

Online Appendix:

Equity Issuances and Agency Costs:
The Telling Story of Shareholder Approval around the World

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A. Classification of Shareholder Voting

To determine the laws and practices on shareholder approval of equity issuances around the world, I started with the legal supplement to Spamann (2010). Although Spamann does not explicitly address shareholder voting for equity issuances, he often covers related laws when reviewing preemptive rights. I then conducted extensive research involving a variety of legal and non-legal sources. An important part of this process was studying individual equity offerings to ascertain what legal and extra-legal factors were at play.

Some issuances could plausibly fall into one of two categories of my classification of the level of shareholder approval, often 3 or 4 (Table 1). When I lack the necessary information to categorize individual issuances, I classify the method by its modal practice. I ascertain this from the academic papers reporting the announcement effects, by talking with academics and practitioners, and through searches of press reports of individual issuances.

These considerations can be illustrated with equity offerings by public corporations in Malaysia. By law in Malaysia shareholders must approve all equity issuances. Shareholders, therefore, must approve all rights offerings, but under exchange rules they may give a general mandate in annual meetings for up to 10% of outstanding stock for a period of one year. This would fall into category 3 of our voting classification. Malaysian studies (Table 2) report that the typical rights offer is for 95% of the outstanding stock. This means that they had to be specifically approved by shareholders, a 4 under our classification. An example is that on January 27, 2010 Malaysia Airlines announced shareholder approval of a rights offer for \$779 Million (US).

Malaysian studies on private placements report an average offering of 39%. As with the rights offers, this suggests that most private placements exceed 10% of the outstanding equity and must therefore be specifically approved by shareholder as opposed to a one-year general mandate. I accordingly classify Malaysian private placements as 4.

With private placements that could be classified as either 4 or 1 (or 5 or 1), I do not assign all to one category but rather note this division as “4 or 1” or “Some” in the tables. My rationale is that given the large differences in announcement returns between those issues that are specifically approved by shareholders and those that are not, it would be inappropriate to pool the observations. When I am able to separate private placements by shareholder approval, as with the United States and Australia, I do so and indicate this.

When classifying shareholder voting, I do not consider whether a firm has sufficient authorized (but unissued) shares to make an offering. If this is not the case, shareholders must vote to authorize more stock. This appears to occur infrequently, at least in the United States.

Finally, I summarize the laws and regulations on shareholder voting as of the time of my sample of announcement effects and frequency of issuance. Some of these laws and regulations changed subsequently. For example, on August 1, 2012 the Australian Stock Exchange changed Rule 7.1A. Now small companies (market capitalization of \$300M AUD or less) may issue up to 25% of their equity through a private placement without shareholder approval. Table 1 does not account for such changes.

B. Event Studies of Equity Issuances

Singapore. Although there are many studies documenting negative announcement returns associated with equity issuances management undertakes unilaterally (that is with only board of director approval), there is only one study that documents negative returns with shareholder approval, Chen et al’s (2002) study of private placements in Singapore. Private placements in Singapore are also the only shareholder-approved national issuance method that is associated with negative average announcement returns (Table 4). A close examination of this study and the other study of private placements in Singapore, however, raises questions about whether the overall announcement returns are in fact negative.

Chen et al document negative returns over days -1 to day 0 (-0.89%, significant at the 0.05 level). They also document positive returns of 4.23% from day -59 to day -2

(Z-statistic = 2.05). This means that their abnormal returns from day -59 to day 1 are 3.34% (significance not reported); their abnormal returns from day -59 to day 10 are 3.20% (significance not reported). Their event day is the day after the SES (Singapore's version of the SEC) receives the application for a private placement. In many instances, however, by this time shareholders had already approved the private placement, usually through a general mandate at the annual meeting. Moreover, the SES's approval is widely viewed as perfunctory. Thus, some of the market's reaction likely came before their designated announcement day, a period of positive returns.

Tan et al (2002) is the other study of private placements in Singapore. In contrast to Chen et al, they discuss the requirement for shareholder approval and it influences their choice of the announcement date. Tan et al document positive but insignificant returns from day -1 to day 1 (0.31%). They also document positive abnormal returns from day -20 to day 1 of 6.27%, which they describe as "significant."

