Intermediated Corporate Governance

Amil Dasgupta

London School of Economics, CEPR, ECGI

Athens, June 28, 2017

EFMA Doctoral Tutorial Keynote

Plan of talk

- **Part 1 ("Big picture")**
  - A classical form of corporate governance.
  - A big change in financial markets that requires us to view this form of governance through a new lens.
  - Initial attempts in the literature to respond to this change.
  - Very broad brush – almost no detail.
- **Part 2 ("Specifics")**
  - A new work-in-progress that builds on this theme: *Some* detail.
    - Wolf Pack Activism by Brav, Dasgupta, and Mathews (ECGI Working Paper, No. 501/2017)

The Public Corporation

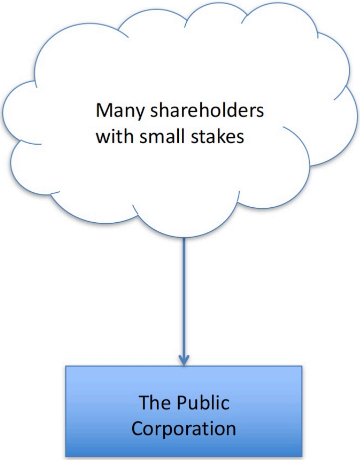
In (famous) words

Michael Jensen (1989, *Harvard Business Review*):

> *The public corporation is a social invention of vast historical importance. Its genius is rooted in its capacity to spread financial risk over the* **diversified** *portfolios of* **millions** *of individuals...*

The Public Corporation

In a picture



The Classical Corporate Governance Problem

In (famous) words

Jensen (1989) again:

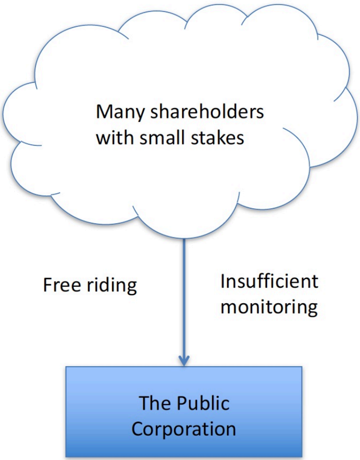
> *From the beginning, though, these risk-bearing benefits came at a cost. Tradable ownership claims create fundamental conflicts of interest between those who bear risk (the shareholders) and those who manage risk (the executives).*

Shleifer and Vishny (1997, *Journal of Finance*):

> *How do the suppliers of finance get the managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?*

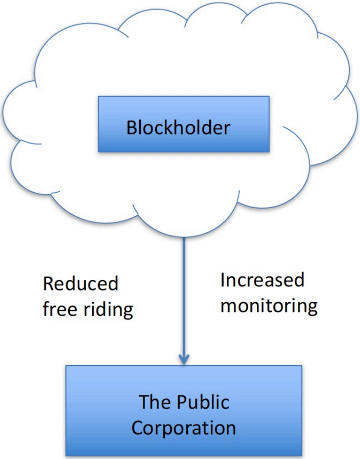
The Classical Corporate Governance Problem

In a picture



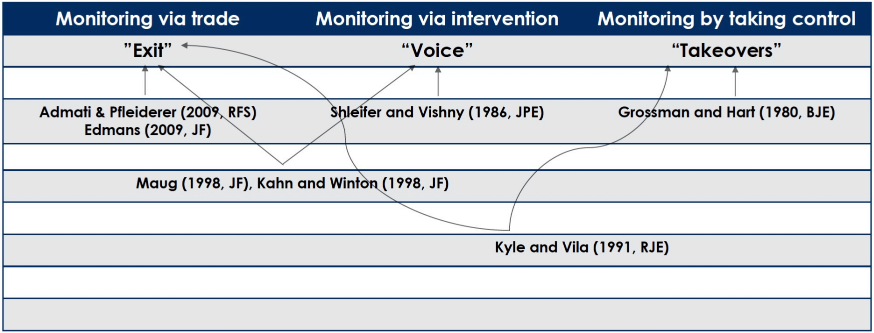
A Classical Corporate Governance Solution

Monitoring by concentrated external owners ("Corporate Governance")



Governance by external shareholders

Starting points: Classified by Monitoring Method



Who exercises corporate governance?

The classics in the governance theory invariably treat blockholders as **profit maximizing principals**

- *literal* interpretation: "rich private individuals"

This is **fine** in the 1980s and early 1990s when many of these classics were written.

