Institutional Investors and Corporate Governance

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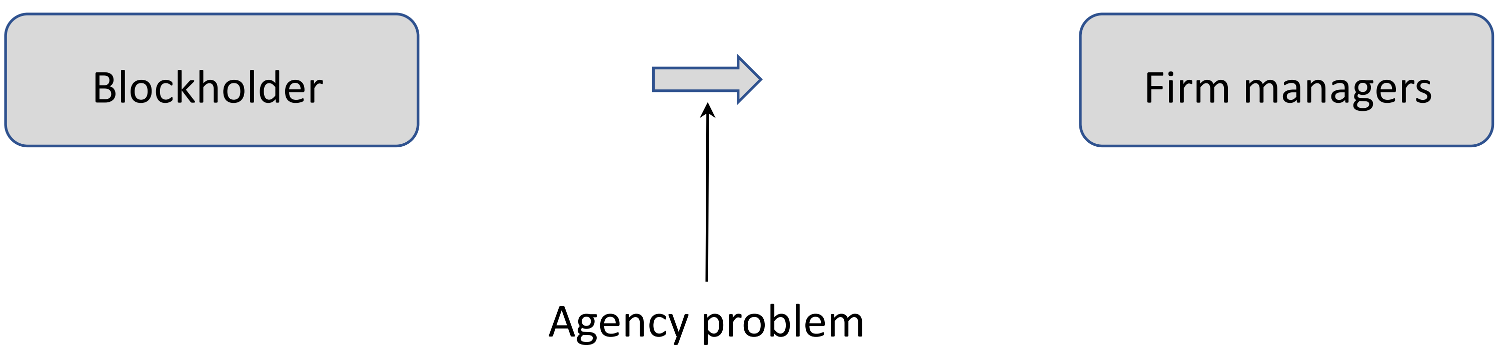
A roadmap

- Our paper aims to give identity to a growing area of research on the role of institutional investors in corporate governance.
- In terms of the strands of the academic literature, there are broadly three inputs:
  1. The law literature
  2. The empirical finance literature
  3. The theoretical finance literature (the most recent of the three)
- We do not survey (1) but try to provide a guide for financial economists to relevant content distilled from it.
- We survey (2) and (3), but selectively so; especially for (3) we discuss only papers that explicitly take the distinguishing features of institutional investors into account.
- We provide new stylized facts that are relevant to financial economists working in this area.
- This talk will take a “slice” of some of the ideas from the paper. We leave many things out, e.g.:
  1. While the paper provides international perspective on legal arrangements, we focus only on the US in this talk.
  2. We do not discuss any finance paper in any detail, but only provide a thematic discussion of the issues.

Blockholders in Corporate Governance: The Classical View

- Public corporation – Separation of ownership and control – Agency problems.
- Unless agency problems perfectly corrected by boards or compensation contracts: role for ***blockholder monitoring*** of company managers, via:
  - The use of shareholder voice (behind the scenes, shareholder proposals, proxy fights)
  - The threat of blockholder exit
- Large literature, recently surveyed by Edmans and Holderness (2017)



