SWEDISH HOUSE OF FINANCE

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Institutional Investors and Corporate Governance

Conference Report | June 2017

Swedish House of Finance, Stockholm

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Session: Overview

Amil Dasgupta, "*Institutional Investors and Corporate Governance – The Theory*"

Amil Dasgupta opened the conference with a thematic survey of the theoretical literature on the role of institutional investors in corporate governance, in the process outlining how the six theory papers in the conference fit into relevant strands of the literature.

Dasgupta highlighted that institutional ownership has increased dramatically over recent decades, from around 10% in the 1950s to around 70% in the early 2000s. He then went back to the origins of the literature on blockholder monitoring. In the "classic" corporate governance papers, monitoring is exercised through several channels, but there is no explicit distinction between institutions and individuals. In practice, until the mid-1980s, participants were principally individuals as opposed to institutions. That has changed in subsequent decades.

Dasgupta then highlighted two strands of the literature that directly responded to the increasing importance of institutional investors in corporate governance. The first strand consists of papers (e.g., Brav and Mathews 2011, Zachariadis and Olaru 2015) that highlight the role of sophisticated trading strategies by institutional investors in dynamically modifying the security voting structure of firms, fostering phenomena such as empty voting. A second, more recent, strand of the literature (e.g., Dasgupta and Piacentino 2015) explicitly models monitors (institutional investors) as agents rather than principals and thus focuses on multi-layered agency relationships in blockholder monitoring. Finally, he noted that an emerging strand of the literature has started to examine interactions amongst blockholders with differing agency problems. Dasgupta concluded his talk by emphasizing the potential benefits of modeling the effects of multi-layered agency problems in corporate governance.

Zach Sautner, *“Institutional Investors and Corporate Governance – The Empirics”*

Zach Sautner started by acknowledging that there are some excellent surveys on the empirical corporate governance literature. He, therefore, focussed his talk on three topics that, so far, have received less attention while growing in importance over recent years: Equity Intermediation Chains; Passive Investing; and Proxy Voting Advisors.

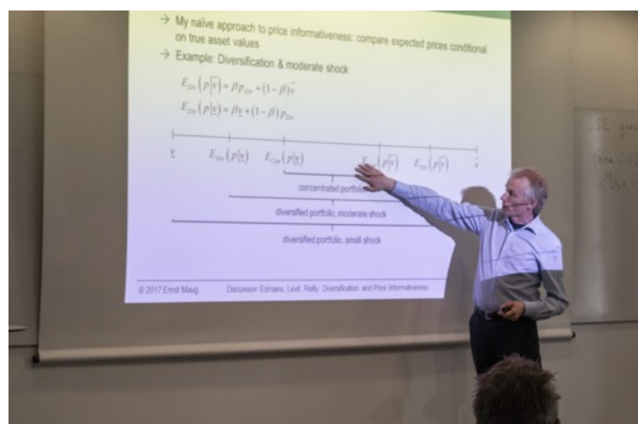
As the number of institutional parties involved in investing in equity has grown, their inter-relationship has become more complicated. Starting with the original asset owner, the intermediation goes through different types of funds and investment consultants until it reaches the end link: the firm and its CEO. At every link of this chain, there are potential conflicts of interest. For instance, a pension fund might have a long-term horizon, but the hired asset manager might focus on (more) short-term goals. It is important to understand how these links affect the quality of corporate governance and also how to best measure institutional ownership given the complex structures. The impact of passive investing on corporate governance has both bright and dark sides as illustrated by two papers on the program: Appel, Gormley, and Keim (2017) show how passive investors facilitate shareholder activism, while Antón, Ederer, Giné, and Schmalz (2017) document how common ownership of firms by passive investors decreases the sensitivity between performance and CEO pay. As for the third theme, Sautner called for a better understanding of how proxy advisors affect voting firm behaviour and how advisors decide on their recommendations. The paper by Aggarwal, Erel, and Starks (2017) directly connects to the latter question by showing how public opinion matters for the recommendations of proxy voting advisors. He concluded by pointing out that there are many open questions and that empiricists should rely on guidance by theorists in addressing these issues.