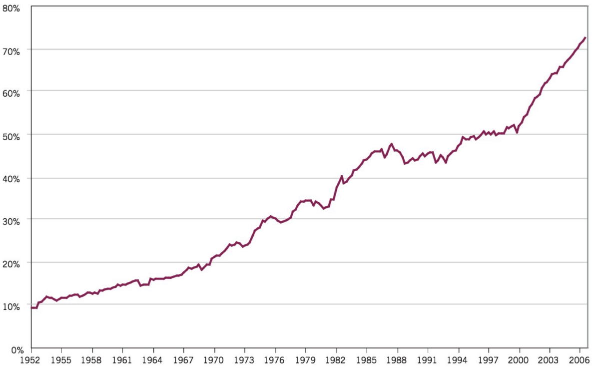
Indeed, until the mid-1980s, individuals feature famously in classic governance mechanisms *in practice!*

- Voice: Main actors until mid-1980s were individuals. "Gadfly investors": Lewis and John Gilbert, Evelyn Davis
- Takeover: Victor Posner—the original corporate raider—first hostile take-over of Detroit cigar maker based on his private real-estate fortune.

The world has changed...

Gillan and Starks (2007, *Journal of Applied Corporate Finance*)

Figure 1 **Percentage Ownership of Institutional Investors in U.S. Stock Markets**



Institutional investors: Asset managers (e.g., mutual funds, hedge funds), financial intermediaries (e.g., banks, insurance companies)

And the identity of blockholders has changed with it

Gilson and Gordon (2013, *Columbia Law Review*)

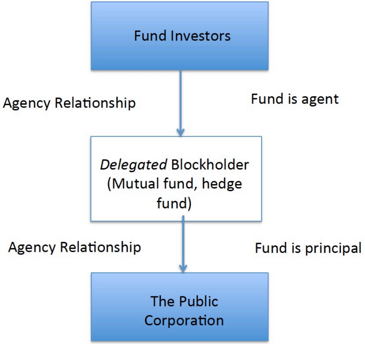
TABLE 2: PERCENTAGE OF OUTSTANDING STOCK IN TEN LARGEST U.S. CORPORATIONS WITHOUT A CONTROLLING SHAREHOLDER HELD BY TWENTY-FIVE LARGEST INSTITUTIONS IN 2009[42]

Corporation (in order of market value)	*Percentage of Stock Held by Twenty-Five Largest Institutions*
Exxon Mobil Corp.	25.0%
Microsoft Corp.	31.9%
Apple Inc.	37.0%
Wal-Mart Stores, Inc.	17.2%
Berkshire Hathaway Inc.	19.2%
General Electric Co.	24.8%
Procter & Gamble Co.	29.1%
Bank of America Corp.	28.9%
Google Inc.	44.1%
JP Morgan Chase & Co.	35.8%

What this means for the study of corporate governance

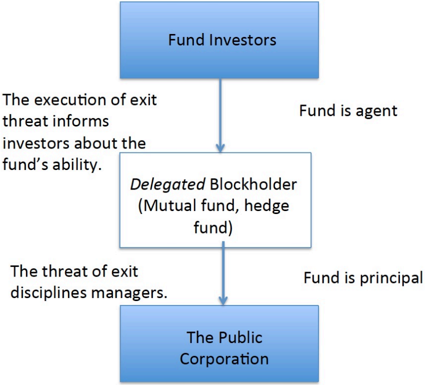
We should recognize that in modern-day corporate governance:

1. Agents (company managers) are monitored by agents (fund managers) – *multiple* agency problems!
2. Agency problems may **interact**!



Intermediated Governance: Monitoring via Exit

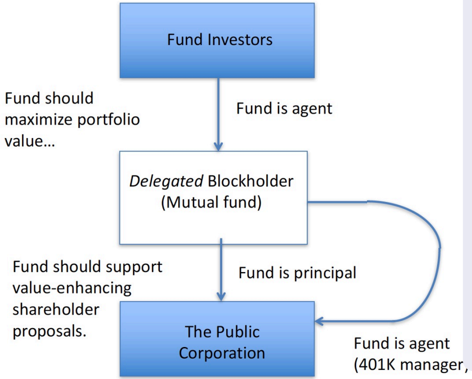
Dasgupta and Piacentino (*Journal of Finance* 2015)



- Flow motivations **weaken** the exit governance mechanism: Signalling role of exit is at odds with its disciplinary role.
- If a firm has a flow-sensitive blockholder (e.g. a MF) exit will be less effective than if it has a single (relatively) flow-insensitive blockholder (e.g. a HF).
- If exit threat makes it more likely that managers heed blockholder voice, flow sensitive institutions will use voice less than flow-insensitive ones.

