OWNERSHIP STRUCTURE AND PROXY CONTEST WITHOUT PROXY TRADING: EVIDENCE FROM TAIWAN SECURITIES MARKETS

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Abstract

This paper discusses how proxy fights affect the incumbent managers' attitude toward the shareholders. In Taiwan, the proxy rules Amendments in 1996 prohibit the proxy fighters to purchase proxy rights from shareholders. We argue that the prohibition of proxy trading favors the incumbents to gain control over the firms. Since the proxy rules favor the incumbent managers, incumbent managers do not have to keep a high ownership to gain control leading to severe agency problems between incumbent managers and outside shareholders. With the case of stopping proxy trading in Taiwan, we indicate that to order to mitigate the managers' unethical behaviors toward shareholders under the separation of ownership and control, proxy rules should be unbiased toward both the incumbents and raiders.

Keywords: Agency cost; Business ethics; Firm performance; Proxy fights; Separation of ownership and control; Takeover

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1. Introduction

Business ethics can be considered as a firm's attitude toward its stockholders, customers, and employees. As to firm's attitude toward stockholders, the separation of ownership and control of a corporation leads to the agency problems between the stockholders and managers. Jensen and Meckling's (1976) seminal paper formulates the implications of the agency problems. In their argument, an agency problem exists when managers do not own the entire ownership of the firm. This manager's partial ownership would result in less efficient management and more perquisite consumption. Less efficient management and more perquisite consumption are unethical behaviors to the shareholders making shareholders suffering poor firm performance. Nevertheless, the agency problem might be mitigated by certain kinds of organized market mechanisms. Fama (1980) indicates that the agency problem could be efficiently controlled by the compensation schemes for managers and the manger job market under an appropriate mechanism. Furthermore, Fama and Jensen (1983) argue that when decision management is separated from decision control, managers will limit their expropriation on stockholders' interest.

If market mechanisms cannot alleviate the agency problems between stockholders and managers efficiently, a takeover would serve as a solution to the agency problem. Manne (1965) argues that a takeover provides an external control device of last resort. A takeover enables outsider raiders to gain the control over the target firm by circumventing the existing managers and the board of directors through a tender offer or a proxy fight. The threat of takeover either through a tender offer or a proxy contest would induce the incumbent managers to improve their performance in order to keep the control of the target firm. From the point of view of agency problems, if the threat of takeover is not significant, the incumbent managers who would like to maximize their own benefits would tend to engage in unethical behaviors to expropriate the outside shareholders leading to poor firm performance.

A proxy contest is a typical way and a cheaper way for outside raiders to challenge against the incumbent managers of firms. Proxy rules regulate the ways that incumbent managers and outside raiders to receive proxy rights. Obviously, the proxy rules will affect the outcome of a proxy contest. If the proxy rules favor the incumbents, the outside raiders will have difficulties to win the proxy battles and vice versa. Therefore, the proxy rules influence the extent of threat of takeover toward an incumbent. In Taiwan, the proxy rules have been revised several times. Basically, the regulations on the qualifications of investors who would like to join the proxy contests become more and more rigid. Especially, the proxy rules Amendments in 1996 prohibit proxy contesters to buy proxy rights from the shareholders. The incumbent managers or the outside raiders can only solicit proxies from the public shareholders but not pay for the proxies. Before the Amendments in 1996, most of the incumbents or raiders fight the proxy battles through purchasing proxy rights rather than soliciting proxy rights. The uniqueness of proxy rules in Taiwan enables us to examine the effect of stopping proxy trading on the manager' ethic behaviors under the separation of ownership and control. This paper examines the proxy contests in Taiwan and discusses how the proxy contests affect the ethic behaviors of the managers of the firms.

The remaining of this paper is organized as follows. We discuss the relation between takeover and firm performance in section 2. The proxy rules in Taiwan are discussed in section 3. Section 4 describes the environment of Taiwan securities market and its special characteristics. In section 5, the effect of proxy regulations along with stock market properties on firm performance is investigated. Finally, section 6 concludes.

2. The Relationship between Takeover and Firm Performance

A takeover is a remedy to the poor performance due to managers' unethical conducts of a target firm and provides the shareholders with a different choice of the management. Therefore, the existence of attempts to takeover a target firm will affect the value of the firm. Amihud, Lev and Travlos (1990), Harris and Raviv (1988), Jensen and Ruback (1983), Raad and Ryan (1995) and Shleifer and Vishny (1986) show that the stockholders of a target firm will earn a higher profit from a successful takeover than from an unsuccessful one. For a successful takeover, the stockholders of the target firm earn even more from a tender offer than from a proxy fight.