Session: Common Ownership

Alex Edmans, “The Effect of Diversification on Price Informativeness and Asset Values” (with **D. Levit,** and **D. Reilly**)

Alex Edmans presented a model to analyze how price informativeness depends on the seller’s holdings. The model contrasts sellers owning only one asset with sellers who hold (infinitely) many assets. As diversified sellers choose which asset to sell, such a sale is more likely to be driven by information rather than liquidity needs. By contrast, undiversified sellers who experience liquidity constraints are forced to sell the asset, irrespective of its underlying quality/value. Consequently, sales by diversified investors result in more informative prices. This also holds true when the different assets are uncorrelated and trades in other assets are unobservable. The paper further shows that financial slack is not equivalent, but inferior, to diversified asset holdings in terms of improving price informativeness. Beside resulting in greater price informativeness, diversified holdings can also increase incentives to gather costly information, thereby raising incentives to improve asset values.

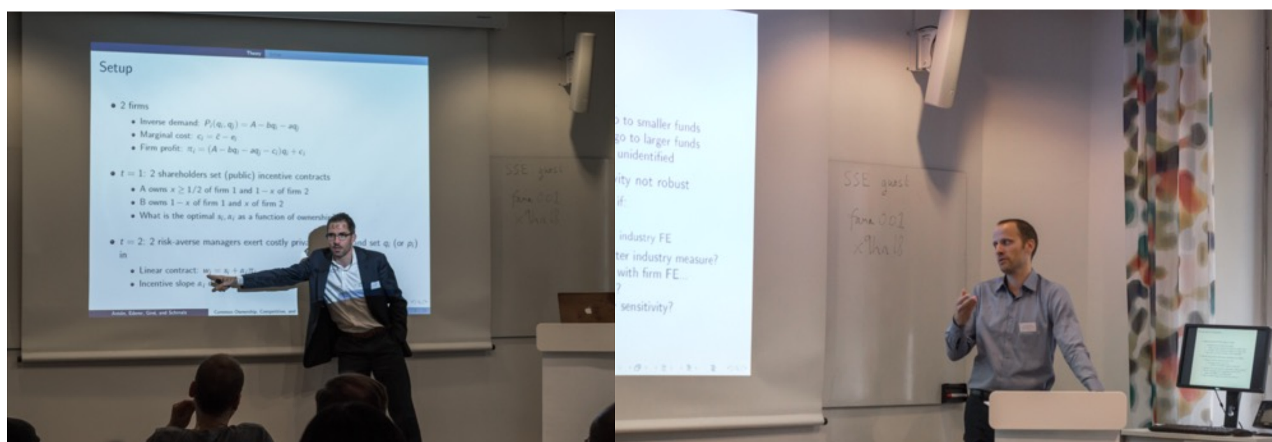
The discussant, **Ernst Maug,** asked in which contexts these results apply as the model assumes buyers know the identity of the seller. This setting might apply better to private equity, bank loans, or conglomerate divisions than to equity markets where this information is typically absent. He as well as the audience enquired about implications that endogenous diversification would generate: For instance, would asset owners choose a certain level of diversification that resulted in a level of price informativeness which best suited their objectives? The audience also wondered how short-selling would impact the results.



Martin Schmalz, “Common Ownership, Competition, and Top Management Incentives” (**M. Antón**, **F. Ederer,** and **M. Giné**)

Martin Schmalz presented a paper that examines how different ownership structures impact CEO compensation structure. In particular, the common notion that self-interested owners foster competition which improves welfare may no longer hold when institutional investors have ownership stakes in several firms within the same industries. Such common ownership potentially reduces the incentives for companies to compete aggressively. The paper develops a model with this mechanism in mind and demonstrates that equilibrium incentives to managers decrease in common ownership. Empirically the paper documents that higher common ownership is negatively related to wealth-performance sensitivity (WPS) and also finds a similar relationship for relative performance evaluation (RPE).