Intermediated Governance: Monitoring via Voice (voting)

Cvijanovic, Dasgupta, and Zachariadis (*Journal of Finance* 2016)



- Big data set 2003-2011 (all MF votes, in all proposals, in all firms).
- Business ties influence promanagement voting at the level of individual pairs of fund families and firms controlling for ISS recommendations and holdings, stronger for closely contested proposals.
- Findings consistent with model in which company execs use existing business ties with funds to influence how they vote.

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Blockholder monitoring without large blockholders?

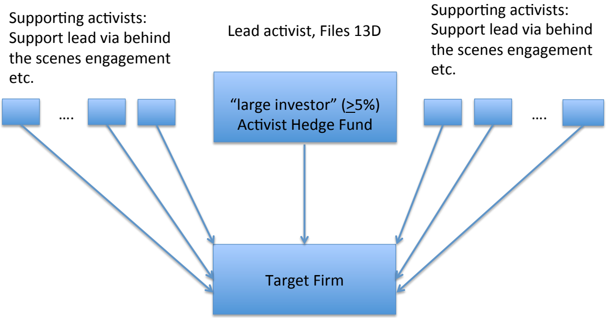
- Remember Shleifer and Vishny (*JPE* 1986) from earlier in the talk?
  - Key point: Concentrating ownership in the hands of a single blockholder aids governance; *more so the larger the block*.
- Problem: while equity blocks are common in the US (Holderness *RFS* 2009), few are big...
  - LaPorta et al (*JF* 1999): 80% of the largest US firms: No blockholder with sufficient holdings (LLS $\rightarrow$ 20%) for effective control.
  - Newer larger sample from Dlugosz et al (2006) $\rightarrow$ $<$ 15% of U.S. firms have a 20% outside blockholder.
- For good governance it would be helpful if *small* blockholders could gain *collective influence*.
- We argue: intermediation of corporate governance can facilitate collective governance.

We make our point in the context of a controversial activist tactic

Theoretical mechanism holds more generally, not tied to this particular application

- Lawyers allege that institutional investors—the majority of blockholders today—*do* act in groups to magnify each other's influence over management.
- Colourful term: *wolf packs* (Briggs *JCL* 2006, Nathan HLS CG Forum 2009, Coffee and Palia *WP* 2015).
  - **Briggs**: "parallel action, driven by numerous independent decisions by like-minded investors, as opposed to explicit cooperation agreements among participants"
- May explain why activist hedge funds can make big changes, often against the wishes of target managers, while holding *only* around 6% of shares.

A Model of Wolf Pack Activism

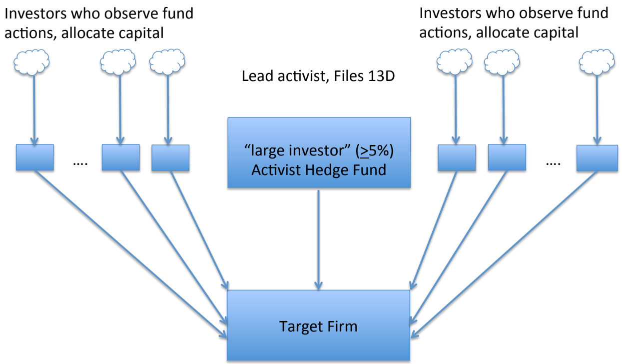


Two Contributions

1. What is the source of complementarity across institutions with small stakes in engaging target management?
    - Without complementarity, group activism irrelevant.
    - Can't be share price appreciation – that's non-excludable!
    - We provide a *micro-founded model of excludable rents* which then endogenously delivers *one-sided complementarity*.
2. What can we say about block acquisition and its dynamics?
    - It is claimed that 13D filings are both succeeded and preceded by unusual turnover.
    - Our model *shows why such turnover is essential*, and makes *predictions on patterns*.

Excludable rents arise in intermediation layer

Supporting activists are fund managers. By engaging in successful campaigns, convince investors that they are informed, receive more money to manage: An *excludable* rent.



How it works: Target Firm and Activists

- **Target firm**
  - Initial value P_ℓ.
  - May become *amenable to activism* $\Rightarrow$ value *can potentially* be raised to $P_h > P_\ell$ by engaging management.
  - If *amenable*, random variable η measures difficulty: Success if *at least* η shares engage.
- **Lead activist**
  - "big" (but not big enough to "go it alone") and "knowledgable" (knows η).
- **Small institutions**
  - Continuum of small institutions: Types G or B.
  - Type G see private signals about η and have profitable outside investment opportunities.
  - Type B are unskilled: No signals, no outside option.
  - Some small institutions know their type, some don't.

