Institutional Investors as Minority Shareholders

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May 2011

What Role Do Institutional Investors Play in Corporate Governance?

- Extensive research on institutional investors in the US/UK, including on voting patterns, evidence is mixed

- But how do institutional investors behave when ownership is concentrated?
  - The answer is virtually unknown

  - Exceptions: recent studies using Swedish data (Giannetti and Laeven, 2009; Norden and Strand, 2008), and recent studies using Chinese data (especially Chen et al., 2010)

Institutional investors as minority shareholders:

- Can affect outcome only in special-majority votes
- Agency issues involve self-dealing and minority protection
- Powerful families and business groups, some of which even own institutional investors

Related Literature

Institutional Investors:

- **Regulation**: Cremers and Romano (2009)
- **Conflicts of interests**: Brickley et al. (1988; 1994); Davis & Kim (2007); Rothberg & Lillian (2006); Ashraf et al. (2009).
- **Strategic voting**: e.g. Matvos and Ostrovsky, 2009, Maug and Rydqvist (2009)

Minority Protection:

- **CG in countries with concentrated ownership** (LLSV etc.)
- **Effectiveness of legal mechanisms to protect minority shareholders** (Goshen 2003; Djankov et al., 2008, Chen et al.'s recent work on China)

Israel: A Unique Experiment

- Corporate law requires a “disinterested” vote on certain issues (e.g. related-party transactions)
- Law requires institutional investors to vote on (some) proposals
- Data on voting are available
- Potential lessons for many other countries attempting to enhance investor protection by empowering minority shareholders

Our Contribution

- Hand-collected data on institutional investor voting in a concentrated ownership environment
- Evidence on the effectiveness of legal measures to empower minority shareholders
- Examine unexplored sources of conflicts of interests (related to institutional investor ownership by business groups or publicly traded companies)
- Many types of institutional investors (not only mutual funds or pension funds as is typical in the lit)

Sample and Data Sources

- About 26,000 votes in 2006 of which 10,000 No Vote, and over 15,000 For/Against
- Mutual Funds – votes reported to ISA
- Other Institutional Investors (pension, provident funds, life insurance) – have to report on their own website (hand collected for institutions exceeding a size threshold)
- Cross-checked with company reports to ISA /TASE on shareholder meetings
- Matched with financial statements (Bank of Israel)
- Matched with data on group affiliation for both firms and institutions (Kosensko, 2008)

Factors Affecting Voting Patterns

- Issue (category)
  - Substance (e.g. compensation, self-dealing, director elections)
  - Required majority (ability of the minority to influence outcomes)

- Institution-level attributes
  - Conflicts of interest (ownership, business ties and others)
  - Other variables (size, % equity held)

- Firm-level attributes/controls
  - Performance; Ownership structure
  - Power (size, group affiliation)

Two Types of Empirical Tests

(1) When do institutional investors vote?

- When minority have voting power?

(2) If they do cast an active vote, what affects the probability of a FOR vote?

- Vote AGAINST tunneling and self-dealing?
- When they can influence outcomes?

In much of the analysis the two questions are addressed separately; in one of the robustness tests we examine the two as a joint decision.

Main Results: When do institutional shareholders vote?

- Primarily when expressly required by statute
- Do not bother to cast a vote on director elections
- Even when the law empowers the minority to influence outcome (legal power of the minority has little effect)

Main Results – contd.
When Do Institutions Vote FOR?

- Very often (70% of votes)…
- Objections concentrated primarily in compensation-related votes regardless of whether institutions can affect outcomes
- Do not necessarily object in other cases where the minority has power

- Why compensation?
- A PR campaign? (media coverage, protection from lawsuits)
- Compensation as *the* major mechanism to expropriate minority shareholders?
- Hard to evaluate the monetary value of compensation packages, more on this later

Main Results (iii): Characteristics of the institution matter

- “Pure-play” institutions (gov’t and employee owned) object more. Unbiased? Vote by the merit of the proposal? Differences between “pure play” and other institutions not necessarily more pronounced when the minority has power

- Bank-owned institutions object more. Less subject to pressure? (other large institutions also tend to object more)

