Institutional Shareholders and Activist Investors

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The Role of Shareholders

• The “shareholder-centric” view holds that the primary purpose of the corporation is to maximize wealth for owners.

• From this perspective, an effective governance system is one that aligns the interests of managers and shareholders, thereby reducing agency costs and increasing value.

• However, deciding on what elements or features will result in an “effective” system is not always easy.

Disagreements arise because investors themselves are not a homogenous group and do not always agree about how to improve governance quality.

Equilar (2007)
Not All Shareholders Are the Same

- **Investment horizon.** Long-term investors might tolerate volatility if they believe value is being created. Short-term investors might prefer that management focus on quarterly earnings and stock price.

- **Objectives.** Mutual funds might care primarily about economic returns. Other funds might emphasize how results are achieved and the impact on stakeholders.

- **Activity level.** Passive investors might focus on index returns and pay less attention to individual firms. Active investors might care greatly about individual outcomes.

- **Size.** Large funds can dedicate significant resources to governance matters. Small funds lack these resources.
Other Limitations

Shareholders also suffer from other limitations.

• **Free-rider problem.** Shareholder actions are expensive. Although all shareholders enjoy the benefits, a few bear the costs. This provides a disincentive to act.

• **Indirect influence.** Shareholders do not have direct control over the corporation. They influence the firm by:
  – Communicating their concerns.
  – Withholding votes from directors.
  – Waging a proxy contest to elect an alternative board.
  – Voting against company proxy items.
  – Sponsoring their own proxy items.
  – Selling their shares.
Blockholders

- A blockholder is an investor who holds a large ownership position in the company (at least 1 to 5 percent).
- Because of the size of their holdings, blockholders are in a position to influence the governance of a firm.
- However, the actions a shareholder will take depend in part on the nature of its relation to the firm. (Corporate partners will not take the same actions as activist hedge funds).

- 68% of publicly traded companies in the U.S. have a 5% blockholder.
- Firms that have a blockholder at one point in time tend to have one 5 years later.
- No clear evidence that blockholders boost firm value; they might be subject to their own agency problems if their interests are not the same as other investors.
- External blockholders have a positive influence on CEO compensation and acquisitions, particularly when they also hold a board seat.

Thomson Reuters (2008); Barclay and Holderness (1989); Holderness (2003); Core, Holthausen, and Larcker (1999); Mikkelsen and Partch (1989)
Proxy Voting

• A primary method for shareholders to influence the corporation is through the proxy voting process.

• Each year, shareholders are asked to vote on a series of corporate matters, either in person at the annual meeting or through the annual proxy.

• Institutional investors are required by SEC regulation to vote all items on the proxy and to disclose their votes to investors.

  • Institutional investors vote “for” a proposal 90% of the time when management recommends a vote in favor.

  • They vote “against” 62% of the time when management is “against.”

ISS Voting Analytics (2009)
Proxy Voting

- **Management proposals** are those sponsored by the company, including the election of directors, ratification of the auditor, approval of equity-compensation plans, say-on-pay, anti-takeover protections, and bylaw changes.
- **Shareholder proposals** are those sponsored by investors. They generally relate to compensation, board structure, antitakeover protections, and bylaw changes.
- Companies may exclude shareholder proposals if they violate the law, deal with management functions, involve dividends, or involve other substantive matters.

33% of shareholder proposals relate to compensation; 20% are board-related (e.g., proposal to require an independent chairman).

Union funds and individual activists sponsor > 80% of proposals.

Gillan and Starks (2007)
Proxy Advisory Firms

Many institutions rely on the recommendations of a third-party advisory firm to assist them in voting the proxy.

- (+) Proxy firms examine all issues on the proxy.
- (+) Small investors lack the resources to do this in-house.
- (+) Large investors might want a second opinion.
- (-) No evidence that their recommendations increase value.
- (-) Guidelines tend to apply a one-size-fits-all approach.
- (-) Proxy firms might not have sufficient staff or expertise.

- The largest proxy advisory firms are Institutional Shareholder Services (ISS) and Glass Lewis, whose clients manage $25 trillion and $15 trillion in equities.
- An unfavorable recommendation from ISS can reduce support by 14% to 20%.
- No evidence that recommendations lead to improved performance. Some evidence that ISS recommendations for option exchanges lead to worse outcomes.

Bethel and Gillan (2002); Larcker, McCall and Ormazabal (2011)
Activist Investors

• An activist investor is a shareholder who uses an ownership position to actively pursue governance changes. Examples might include:
  – Union-backed pension funds.
  – Socially responsible investment funds.
  – Hedge funds that take an active position.
  – Individual investors with strong personal beliefs.

• Activist investors play a prominent role in the governance process, sometimes for the better and sometimes not.
Pension Funds

- Public pension funds manage retirement assets on behalf of state, county, and municipal government employees.
- Private pension funds manage retirement assets on behalf of trade union members.
- Pensions are active in the proxy voting process. However, their activism has not been shown to have a positive impact on shareholder value or governance outcomes.

- Companies that are the target of activism by CalPERS experience marginal excess stock price returns following the announcement; no excess returns or improvement in operating performance is discernable over the long term.
- The AFL-CIO is likely to vote against directors at companies in the middle of a labor dispute, particularly when the AFL-CIO represents the workers.