Thus, both studies of Singapore private placements document positive abnormal returns during the pre-announcement period, which is relevant because shareholders through general mandates at annual meetings approved many of the placements. Both studies also document positive returns over longer event windows.

Japan. Public issues in Japan, which do not require shareholder approval, is the only other issuance method for any country where the existing event studies differ on the sign of the announcement effect. Two studies find positive returns (with mixed significance); two other studies find negative returns (which are highly significant). All four studies are incorporated in the observation for Japanese public offers (-1.17%).

One reason why the results differ is that there are different sampling periods and the mechanics of public offers changed significantly over time. In January 1994, Japan came to resemble the United States in that investment banks began using a book building process for public offers of seasoned equity. Both of the studies finding positive returns have samples that predate this change. After the change, all studies find negative announcement returns.

There are also differences in the studies' announcement dates. The two papers finding positive announcement effects use the initial announcement of the offering,

either the board of director's announcement or the newspaper announcement. Christensen et al (1996), who have an extensive discussion of institutional details, explain that the initial announcements of public offers in Japan seldom contain key terms including the amount of the offering and the discount to the exchange price.¹ These terms are usually revealed in a second public announcement which usually comes immediately before the issue day. Christensen et al find this to be the key day, although they consider the earlier day as well. One of the studies finding positive (initial) announcement returns, Kang and Stulz (1996), find negative and significant returns in the three-day window surrounding the issue day. When these returns are added to the returns from the initial announcement, the overall returns are negative and marginally significant. (I do not use this return because Kang and Stulz stress the returns from the initial announcement.) Kato and Suzuki (2012), with the largest sample, find negative and significant returns similar to those found by Christensen et al. Christensen et al conclude (p. 117) "our results [on public equity offers] are quite similar to those in the U.S. markets."

The Event Dates. An important issue for any event study is the identification of the correct event date, as just discussed with Singapore and Japan. With equity issuances that are not approved by shareholders, this identification presents no special challenges. Although as we have just seen with Japan, attention should be paid to institutional details which often vary from country to country. With issuances that must be approved by shareholders, problems can arise due to the leakage of information, particularly if researchers rely on the initial press announcement and it came after the proxy had been mailed (if proxies or their equivalent were used) or shareholders had already voted. Having said this, researchers are generally identifying statistically significant returns with issuances that are shareholder approved; they thus seem to have identified unanticipated events of some importance. Moreover, management often

¹ Kato and Suzuki (2012) make the same point.

publicly announces they will seek shareholder approval before the actual shareholder meeting.

The main worry would be if the pervasive positive returns associated with shareholder approval were systematically preceded by negative returns. If the reversals were large enough, shareholder-approved equity issuances may not be associated with positive announcement effects and could even be negative. I therefore investigated the pre-announcement returns in all of the studies involving shareholder approval. Of the 33 such studies, 26 report pre-announcement returns. The only case of negative returns (independent of statistical significance) prior to an issuance that involved shareholder approval is Tan et al (2002) for rights issues in Singapore. (Tan et al study rights issues in addition to private placements). As noted above, they discuss the requirement for shareholder approval, which is also required for rights offers, and that influences their choice of the event date. They report abnormal returns of -0.29% (t -statistic = 0.15) from day -20 through day -1. They also report abnormal returns of 2.34% from day -1 to day 1 (they describe this return as “statistically significant.”) Thus, their returns over longer event windows remain positive even with the small and insignificant but negative pre-announcement returns.

The other study of rights offerings in Singapore, Ariff et al (2007), reports abnormal returns of 4.32% from day 0 to day 1 (t -statistic = 6.19); abnormal returns of 3.19% from day -20 to -1 (t -statistic = 1.60); and abnormal returns of 12.51% (t -statistic = 3.00) over their entire event period of day -20 to day 12.

Some readers have noted that the positive pre-announcement returns associated with shareholder approval of equity issuances are not surprising given that it is well documented that firms generally issue equity following periods of positive returns. This is true. What is surprising is that these positive returns are followed by negative announcement returns for equity issuances that management undertake unilaterally but followed by positive announcement returns for equity issuances that have been approved by shareholders.

