

Monitoring the Monitor: Distracted Institutional Investors and Board Governance

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Motivation

In the U.S., large shareholder's influence over corporate governance is primarily channeled through its board of directors.

- ▶ “Gatekeeper” of all shareholder proposals
- ▶ Approves almost all major corporate decisions
- ▶ Hires and fires CEOs and sets executive compensation

Since SOX, boards are primarily composed of outside directors

Recent evidence shows that independent directors effectiveness varies greatly. Their monitoring incentives also do not appear to be strong

- ▶ Their financial incentives appear weak
- ▶ The effectiveness of labor market penalties is unclear
- ▶ Director reputation incentives vary with other directorships also held

Key Question: Does board performance significantly benefit from active shareholder monitoring?



Shareholder Effectiveness in Monitoring Boards

Shareholder incentives to monitor directors are limited due to several considerations

- ▶ Limited shareholder expertise & credibility
- ▶ Weak incentives to monitor when they hold small blocks
- ▶ Difficulty in coordinating with other shareholders

One possible exception are **institutional investors (IIs)**

- ▶ **IIs** have stronger incentives to monitor boards
 - ▶ Given their large shareholdings, they are exposed to severe agency problems & experience significant losses in the absence of effective board monitoring
- ▶ Several recent studies show that **IIs** improve corporate decision making & firm value
 - ▶ But they are silent on the channels through which this occurs



Basic Research Question

Do **IIs** improve board monitoring incentives & board effectiveness?

- ▶ Institutional investors often hold large investment positions, and they have specialized expertise & information access for effective monitoring

Existing evidence emphasizes shareholder activist activities, including proxy contests & lawsuits as primary channels

- ▶ These actions are usually rare events, only occur in a small group of firms & are conducted by specific type of **IIs** such as hedge funds

Yet, board incentives generally need to be improved beyond strong shareholder activism & the threat of such activism

- ▶ Surprisingly, the literature often overlooks how **non-activist shareholders** can influence board monitoring.



Hypothesis 1: II Monitoring Is Beneficial

IIs improve board monitoring

- ▶ Without shareholder monitoring, it is unclear whether independent directors have sufficient incentives to do their jobs well
 - ▶ Independent directors generally have weak financial incentives, & strong financial incentives may not be optimal as it can encourage collusion with management (Kang, 2013)
 - ▶ Directors have limited labour market reputation incentives:
 - ▶ Directors only appear to be punished when extreme events happen
 - ▶ The punishment may be insufficient to create strong performance incentives (Harford & Schonlau, 2013; Fahlenbrach, Low & Stulz, 2016)



Hypothesis 2: IIs Are Not Effective Monitors

IIs do not improve board governance because:

- ▶ **II** monitoring is costly & subject to a free-rider problem
 - ▶ Voice is costly: reduces private benefits and access to information from management
 - ▶ Exit is costly: illiquidity increases trading costs; selling may also signal that an **II** picked a low-quality stock to invest in
 - ▶ An **II** bears all the costs of intervention, but can realise only a fraction of the benefits equal to their percentage share ownership
- ▶ Furthermore certain types of **IIs** do not have appropriate incentives to pursue costly intervention
 - ▶ “**Grey IIs**” may not have incentives to monitor a board, but instead to be manager-friendly, so as to continue to sell their companies’ products to the firm (Davies & Kim 2007)
- ▶ **IIs** are agents of their own shareholders with conflicts of interest of their own



Identification of Institutional Investor Effects

Identifying a causal effect of shareholders on firm governance is difficult: since changes in share ownership can often be the result of changes in expected firm profits, instead of being the cause of them (Reverse causality - Edmans, 2014)

Following Kempf, Manconi, and Spalt (2016), we use *unrelated* return shocks on an **II's** portfolio as the cause of exogenous variations in investor monitoring

- ▶ Shock=1 if another FF 12 industry (other than the focal firm's industry) in the individual **II's** portfolio is experiencing the highest/lowest return among the 12 FF industry sectors in a given quarter