However, the target's shareholders gain nothing from an unsuccessful tender offer but still receive abnormal profit from an unsuccessful takeover through proxy contests. Sridharan and Reinganum (1995) investigate the effect of target firm's operating performance, capital structure, and ownership profile on the decision of a hostile tender offer or a proxy contest. They find that a target firm with poor operating performance is more likely to experience a proxy fight rather than a hostile tender offer. On the other hand, a highly leveraged target that tends to be management-controlled is more likely to encounter proxy contests instead of hostile tender offers. Borokhovich, Brunarski and Parrino (1997) point out that the antitakeover charter amendments help incumbent managers protect above market levels of compensation.

Core, Holthausen and Larcker (1999) also show that CEOs earn more compensation when governance structures are less effective. The outside shareholders suffer costs of incumbent managers' earning more compensation than they deserve. The stockholders of a target firm benefit from the tender offers or proxy contests triggered by the outside raiders. Israel (1992), Stulz (1988) show that tender offers by raiders will raise the stock price and benefit the stockholders. Even without tender offers, the proxy fights by raiders can threat the incumbent managers not to consume undesirable perquisites or compensation. Therefore, without tender offers or proxy fights, the incumbent managers will be better off but the shareholders will be worse off.

3. Proxy rules and amendments in Taiwan

The proxy contests may result in the switch of the management of the target firms and thus affect the benefits of the shareholders of the target firms. Taiwan SEC sets up proxy rules to regulate proxy contests to keep the proxy right market operating smoothly and normally. The proxy rules regulate the proxy contests and influence the threat of takeover. The most important proxy rules are the regulations on the ways to receive proxy rights and the regulations on the number of proxy rights received by proxy fighters. There are two ways to receive proxy rights from the stockholders. One is to purchase stockholders' proxy rights; the other is to solicit stockholders' proxy rights without paying anything.

Based on the proxy rules in Taiwan, a proxy purchaser or solicitor must keep more than 0.2% of outstanding shares (which must be more than 100,000 shares) or own 800,000 shares of the target for more than six months in order to purchase or solicit proxy rights in a proxy contest. In this case, shareholders with small numbers of shares or the short-term investors will not be allowed to purchase or solicit proxy rights and have little chance to be on board even if they are potentially efficient managers. For the number of purchased or solicited proxy rights, proxy fighters cannot purchase or solicit proxy rights more than four times of shares they own.

Moreover, the purchased or solicited proxy rights are not transferable. Therefore, the maximum number of proxy rights purchased or solicited is four times of the shares owned by proxy fighters. The rule of number of proxy rights received favors the incumbent managers since the outside raiders have to own more shares to receive more proxy rights. If the raiders have to receive proxies more than four times of his current shares to win the proxy contest, they have to buy more shares. Even though the regulations of number of proxies purchased or solicited also apply to the incumbent managers, the incumbents are still incumbents without being taken over. Hence, the incumbents prefer any regulation to deter the proxy fights. On December 17, 1996 Taiwan proxy rules are amended. The most important revision of proxy rules Amendments in 1996 is that the proxy fighters are not allowed to purchase proxy rights from shareholders any more. After December 17, 1996, proxy fighters can only solicit rather than purchase proxy rights. The stopping of proxy trading in Taiwan since 1997 significantly affects the proxy fight activities in Taiwan stock markets, especially under the specific characteristics of Taiwan stock markets. We argue that the rules of stopping proxy trading favor the incumbents and deter the threat of takeover by outside raiders.

4. Characteristics of Taiwan Securities Markets

In this section, we describe the special characteristics including the ownership of institutional investors and stock turnover rate of Taiwan securities market relative to other major East Asian securities markets, such as Japan, Korea and Singapore. Basically, the special characteristics of Taiwan Securities Markets result from the particular characteristics of investors.

4.1 Ownership of Institutional Investors and Individual Investors

Taiwan stock market is somewhat different from those of other Asia stock markets with respect to the ownership structure of the firms. The ownership structures of major East Asia stock markets are reported in table1. From table 1, we can see that the proportions of domestic individual investors for the stock markets of Japan, Korea, Malaysia, Singapore and Taiwan are 26.4%, 39%, 17.4%, 15.0% and 58.0%, respectively. Obviously, relative to other East Asian stock markets, Taiwan stock market has more individual investors. Compared to other East Asian stock markets, the proportion of domestic institutional investors (8.1%) in Taiwan stock market is the smallest one. Typically, individual investors are less informed and more sentimental than the institutional investors. Therefore, we expect that individual investors have little idea about how efficient the incumbents or raiders are. If the individual investors have little idea about who is more efficient, they provide their proxy rights to those who offer a higher price on their proxies when there is an offer. However, proxy rights are forbidden to trade after December 17, 1996. The individual investors can only provide their proxies without any compensation. In this case, the individual investors are not interested in the proxy battles between the incumbents and outside raiders.