Summary. The mosaic of the evidence is consistent with positive valuation effects for equity issuances that are approved by shareholder vote. Most notably, the pattern is

pervasive: It is found in 32 of 33 studies involving three different issuance methods in 23 countries over various time periods. Second, wider event windows likewise reveal positive returns. Often these returns are larger than those associated with the shorter windows. No paper reports negative longer returns. Third, the pre-announcement returns are almost always positive.

The contrast with the managerial stock issuances is notable. Here 48 of 57 studies report negative announcement returns. I have already discussed two of the nine studies reporting positive returns with managerial issuances, public offers in Japan (0.50% and 0.45%). As noted earlier, two other studies of Japanese public offers find negative returns (-2.35% and -2.02%). Three studies report insignificant positive returns for managerial rights offers in Germany, India, and Korea. There are no other event studies of rights offerings for any of these countries. There is also one study of rights offerings in Japan with 28 observations with marginally significant returns (2.02%, t -statistic = 2.11). Since the time of this study, the use of rights has fallen to where in some years there are no rights offerings on the Tokyo Stock Exchange. Moreover, during the period studied many firms issued a premium cash dividend simultaneously with a rights offer. This practice, which is not noted in the sole Japanese-rights study, has since stopped.² Finally, for some event windows, the announcement effects of private placements undertaken without shareholder approval in the United States are positive. But for longer event windows these returns are typically negative, and they are always significantly lower than those that are approved by shareholders. The last point is also true of private placements in Australia, which is the final observation involving positive short-run announcement returns for managerial stock issuances.

C. Case Study of Two Major Rights Offerings

The association between shareholder approval of a rights offer and the announcement effect can be illustrated by two of the largest stock offerings of any type

² I thank Professor Katsushi Suzuki of Kobe University for this information.

in some years. Both were conducted in 2008 by major European banks, UBS and Santander. Internet Appendix Table 1 compares key aspects of these two rights offerings.

UBS is subject to Swiss law and thus had to obtain shareholder approval for its “Ordinary” rights offering.³ On April 1, 2008 UBS’s management announced their intention to seek shareholder approval for a \$15.1 billion rights offering, explaining that a capital infusion was needed to repair losses caused by investments in mortgage-back securities. UBS’s market-adjusted stock price increased by 11% on the day of the announcement. Management received the needed approval at the annual general meeting of shareholders on April 23, 2008. The final terms of the rights offer were set on May 23, 2008, and the subscription period began the following day.⁴ The offer successfully closed ten days later.

Santander is subject to Spanish law. In contrast to Swiss law, Spanish shareholders do not have to approve specific rights offerings. Instead, the practice is for shareholders to approve mandates for management to issue large amounts of stock at their option. By law these mandates may stay open for five years. Often the mandates expire unexercised, but that was not the case here. On November 10, 2008 management announced a \$9.2 billion rights offer to increase the bank’s Tier 1 capital. Santander’s market-adjusted stock price declined by 6.9% on the day of the announcement.⁵ The subscription price for the offer was priced at a 46% discount to the exchange price, presumably to help ensure success of the offer. Santander’s stock price continued to decline, however, and there was speculation in the financial press that the underwriters

³ The alternative in Switzerland is an “Authorized” rights offering. This requires shareholder approval to amend the articles of association to increase authorized capital. Under this option, the board may issue up to 50% of existing share capital within the two years following the shareholders’ resolution. Most rights offerings in Switzerland are Ordinary and by law must be completed within three months of the shareholders’ resolution. This was the case with UBS’s 2008 rights offer.

⁴ The size of the offering was increased from \$15.1 billion to \$15.5 billion.

⁵ This announcement apparently surprised market participants. For instance, the following day *The Telegraph* ran an article entitled: “Santander stuns the markets with €7.2bn rights issue.”

would have to purchase the new shares. This turned out not to be the case as the rights remained in the money. The bank successfully raised the capital sought, but there was considerable public discontent among shareholders.