Investors have a limited supply of attention - so they tend to allocate more attention to industries with extremely good or extremely bad returns

- ▶ **Rational explanation:** They focus on processing particularly valuable information in recessions & booms (Kacperczyk et al., 2016)
- ▶ **Behavioural explanation:** People pay more attention to extreme events

To obtain distractions by a particular **II**, we adjust for the importance of the **exogenous industry shocks** using the **II's industry portfolio weights**

We then aggregate various industry distractions borne by all **institutional shareholders** at a focal firm, weighting by each **II's shareholding %** in a focal firm

- ▶ To the extent that shocks in other industry are unrelated to focal firm fundamentals, this measure captures exogenous variation in shareholder monitoring



Summary of Results

We construct an **II**s distraction measure to capture exogenous variation in major shareholders' attention caused by unrelated industry return shocks in their portfolios

We find that investor distraction weakens board governance

Distracted **II**'s lead to weaker board oversight

- ▶ They are less likely to vote against **ineffective** independent directors

With weaker **II** oversight, board monitoring intensity falls

- ▶ Independent directors miss more meetings
- ▶ Boards hold fewer meetings

Distracted **II**s also lead to poorer board monitoring

- ▶ More conflicted directors are appointed to boards
- ▶ Boards approve higher CEO excess pay
- ▶ Board accept more earning management



Conclusions

We examine how monitoring by **IIs** influences board governance by constructing an investor distraction measure to capture exogenous variations in shareholder attention

We find that **II** distraction weakens board oversight, which in turn leads to weaker board monitoring incentives, and poorer board monitoring quality

Our findings suggest that **II** monitoring represents an important determinant of board monitoring incentives and performance

This study also extends our understanding of how **IIs** intervene in portfolio firms to improve corporate governance and firm value.





Distraction Measures

For each institutional investor-firm pair, we aggregate return shocks to the investor's portfolio industries *other than* the focal firm f 's industry, to calculate distraction by a particular investor i :

$$\text{Institutional Investor Distraction}_{i,f,q-1} = \sum_{IND \neq IND_f} w_{i,q-1}^{IND} \times IS_q^{IND}$$

We then aggregate institutional investor-level distraction to calculate a focal firm f 's aggregate institutional investor distraction level, adjusting for institutional investor i 's importance in firm f ($w_{i,f,q-1}$):

$$\text{Total Distraction}_{f,q-1} = \sum_{i \in f} \sum_{IND \neq IND_f} w_{i,f,q-1} \times w_{i,q-1}^{IND} \times IS_q^{IND}$$

- ▶ To proxy for investor i 's importance in f , we sort i 's percentage ownership in f and f 's weight in i 's portfolio into quintiles, and denote them as $QPercOwn_{ifq-1}$ and $QPFweight_{ifq-1}$, and use the quintile values to calculate $w_{i,f,q-1}$:

$$w_{i,f,q-1} = \frac{QPFweight_{ifq-1} + QPercOwn_{ifq-1}}{\sum_{i \in F,q-1} (QPFweight_{ifq-1} + QPercOwn_{ifq-1})}$$

Therefore, our investor distraction measure captures to what extent all the institutional investors will shift their attention away from the focal firm.