In his discussion, **Laurent Bach** raised the question of whether it is appropriate to presume that passive index funds and active owners have the same impact on firm behaviour. Earlier empirical results suggest that passive owners do not affect specific policies, such as managerial pay. Hence, the results could be interpreted as passive funds letting activists pursue their agenda, including setting CEOs’ pay packages. More generally, it seems important to distinguish between active and passive institutional owners and to identify the extent to which they engage in governance since the consequent policy implications may differ considerably. The subsequent discussion from the audience also brought up the question as to what extent contractual incentives focus on dimensions that are beneficial for firms without affecting competition, e.g., reducing costs and increasing market volume, as opposed to gaining market share.



Session: Interactions amongst Blockholders

Richmond Mathews, “Wolf Pack Activism” (with **A. Brav,** and **A. Dasgupta**)

Rich Mathews presented a model which examines how small blockholders gain collective influence. The paper is motivated by the fact that small blockholders are common but large blockholders (who can exert unilateral influence) are rare. Since any price appreciation from successfully engaging target firm managers is non-excludable, i.e., enjoyed by all shareholders regardless of individual engagement choices, what is the source of complementarity across institutions to engage target management? The paper shows that the reputational concerns of fund managers can give rise to excludable rents that can, in turn, generate strategic complementarity in engagement strategies and enable collective influence. The paper also examines the dynamics of wolf pack formation.

The discussant **Doron Levit** was unable to attend the conference but sent his slides. His slides discussed alternative ways to model wolf packs. For instance, he asked whether reputational concern is a more plausible solution than repeated interaction or proxy advisors. He also noted that behind-the-scenes discussions might not be fully captured by the model since private communication is not observable to (ultimate) investors. The audience asked whether the model can shed light on the composition of wolf packs and about its testable implications.

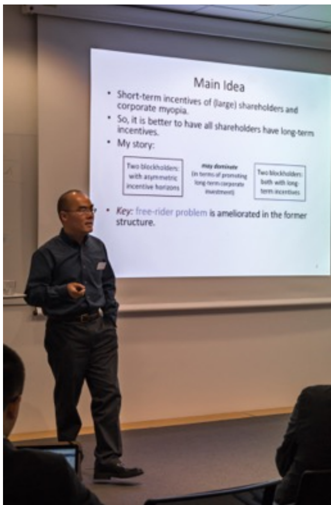
Todd Gormley, "Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism" (with **I. Appel,** and **D. Keim**)

Todd Gormley presented a paper which examines how the trend to frequent and aggressive activist campaigns co-moves with the observed growth in passive ownership. For instance, does passive ownership affect the objectives of activist campaigns, or does it change the tactics and eventual outcomes? To assess whether passive ownership facilitates or hinders activism, the paper uses an IV approach based on Russel index assignments. In the first stage, it documents that firms in the Russel 3000 display more passive ownership. In the second stage regressions, it finds that the instrumented passive ownership does neither affect the likelihood of being targeted by an activist nor the ex-ante characteristics of the target. Conditional on being targeted, more passive ownership affects the type of campaign (seeking more board seats), the tactics (more proxy fights), and the outcomes (more likely to win settlements). The results shed light on the determinants of activists' objectives as well as on how the impact of the growing passive ownership extends beyond its direct effect on governance.

In his discussion, **Rüdiger Fahlenbrach** asked about the plausible sequence of interactions between activists and passive investors: Do activists identify underperforming firms and subsequently make use of passive owners, or do they actively seek out underperforming firms with high passive ownership? He also pointed out that passive investors would be more helpful to activists than other investors. The audience wondered about the mechanism at work as, for instance, some activists have indicated that countries with low passive ownership are good places to invest. The audience noted that there is a distinction between high passive ownership and ownership concentration and wondered how it affects the interpretation of the results.