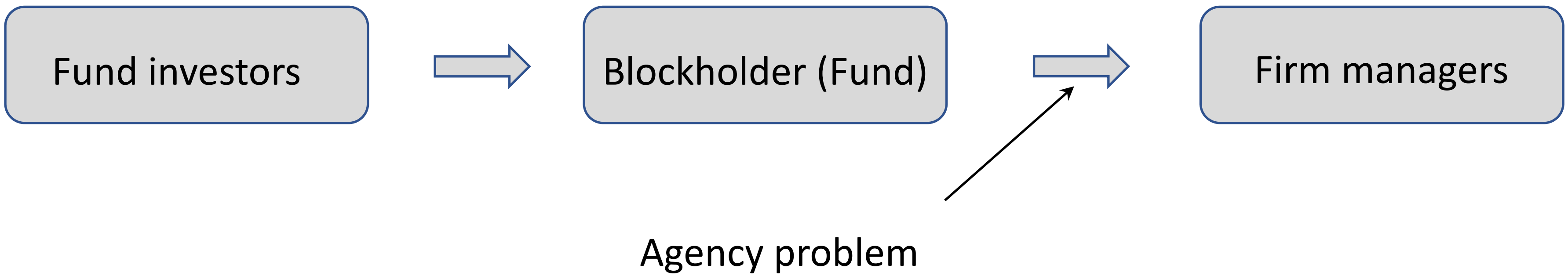
Equity ownership has evolved

Table 1: Ownership Shares of the US Stock Market in Percent

Sector	1950	1970	1990	2000	2010	2018
Private Pension Funds	0.0	8.1	16.2	11.2	7.8	5.5
Federal, State and Government Pension Funds	0.0	1.2	8.1	7.7	8.5	6.5
Insurance Companies	2.6	3.3	4.1	6.2	6.7	2.2
Mutual Funds	1.6	4.8	7.1	18.3	20.2	22.6
Closed-End Funds	0.9	0.5	0.5	0.2	0.4	0.2
Exchange-Traded Funds	0.0	0.0	0.0	0.4	3.6	6.2
Foreign Sector	1.6	3.3	6.9	9.3	13.7	15.1
Household Sector	92.8	78.2	56.5	45.6	37.2	36.4
Other	0.4	0.6	0.7	1.1	1.8	5.4

Source: Federal Reserve Statistical Release Data: Flow of Funds Data United States. Exchange-Traded Funds are first listed in December 7, 2001.

Defining characteristic: Use “other people’s money” to own blocks



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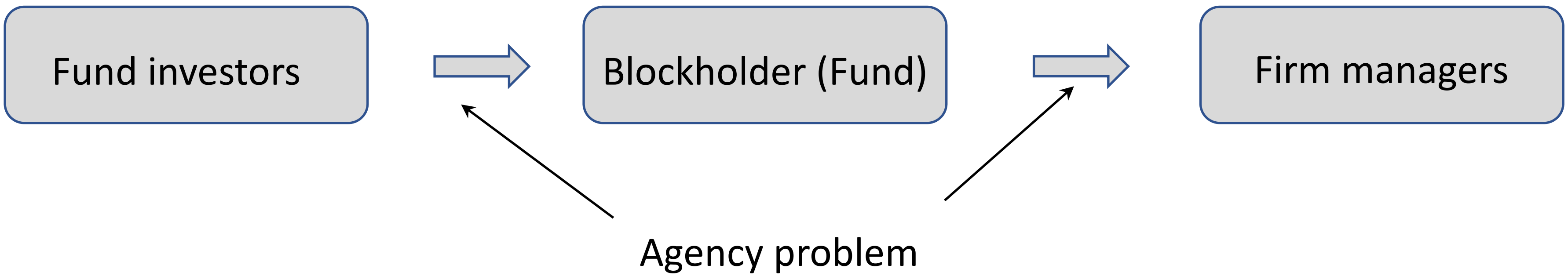

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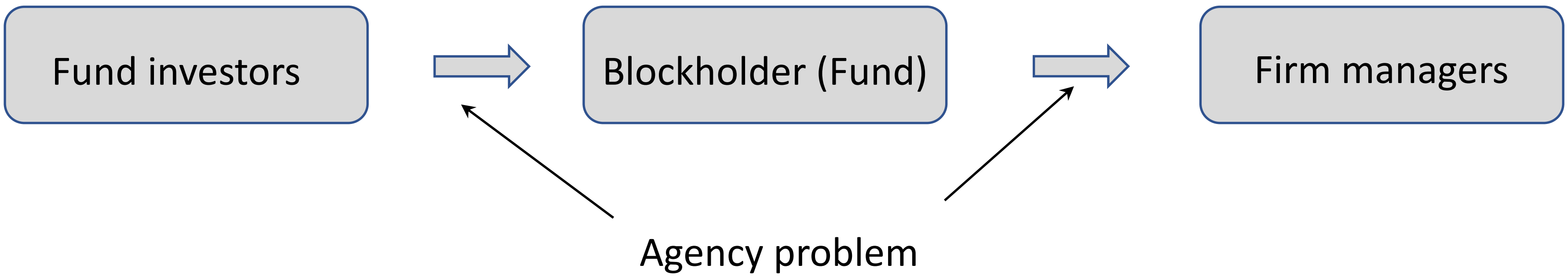


- The interaction of dual agency problems is central to the role of institutional investors in corporate governance and forms a core element of our survey.
- An attempt to trace the fundamental consequences of dual agency leads back to the law:
- It is <u>because</u> institutional investors manage other people’s money (i.e., are agents) that they are <u>regulated</u>.
- Such regulation, in turn, influences institutional structure, which then drives the *incentives* and *obligations* of institutional investors, and fosters *heterogeneity*.