Empirical Results – Table 1. Summary Statistics

Variable	N	Mean	Median	25%	75%	STD
<i>Panel A: Distraction Measures</i>						
Mutual Fund Distraction	7,848	0.15	0.14	0.10	0.18	0.07
Total Distraction	16,391	0.17	0.17	0.13	0.21	0.06
Monitoring Investor Distraction	16,391	0.06	0.06	0.04	0.07	0.02
Grey Investor Distraction	16,391	0.02	0.02	0.02	0.03	0.01
<i>Panel B: Voting Characteristics</i>						
Oppose Management	1,710,792	0.07	0	0	0	0.26
% “Yes” Votes	47,319	0.96	0.98	0.96	0.99	0.08
Average Firm % “Yes”	47,319	0.96	0.98	0.95	0.99	0.06
Negative ISS	47,283	0.06	0	0	0	0.25
<i>Panel C: Director Characteristics</i>						
Director Age	114,293	62.40	63	57	68	8.23
Female Director	114,293	0.12	0	0	0	0.33
Director Ownership	114,293	0.10	0.029	0.006	0.110	0.15
Director Tenure	114,288	11.32	10	5	16	7.49
Number of Directorships	114,293	1.67	1	1	2	1.03
Outside Public Boards	114,234	2.01	2	1	3	1.26
Attended <75% of meetings	114,293	0.02	0	0	0	0.13
Busy Director	114,293	0.06	0	0	0	0.24
Social ties with CEO	50,205	0.10	0	0	0	0.30
Controversial Director	50,205	0.15	0	0	0	0.35



Table 2: Mutual Fund Distraction and Fund Votes for Director Election Proposals

Dependent Variable: Oppose Director

Panel B: Independent Director Candidates

	<i>All Independent directors</i>	<i>Controversial directors</i>	<i>Non-controversial directors</i>
	(1)	(2)	(3)
Fund Distraction	-0.002** (-2.01)	-0.003*** (-2.68)	-0.001 (-0.72)
Fund-year FE	Y	Y	Y
Director Election FE	Y	Y	Y
N	1,591,506	516,950	1,074,297
adj. R-sq	0.354	0.340	0.364

Panel C: Grey Director Candidates/Placebo test

	<i>All Grey directors</i>	<i>Controversial directors</i>	<i>Non-controversial directors</i>
	(1)	(2)	(3)
Fund Distraction	-0.001 (-0.52)	-0.008** (-2.22)	0.003 (-1.30)
Fund-year FE	Y	Y	Y
Director Election FE	Y	Y	Y
N	118,587	35,178	81,862
adj. R-sq	0.431	0.396	0.446



Table 3: Institutional Investor Distraction and Director Election Results, Panel A

Dependant Variable=Percent "Yes" Votes for a Director

	<i>All Firms</i>		<i>Exclude Closely-held Dual-Class Shares Firms</i>	
	Independent Directors		Independent Directors	
	(1)	(2)	(3)	(4)
Total Distraction: a	-0.000 (-0.10)	-0.001 (-1.23)	0.003** (2.22)	
Negative ISS: b	-0.130*** (-36.95)	-0.175*** (-8.71)	-0.189*** (-41.37)	-0.189*** (-41.37)
a * b		0.016** (2.31)		
Monitoring Investor Distraction				0.006** (2.41)
Grey Investor Distraction				-0.004 (-1.32)
Attendance < 75%	-0.066*** (-7.25)	-0.065*** (-7.21)	-0.112*** (-8.97)	-0.112*** (-8.96)
Average Director Percent "Yes"	0.809*** (84.85)	0.808*** (84.85)	0.704*** (61.23)	0.704*** (61.29)
Other Controls	Y	Y	Y	Y
Director FE	Y	Y	Y	Y
Firm FE	Y	Y	Y	Y
Year FE	Y	Y	Y	Y
N	45966	45966	31120	31120
adj. R-sq	0.798	0.798	0.838	0.838

Table 3: Institutional Investor Distraction and Director Election Results, Panel B

Dependant Variable=Percent "yes" Votes for a Director			
<i>Exclude Family Firms and Closely-held Dual-Class Shares Firms</i>			
	Independent Directors		Grey Directors
	(1)	(2)	(3)
Total Distraction: a	0.006*** (2.94)	0.003 (1.05)	0.003 (0.87)
Negative ISS: b	-0.205*** (-29.88)	-0.284*** (-8.02)	-0.274*** (-24.56)
a * b		0.028** (2.28)	
Attendance < 75%	-0.126*** (-5.80)	-0.127*** (-5.83)	0.006 (0.06)
Average firm % "yes"	0.657*** (37.03)	0.655*** (37.29)	0.411*** (8.97)
Other Controls	Y	Y	Y
Director FE	Y	Y	Y
Firm FE	Y	Y	Y
Year FE	Y	Y	Y
N	11267	11267	2268
adj. R-sq	0.862	0.863	0.753

