



Foreign institutional investors and corporate governance in emerging markets: Evidence of a split-share structure reform in China



Wei Huang^{a,b,1}, Tao Zhu^{c,*}

^a Shidler College of Business, University of Hawaii at Manoa, 2404 Maile Way, Honolulu, HI 96822, USA

^b Center for Economics, Finance and Management Studies (CEFMS), Hunan University, Changsha 410006, China

^c Accounting Department, Management School, Jinan University, Huangpu Road West, Guangzhou 510632, China

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ABSTRACT

Using data on China's split-share structure reform that floats non-tradable shares, we find that Qualified Foreign Institutional Investors (QFIIs) have greater influence over the controlling state shareholders than local mutual funds. QFIIs are less prone to political pressure and are more likely to participate in arm's-length negotiation and monitoring in state-controlled companies. The presence of QFII ownership shortens the duration of the reform and increases the compensation to minority tradable shareholders. Unlike local mutual funds, the positive relationship between state ownership and the compensation to tradable shareholders *increases* with the presence of QFII ownership. Furthermore, QFIIs increase the likelihood of revision in reform proposals among state-controlled companies. Domestic mutual funds seem to make earnest negotiations in non-state-controlled companies in the absence of political pressure. Evidence suggests that involving foreign institutional investors in corporate governance practices can significantly reduce expropriation by controlling shareholders in emerging markets.

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1. Introduction

The effect of opening local equity markets to foreign investors on corporate governance has attracted much attention in the literature. Activist institutional shareholders, particularly foreign institutional investors, are believed to play a positive role in external monitoring, especially when large controlling shareholders may potentially engage in expropriation by pursuing exclusive benefits through their influence on management. In particular, as “outsiders,” foreign institutional investors are more likely to perform arm's-length monitoring, thereby benefiting minority shareholders. However, there has been little empirical evidence of the different roles that foreign and domestic institutional investors may play in corporate monitoring and governance practices, particularly in emerging markets that typically face a “twin agency” problem of corporate insider and state ruler discretion (Stulz (2005)).² In this paper, we study the different governance roles of foreign vs. local institutional investors by utilizing a unique Chinese corporate event that requires investors' voting.

* Corresponding author. Tel.: +86 20 85220178.

E-mail addresses: weih@hawaii.edu (W. Huang), zhutao@jnu.edu.cn (T. Zhu).

¹ Tel.: +1 808 9567679.

² There are several attention-grabbing cases in the last few years in which foreign shareholders played roles in forced management turnover and corporate takeovers. For a summary, see Aggarwal et al. (2011).

In recent years, financial globalization has further opened emerging markets that were previously off-limits to international investment. One such important example is the openness of China's domestic stock market to foreign institutional investors. Through a quota system, Qualified Foreign Institutional Investors (QFIIs) can invest in local shares with the same voting rights as domestic investors. Foreign investors have increasingly invested in this important emerging market.³ Historically, the majority of the Chinese listed companies have state entities as controlling shareholders holding mostly non-tradable shares. In what was a milestone development in the stock market, China launched the so-called split-share structure reform in 2005, making non-tradable shares floatable.⁴ To pass a deal, two-thirds of the tradable shareholders must approve a proposal involving a compensation offer made by non-tradable shareholders to tradable shareholders for the dilution of their stock values.

Because non-tradable shareholders are largely controlling shareholders, the split-share structure reform offers a natural experiment to study i) whether controlling shareholders make differential compensation offers to local and foreign institutional investors holding tradable shares; ii) how domestic and foreign institutional investors carry out their respective voting rights under a diffuse ownership structure in which dominant controlling shareholders such as state entities often represent a "grabbing hand" and exert their influence over the management and minority shareholders. In this paper, we investigate whether QFIIs and their local counterparts differ in the monitoring role in the negotiation process of the split-share structure reform. This issue is important because external monitoring such as a strengthened role of sophisticated and activist institutional investors is a key aspect of corporate governance practices.⁵