Although these are only two observations during a tumultuous time for financial markets, in general, and large banks, in specific, they nevertheless illustrate the broader association between the market's reaction to a rights offering and shareholder approval. In Switzerland, where shareholder approval is required, the average announcement effect for rights offers is 2% (Table 6). In Spain, where shareholder approval is not required, the average announcement effect for rights offers is -1.32% (Table 6).

D. Avoiding Shareholder Votes for Equity Issuances

My paper documents that managers in the United States and Australia at times avoid shareholder votes by clustering the fractional size of private placements directly below the stock-exchange-imposed thresholds that trigger a mandatory shareholder vote (Figure 2). I now briefly review some of the papers documenting that managers attempt to avoid shareholder votes in other situations involving the issuance of equity as well.

Mergers. The 20% threshold for mandatory shareholder approval also applies in the United States for stock issued as payments in mergers.⁶ One example of management maneuvering to avoid shareholder approval of a stock issuance in this setting, essentially avoiding a shareholder vote on an acquisition, involves Kraft's 2010 acquisition of Cadbury. At the time Warren Buffett was the largest shareholder in Kraft. Originally, Kraft planned on issuing more than 20% of its common stock as payment to the Cadbury shareholders. This would have triggered a shareholder vote under NYSE rules. Kraft circulated a proxy statement in anticipation of this vote. At this point Buffett went public with his criticism of the deal. Kraft's management responded by reducing

⁶ Acquiring-firm shareholders in the United States typically must also vote to approve acquisitions when a new legal entity is created to acquire both the target and the bidder. Wall Street Journal, September 29, 2015, p. C2 ("Media General Could Save Its Deal").

the amount of new stock to below 20%, thereby avoiding a shareholder vote. This triggered widespread criticism among the Kraft shareholders, including Buffett;

The events at Kraft do not appear to be unique; Li et al (2017) and Mason et al (2017) present evidence that managers of acquiring firms in the United States often structure acquisitions to avoid a vote by their shareholders.

Closed-End Mutual Funds. Under Section 23 of the Investment Company Act of 1940, closed-end funds that are trading at a discount to net asset value may issue stock only pursuant to a rights offer or through another method “with the consent of a majority of its common stockholders.” Khorana et al (2002) report that the few public offerings by closed-end funds between 1988 and 1999 all involve funds that were trading at substantial premiums to net asset value, so no shareholder vote was required. I have been unable to identify any votes by shareholders of closed-end funds approving the sale of seasoned stock even though I searched for such votes as part of another research project. Instead closed-end funds almost always raise equity through rights offerings, which do not require a shareholder vote (except in unusual circumstances). Holderness and Pontiff (2016) report that 39% of their sample of rights offerings involve closed-end funds.

Equity-Based Compensation Plans. Another category of management reacting to external requirements for shareholder votes involving the issuance of equity involves stock-based compensation plans in the United States. By exchange rules and IRS regulations, these plans must be approved by shareholders. A number of papers document that shareholder approval of these plans is associated with positive announcement returns and superior post-announcement long-run accounting returns.⁷ These findings are consistent with the positive announcement returns documented in this paper.

⁷ Although some compensation plans instituted prior to 2003 did not require shareholder approval, all of the studies I am aware of analyze shareholder-approved plans exclusively. For example, Brickley et al (1985); Morgan and Poulsen (2001).

If a compensation plan involves less than 5% of a firm's equity, under exchange rules brokers may vote uninstructed stock held in street name. In many firms this constitutes a significant percentage of the stock traded, sometimes more than half. Moreover, brokers virtually unanimously vote for management. Thus, plans involving less than 5% of a firm's equity can count on near-unanimous support from broker-held stock. Bethel and Gillan (2000, 2002), who discuss these institutional details, identify a clustering of compensation plans at 4.9%.⁸ They quote (2002, p. 33) a compensation consultant who says he is "surprised when he sees a [stock-option plan] request for more than 5%. They [the companies] are gaming the system."

E. Simple Model of Equity Issuances and Agency Conflicts

A simple model helps explain both the announcement effects and some of the patterns of how seasoned equity is issued. Because this model incorporates a wide array of variables, I follow an informal analysis in the spirit of Jensen (1985) or Blanchard et al (1994). The model is agency based in that it assumes that managers are self-interested and that at times their objective conflicts with their shareholders' objective, which is the maximization of firm value. The model also assumes that market forces (such as a manager's reputation) and organizational arrangements (such as boards of directors) reduce but do not eliminate agency conflicts.