Table 4A: Investor Distraction and the Sensitivity of Director Departures to ISS Support

	Dependent Variable=Director Departure			
	<i>All Outside Directors</i>	<i>Independent Directors</i>		<i>Grey Directors</i>
	(1)	(2)	(3)	(4)
Total Distraction: a	0.008 (0.88)	0.008 (0.89)		0.012 (0.32)
Negative ISS: b	0.082* (1.71)	0.105** (1.96)	0.055** (2.20)	-0.033 (-0.25)
$a * b$	-0.028 (-1.63)	-0.035* (-1.86)		0.003 (0.07)
Monitoring Investor Distraction: c			0.005 (0.75)	
$b * c$			-0.024** (-2.01)	
Grey Investor Distraction			-0.017 (-1.35)	
Attendance < 75%	0.131*** (5.35)	0.131*** (5.08)	0.131*** (5.08)	0.148 (1.59)
Number of Directorships	-0.020*** (-3.98)	-0.019*** (-3.77)	-0.019*** (-3.76)	-0.026 (-1.02)
Other Controls	Y	Y	Y	Y
Industry-year FE	Y	Y	Y	Y
Observations	35378	32419	32401	2903
Adjusted R-squ~d	0.021	0.020	0.020	0.001

Table 4B: Investor Distraction and the Sensitivity of Director Departures to Vote Results

	Dependent Variable=Director Departure			
	<i>All Outside Directors</i>	<i>Independent Directors</i>		<i>Grey Directors</i>
	(1)	(2)	(3)	(4)
Total Distraction: a	-0.364* (-1.71)	-0.350 (-1.49)		-0.552 (-0.94)
% "yes" Votes: b	-0.264** (-2.00)	-0.257* (-1.77)	-0.159*** (-3.11)	-0.361 (-0.99)
$a * b$	0.081* (1.73)	0.078 (1.51)		0.126 (0.98)
Monitoring Investor Distraction: c			-0.300** (-2.52)	
$b * c$			0.066** (2.56)	
Grey Investor Distraction			-0.017 (-1.36)	
Attendance < 75%	0.120*** (4.87)	0.119*** (4.58)	0.121*** (4.65)	0.149 (1.55)
Number of Directorships	-0.021*** (-4.16)	-0.020*** (-3.99)	-0.020*** (-4.01)	-0.018 (-0.68)
Other Controls	Y	Y	Y	Y
Industry-year FE	Y	Y	Y	Y
Observations	34767	31876	31858	2831
Adjusted R-squ~d	0.022	0.021	0.021	0.001

Table 5B: Institutional Investor Distraction and Directors' Meeting Attendance, Logit

Dependent Variable: Director Attendance < 75% (dummy)

