

# Do Institutional Investors Monitor their Large vs. Small Investments Differently? Evidence from the Say-On-Pay Vote



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# Motivation

- Traditional view: large shareholders most likely to monitor management (Grossman and Hart, 1980; Shleifer and Vishny, 1986; and Hart, 1995)
- We ask: Do shareholders monitor differently their small-scale versus large-scale investments?
  - Direct monitoring by shareholders is costly—shareholders can be expected to focus on their largest holdings
    - More likely to talk directly to management, relative to small shareholdings
  - Small shareholdings—more likely to voice any displeasure with management through voting
- We examine a new low-cost opportunity for shareholders to provide feedback to management: the Say-on-Pay (SOP) vote

# What is Say-on-Pay (SOP)?

## (A Brief Review)

- Since January 21 2011, companies with a free float exceeding 75 million USD must hold a Say-on-pay (SOP) vote. Main components:
  - Frequency SOP vote
  - SOP vote – non binding vote on the compensation awarded to the named executives (5 top earning executives)

# Why focus on SOP?

- The only other issues discussed annually at shareholders meetings are:
  - ~~– Approving a slate of directors~~
  - ~~– Ratifying auditors.~~
- SOP is virtually the only regular opportunity shareholders have to express their satisfaction/dissatisfaction with management. ✓

# What's Special About SOP?

The SOP vote is the best opportunity shareholders have to provide a feedback directed to management.



*"This is the part of capitalism I hate."*

Spencer Stuart (2014): SOP was the most common topic for which companies reached out to their largest shareholders.

# What is Institutional Shareholder Services (ISS)?

- ISS is based in Rockville, MD (a “bike ride” away for one of us)
- Created as a subscription-based business that provides institutional investors with information
  - Voting by their portfolio companies (i.e., stocks)
  - Data on Board composition, election procedures
  - Other data, such as existence of poison pill, CEO as Chairman, etc., that is relevant to “good governance”
- ISS is demanded by institutions because of the scale economies in collecting and interpreting governance information
- Yet, it is reasonable to conjecture that institutional investors, especially large ones, conduct independent research when the “stakes are high”—and, evidence supports this (e.g., Iliiev and Lowry, 2015)

# Why focus on mutual funds and 13f- advisor-aggregated mutual funds?

- Mutual funds (MF) hold on average 27.5% of the shares of companies required to hold a SOP vote, and their votes amount, on average, to 36% of all SOP votes cast
- MF tend to hold shares for longer terms than other shareholders such as hedge funds.
- Mutual funds are required to document their votes in the N-PX form, while other shareholders are not.

→ This setting can allow us to study which conditions enhance shareholders governance.



# Large Cross-Sectional Variation in Institutional Voting Patterns\*

Name of institution	Number of votes cast	% votes opposite ISS <u>recomm.</u>	S.D. of votes within institution
(1)	(2)	(3)	(4)
1 BlackRock Advisors, Inc.	154,756	34%	1.02%
2 Vanguard Group, Inc.	124,903	7%	0.00%
3 Fidelity Management & Research	111,756	4%	3.67%
4 Dimensional Fund Advisors, Inc.	68,585	0%	0.01%
5 <u>ProShare</u> Advisors LLC	61,106	0%	0.00%
6 TIAA-CREF Asset Management LLC	60,822	9%	0.00%
7 <u>Rydex</u> Investments	48,975	21%	0.04%
8 T. Rowe Price Associates, Inc. (MD)	42,088	8%	0.50%
9 State Street Global Advisors	40,938	8%	1.96%
10 EQ ADVISORS TRUST	39,294	11%	10.87%
11 JPMorgan Asset Management, Inc. (US)	38,787	3%	1.89%
12 SEI Investments Management Corporation	33,414	0%	0.07%

\* Suggest an Institutional “fixed-effect” is needed



# Findings In a Nutshell

- We examine the institutional, fund and aggregate level of votes and find that mutual funds are particularly likely to oppose management for their **small-scale investments** compared to their large-scale ones.
- This pattern is particularly strong on the **institutional level** in comparison to the fund level, indicating that institutions frequently determine on the institutional (aggregate) level how they wish to vote, but that they use the SOP vote differently for their small- versus large-scale investments.