Law shapes institutional form: incentives, obligations, heterogeneity

- Type of capital managed drives heterogeneity
  - Retirement savings – Pension Funds – ERISA (Private), State Law (Public)
  - Discretionary savings – Investment Companies Act (ICA) and associated Investment Advisers Act (IAA).
  - Differences in voting and reporting obligations (and evolves over time).
- Within institutions that manage discretionary savings, institutional "response" to regulation drives heterogeneity
  - *"Regulation takers"* – Some institutions organize as Registered Management Investment Companies (majority of what are commonly referred to as **mutual funds** or **ETF**s) – assume the obligations of the ICA and obtain full access to the investing public.
  - *"Regulation arbitrageurs"* – Other institutions (majority of what are usually called **hedge funds**) organize as limited partnerships around exemption clauses in the ICA (e.g., 3(c)1 or 3(c)7) that limits them to high net-worth clients and places marketing restrictions.

Law shapes institutional form: incentives from contracting

Mutual funds

- Contracts with investors restricted by ICA/IAA clauses
  - Vast majority use simple proportionate **assets under management** fees
  - Creates “pure” incentives to compete for investor capital:

    fear of outflows, keen for inflows
  - Nature of investors fosters “simplicity” in contracting:

    rare to have lock-ins (“100%” open ended)

    and

    little managerial self-investment

Hedge funds

- Relatively unrestricted contracting
  - More performance-contingent contracts
  - More nuanced competition for investor capital: Lock-ins mitigate outflows, but future inflows still attractive to GPs
  - Sophisticated nature of investor base enables (enforces?) greater contractual self-investment by GPs

Law shapes institutional form: agency conflicts via investor access

Mutual funds

- Can reach all retail investors
  - Can be (very) large
  - Can provide additional services to portfolio firms

    e.g., 401K retirement capital management services
  - Generates additional revenue streams
  - Risks fostering conflicts of interest in governance activities

Hedge funds

- Restricted investor reach
  - (Relatively) small, limits scope for diversification of services
  - e.g., Cannot accept 401K capital.

Law shapes institutional form: law changes affect governance mode

Mutual funds

- 2003 update to ICA/IAA (in response to the concerns on previous slide) affected the way in which mutual funds exercise “voice”
  - Mandated public reporting of mutual fund proxy votes.
  - Created “compliance challenge”
  - Enhanced use of proxy advisory services
  - Encouraged information intermediation

Hedge funds

- 1992 “Proxy Reform” may have affected the way in which hedge funds exercise “voice”
  - Excluded public statements from the definition of proxy solicitation
  - Eliminated pre-disclosure requirements for communication between shareholders who did not seek to act as proxy for each other
  - Arguably aided governance model in which minority shareholders publicly argue for others to vote in some way?

These themes are at play in the recent literature: Some examples

1. Competition for investor capital ➡ institutions will consider “signaling role” of governance actions before taking them. Affects governance by institutions and *more so* for flow-sensitive institutions and *less so* for those institutions with significant managerial self-investment (*heterogeneity*)
   - Dasgupta Piacentino (2015, JF), McCahery Sautner Starks (2016, JF)
2. Competition for investor capital link together the governance actions of multiple institutional investors (since flow endogenously reallocates *across* funds) reducing free riding and enhancing governance
   - Song (2017, WP), Becht Franks Grant Wagner (2019 RFS) , Brav Dasgupta Mathews (2019, WP)
3. Use of information intermediaries (proxy voting advisory services, encouraged by 2003 transparency requirements in the ICA/IIA) can crowd out information production, potentially weakening governance
   - Malenko and Malenko (2019, JF)

