



Do exogenous changes in passive institutional ownership affect corporate governance and firm value?[☆]



Cornelius Schmidt^{a,b,*}, Rüdiger Fahlenbrach^c

^a Department of Finance, Norwegian School of Economics (NHH), 5045 Bergen, Norway

^b Directorate-General for Competition, European Commission, MADO 17/055, Brussels, Belgium

^c Swiss Finance Institute, Ecole Polytechnique Fédérale de Lausanne (EPFL), Quartier UNIL-Dorigny, Extranef 211, CH-1015 Lausanne, Switzerland

ARTICLE INFO

Article history:

Received 7 April 2014

Revised 31 May 2016

Accepted 13 June 2016

Available online 18 January 2017

JEL classification:

G34

G23

G32

Keywords:

Corporate governance
Institutional ownership
Monitoring
Index reconstitutions

ABSTRACT

We investigate whether corporations and their executives react to an exogenous change in passive institutional ownership and alter their corporate governance structure. We find that exogenous increases in passive ownership lead to increases in CEO power and fewer new independent director appointments. Consistent with these changes not being beneficial for shareholders, we observe negative announcement returns to the appointments of new independent directors. We also show that firms carry out worse mergers and acquisitions after exogenous increases in passive ownership. These results suggest that the changed ownership structure causes higher agency costs.

© 2017 Elsevier B.V. All rights reserved.

[☆] The paper is derived from the first chapter of Schmidt's 2013 dissertation at the University of Lausanne and was previously circulated under the title "Shareholder Monitoring Incentives and Corporate Policies". We thank Eliezer Fich (the referee) whose comments have significantly improved the paper. Bo Becker, Carsten Bienz, Alon Brav, Itzhak Ben-David, Pierre Collin-Dufresne, Espen Eckbo, Isil Erel, Amit Goyal, Yaniv Grinstein, Christoph Herpfer, Michael Ingenga, Victoria Ivashina, André Lucas, Lorian Mancini, Roni Michaely, Bernadette Minton, Konrad Raff, Norman Schürhoff, Laura Starks, René Stulz, Karin Thorburn and Michael Weisbach as well as seminar participants at the Ohio State University, the 2012 Swiss Finance Institute Doctoral Workshop in Gerzensee, EPFL, NHH Bergen, Warwick Business School, BI Oslo, VU Amsterdam and the University of Bern provided helpful comments and suggestions. Claire Eagle from Russell Investments provided precious feedback on the construction of the index data. We thank Brian Bushee for sharing his investor classification data and Antti Petajisto for sharing his benchmark classification data. Karl Fredrik Schjøtt-Pedersen provided excellent research assistance. Fahlenbrach and Schmidt gratefully acknowledge financial support from the Swiss Finance Institute. Schmidt gratefully acknowledges financial support from the [Swiss National Science Foundation](http://www.swissnationalsciencefoundation.ch) and NHH's FO-

1. Introduction

From 2007 through 2013, U.S. index domestic equity mutual funds and exchange-traded funds (ETFs) received \$795 billion in cumulative net new cash and reinvested dividends, and at the end of 2013, index mutual funds and large cap ETFs held \$1.2 trillion and \$450 billion in assets, respectively. Actively managed domestic equity mutual funds had outflows of \$575 billion ([Investment Company Institute, 2014](http://www.investmentcompanyinstitute.com)). The dramatic increase in ownership of U.S. corporations by passively managed funds raises important

CUS initiative. Part of this research was completed while Schmidt was a visiting scholar at The Ohio State University. The views expressed in this article are personal, and do not necessarily represent those of DG Competition or of the European Commission.

* Corresponding author at: Department of Finance, Norwegian School of Economics (NHH), 5045 Bergen, Norway.

E-mail address: cornelius.schmidt@nhh.no (C. Schmidt).

issues for the corporate governance of firms because it is uncertain to what extent passively managed funds have the capacity and interest to monitor corporations.

The academic governance literature proposes two main channels through which large institutional investors can affect corporate governance decisions: Voice and exit (the “Wall Street walk”). Both channels, however, appear ill-suited for index-tracking institutions. The voice channel, in which institutional investors actively interact with management to voice their preferences, seems expensive for low-cost and low-overhead passive institutional investors that cover thousands of stocks. The exit channel is not available to institutional investors who track indexes and are often paid by tracking error. Passive institutional investors insist that they have a fiduciary duty to exercise governance and do so, for example, through informal meetings with management and through voting at annual general meetings. It is not clear, however, how active they really are in corporate governance. Organizations such as Institutional Shareholder Services (ISS) that give vote recommendations to institutional investors at annual general meetings have rapidly grown and there exists evidence that many institutional investors mechanically follow their advice so that they can prove to have complied with their fiduciary duties (Malenko and Shen, 2016).

