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Geographic concentration of institutions, corporate governance, and firm value☆

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ABSTRACT

We examine the impact of geographic concentration of institutional investors on corporate governance and firm value. We find that firms whose large institutions are closely located to each other experience more shareholder-coordinated activities before Schedule 13D filings, more concerted proxy votes against management proposals, higher forced CEO turnover-performance sensitivity, higher returns around CEO turnover announcements and Schedule 13D filings, and larger increases in Tobin's *q*. These results are robust to using the introduction of new direct airline routes as an exogenous source of variation in proximity. Our results suggest that geographic concentration of investors increases monitoring effectiveness.

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A recent theoretical paper by Brav et al. (2017) investigate the implicit coordination network (e.g., through word-of-mouth effect) that wolf pack shareholders form to intervene in a target firm. Also, Coffee and Palia (2014) describe a new tactic in which “a loose network of activists act in a parallel fashion” in order to reap high profits at low risk. McCahery et al. (2015) survey 143 large institutional investors, 59% of which are willing to coordinate with each other in governance but the legal barrier is their major concern.[1] Finally, the world's largest asset managers have reportedly held secret indoor summit meetings to hammer

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[1] The legal concern arises from filing jointly if the activities are formally collaborated. U.S. disclosure rules (Regulation 13D) require investors to file jointly as a group when form formal group in collective activities. Due to the concern of legal filing potentially reduce trading profits and trigger poison pills, the total holdings that can be obtained by the group is limited. Thereby, formal coordination of institutions is restricted in the US. However, the 1992 SEC Proxy Reforms allow institutions to communicate during a proxy contest about their voting intentions without the need to file jointly, which lift restrictions on shareholder communications (Choi, 2000). Moreover, coordination can be implicit through informal conversations as in Shiller and Pound (1989) and Brav et al. (2017). Survey evidence (McCahery et al., 2015) and recent anecdotal evidence of investors' informal coordination (Benoit and Grind, 2015, Foley and McLannahan, 2016) supports this view.

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out proposals for improving public company governance to encourage longer-term investment and reduce friction with shareholders (Benoit and Grind, 2015, Foley and McLannahan, 2016). This recent trend in literature shows the importance of understanding the implicit coordination network of institutional shareholders.

We argue that the geographic concentration of large institutions holding the same stocks should facilitate the formation of an implicit coordinated network of shareholders for corporate monitoring and in turn increase firm value. Institutions that are closely located to each other have more opportunities to network through word-of-mouth effect (Hong et al., 2005). Efficient information-sharing arising from networking effects decreases information asymmetry vis-à-vis firms (Pagano and Jappelli, 1993, Doblas-Madrid and Minetti, 2013, Doidge et al., 2015), thereby increasing institutions' monitoring capabilities by improving their informational economies of scope. The geographic concentration of large institutions also increases institutions' incentives to pursue active monitoring by reducing their communication and transportation costs and in turn the costs of taking coordinated governance actions.

More importantly, geographic concentration of institutions mitigates the moral hazard of free-riding (Grossman and Hart, 1980, Holmstrom, 1982, Shleifer and Vishny, 1986) and thus further increases institutions' incentives to collaborate in monitoring portfolio firms. Holmstrom (1982) argues that the free-rider problem is due to information asymmetries that arise because individuals' actions cannot be observed. Therefore, in our context, the institutions have the incentives to monitor each others' actions and acquire information of individuals' collective effort to mitigate the free-rider moral concern in jointly exercising influence (Black, 1990). As geographic proximity reduces unobservability thereby mitigating moral concern (John et al., 2011, Stiglitz, 1990, Arnott and Stiglitz, 1991), the geographic concentration among large institutions enhances the observability of the coordination efforts vis-à-vis each other and curbs moral hazard of free-riding. To the extent that more active governance translates into better firm performance, firms whose large institutional investors are closely located to each other are expected to have higher firm value than other firms.

To shed light on the role of the geographic concentration of large institutional investors, we first examine whether coordinated actions of large shareholders are increasing function of institutions' geographic concentration, where the shareholder coordination is proxy by the abnormal stock turnover before Schedule 13D filings. We expect the shareholders' geographic concentration to increase collective trading before 13D filings. Second, we investigate the coordinated mechanism through which large institutions influence corporate governance, as measured by the likelihood of two institutions making the same decisions to vote against management. We expect institutional shareholders that are located near each other to be more likely to vote similarly against management. We then explore whether geographically proximate large institutions pursue more active monitoring as measured by forced CEO turnover-performance sensitivity. The arguments above suggest that firms with large institutional investors that are closely located to each other have higher forced CEO turnover-performance sensitivity. Next, we examine whether the geographic concentration of large institutions increases firm value. We expect firms with geographically proximate institutions to have higher abnormal announcement returns around CEO turnover announcements and Schedule 13D filings, and larger increases in Tobin's *q*. Finally, we examine whether the effects of large institutions' geographic distance on corporate governance and firm value depend on institution type. To the extent that long-term or nontransient institutions (i.e., dedicated/quasi-index institutions) with large ownership have stronger incentives to take an active monitoring role than transient institutions (Chen et al., 2007), we expect the above effects to be more pronounced when nontransient institutions are closely located to each other than when transient institutions are. Also, as institutions facing higher collective need are more likely to collaborate, we expect the impact of shareholder geographic concentration on shareholder coordination, governance and firm value to be stronger in firms that are larger and with higher G-index.

We test the above predictions using various measures of the geographic distance between a firm's top 10 institutions,[2] including the ownership-weighted physical distance between a firm's top 10 institution pairs (*Vw Distances*), the sum of the ownership-weighted standard deviations of the top 10 institutions' latitudes and longitudes (*Vw Std LatLon*), one minus the Herfindahl index of institutional ownership in the states in which the top 10 institutions are located (*1–Herfindahl State IO*) and the ownership-weighted number of golf courses that are located within the overlap region between two of a firm's top 10 institutional shareholders (*Vw Num Golf*).

Our results using these concentration measures provide consistent, strong support for the view that geographic concentration of large institutions improves collective shareholder actions, corporate governance and in turn firm value. Specifically, using abnormal stock turnover during the 10-day period before Schedule 13D filings as a proxy for shareholder collective actions, we find that one-standard-deviation decrease in *Vw Distances_filing* is associated with an increase in abnormal turnover of almost 0.07% ($=0.001 \times 0.700$), which accounts for 23.3% of the unconditional sample mean. Moreover, for the channel by which closely located institutions pursue active monitoring, we find an increase in concerted proxy voting decisions against management by mutual funds families located near each other relative to those that are remote.[3] For example, using the indicator of two of the top 10 voting institutions not in the same state (*Dif States_voting pair*) as the measure of geographic concentration, we find that a one-standard-deviation decrease in *Dif States_voting pair* is associated with a 0.22 percentage-point increase in the

[2] The mean (median) equity ownership held by the top 10 institutional investors in our sample firms is 29.8% (30.0%), suggesting that they hold a substantial portion of a firm's outstanding shares. In untabulated tests, we use block institutions that own at least 5% of a firm's outstanding shares as an alternative definition of large institutions and find qualitatively similar results.

[3] For the tests of proxy voting decisions by mutual funds (Schedule 13D filings), we measure large institutions' geographic concentration by considering voting (13D filing) top 10 institutions' geographic locations relative to other top 10 institutions.

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