4.2 Stock Turnover Rate

Stock turnover rate indicates how long the investors keep their shares. If the stock turnover rate is higher than one on average, the stocks are traded more than once over a certain period. Stock turnover rate is measured by stock transaction value divided by the stock market value. Stock transaction value is the product of transaction price and transaction volume. Obviously, the more frequently the stocks traded, the higher the transaction volume and thus the higher the stock turnover rate. We report the stock turnover rates of the major East Asian stock exchanges in table 2. From table 2, we can see that the stock turnover rate is highest in Taiwan stock market (the average turnover rate from 1992 to 2000 is 280.3%) and is much higher than the second highest one (Korea stock market has the second highest stock turnover rate at 189.03%). This result implies that the investors in Taiwan stock markets keep the shares for a shorter time period. Taiwan investors tend to buy the shares and sell the shares very quickly to capture the short-term profit. This phenomenon is consistent with the fact that Taiwan stock market is full of the individual investors. As in table 1, the majority of the investors in Taiwan securities market are the individual investors rather than institutional investors.

Generally speaking, the institutional investors are the long-term investors and are more likely to keep the stock shares for a longer time horizon. Therefore, the findings of tables 1 and 2 imply that most of the stock investors in Taiwan are liquidity traders. Once the investors are liquidity traders, they simply keep their shares for a short time period and they do not care about the long-run performance of the stocks. Hence, they are not interested in the inefficiency of the existing incumbents and the replacement of the inefficient incumbents. The liquidity investors prefer a tender offer offered by the raiders to make a short-term profit by selling the shares to the raiders. If a takeover happens through a proxy fight rather than a tender offer, the individual investors will sell their proxy rights to make profit.

Since the liquidity traders prefer to sell the proxy rights, the proxy rule that stops proxy trading hurts the benefits of the individual liquidity investors. When the individual liquidity investors are prohibited to sell their proxy rights, the occurrence of proxy contests reduces and the incumbents are still incumbents. Therefore, stopping proxy trading facilitates the incumbents to keep control over the firms.

5. The Effect of Stopping Proxy Trading on Incumbents' Ownership and Firm Performance

The incumbents or outside raiders can solicit or buy proxies from shareholders in proxy battles to gain control over the firm before December 17, 1996. Since most of the shareholders in Taiwan are liquidity investors, they prefer to sell their proxies to those who offer a higher price for their proxies. However, starting from 1997, shareholders are not allowed to sell their proxies. Shareholders can only provide their proxies to the incumbents or to outside raiders without asking for any compensation for their proxy rights. In this case, the number of proxy fights will decrease because the majority of the shareholders (liquidity shareholders) have no idea to provide their proxies to incumbents or to raiders. Table 3 shows that the number of proxy fights decreases after the rule to stop proxy trading. Table 3 indicates that there are 579 board re-elections during 1989 to 1996 and 772 board re-elections during 1997 to 2001. Even though the number of board re-elections after stopping proxy trading is larger than that before stopping proxy trading, the number of proxy fights is smaller after stopping proxy trading (116 vs 148). Therefore, we argue that the threat of takeover through proxy fight is less severe after the proxy rule Amendments in 1996. Under the separation of ownership and control, Brigham, Gapenski and Ehrhardt (1998) argue that the threat of takeover is a good device to prevent the incumbent managers to behave unethically. In Taiwan, the proxy rule amendments in 1996 prohibit the incumbents or outside raiders to buy proxy rights from the shareholders. These amendments along with the specific characteristics in Taiwan securities markets reduce the possibility of proxy battles in Taiwan. Therefore, the proxy rule amendments in 1996 mitigate the threat of takeover through proxy fights. Hence, the raiders have to get rid of the incumbents through other media such as tender offers or open market purchase of the target shares. Nevertheless, a takeover through a tender offer or an open market purchase of target shares is costly and is more expensive than through a proxy fight. Thus, the amendments in 1996 stopping proxy trading will also mitigate the threat of takeover. With the ease of takeover, the incumbents can gain control over the firms with less ownership. Table 4 shows that the average ownership of board of directors is 28.07% during 1989 to 1996. However, ownership of board of directors is 25.14% during 1997 to 2000. The findings of table 4 are consistent with our argument that after stopping proxy trading the ownership of incumbents decreases significantly. Jensen and Meckling (1976) argue that under the separation of ownership and control, the managers would behave unethically to expropriate the outside shareholders, which is known as the agency costs between managers and shareholders. However, the higher the ownership of managers, the closer the benefit between stockholders and managers. Therefore, the higher the ownership of managers, the lower the agency cost leading to higher the performance of the firm. Under the proxy rule amendments in 1996, we argue that the firms will perform poorer after the prohibition of proxy trading and more importantly the positive relationship between incumbents' ownership and firm performance is even stronger. Demsetz and Villalonga (2001) indicate that Tobin's Q is strong influenced by investor psychology, because it pertains to forecasts of a multitude of world events that include the outcome of present business behaviors.