	<i>All outside</i>	<i>Independent</i>		<i>Grey</i>
	(1)	(2)	(3)	(4)
Total Distraction: a	0.279** (2.08)	0.266* (1.78)	2.519** (2.39)	0.313 (1.14)
Ln(Total Assets): b	-0.077** (-2.33)	-0.094** (-2.50)	0.210 (1.44)	-0.026 (-0.38)
a * b			-0.107** (-2.16)	
Number of Directorships	0.089*** (2.94)	0.077** (2.28)	0.078** (2.33)	0.154** (2.43)
Director Own	-0.068* (-1.91)	-0.036 (-0.83)	-0.036 (-0.83)	-0.162** (-2.55)
Ln(Director Age)	-0.837*** (-2.84)	-1.257*** (-3.98)	-1.266*** (-4.01)	0.424 (0.72)
Director Tenure	0.011 (0.20)	0.035 (0.55)	0.035 (0.55)	-0.112 (-1.13)
Board Size	0.864*** (5.19)	1.030*** (5.42)	1.028*** (5.41)	0.390 (1.16)
Female Director	-0.220** (-1.96)	-0.204* (-1.73)	-0.206* (-1.75)	-0.353 (-1.05)
Major Committee Member	-0.396*** (-4.27)	-0.378*** (-3.18)	-0.375*** (-3.16)	-0.388** (-2.51)
Meeting Fee	-0.014 (-1.31)	-0.020* (-1.72)	-0.020* (-1.72)	0.016 (0.70)
Number of Meetings	-0.201** (-2.18)	-0.137 (-1.34)	-0.132 (-1.29)	-0.436* (-1.95)
Director Retainer	-0.034*** (-3.27)	-0.031*** (-2.71)	-0.031*** (-2.71)	-0.042** (-1.97)
Other Controls	Y	Y	Y	Y
Industry FE	Y	Y	Y	Y
Year FE	Y	Y	Y	Y
Observations	126778	109879	109879	15393
Adjusted R-square	0.153	0.128	0.128	0.227

Table 5A: Institutional Investor Distraction and Directors' Meeting Attendance, Linear Probability Model

	Dependent Variable: Director Attendance < 75%			
	<i>All Outside</i>	<i>Independent</i>		<i>Grey/Place-bo</i>
	(5)	(6)	(7)	(8)
Total Distraction: a	0.003* (1.71)	0.002 (1.12)	0.028* (1.80)	0.009 (1.24)
Ln(Total Assets): b	-0.002 (-1.28)	-0.002 (-1.36)	0.001 (0.50)	0.001 (0.30)
a * b			-0.001* (-1.69)	
Number of Directorships	0.002* (1.65)	0.002* (1.77)	0.002* (1.78)	-0.001 (-0.16)
Director Own	-0.004*** (-4.47)	-0.002** (-2.15)	-0.002** (-2.20)	-0.005* (-1.76)
Ln(Director Age)	-0.060 (-1.27)	-0.111** (-2.06)	-0.113** (-2.09)	0.107 (0.64)
Director Tenure	0.007*** (3.45)	0.006*** (2.60)	0.006*** (2.64)	0.022*** (2.84)
Other Controls	Y	Y	Y	Y
Director FE	Y	Y	Y	Y
Firm FE	Y	Y	Y	Y
Year FE	Y	Y	Y	Y
Observations	60557	49625	49625	10210
Adjusted R-square	0.035	0.038	0.039	0.048



Table 6: Investor Distraction and Board Meeting Frequencies, OLS

Dependent var: Number of Board Meetings

	(1)	(2)	(3)	(4)
Total Distraction	-0.062*** (-3.63)	-0.050*** (-2.82)	-0.028** (-2.18)	-0.015 (-1.08)
Meeting Fee	0.002 (0.93)	0.001 (0.66)	0.005** (2.47)	0.005** (2.28)
Board Size		-0.000 (-0.17)		-0.002 (-0.65)
Board Independence		0.038*** (3.11)		0.011 (1.58)
CEO-Chairman Duality		-0.026** (-2.35)		-0.030*** (-2.83)
CEO Ownership		-0.435*** (-4.34)		-0.077 (-0.54)
Other Controls	Y	Y	Y	Y
Observations	11099	9486	10882	9276
Adjusted R-squ~d	0.092	0.112	0.502	0.513
Firm FE	N	N	Y	Y
Industry FE	Y	Y	N	N
Year FE	Y	Y	Y	Y