- Institutions offering underwriting services support more, and so do publicly traded and group-affiliated institutions (conflicts of interest)

Main Results (iv): Firm Characteristics

- Performance does not affect the probability of a FOR vote
- Larger firms elicit more FOR votes
- No clear results regarding the impact of ownership concentration (% equity held by controller)
- Not much effect of group affiliation

Caveats and Limitations

- Pre-negotiations (modified proposals) and proposals not brought to a vote (selection of proposals):
  - Info on % votes AGAINST by large institutions alleviates this concern?
  - No clear link between measures of how “pivotal” an investor is and the probability of a vote FOR
- No data on proxy advisory services;
  - Not so important during sample period (2006);
  - Info on votes by small institutions (heterogeneity) alleviates this concern?

Table 1 – Voting Categories

	Definition/Required Majority/Duty to Vote	Explicit Duty to Vote?	Required Majority	% FOR/ AGAINST votes out of all votes [a]	% FOR Votes	% Proposals Adopted [b]	# FOR/ AGAINST votes
	Full Sample			57.2	67.5	97.8	15,475
Category 1A	Direct or indirect self-dealing by controlling shareholders – compensation related	Yes	1/3 of disinterested (minority) shareholders	90.7	41.0	92.6	1,401
Category 1B	Direct or indirect self-dealing by controlling shareholders – related party transactions	Yes	1/3 of disinterested (minority) shareholders	90.6	78.2	98.7	2,421
Category 2	Waivers of the duty of care, liability insurance, and indemnification when the beneficiaries of such measures include the controlling shareholders	Yes	1/3 of disinterested (minority) shareholders	92.5	67.4	96.2	3,087
Category 3	Electing "outside directors"	No	1/3 of disinterested (minority) shareholders	12.2	78.0	99.1	227
Category 4	CEO/Chairperson unification	No	2/3 of disinterested (minority) shareholders	92.1	74.8	95.9	329
Category 5	Charter amendments	No	75% supermajority	80.2	59.1	97.0	856
Category 6	Certain reorganizations	No	75% supermajority	91.3	91.3	98.3	115
Category 7	Executive compensation for professional managers or directors	Yes	Regular majority	89.8	55.6	99.7	2,589
Category 8	Liability waivers, liability insurance, and indemnification for directors or officers who are not related to the controlling shareholders	Yes	Regular majority	91.9	73.4	98.4	1,221
Category 9	Electing directors and auditors	No	Regular majority	6.3	89.1	99.7	349
Category 10	Compensation plans for board members	No	Regular majority	64.2	58.0	98.7	720
Category 0	All other proposals (e.g. various charter and bylaw amendments, increasing the firm's authorized capital, ratifying dividends, employee stock options plans etc.)	No	Regular majority	43.1	83.1	99.5	2,160

Definition/Required Majority/Duty to Vote	% FOR/AGAINST votes out of all votes [a]	% FOR Votes	% Proposals Adopted [b]	# FOR/ AGAINST votes
All categories where the support a 1/3 of minority shareholders is needed (Categories 1-4)	76.5	66.6	96.5	7,465
All categories where a 75% support is needed (Categories 5-6)	81.4	62.9	97.2	971
All categories where a regular majority is needed (all others)	44.3	69.1	99.3	7,039

“Pure Play” vs. Other Institutions

Category	“Pure Play” Institutions (Types 1 and 2) % of FOR Votes	Institutions with Commercial Interests (Types 3 and 4) % of FOR Votes
Full Sample	59.3 (N=2,559)	69.1 (N=12,916)
0	82.7	85.0
1A	22.2	43.6
1B	73.3	79.2
2	59.8	68.8
3	41.9	86.4
4	53.5	80.0
5	41.2	63.2
6	92.3	91.2
7	40.8	58.7
8	68.5	74.3
9	70.4	92.5
10	51.4	59.6
“Close Call Votes” (with support rates of 30-60%, N=992)	37.8	48.9
Rejected Proposals (N=350)	9.5	19.5