How it works: Actions and Payoffs

- Each owner (lead or supporting) can *engage* or *not*.
- Choice doesn't affect non-excludable rents: price appreciation if engagement successful is enjoyed by all.
- Engagement is (at least somewhat) costly. Small institutions effort cost c_s to engage.
- What are the sources of excludable benefits for small institutions?
    - Own investors update beliefs about type after observing activism outcome and the institution's choice (engage or not).
    - If posterior belief $\hat{\gamma} \geq B$ for some $B > prior$, get private benefit $R \in (c_s, 2c_s)$. Interpretation: Fees on additional funds invested by existing investors, i.e., flow motivations.

Characterising engagement: Simplified main result

Proposition: When private signals are sufficiently precise, in equilibrium:
(i) unskilled small institutions never engage.
(ii) skilled small institutions engage iff signal below a (unique) threshold.
(iii) (consequently) engagement succeeds iff η below a (unique) threshold
(iv) lead activist engages whenever engagement succeeds

Understanding the unskilled

Intuition for the case of very precise signals

- When noise vanishes the skilled always make correct choices.
- This means that the unskilled cannot always engage in equilibrium. If engage, engagement can either:
  - **Fail**: Clearly unskilled, no reputational rents.
  - **Succeed**: But now (essentially) all institutions, skilled and unskilled, engage $\Rightarrow$ Posterior update insufficient to generate reputational rents R.
- No excludable rents from engaging! Never wish to pay c_s.
- But it *is* an equilibrium for them to never engage. Non-engagement delivers no excludable rents, yet deviation to engaging unattractive since $R < 2c_s$.

Understanding the skilled

Intuition for the case of very precise signals

- Since unskilled (*endogenously*) never engage, skilled can only gain reputation from engaging when engagement succeeds.

Excludable payoffs	Engagement succeeds	Engagement fails
Engage	$R - c_s$	$-c_s$
Not Engage	0	0

- Skilled *endogenously* play a "coordination game".
  - The coordination game makes collective governance *feasible*, and the game itself is generated *endogenously* by flow motivations, i.e., due to intermediation.
  - Not all actions are equal in generating flow rents: can't gain rewards (exclusively) from doing nothing in unsuccesful campaigns. Also endogenous! Realistic?

Wolf Pack Dynamics

Anecdotal and empirical evidence

- Noticeable change in target ownership *following* 13D filing:
  - Nathan (2009, HLS Corporate Governance Forum): "...rapid (and often outcome determinative) change in composition of the target's shareholder base seemingly overnight."
  - US activism data 1994 to 2011: In 10-days following 13D filings, for the largest tercile of firms – where wolf pack support is most salient – additional average abnormal turnover of $> 30\%$ of the activist's typical stake.

Trading Model: Endogenous Turnover

Frictionless market ("no tricks"): Everyone shares common information about the market and identity of traders, so **shares change hands at their expected cash-flow value**.

Proposition: *Endogenous* turnover in target firm shares.

1. When amenability rare, pre-amenability owners of a target firm *must* be institutions who know themselves to be unskilled.
2. Since unskilled institutions never engage management in equilibrium, initial owners cannot earn reputational rewards.
3. Gains from trade between initial owners and potentially skilled institutions who assign positive probability to the prospect of earning reputational rewards.

Empirical support: Boyson and Pichler (2016) find 1 s.d. increase in abnormal turnover around 13D associated with a 22% increase in probability of anti wolf pack measures.

Concluding thoughts

Back to the beginning

- Let's go back to the question I posed at the outset.
- The world has changed since the governance classics were published.
- Fund managers (not individuals) now own majority of corporate equity.
- How should we understand corporate governance in today's intermediated economy?

Concluding thoughts

The answer is nuanced!

- A reasonable initial reaction may be that increasing distance between ultimate principals and ultimate agents is bad.
  - Forcefully argued in, e.g., Gilson and Gordon *Columbia Law Review 2013* "The Agency Cost of Agency Capitalism."
- Theoretical and empirical work confirms the existence of negative aspects (I've discussed two papers that make this point theoretically and empirically earlier in the talk).
- But the overall picture is rich and subtle!
- In Wolf Pack Activism we argue that fund managers' incentives give rise to strategic complementarity in their engagement strategies, overcoming free-rider problems in blockholder monitoring.

Concluding thoughts

Looking forward...

- How should we understand corporate governance in today's intermediated economy?
- The work is just beginning!