Table 7: Investor Distraction and Board Structure, OLS

Dependent Variable=Controversial Director

	<i>Independent Directors</i>				<i>Grey Directors/Place-bo</i>	
	(1)	(2)	(3)	(4)	(5)	(6)
Total Distraction: a	0.018*** (3.10)	0.011** (2.23)	-0.011 (-1.25)	-0.005 (-0.71)	0.030 (1.45)	0.014 (0.87)
CEO-Chairman Duality: b			-0.093*** (-2.89)	-0.074*** (-3.09)		
a * b			0.049*** (4.32)	0.030*** (3.70)		
Old Firm	0.007 (1.01)	-0.001 (-0.08)	0.005 (0.72)	0.003 (0.29)	0.012 (0.56)	0.032 (1.03)
Ln(Total Assets)	0.032*** (11.58)	0.018*** (2.80)	0.030*** (10.16)	0.017** (2.35)	0.036*** (5.35)	-0.009 (-0.37)
Sales Growth	-0.069*** (-3.81)	-0.003 (-0.20)	-0.064*** (-3.24)	0.004 (0.25)	0.003 (0.05)	0.125** (2.21)
ROA	0.055*** (2.60)	0.018 (1.08)	0.047** (2.10)	0.008 (0.44)	0.042 (0.85)	0.020 (0.41)
Inst Own	-0.003 (-1.10)	-0.004** (-2.38)	-0.009 (-0.71)	0.017 (1.58)	-0.008 (-0.70)	-0.005 (-0.58)
Staggered Board	0.021*** (3.24)	0.029*** (2.76)	0.019*** (2.77)	0.033*** (2.85)	0.031 (1.42)	0.043 (1.11)
Observations	52847	52746	45539	45460	4762	4583
Adjusted R-squ~d	0.371	0.455	0.300	0.394	0.447	0.656
Firm FE	N	Y	N	Y	N	Y
Industry FE	Y	N	Y	N	Y	N
Year FE	Y	Y	Y	Y	Y	Y

Table 8: Institutional Investor Distraction and Abnormal CEO Pay

	Dependent Variable: High CEO Pay Indicator			
	(1)	(2)	(3)	(4)
Total Distraction: a	0.036** (2.07)	-0.001 (-0.04)	0.049*** (2.78)	0.023 (0.80)
CEO-Chairman Duality: b		-0.108 (-1.53)		-0.119* (-1.69)
$a * b$		0.045* (1.84)		0.047* (1.93)
Ln(Total Assets)	-0.074*** (-7.14)	-0.087*** (-6.53)	-0.058*** (-5.34)	-0.062*** (-4.49)
Tangibility			-0.062 (-1.56)	-0.072 (-1.50)
Board Independence			0.064*** (4.19)	0.063*** (3.69)
Ln(Board Size)			-0.026 (-0.96)	-0.042 (-1.33)
Other Controls	Y	Y	Y	Y
Firm FE	Y	Y	Y	Y
Year FE	Y	Y	Y	Y
Observations	26779	19065	26763	19051
Adjusted R-squ~d	0.308	0.300	0.311	0.303

Table 9: Institutional Investor Distraction and Earning Management

Dependent Variable: Ln(1+Discretionary Accruals)

	(1)	(2)
Total Distraction	0.028*** (2.79)	0.024** (2.43)
Ln(Total Assets)	-0.010* (-1.77)	-0.015** (-2.53)
ROA	0.004 (0.36)	0.006 (0.63)
Inst Own	-0.013* (-1.78)	-0.013* (-1.73)
Tangibility		-0.017 (-0.75)
Leverage		0.038** (2.52)
Board Independence		0.011 (1.26)
Ln(Board Size)		0.008 (0.56)
Other Controls	Y	Y
Firm FE	Y	Y
Industry FE	N	N
Year FE	Y	Y
Observations	23862	23848
Adjusted R-square	0.032	0.033

Robustness Checks

We repeat our primary analysis using alternative investor distraction measures:

- ▶ we construct distraction metrics that only accounts for industry sector shocks in the portfolio of the firm's largest 5, 10 or 20 institutional shareholders respectively.
- ▶ we construct distraction metrics that separately account for positive return shocks and negative return shocks.
- ▶ We also construct a distraction measure based on extreme trading volume in unrelated industries by institutional investors.

We find similar results using the above measures as robustness checks.