Institutional Investors with Business Activities

	No. of Institutions (votes)	% of FOR votes	Average Size (assets under management, million 2005 NIS)	No. of Bank-affiliated	No. of Insurance affiliated	No. with affiliated underwriter	No. publicly traded	No. of non-bank group-affiliated institutions
Bank-affiliated Institutions	17 (2,424)	55.0	10,438	N/A	0	12	12	0
All non-bank Institutional investors with business activities	55 (10,321)	72.4	6,554	0	23	45	43	8
Insurance-affiliated Institutions	23 (5,035)	66.5	10,728	0	N/A	17	22	6
Non-bank institutions with an Affiliated Underwriter	34 (6.961)	73.0	6,742	0	17	N/A	23	6
Non-bank publicly-traded Institutions	31 (7,138)	71.7	8,586	0	22	23	N/A	7
Non-bank group-affiliated Institutions	8 (1,429)	72.6	15,437	0	6	6	7	N/A
Non-"pure play" Institutions with none of the above business activities	13 (1,807)	71.4	4,810	0	0	0	0	0

Institutional Investors: Size and Equity Stakes

Pair-wise differences by institution size or equity stake are statistically significant

	% of FOR votes	Average Size (assets under management, million 2005 NIS)	Number of Votes
Institutions whose size is above the sample median (2862 million 2005 NIS)	65.2	14,283	7033
Institutions whose size is below the sample median	70.8	1,207	7417
Institutions whose equity stake is above the sample median (0.08%)	65.7	9,678	6152
Institutions whose equity stake is below the sample median	69.8	5,308	6661

Multivariate Probit Regressions

Robustness Tests
Sub-Samples

Of the 15,000 FOR/AGAINST votes we lose about 5000 observations in the regressions due to missing data; Results are unchanged when we increase the sample size by excluding variables with many missing observations (e.g. equity stakes held by institutions or controlling shareholders)

- “Pure Play” only: affected by firm size (pressure or reputation?), not by other firm attributes

- Sub-sample of compensation categories only: still no effect of firm performance

- Regressions by required majority (1/3 of minority, 75%, regular): results are generally similar

Robustness Tests
Sub-Samples (2)

- Sub-sample of firms with no controlling shareholder holding above 50%

- Sub-sample excluding small mutual funds (below the threshold of being included in the sample for other types of institutions)

- Some of these tests are tabulated in Table 8 in the paper (no slide here)

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Robustness Tests/ Additional Specifications

- “Pure Play” interactions with categories: confirms that tendency to vote AGAINST is more pronounced in some categories, not always when the minority has power
- Industry dummies – no change in results
- Mutual fund dummy (myopia?) – insignificant, no change in results
- Aggregate holdings by all institutions – ditto
- Logit instead of probit
- Joint estimation of the decision to cast an active vote and the decision how to vote when participating – qualitatively unchanged flavor of the results

Robustness Tests/ Additional Specifications (2)

- Subjective classification of proposals into “outrageous” and “material/immaterial”
- “Pivotal” institutional investors (few) and the probability of voting FOR in related party/compensation transactions
- Some of these tests are presented in Table 9 (no slide)

Variation with vote-specific FE's

- Main specification: OLS with SE's clustered at the firm level; SE's classified at the vote level – same results

- Alternative: vote-fixed effects and SE's clustered at the vote level. Very similar results, slight variations

- Most important: "Pure Play" remains negative and significant (Same for Bank and Insurance-affiliated) ➔ Vote NO at the same votes, results are not only due to different portfolios

Tentative Conclusions

- The power granted to the minority seems to have only a limited effect on voting patterns in the existing voting data (prob. of participation and vote FOR)
- Conflicts of interest related to institutional ownership (e.g. "Pure Play") and potential conflicts of interest (e.g. underwriting) consistently affect voting behavior
- The issues put to a vote matter: Objections to compensation-related proposals even when institutions cannot influence outcomes (regardless of required majority)

Tentative Conclusions

- <u>Interpretation I:</u> Law is effective, primarily through its effect on unobserved "outrageous" proposals modified or not brought to a vote (i.e. through its effect on what is not in the existing data set).
- Doubts: the behavior of large/pivotal voters (more AGAINST votes) and many anecdotes of minority shareholder expropriation despite this system
- <u>Interpretation II:</u> Empowering the minority is less important than addressing conflicts of interest?