Stylized Facts

Data

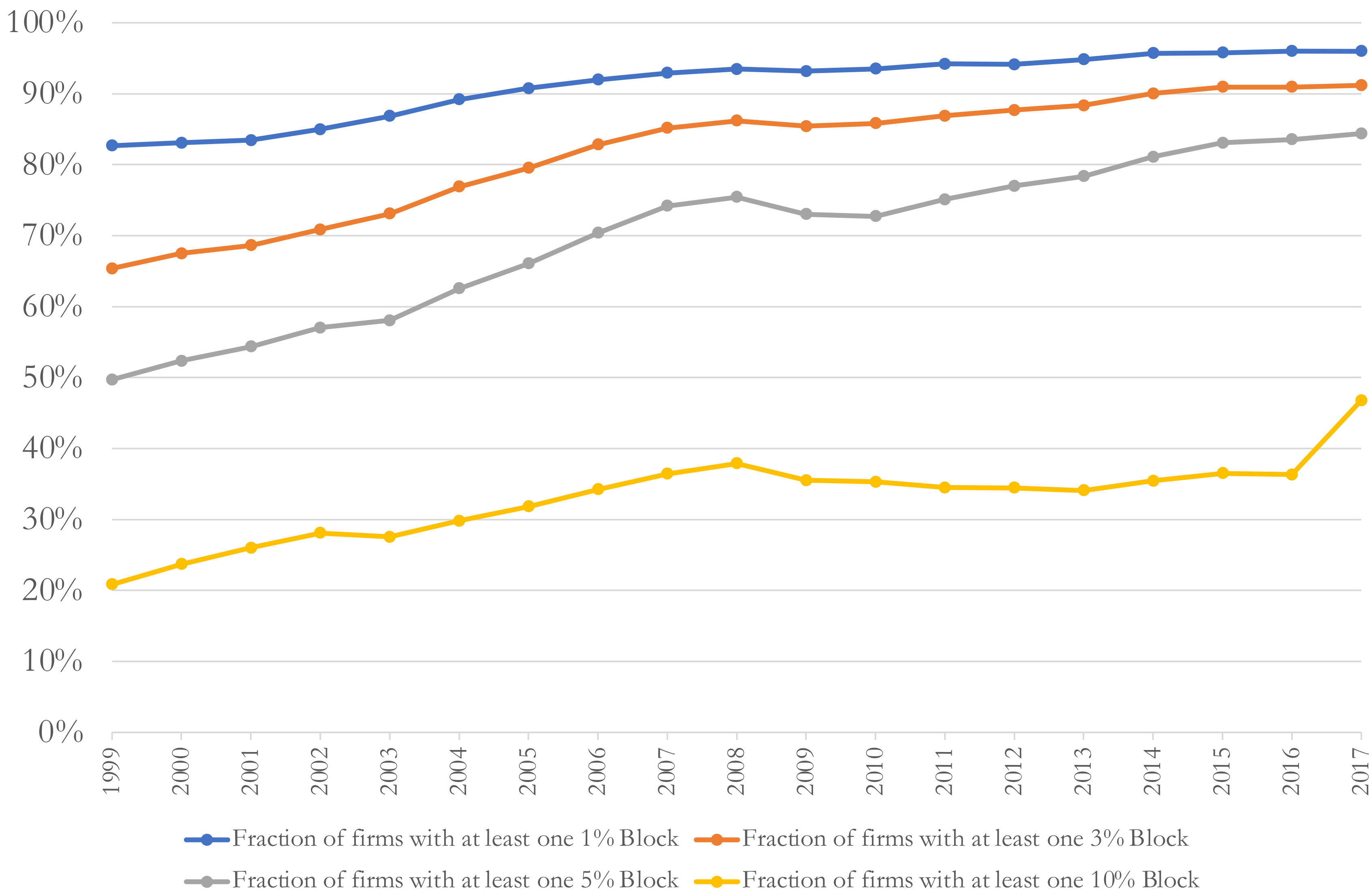
- We rely on the following data sources:
  - Quarterly stock ownership data from Schedule 13F filings required by the SEC
    - We rely on the Schedule 13F dataset compiled by Backus, Conlon, and Sinkinson (2019).
    - This dataset covers the years from 1999 to 2017 and arguably has better coverage than the Thomson Reuters database during this sample period.
  - The list of Schedule 13F filers identified as hedge funds by Agarwal, Fos, and Jiang (2013)
  - The CRSP Survivor-Bias-Free US Mutual Fund Database, which includes a monthly history of each mutual fund's holdings

- In our analysis, we focus on four block sizes: 1% blocks, 3% blocks, 5% blocks, and 10% blocks.
  - An institution is set to hold an X% block if it holds at least X% of the shares outstanding.

