THE EFFECT OF MINORITY VETO RIGHTS ON CONTROLLER TUNNELING Jesse Fried, Ehud Kamar and Yishay Yafeh

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The paper

- The paper examines a regulatory reform in Israel known as Amendment 16 – as an exogenous shock to controllerexecutive pay.
- Findings:
 - The reform works!

A 10% decline in controller-executive pay, on average.

- The likelihood of controller executives disappearing from a firm's list of 5 highest paid executives increased by about 40%; About 10% of the disappearing controllers were replaced by professional managers.
- Lower likelihood of pay reductions in second-round approvals vs. first round approvals.
- No observed post-reform increase in other forms of tunneling, such as change in dividend policy.

Amendment 16

- The paper focuses on the impact of minority veto rights
- However, Amend. 16 is much wider. It includes:
 - Reinforcement of the board's independence:

Redefining the terms of outside directors; empowering minority shareholders to appoint outside directors – even against controller opinion; increase majority level in shareholders' meetings w.r.t executive appointments

 Improving minority rights in related party transactions (RPT):

Increase majority of unrelated parties from 33% to 50% in shareholders votes;

requirement to approve RPT, including compensation, every 3 years.

Amendment 16

- The multiple changes in Amend. 16 makes it almost impossible to trace what is the major factor if any that caused a reduction in controllers' executive pay.
- First, the paper does not relate to the reinforcement of the board's independence – thus assumes that it has no effect on the level of controller's pay.
- While the 'reinforcement effect' might be small, it may contributes the incremental effect that causes the results to be significant.

Repeated game in Amendment 16

- On top of that, the requirement to approve RPT every 3 years is material.
- By doing so, Amend. 16 turn RPT into a repeated game.
- In Game Theory, if the players do not know how many times the game will be repeated, it is regarded as a game with infinite horizon.
- The common result of an infinite game is that the players will prefer to cooperate. Otherwise, they will be punished by the other players.

Repeated game in Amendment 16

- There is both anecdotal evidence and results from the paper that supports the repeated game prediction.
- Anecdotal evidence:
 - <u>Cooperation</u>: The Israeli SEC acknowledged that following Amend. 16, controllers negotiate with institutional investors regarding their compensation
 - <u>Punishment</u>: institutional investors forced Rami Levy to cut half of the bonus that has been approved by the board, and also to lower the rent in the buildings he rents to the public company via RPT (Calcalist, December 5, 2018).

Repeated game in Amendment 16

- Results from the paper:
 - lower likelihood of pay reductions in second round approvals vs. first round approval.
 - Likelihood for 'disappearing controllers' increased after the reform
 - There is no observed post-reform increase in other forms of tunneling, such as RPTs or change in dividend policy.
- Perhaps analyzing why 33% approval doesn't work and 50% approval works will assist to differentiate the effects of minority votes from the repetition.

Focusing on controller-executive family

- Since the paper relates to *Tunneling via* compensation, it is interesting to examine a subsample family firms that employs several family members.
 - What is the reaction in total compensation of the family in this subsample?

Using ownership data for the analysis

- The paper presents results on % of equity held by executive controllers (Panel A, Table 1).
- This data is not used in the analysis, but since Israel have a very specific ownership structure, it can be useful for the analysis.
- For example:
 - Where are the disappearing controllers are focused? On firms with controllers between 25-50%, or above 50%?
 - Where are pay reduction are more aggressive?
- It might assist in differentiating between the veto effect from the repetition effect, since as concentrated ownership is higher it is easier to achieve 50% of minority shareholders.

Disappearance rates from the list of the highest paid employees

Figure 2: Disappearance Rates of Controller Executives and Non-Controller Executives

A disappearing executive is defined as an executive who no longer appears on the firm's list of highest paid executives after the current year. The disappearance rate is the likelihood that a particular type of executive (controller or non-controller) will disappear, with the 2009 disappearance rate (corresponding to executives who last appear in 2009) normalized to 100.



Comment 3

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| | (1) | (2) | (3) | (4) | (5) | (6) |
|--|-------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| Controller Executive*Post Reform | -0.12** (0.04) | -0.10*** (0.04) | -0.13*** (0.03) | -0.10*** (0.03) | -0.07** (0.03) | -0.11*** (0.02) |
| Partial Employment | | | | -0.36*** (0.03) | -0.19*** (0.05) | –0.35*** (0.02) |
| Log (Total Assets, in thousands of NIS) | | | | 0.20*** (0.02) | 0.19*** (0.03) | 0.19*** (0.01) |
| ROA | | | (| 0.02 (0.12) | 0.28** (0.12) | 0.14*** (0.05) |
| Year Fixed Effects | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Fixed Effects | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 13,576 | 5,198 | 13,530 | 13,576 | 5,198 | 13,530 |
| R-Squared | 0.88 | 0.91 | 0.87 | 0.89 | 0.91 | 0.89 |

summary

- A very interesting paper
- Contributes additional evidence to the claim show that only meaningful intervention can change executive compensation (similar to the law that limit executive pay in Israeli financial firms to 35 times of the lowest paid employee).
- My major concern is one cannot point out on the specific effect that led to pay reduction in the executive-controllers' firms following Amend. 16.