Session: Competition for Flow

Fenghua Song, “Blockholder Short-Term Incentives, Structures, and Governance”



Fenghua Song presented a paper that theoretically analyzes how different time horizons among blockholders affect firm value. The paper shows that two blockholders with different time horizon may be more efficient than two with the same horizon because it ameliorates the free-rider problem. Overall, the level of intervention/governance may be higher because the incentives for a reputation-unconscious (long-horizon) fund to intervene becomes stronger when the other blockholder is a reputation-conscious (short horizon) fund which provides too little intervention due to career concerns. This contrasts with the single blockholder case where short horizons unambiguously weaken governance.

In her discussion, **Jing Zeng** put the model into perspective and discussed the bright and dark sides of myopic blockholders. She raised the question how asymmetries along other dimensions than the time horizon may influence the results. Also, she called for a better understanding of the results by broadening the benchmark cases to include, not only two blockholders with similar horizons, but also a single blockholder. Relatedly, the audience was curious how robust the results are to the choice of monitoring technology and how to think about a setting with an initial incumbent blockholder, as opposed to the case where the two blockholders acquire their stakes contemporaneously.

Giorgia Piacentino, “Venture Capital and Capital Allocation”

Giorgia Piacentino presented a paper that analyses how venture capitalists’ career concerns affect primary market outcomes and capital allocation. In the model unskilled career-concerned VCs are conservative which leads them to turn down some high-quality start-up firms. However, such conservatism can generate more efficient aggregate outcomes: As the unskilled VC is less likely to invest, the probability that a VC-backed firm is of high quality increases, making VC-certification a more reliable signal thereby reducing asymmetric information at the IPO stage. The model results line up with a number of stylized facts, e.g., VC-backing lowers IPO underpricing. The model also predicts that career concerned VCs back fewer, higher quality firms and have fewer IPOs in normal times, but more IPOs in downturns relative to other investors.

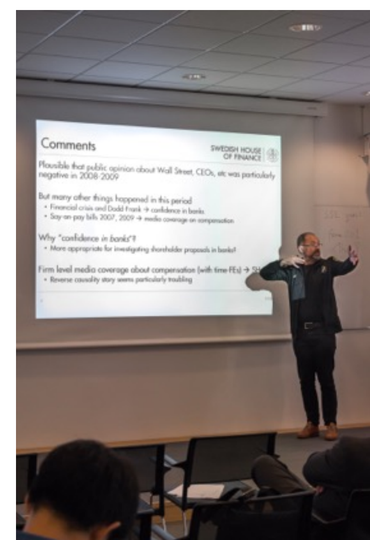
The discussant, **Hongda Zhong**, asked whether it matters for the result that the model is static. He suggests that in a dynamic model with reputation outcomes may well differ. The audience agreed and pointed to the fact that return skewness with few really profitable firms/outcomes is important in VC investing and that this empirical pattern might also be easier to analyze with a dynamic model. Finally, the discussant raised questions about how to interpret the co-existence of both types of VCs, skilled and unskilled.

Session: Influences on Institutional Investors

Laura Starks, “Influence of Public Opinion on Investor Voting and Proxy Advisors” (with **R. Aggarwal,** and **I. Erel**)

Laura Starks presented a paper which studies how the media and proxy advisors interact. Specifically, the paper analyzes whether public opinion affects shareholder voting and if public opinion and media monitoring affect the recommendations of proxy advisors. To this end, the paper examines how measures of public opinion are related to the support rate for shareholder proposals. It finds that the frequency of media reporting and the extent of adverse media coverage have a positive impact on the support for shareholder proposals. This relationship helps explain the empirical observations that i) institutional investors increasingly supported shareholder proposals after the financial crisis, that ii) shareholder proposals become more important to the governance process and that iii) shareholders become more independent of both management and proxy advisors.