Blockholder Heterogeneity: Size

- We explore blocks of 1% and 3% as such relatively small percentage blocks can require large capital commitments at firms have large market capitalization.
- Such small blocks may be of key relevance for several governance mechanisms relevant to institutional investors.
  - For example, such smaller blocks are arguably equally if not more relevant to governance via exit.
  - Further, given the emerging evidence that multiple institutional investors engage in parallel in target firms, such small blocks may collectively play a key role in achieving governance outcomes.
- Stylized facts about such smaller blocks therefore fill an important gap in the literature.

Blockholder Heterogeneity: Size



Co-existence of different types of blockholders

	N	Mean	STD	10th percentile	Median	90th percentile
Panel A: Full Sample						
Number of 1% blocks	353,729	**11.19**	11.11	1.00	**9.00**	23.00
Number of 3% blocks	353,729	4.33	6.26	0.00	3.00	9.00
Number of 5% blocks	353,729	2.40	4.77	0.00	1.00	5.00
Number of 10% blocks	353,729	0.90	3.21	0.00	0.00	2.00
Panel B: Hedge Fund Blocks						
Number of 1% blocks	353,729	**2.64**	2.71	0.00	2.00	6.00
Number of 3% blocks	353,729	1.15	1.67	0.00	1.00	3.00
Number of 5% blocks	353,729	0.68	1.31	0.00	0.00	2.00
Number of 10% blocks	353,729	0.23	0.86	0.00	0.00	1.00
Panel C: Mutual Fund Blocks (company-level)						
Number of 1% blocks	865,963	**2.48**	3.25	0.00	1.00	7.00
Number of 3% blocks	865,963	0.64	1.13	0.00	0.00	2.00
Number of 5% blocks	865,963	0.29	0.70	0.00	0.00	1.00
Number of 10% blocks	865,963	0.03	0.19	0.00	0.00	0.00

The unit of observations is the security–reporting quarter.

Directions for Future Research

Review of empirical literature

- Provide a thematic overview of the empirical literature on institutional investors and corporate governance.
- Bulk of the empirical literature predates the theory literature.
- Focus on two ways in which institutional investors feature in the empirical literature.
  - Literature that deals with classical theories on the role of institutional investors in corporate governance.
  - Literature that deal with institution-specific aspects of corporate governance.
- Highlight potential areas of future research, building on recent theoretical progress.
  - Here: focus on two examples (investor horizon; investor incentives)

1. Evidence on the endogeneity of investor horizon

- Most work treats investor horizons as exogenous, classifying investors ex-ante based on investor types or ex-post measures (e.g., share turnover).
- Point out that investor horizons are not fundamental characteristics of institutional investors, but endogenous consequences of their incentives, implying large heterogeneity.
  - Incentive to compete for flow.
  - Locked up capital or patient investors.
  - Skin in the game.
- The growth of the theoretical literature may offer opportunities to reinterpret existing empirical results and to consider new empirical approaches (new metrics, data).

2. Evidence on direct and indirect engagement incentives

- Theoretical literature shows how dual-layered agency structures may affect the governance role of institutional investors.
  - Heterogeneity due to different direct and indirect incentives across institutional investors affects the governance role.
- Some first empirical evidence in support of specific model predictions of this literature.
  - Quantification of flow-based incentives represents an important first step towards evaluating the role of institutional incentives to govern portfolio firms Lewellen and Lewellen (2018) .
- Important, rich area where more work is needed.
  - Flow motivations have nuanced effect on governance incentives, which can be either negative by inducing short-termism (Dasgupta and Piacentino, 2015; Burkart and Dasgupta, 2020) or positive by inducing intervention, particularly in multiple blockholder contexts (Song, 2017; Brav et al., 2019).