutional investor have other affiliations with the firm i.e., underwriting, merchant banking, loans
  - Type of proposal
    - Equity offerings
    - RPT
    - Compensation contracts
  - Ability to influence outcome
    - Extent of shareholding in that firm
    - Is share ownership pivotal
    - Can institutional investors co-ordinate

Incentive to vote

- Can we get weight of that firm in the investor’s portfolio?
  - Possibly yes

- Can we get data for “affiliation” which ties the institutional investor with that firm?
  - It will proxy for possible “Conflict of interest” and capture possibility of “management threat” on institutional investors

- Can we use ownership data to find if institutional investors have holdings in other member firms in a group?
  - Need ownership data only

Type of proposals

- Can we look at other types of proposals to generalize the conclusions

- For example, institutional investors including mutual funds may not have the expertise to vote on compensation contracts

  - Compensation proposals → have to be judged in relation to a benchmark; annual rewards versus long-term payments

- Financial institutions may be ambivalent or may even vote against good equity offerings proposals as they are concerned only about fixed payments; but they may rightly vote against bad RPT proposals

- The quality of proposal brought in by management may depend on the “incentive” to tunnel

  → Can look at location in the pyramid, divergence of control and cash flow rights

  → If controlling shareholders have high ownership stake then incentive to reduce firm value is small unless one can tunnel resources

Ability to influence outcome

- Shareholding of institutional investors in China seems relatively small to generate strong incentive for individual voting and may hence influence the propensity of the management to bring in value decreasing proposals
    - Can institutional investors coordinate with other mutual funds and other minority investors?
- Identify where institutional ownership is “Pivotal”
    - Will require detailed equity holding data
- Make a proxy for coordination
    - proportion of total tradable shareholding held by all types of institutional investors

Other channels of governance

- Is exit an alternative over voice?
  - Can look at changes in institutional ownership and implied trading patterns
- Do independent boards monitor?
- Unobserved proposals or pre negotiation
  - Is there a relation between the number and type of proposals that are put to vote and institutional ownership?
- Do companies with more mutual funds ownership eventually perform better?
  - → look at before and after performance