In this paper, we ask whether the increase in passively managed institutional ownership changes the governance of corporations to the detriment of shareholders, or whether index-tracking institutions participate in governance as much as more active institutions. If corporate governance worsens, do managers take advantage of a change in their firm’s shareholder structure towards more passive ownership to advance their personal interests?

We concentrate on two corporate governance areas which executives may rapidly influence after a change in the balance of power in corporations—the board of directors and their relative power in the organization measured by an accumulation of titles (e.g., Morck, Shleifer, and Vishny, 1989). We also examine whether passive institutional investors use their main governance device, shareholder proposals, more actively. We study announcement returns to mergers and acquisitions to test whether agency costs are higher and whether managers can reap personal gains from empire building after increases in passive ownership.

One challenge for our analysis is the endogenous nature of a company’s shareholder structure. It is plausible to expect that a firm’s shareholder structure is influenced by firm characteristics that also drive changes in governance. For example, Brav, Jiang, Partnoy, and Thomas (2008) find that hedge fund activists target firms that have a low market value relative to book value, low payout ratios, more takeover defenses, and high chief executive officer (CEO) pay. One of the contributions of our paper is therefore to use—in addition to the standard ordinary least squares (OLS) approach—plausibly exogenous changes in a firm’s shareholder structure. The exogenous change is driven by the annual reconstitution of the Russell 1000 and the Russell 2000 indexes, following Chang, Hong, and Liskovich (2015). The reconstitution of the indexes changes the shareholder structure because the Russell 1000 in-

dex (the largest 1000 U.S. stocks by market capitalization) and the Russell 2000 index (the 1,001st to 3,000th largest U.S. stocks by market capitalization) are value-weighted. A stock moving from the bottom in the Russell 1000 index to the top of the Russell 2000 index will become much more important to an index-tracking institution.

Using a sample of U.S. stocks from 1993–2010, we find evidence suggesting that corporate executives use the (index-reconstitution-driven) exogenous change in the shareholder base to influence corporate governance to advance their personal interests. We find that the power of CEOs increases in firms with more passive owners. The likelihood to become chairman or president increases significantly. While the fraction of independent board members does not change, we find that in firms with more passive investors, independent board turnover decreases so that directors serve longer terms. Interestingly, the incidence of a broad basket of governance-related shareholder proposals does not change following changes in the shareholder base, which is consistent with these shareholder proposals not being initiated by the passive, index-tracking institutional shareholders that form the basis of our study.

Are the observed changes in governance good or bad for shareholders? The answer is not obvious. For example, more powerful CEOs may be able to have more influence on the firm and help the firm succeed (e.g., Adams, Almeida, and Ferreira, 2005, 2009; Anderson and Reeb, 2003; Fahlenbrach, 2009) but are also more entrenched and may be able to carry out actions that are to their personal benefit but to the detriment of shareholders. To answer this question, we examine the announcement returns to two governance changes—the accumulation of titles and new director appointments.¹ We find evidence that shareholders react more negatively to the accumulation of titles and the appointment of new directors in firms with more passive owners, consistent with these governance changes being value-decreasing.

Finally, we examine whether firms undertake more value-decreasing mergers and acquisitions (M&A), after exogenous increases in passive ownership. Jensen (1986) emphasizes that value-destroying M&A activity is one of the main mechanisms for extracting private benefits in public corporations. Masulis, Wang, and Xie (2007) empirically show that managers of firms with less effective corporate governance indeed engage in more value-destroying acquisitions. We find strong evidence that the cumulative announcement returns to mergers and acquisitions decrease after exogenous increases in passive ownership and that the reduction of shareholder value is economically meaningful in dollar terms. In additional tests, we show that the same firms make worse M&A decisions after they experience an exogenous increase in passive ownership.

Our paper’s hypotheses are firmly grounded in existing theory and relate to several strands of the empirical literature on institutional ownership and governance that we review in Section 2. A few papers use an identification strategy similar to ours. Chang, Hong, and Liskovich (2015)

¹ We take great care to only examine announcements of director appointments and accumulation of titles that are communicated on days without confounding news.

Download English Version:

<https://daneshyari.com/en/article/5100535>

Download Persian Version:

<https://daneshyari.com/article/5100535>

[Daneshyari.com](https://daneshyari.com)