Using data around the split-share structure reform, we study three aspects of the reform: the time duration of the reform, the compensation offered by non-tradable shareholders to tradable shareholders, and the factors affecting the likelihood of the revision of the compensation proposal. We first examine the time duration of the reform and the compensation offered by non-tradable shareholders to tradable shareholders. In general, a shorter duration suggests a faster negotiation process and higher compensation implies that tradable shareholders have relatively stronger negotiation power and face less expropriation by non-tradable shareholders. We further examine whether the presence of domestic and foreign institutional investors affects the likelihood of revision in the compensation proposal offered to tradable shareholders by the non-tradable shareholders. A revision of the compensation offer often leads to a better deal for tradable shareholders. We study differences in these aspects between state-controlled and non-state-controlled companies. Our objective is to examine whether QFIIs, in comparison to local mutual funds, are less susceptible to local political pressure and more likely to perform arm's-length monitoring than their local peers.

Our study makes a number of contributions to the literature. *Firth et al. (2010)* examined the roles of state shareholders and domestic mutual funds in China's split-share structure reform and found that local mutual funds yield to political pressure to help state-owned firms to complete the reform quickly with a relatively lower cost at the expense of mutual fund investors and other minority shareholders of the company. Their findings imply that political pressure compromises the role of mutual funds in maximizing returns to their unit holders. In this study, we focus on whether and how QFIIs, as comparable active institutions, play a different monitoring role in comparison with their local counterparts in this important reform that redistributes shareholder wealth. Studying the difference helps us understand how international institutional investors function in corporate governance practices in emerging markets in which controlling state shareholders often exert political pressure to expropriate minority shareholders. Furthermore, given that China is the recipient of the world's second-largest investment inflow, international institutional investors are concerned with how the governance role of the QFIIs may play out in China and whether QFIIs are subject to similar political pressures faced by their domestic counterparts.⁶

Our study further contributes to the research on the impact of market openness and foreign equity ownership on corporate governance. In theory, the growth in institutional ownership and influence should result in better monitoring and governance, despite the institutional differences across markets (*Gillan and Starks (2003)*). Prior studies have found that increased openness to foreign equity investors in emerging markets enhances the information environment such as increasing analyst coverage and decreasing earnings management (*Bae et al. (2006)*); ownership by foreign and independent institutional investors enhances shareholder value (*Ferreira and Matos (2008)*); increases in institutional ownership in developed countries lead to increases in the Governance Index, and domestic institutional ownership (foreign institutional ownership) is the main driver of governance improvements in common-law countries (civil-law countries) (*Aggarwal et al. (2011)*).⁷ Prior studies have noted the limitation of the Governance Index and the importance of further research in exploring the ways in which foreign institutional investors exert their influence on corporate governance practices and their role in specific corporate events.⁸ In this study, we provide specific evidence of how the involvement of foreign institutional investors in corporate governance in emerging markets can promote the rule of market principles in corporate voting and governance practices.

³ For example, according to the Wall Street Journal ("China Stocks Turn Inside Out", January 22, 2013, C3), while some Chinese investors are turning away from their local markets, foreign investors find bargains and are maxing out on the quotas. Chinese stock market regulators had gradually increased the quota for QFIIs to about 36 billion U.S. dollars until early 2012 and more than doubled it in April 2012 to 80 billion U.S. dollars.

⁴ See the next section for details on institutional changes.

⁵ The other important aspect of corporate governance is internal controls such as the introduction of independent boards and incentive mechanisms.

⁶ According to the U.N. Conference on Trade and Development, in 2010 the U.S., with foreign direct investment reaching \$228 billion, remained the largest recipient of foreign investment; China was second, with investment inflow at \$106 billion (Wall Street Journal, July 27, 2011, A11).

⁷ In view of the weaker legal environment in civil-law countries, their results imply that foreign institutional investors improve corporate governance, especially in nations with weaker legal systems.

⁸ *Ferreira and Matos (2008)* stressed the importance of further research in exploring the role of foreign institutional investors in specific corporate events. Similarly, as noted by *Aggarwal et al. (2011)*, although the Governance Index is comparable across countries and can capture overall firm level governance, it is a continuous number based on the average of many firm attributes and may not capture specific aspects that really matter to corporate governance. Considering the limitations of the Governance Index, their study further examined the impact of institutional investors on governance provisions such as board structure and the choice of auditors.

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