Tobin's Q is a typical measure for firm performance (see Morck, Shleifer and Vishny, 1988). With Tobin's Q as the measure of firm performance, we reach the following regression results to examine the effect of stopping proxy trading on behavior of the incumbent managers.

$$\begin{array}{llllll} \text{Tobin's Q} & = & 1.55 & +0.004\times\text{BOARD} & +0.004\times\text{BOARDYEAR} & \\ \text{(t-statistic)} & & (69.03) & (5.58) & (1.82) & \\ & & & -0.619\times\text{YEAR} & +0.034\times\text{R\&D} & \\ & & & (-17.25) & (12.16) \quad R^2=18.05\% & (1) \end{array}$$

Where,
Tobin's Q is measured by the market value of total assets divided by the book value of total assets. Market value of assets is estimated by the market value of equity plus the book value of debt.
BOARD is the ownership of board of directors;
YEAR is a dummy variable with YEAR=1 after 1996; YEAR=0 otherwise;
BOARDYEAR is the product of BOARD and YEAR;
R&D is the expenditure on R&D divided by Sales.

The positive coefficient (0.004) of BOARD in equation (1) means that the lower the board ownership, the higher the ethic problem of the incumbent managers resulting in poorer firm performance. When ownership of board of directors decreases by 1%, the firm performance (measured by Tobin's Q) decreases by 0.004. The positive coefficient (0.004) of BOARDYEAR implies that after the stopping of proxy trading the incumbents' ethic problems are even severe when they own less ownership. After December 17, 1996, 1% decrease in ownership of board of directors will lead to firm performance to decrease by 0.008 (0.004+0.004=0.008) which is twice than that before the stopping of proxy trading. The negative coefficient (-0.619) of YEAR indicates that the firm performance is poorer after the stopping of proxy trading. The most important finding of equation (1) is that the ethic problem (or the agency problem) becomes more severe after the stopping of proxy trading.

6. Discussion and Conclusions

The ownership of a corporation is typically diversified. The managers of a firm may not own a signifycant proportion of the ownership. In this case, the agency problem becomes severe for a corporation. The proxy contests provide the efficient shareholders to have a chance to get rid of the inefficient incumbents to takeover the firm. Without the proxy contests, the outside raiders have to make tender offers or open market purchases of target shares in order to gain the control over the firm. Obviously, a tender offer or an open market purchase of shares is more costly than a proxy fight for outside raiders. With the mechanism of proxy contests, the threat of takeover is stronger and the effect of alleviating agency problem is better. Therefore, under a solid and healthy proxy contest mechanism, the management of a firm will be more efficient, the incumbent managers will behave more ethically and the shareholders will receive more benefit from investing a corporation.

In Taiwan, a proxy fighter must own at least 0.2% of target shares, which must be more than 100,000 shares or must own more than 800,000 shares in order to be a proxy solicitor. Moreover, the proxy rule amendments in 1996 prohibit proxy rights to be traded. The purpose of these regulations on proxy fights is to prevent the shareholders of small investments from being in control of a firm. Basically, these regulations assume that the minority shareholders are not efficient managers. This is not true, however. Whether an incumbent or a raider is efficient will be determined by the governance mechanisms in capital markets.

Under Taiwan proxy rules, the incumbents and the raiders are not put on an equal basis to play the game. The raiders are playing an unfair game relative to the incumbent managers in the proxy contests. When the regulations favor the incumbents, the threat of takeover is less serious. The managers would presumably operate to improve their own personal wealth, leisure, and perquisites at the costs of shareholders. The agency costs between the stockholders and the managers, thus, become higher.

Why the regulations on proxy contests favor the incumbent? Generally speaking, Taiwan SEC assumes that the proxy contests increase the uncertainty of the personnel system of the target firms and thus the uncertainty of the targets' future earnings. Therefore, the operations of the target firms and their earnings become more risky. To overcome these kinds of uncertainty, the regulations favor the incumbents to mitigate the threat of takeover through proxy contests. Furthermore, Taiwan SEC assumes that the raiders are the robbers to the target firms. Once the raiders gain the control of the target firms, they will milk the firms to favor their own benefits. Thus, Taiwan SEC sets rules to limit the raiders possibility to gain control through proxy contests. However, if outside raiders may divest the targets to benefit themselves, we do not know why the incumbents will not do the same thing and thus need the threat of takeover to induce the incumbents to operate ethically.