Internet Appendix Figure 1 illustrates this model. The present value of the net impact of an equity issuance on the managers personally is measured on the Y-axis. The expected value of an issuance on the share price is measured on the X-axis. Shareholders as a group are sophisticated enough to identify most issuances that are likely to enhance firm value, although in some instances they are wrong ex post. In all instances, managers must initiate equity issuances. In some instances, the law requires shareholder ratification.

⁸ The histogram in Bethel and Gillan (2000) shows the clustering at 4.9%. It paints a picture of clustering similar to Figure 2 in my paper, albeit at a different fractional threshold.

If managers may unilaterally issue stock, Section I issuances will occur and stock prices will decline. An example would be that market participants believe the new equity will enable managers to engage in empire building or growth for growth's sake. This fits with the Jensen (1986) free cash flow theory, although here the funds for negative net present value projects come not from retained earnings but from new equity. Another explanation is that managers are over-confident about their abilities to implement certain investment projects. If shareholders must ratify equity issuances, Section I issuances will not occur on a systematic basis.

Section II issuances benefit managers, so they will initiate them; the issuances also benefit shareholders, so they will ratify them. Thus, Section II issuances will occur under both legal regimes. An example would be issuing stock to finance an investment that would both increase firm value and managers' compensation (say through stock options). Section II issuances could also result from market timing (as it would benefit both shareholders and presumably management). Having said this, given the paucity of public offerings in many countries, seasoned equity offerings driven by market timing appear to be rare, at least when shareholder approval is required.

Shareholders would ratify Section III issuances, but managers will not initiate them because of the negative impact on them personally. This would be the case, for instance, if managers do not want to work hard on a valuable project to be funded by the newly raised equity (managerial shirking), or if they lack the requisite skills to implement the project and fear replacement by managers with the necessary skills.

Section IV projects are not proposed by management and would not be ratified by shareholders if they were proposed.

This framework yields several predictions that are consistent with the evidence, both from this paper and elsewhere. First, shareholder-approved equity issuances will on average be associated with positive announcement returns. Second, the announcement returns associated with shareholder approval will be greater than the returns with managerial issuances because the negative Section I issuances occur on a regular basis only when managers may unilaterally issue stock. Third, managers (if they can) will use methods that do not require shareholder approval to secure Section I

issuances. Finally, because managers will unilaterally issue stock in both Sections I and II, the net effect of managerial issuances can be either positive or negative (although on average lower than with shareholder approval). This too is consistent with the evidence. Masulis and Korwar (1986), for instance, report that 29% of domestic seasoned equity issuances by industrials and 50% of those by utilities have positive announcement day returns. This suggests that in the United States, although Section II issuances occur on a regular basis, Section I issuances predominate.⁹

⁹ In contrast, Myers and Majluf (1984) predict a negative announcement effect for all seasoned public equity offerings.

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Internet Appendix Table 1

Comparison of Rights Offers Conducted by UBS and Santander

UBS is subject to Swiss law which requires shareholder approval of specific rights offerings. UBS shareholders approved the rights offer on April 23, 2008 at the annual general meeting. Santander is subject to Spanish law which does not require shareholder approval of specific rights offerings. Abnormal stock returns are the raw stock returns on the announcement day minus the return on the market. (*t*-statistics are in parentheses.)

