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More say by minority shareholders does not always mean better decisions

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Due either to weak investor protection or legitimate business reasons, ownership of publicly listed companies in many markets – Argentina, Greece, Italy, Hong Kong, Singapore, Japan and mainland China, for example – is highly concentrated in the hands of one or a few controlling shareholders.

Because controlling shareholders typically have control power over firms significantly in excess of their cash flow rights, primarily through the use of pyramids and participation in management, they have a direct conflict of interest with minority shareholders.

While minority shareholders want management to take action that increases stock prices, controlling shareholders may find it more beneficial to directly channel the resources of the companies to themselves through various mechanisms, such as related party transactions or outright theft.

Anticipating such potential channelling, rational minority shareholders would, of course, price protect by discounting the stock prices of the shares offered for sale by the controlling shareholders at the initial public offering.

Therefore, to reduce the cost of external financing, controlling shareholders should have an incentive to bond themselves to good corporate governance in order to mitigate minority shareholders' adverse selection.

However, in reality, many listed firms in weak investor protection countries do not adopt good corporate governance because weak country-level investor protection directly increases the costs that controlling shareholders incur to bond themselves to good governance.

It is thus critical to identify effective control mechanisms that can strengthen protection for minority shareholders and, therefore, increase shareholder value.

One such mechanism shareholder activists have been increasingly advocating is granting minority shareholders more decision-making power. Regulators have also become more willing to propose regulations that will enhance minority shareholders' control over corporate decisions.

Even in Singapore, where minority shareholders traditionally do not have much power compared with those in countries such as the US, calls have been made to give this group of investors more voice, enabling them to engage in corporate governance. For example, some have advocated online voting to encourage shareholder participation on matters such as senior management remuneration.

However, the jury is still out on whether such increased control should be given to minority shareholders as its costs and benefits are not immediately apparent.

Minority shareholders' participation in corporate decisions may just do the opposite by reducing shareholder value as such shareholders may not have the necessary information to make informed decisions, or have the ability to effectively exercise their rights.

There is also concern that if minority shareholders are affiliated with certain interest groups, they may pressure companies to pursue social, political or environmental agendas that can potentially hurt shareholder value. Such intervention in firm management can also create unnecessary diversion of management attention and resources from more productive uses.

To investigate whether giving minority shareholders increased control increases shareholder value, my co-authors and I studied the effects of a unique securities regulation issued by the China Securities Regulatory Commission known as the segmented voting regulation.

Prior to the segmented voting regulation, controlling shareholders of publicly traded Chinese firms frequently diverted corporate resources to themselves through various mechanisms, such as issuing new equity at discounted prices and then diverting the equity offering proceeds to themselves.

The segmented voting regulation sought to reduce the extent of such diversion by requiring several major corporate decisions, such as equity offering proposals, to obtain the separate approval of minority shareholders.

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WOULD REQUIRING APPROVAL FROM MINORITY SHAREHOLDERS IMPROVE STOCK VALUE?

We conducted three analyses on equity offering proposals submitted pre- and post-regulation. We also studied whether there were differences in results for listed companies with varying levels of mutual fund ownership, individual shareholder ownership and other institutional shareholder ownership.

Our first analysis examined whether the new regulation discouraged management from submitting value-decreasing proposals. Indeed so. The regulation significantly deterred value-decreasing proposals, especially in firms with high mutual fund or individual shareholder ownership but not in firms with high other institutional ownership.

Our second analysis examined whether there was a difference in the quality of the submitted equity offering proposals pre- and post-regulation.

We found the quality of the proposals to be significantly higher post-regulation for firms with mutual fund ownership but not for firms with individual or other institutional ownership. This implies that the stock value improved upon the adoption of the regulation but only for firms with high mutual fund ownership.

Our third analysis used detailed post-regulation voting data to examine which minority shareholders are more likely to participate in the voting, and whether minority shareholders' voting decisions are correlated with proposal quality.

As expected, minority shareholders with lower stock ownership levels are less likely to vote on submitted proposals. Among the top 10 minority shareholders, individual shareholders are less likely to vote on submitted proposals than mutual funds and other institutional investors.

However, it was not conclusive that minority shareholders' voting decisions are associated with proposal quality.

Our findings suggest that mutual funds play a key governance role in deterring management from submitting value-decreasing proposals.

While the common perception is that mutual funds often support management in proxy voting, and hence raises questions regarding its governance role, our research found just the contrary.

Our research gives timely information as regulators in Singapore are enabling minority shareholders to have more direct influence over corporate decisions.

In weak investor protection countries, the benefits of giving minority shareholders a direct say on corporate decisions appear to depend on the composition of minority shareholder ownership.

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