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The determinants and effects of voluntary adoption of a cumulative voting system: Evidence from China

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ABSTRACT

Using a unique sample of China's listed firms, we find that firms with strong corporate governance are more likely to adopt the cumulative voting system (CVS) and CVS adoption improves firm performance. Further analyses show that the positive relationship between CVS adoption and firm performance is more significant for firms with less mutual funds' ownership, in a weak firm information environment, and whose managers have more power. Finally, we find three channels – professionalism of board directors, controlling shareholders' expropriation, and managerial entrenchment– through which CVS adoption affects firm performance. This study enriches the literature on corporate governance in general and the literature on the principal-principal problems in particular. Our findings also have important policy implications for minority shareholder protection.

1. Introduction

Firms in emerging markets such as China often have highly concentrated corporate ownership structures in which controlling shareholders frequently seek to extract private benefits at the expense of minority shareholders (i.e., the principal-principal problems) (Shleifer and Vishny, 1997; La Porta et al., 1998). The limited protection of minority rights and low corporate transparency in Asia exacerbates the expropriation of minority shareholders (Claessens and Fan, 2002).

Shareholders' meetings and the board of directors are perhaps the two most important of all of the corporate governance mechanisms. Shareholder voting and board representation are an important means by which shareholders participate in corporate governance to protect their interests. In this study, we examine the determinants and effects of the voluntary adoption by China's listed firms of a cumulative voting system (CVS), which is designed to give a degree of control to minority shareholders and increase minority shareholder representation on the boards.

Before 2002, almost all of China's listed firms used a straight voting system to elect their directors.[1] Under this system, each shareholder votes according to the number of shares s/he owns for as many candidates as may be elected. If two directors are to be elected, the shareholder may vote dependent on the number of shares s/he owns for each of the two candidates. Under this procedure,

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[1] China Vanke Co., Ltd. (Stock ID: 000002) and Foshan Electrical and Lighting Co., Ltd. (Stock ID: 000541) adopted the CVS in 1988 and 2000, respectively.

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a shareholder who owns a majority of the shares in a particular election can elect the entire board of directors.

In 2002, the China Securities Regulatory Committee (CSRC) introduced *the Code of Corporate Governance for Listed Firms in China*, which stipulated provisions for the protection of investors' interests and rights, including the CVS. The CSRC required listed firms whose controlling shareholders hold over 30% of the total number of shares to adopt the CVS. In 2006, the CVS was incorporated into the newly amended *Corporate Law*.[2] Under the CVS, each shareholder receives a block of votes equal to the number of shares s/he owns multiplied by the number of directors to be elected. The shareholder may then cast his entire block for a candidate or may distribute his votes among any number of candidates in whatever proportion s/he desires. Therefore, with the CVS it is possible for minority shareholders to elect one or more board members even if a controlling shareholder opposes their election (Bhagat and Brickley, 1984).

The 2002 Code of Governance does not require firms whose controlling shareholders hold less than 30% of the total number of shares to adopt the CVS. That is, the CVS is optional for these firms. However, between 2002 and 2005, 143 listed firms voluntarily adopted the CVS even though they did not meet the shareholding criteria.[3] Using these firms as the unique sample, this paper examines the determinants and effects of voluntary adoption of the CVS.

It is particularly important to identify corporate governance factors associated with voluntary CVS adoption to inform securities regulators of the demand for and (dis)incentives against CVS adoption. On the one hand, compared with firms with strong corporate governance, firms with weak corporate governance may be under greater regulatory pressure and minority shareholders in such firms have stronger desire to protect their benefits. If such pressure and desire are sufficiently high, it is likely for these firms to adopt the CVS. On the other hand, it is more likely for firms with strong corporate governance to adopt the CVS because monitoring agents like institutional investors (e.g., mutual funds) and independent directors may push them to adopt new corporate governance mechanisms. Identifying the corporate governance determinants of CVS adoption may assist regulators to gauge the likelihood of success of the CVS, any potential impediments or favorable factors, and the strategies necessary to make the system successful. Furthermore, by finding out whether the CVS is effective in protecting shareholder benefits and how it does, regulators can decide whether CVS adoption should be a mandatory requirement for all listed firms in China. It can also help minority investors to make appropriate investment decisions by focusing on CVS-adopting firms.

To investigate the determinants of CVS adoption, we focus on corporate governance variables that potentially affect the voluntary adoption of the CVS. We find that firms with strong corporate governance (in terms of mutual funds' ownership and board independence) are more likely to adopt the CVS.

Adopting propensity score matching (PSM) and difference-in-differences (DID) analysis, we find that CVS adoption improves firm performance. Moreover, we explore the moderating factors that influence the positive association between CVS adoption and firm performance and find that this relationship becomes more significant for firms in a weak firm information environment, with less mutual funds' ownership, and whose managers have more power.

Finally, we identify three channels – professionalism of board directors, controlling shareholders' expropriation, and managerial entrenchment – through which CVS adoption affects firm performance.

Our study differs from the prior studies in two ways. First, contrary to the findings of Xi and Chen (2014), Chen and Du (2015), and Chen et al. (2015), our study empirically demonstrates that CVS adoption can improve firm performance by increasing the number of directors with professional experience, mitigating controlling shareholders' expropriation, and constraining managerial entrenchment. In this regard, our study enriches the literature on corporate governance in general and the literature on the principal-principal problems in particular. As the expropriation of minority shareholders is common in China's listed firms, our findings are important to researchers and regulators interested in resolving the principal-principal problems.

Second, contrary to Xi and Chen (2014), Chen and Du (2015), and Chen et al. (2015), we focus on voluntary CVS adoption during the period 2002–2005. Compared with compulsory adoption, voluntary adoption is more interesting as it shows what firms are likely to be the first movers and whether there are economic consequences of doing so. When examining the effects of CVS adoption, we combine the PSM and DID methods to address endogeneity issues arising from omitted unobservable variables and reverse causality. As an overwhelming majority of listed firms adopt the CVS from 2005 (Xi and Chen, 2014), examining the voluntary adoption of the CVS during 2002–2005 helps us find out an appropriate matched sample which did not voluntarily adopt the CVS during that period.

The remainder of the paper is organized as follows. We introduce the institutional background and discuss principal-principal problems in relation to the CVS in Section 2, develop hypotheses in Section 3, introduce the research design in Section 4, discuss the empirical results in Section 5, examine the moderating effects of firm information environment, mutual funds' ownership, and managerial power in Section 6, and explore the channels through which CVS adoption affects firm performance in Section 7. Section 8 concludes the paper.

2. Institutional background

2.1. Principal-principal problems in China's listed firms

Traditionally, agency theory focuses on the agency relationship and divergent interests between the principal and the agent in the

[2] We collected the data and found that more than 90% of listed firms adopted the CVS after 2006.

[3] For convenience, we refer to the firms that adopted the CVS during 2002–2005 as "CVS-adopting firms" and firms that did not adopt the CVS as "non-adopting firms".