In his discussion, **Per Strömberg** noted the difficulty of finding a good measure of public opinion on corporate governance. For example, Gallup Polls of confidence in banks may co-move with variables which may be related to institutional voting through channels other than proxy advisors. He suggested considering these questions outside the financial crisis by extending the sample backward to include the passing of SOX and major auditing scandals. He also wondered about the mechanism: does public opinion, as measured by media content and Gallup Polls, influence the views of proxy advisors which then influence institutional investors? Or does the link go directly from public opinion to both institutional investors and proxy advisors without interaction between the latter two? The audience asked why public opinion should impact the recommendations of proxy advisors, and how following or neglecting public opinion affected their revenues or business model.



Session: How to Govern

Slava Fos, “Activism, Strategic Trading, and Liquidity” (with **K. Back**, **P. Collin-Dufresne**, **T. Li,** and **A. Ljungqvist**)

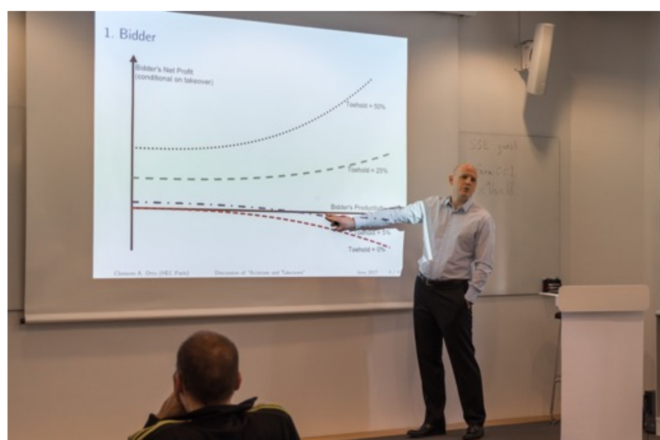
Given the increased role of activism, it is of interest to explore the interdependencies between firm values, corporate governance, and market liquidity. **Slava Fos** presented a paper which analyzes these links in a continuous-time model which explicitly considers different cost function of activist intervention. The paper demonstrates that the nature of activism plays a crucial role in shaping the relationship between liquidity and activism. Furthermore, increased noise trading need not improve market liquidity, and the relationship between activism and liquidity crucially depends on the source of the actual variation.

In his discussion, **Kostas Zachariadis** asked how to think about the cost born by activists and how intervention not being a binary choice matters for the results. He also noted that it is not clear how the results would differ in a discrete time model. The discussion from the audience also brought up the differences between modeling in continuous vs. discrete time and called for future work linking the different results to the specific building blocks of the model.

Samuel Lee, *"Activism and Takeovers"* (with **M. Burkart**)

There are two ways outside investors can intervene to improve firm value: takeovers and activism. **Samuel Lee** presented a model which endogenizes the choice between the two. In the model, any outside investor faces a dual free-rider problem: dispersed shareholder hold out ex ante and do not share in the effort to improve firm value ex post. While bidders need to buy enough shares to accumulate 50% ownership, activists campaign to convince incumbent management and/or other shareholders of the proposed value improvements. The paper shows that, as the potential for value improvement increases, buying control becomes expensive while activism becomes more profitable. Furthermore, activists can add value by engaging in takeover activism, i.e., brokering a firm sale to a bidder, rather than implementing the value improvement themselves. The model suggests that activism increases total M&A activities but reduces (hostile) tender offers.

The discussant, **Clemens Otto**, wondered about the reduced form formalization of the activist's intervention. Is there a micro-foundation to support that activists sometimes succeed and sometimes fail in controlling the firm with less than 50%, whereas bidders need a majority stake? The subsequent discussion centred on how to interpret the model implications and how to apply it to the real world: In which situations are takeovers and activism substitutes? The audience discussed anecdotal evidence that activist funds indeed take minority positions with the explicit objective to change firms similarly to what investors with a majority stake do.



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