Under the separation of ownership and control, it is difficult to ask the incumbent managers to behave ethically without efficient governance mechanisms. The threat of takeover is considered as an efficient mechanism to induce the incumbent managers to favor the shareholders rather than to favor themselves. In this paper, we show that the proxy rules are influential to outcome of the proxy contests. If the proxy rules favor the incumbents, the threat of takeover is mitigated and the incumbents would behave unethically to expropriate the outside shareholders. Taiwan SEC stops the proxy trading from December 17, 1996. Stopping proxy trading reduces the winning possibility of outside raiders in the proxy battles. After the proxy rules of stopping proxy trading, the incumbents become less efficient and the firm performance becomes poorer due to less threat of takeover. Hence, we argue that a fair proxy fight mechanism is necessary to induce the incumbents to behave ethically and to raise firm performance under the separation of ownership and control.

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Appendices

Table 1. The ownership structures of major East Asia stock markets

	Japan	Korea	Malaysia	Singapore	Taiwan
Domestic individual investors	26.4%	39.0%	17.4%	15.0%	58.0%
Domestic institutional investors	37.0%	13.7%	38.3%	41.0%	8.1%
Domestic non-financial institutional investors	23.7%	17.3%	16.7%	38.0%	26.8%
Foreign investors	12.4%	12.4%	19.6%	10.0%	7.2%

Source: FIBV, Focus, Dec 2000.

Table 2. The turnover rate of Major East Asia Stock Markets

Year	Japan	Korea	Thailand	Singapore	Taiwan
1992	19.91%	133.42%	125.26%	12.8%	161.33%
1993	25.86%	186.55%	66.19%	26.2%	252.42%
1994	24.93%	174.08%	64.04%	26.7%	366.11%
1995	26.77%	105.11%	43.06%	17.8%	227.84%
1996	28.94%	102.98%	50.91%	13.6%	243.43%
1997	32.93%	145.56%	49.56%	56.28%	407.32%
1998	34.13%	207.00%	68.86%	63.95%	314.06%
1999	49.37%	344.98%	78.14%	75.16%	288.62%
2000	58.86%	301.56%	64.91%	64.97%	259.16%
1992-2000	33.52%	189.03%	67.88%	39.72%	280.03%

Stock turnover rate = (transaction value) / (market value), where transaction value = (transaction price) × (transaction volume).
Source: The website of Taiwan Stock Exchange, *http://www.tse.com.tw*

Table 3. Cases of board re-elections and proxy contests

Year	Number of board re-elections	Number of proxy contests	Percentage of proxy fights out of board re-elections
1989	37	18	48.65%
1990	43	13	30.23%
1991	72	42	58.33%
1992	63	12	19.05%
1993	67	13	19.40%
1994	97	26	26.80%
1995	95	14	14.74%
1996	105	10	9.52%
1997	124	25	20.16%
1998	139	28	20.14%
1999	137	20	14.60%
2000	185	25	13.51%
2001	187	18	9.63%
1989-1996	579	148	25.56%
1997-2001	772	116	15.03%

Source: The proxy statements collected in Securities and Futures Foundation Taiwan.

Table 4. Ownership of board of directors

YEAR	Mean	Standard deviation	Maximum	Median	Minimum
1989	29.29%	15.91%	79.35%	24.21%	6.37%
1990	28.00%	15.80%	93.57%	24.09%	2.42%
1991	28.89%	17.23%	91.40%	24.29%	2.08%
1992	28.95%	17.15%	88.68%	25.27%	1.32%
1993	28.75%	17.30%	91.49%	25.36%	0.66%
1994	28.05%	16.19%	82.44%	25.13%	0.66%
1995	27.54%	16.14%	82.37%	24.37%	0.84%
1996	26.61%	15.76%	97.61%	24.23%	3.58%
1997	25.35%	15.18%	99.04%	21.57%	0.70%
1998	25.33%	15.01%	85.71%	22.08%	2.11%
1999	25.23%	14.52%	79.77%	22.86%	0.02%
2000	24.72%	14.60%	97.13%	22.28%	0.96%

When we test the equality of means of ownership of board of directors before and after 1996, we reach t-value=5.84 and p-value=0.000.
Source: Taiwan Economic Journal (TEJ) ownership data base.