	UBS	Santander
Date	April-May 2008	November 2008
Amount Raised	\$15.5 Billion	\$9.2 Billion
Discount of Offer Price to Exchange Price at Announcement	31%	46%
Funds Raised as Fraction of Value of Pre-Rights Equity	0.21	0.14
Announced Rationale	Repair Balance Sheet	Increase Tier 1 Capital
Underwritten	Yes	Yes
Announcement Day Abnormal Stock Return	11.0% (8.39)	-6.9% (4.90)
Shareholder Approval of Rights Offer by Vote	Yes	No

Internet Appendix Figure 1
Theoretical Framework for Equity Issuances and Agency Costs

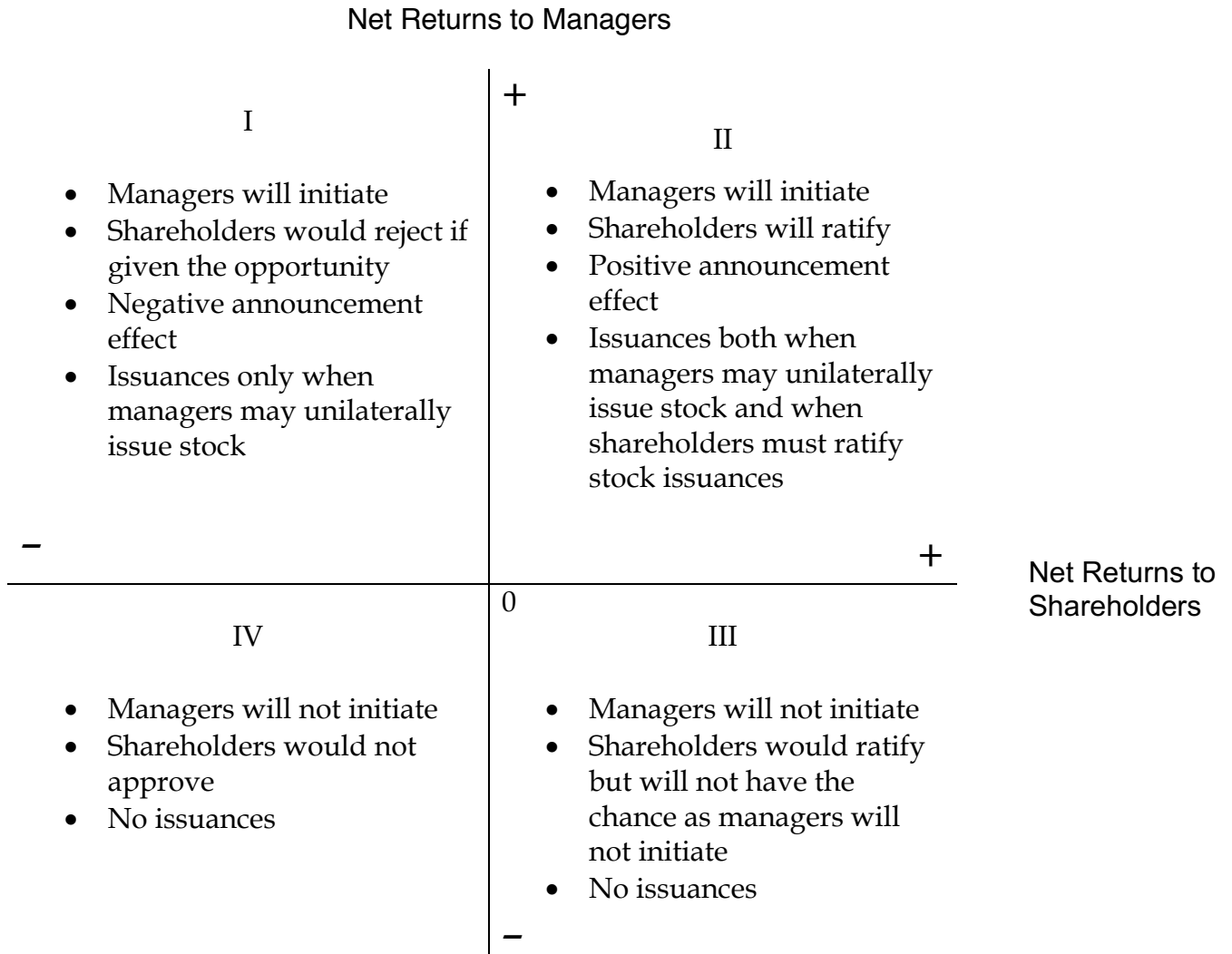


Figure 1. Likely outcomes of hypothetical equity issuances by public corporations. In all instances managers must initiate the issuance. In some instances shareholders must vote to ratify the issuance, but in other instances shareholder ratification is not required.