Barber (2007); Agrawal (2010)
Socially Responsible Funds

- Socially responsibility funds cater to investors who value specific objectives and want to invest only in companies whose practices are consistent with those objectives.
- Examples include fair labor practices, environmental sustainability, and the promotion of religious or moral values.
- These funds are visible in the proxy process, although it is only one tool they use to influence corporate behavior; proxy items sponsored by these funds generally do not receive majority support.

- Shareholders submitted 410 resolutions relating to social and environmental objectives in 2008. Of these, 202 came to a vote. On average, they received support from 5% to 10% of shareholders.
- Research is mixed on whether socially responsible funds succeed in their dual objective of achieving market returns and advocating social mission.

ISS (2009); Geczy, Stambaugh, and Levin (2005); and Renneboog, Ter Horst, and Zhang (2008)
Activist Hedge Funds

- Hedge funds are private pools of capital that engage in a variety of trading strategies to generate excess returns.
- Hedge funds are known for their high fee structure (2% management fee, 20% carry). They face pressure from clients to generate superior performance to justify these fees.
- Pressure to perform might encourage activism.

- Activist hedge funds target companies with high ROA and cash flow, but below market price-to-book ratios and stock price performance.
- Activist hedge funds accumulate an initial position of 6.3%; many coordinate their actions with other funds (“wolf pack strategy”).
- Target companies realize positive excess returns following the announcement.
- A majority of hedge funds achieve the stated objective of their activism (such as replacing the CEO, sale of company, or increased share buybacks); however, target companies do not exhibit superior long-term operating performance.

Brav, Jiang, Thomas, and Partnoy (2008); Klein and Zur (2009)
Shareholder Democracy

- In recent years, there has been a push by Congress, the SEC, and others to increase the influence that shareholders have over governance systems (“shareholder democracy”).

- Advocates of shareholder democracy believe that it will make board members more accountable to shareholder concerns, such as excessive compensation, risk management, and board accountability.

- Elements of shareholder democracy include:
  - Majority voting in uncontested elections.
  - Brokers disallowed from voting in uncontested elections.
  - Investor right to nominate directors (“proxy access”).
  - Investor vote on executive compensation (“say on pay”).
Majority Voting

- Shareholder advocates believe that plurality voting lowers governance quality by insulating directors from investors.

- They advocate a stricter standard—majority voting—under which directors must receive 50% of the votes to be elected.

- The impact of majority voting on governance is unclear. Dissenting votes are often issue-driven and not personal to the director (e.g., vote against directors on comp committee to protest CEO compensation levels).

- This might inadvertently work to remove directors who bring important strategic, operational, or risk qualifications.

- More than 80% of the largest 100 companies in the U.S. use majority voting. However, only 46% of all U.S. companies use majority voting.

Sterling Sherman (2010); NACD (2009)
Broker Nonvotes

• Shares held at a brokerage firm are registered in the name of the broker, even though they are beneficially owned by individuals.

• If the broker does not receive proxy instructions from the investor within 10 days of the vote, a “nonvote” occurs.

• NYSE Rule 452 allows brokers to vote these shares for “routine” matters but not for “nonroutine matters”.

• Historically, uncontested director elections were considered routine. In 2009, they were reclassified as nonroutine.

• An estimated 20% of director elections will be influenced by the change in Rule 452.
Proxy Access

- Historically, the board of directors has had sole authority to nominate candidates whose names appear on the proxy.

- Following Dodd-Frank, shareholders or groups of shareholders owning 3% or more of a company’s shares for at least 3 years are eligible to nominate up to 25% of the board.*

- Proxy access (or the threat of proxy access) is likely to increase the influence of activist investors over boards.

- The market reacts negatively to proxy access regulation, and the reaction is most negative among companies that are most likely to be affected.
- Only 11% of directors believe that proxy access is likely to improve corporate governance.

Larcker, Ormazabal, and Taylor (forthcoming); Boardmember.com (2010).
Say on Pay

• Shareholders are given an advisory (nonbinding) vote on executive or director compensation.

• Variations of “say on pay” have been enacted in the U.S., U.K., Netherlands, Australia, Sweden, Norway and India.

• Under Dodd-Frank, companies are required to hold a nonbinding say-on-pay vote at least every 3 years.

• Research indicates that say-on-pay votes outside the U.S. have not reduced executive compensation levels; it has been shown to change the structure of pay contracts.

• Evidence in the U.S. suggests that capping or regulating executive pay results in less efficient contracts and negatively affects shareholder wealth.

Larcker, Ormazabal, and Taylor (2012)
Conclusion

• In theory, shareholders should be in a strong position to influence the structure of governance systems.

• In practice, shareholders have limited influence, and in some cases they have conflicting agendas.

• Regulators have attempted to increase the influence of shareholders by mandating elements of “shareholder democracy.”

• However, shareholders tend to react negatively to these regulations. A positive impact on governance quality has not yet been demonstrated.


ISS Voting Analytics. 2009.


ISS. 2009 Proxy Season Preview: Environmental and Social Issues.