# Main Contributions

- Demonstrate that vote outcomes depend on shareholder structure. In companies with a **dispersed** shareholder structure SOP vote outcomes are more likely to be unsupportive of management. Thus, small investors can play a **meaningful** role in corporate governance, when the costs of doing so are relatively low.
- Voting decisions are potentially conditioned on the presence of **other** shareholders in a firm. In particular, blockholder presence is associated with a general tendency for institutions with small-scale investments to more heavily oppose management on the SOP vote.
- First to examine how the magnitude of an investment at the institution level (and not only fund level) relate to a vote cast. We show that magnitude of an investment at the institutional predicts the vote outcome.

# Hypotheses to Test

# First Hypothesis

Institutional shareholders are particularly likely to vote against SOP for their small-scale investments.

- Large shareholders can talk to management directly, so they do not need to rely on SOP to demonstrate opposition. Moreover, the SOP vote may serve as a potential threat to management (Fos and Kahn, 2016) which catalyzes communication.
- Small shareholders may want to use a low-cost monitoring opportunity.
- Large shareholders may prefer to avoid the negative short-term stock price decrease following a negative SOP vote.

# Second Hypothesis

Shareholders opposing SOP for their small-scale holdings is a pattern likely to be prevalent on the fund level, but even more so on the institutional level.

- Efficiency of scale – voting decisions are time consuming, particularly during the proxy season.
- Common for funds advised by the same financial institution to vote consistently with each other

# Magnitude of investment

- We use two measures to capture the magnitude of the holding:
  - Fraction of shares held
  - Portfolio weight

# Data

- ISS voting analytics: aggregate results and votes cast by MFs (8,307 MFs within 357 fund families).
- Thompson s-12 holdings database
- CRSP mutual fund database
- CRSP and Compustat stock and firm databases
- Execucomp
- ISS peer-companies data
- GMI 5% blockholders data



# Shares held and votes cast by institutions and mutual funds

	Average	Median
Percentage of shares held by institutional investors	70.0%	
Estimation of percentage of SOP votes cast by institutional investors	87.8%	
Percentage of shares held by mutual funds	28.5%	29.2%
Estimation of percentage of SOP votes cast by mutual funds	35.7%	36.6%

# SOP Votes on Institutional Level

(Dep var=inst/stock/year vote)

Extracted from Table 4 in paper

	Weighted average of the institution's SOP support rate			
	(1)	(2)	(3)	(4)
Institution's portfolio weight (in fraction)	0.8845** (.046)	0.8474* (.061)	0.4842 (.658)	0.9745** (.044)
Fraction of company's shares held by institution	0.6422** (.014)	0.6421** (.014)	0.3732** (.023)	0.6579** (.012)
Institution's portfolio weight (in fraction) squared		-13.1819 (.163)		
Fraction of company's shares held by institution squared		-3.0086* (.084)		
Fund's portfolio <u>weight</u> <u>X</u> ab. Return				
Fraction of comp. held by <u>fund</u> <u>X</u> ab. return				
Top third <u>blockholders</u> , bottom third port. weight				-0.0077** (.045)
Top third <u>blockholders</u>				-0.0043 (.264)
Bottom third port. weight				0.0009 (.886)
Fraction of shares held by <u>blockholders</u>	-0.0201** (.015)	-0.0190** (.024)	-0.0172* (.068)	0.0001 (.993)
Fraction of shares held by executives	-0.0176* (.077)	-0.0168* (.092)	-0.0245* (.074)	-0.0161 (.105)

Two-tailed P values are reported in parenthesis. \* indicates  $p < .05$ , \*\*  $p < .01$ , and \*\*\*  $p < .001$ .

**Regressions 1,2, and 4 use Institution fixed-effects**

**Additional control variables not reported on slide, reported in paper:** Market capitalization of company, number of institutional shareholders, percent of shares held by institutionals, fraction of shares held b executives, CEO age, and CEO tenure.

# SOP Votes on Institutional Level

- The smaller the portfolio weight, and/or the fraction of outstanding shares held by an institution, the more likely the fund is to vote against SOP
- For example, a one S.D. increase in the fraction of company's shares held by an institution is expected to decrease, by 11.8%, the SOP opposition propensity, relative to its mean

# Results at Mutual Fund Level

- Consistent with, but weaker than results at institutional-advisor level
- Confirms that the institutional-advisor level is the most powerful unit of analysis

# SOP Vote Outcomes

Table 8 in paper

	Fraction voted for SOP			
	(1)	(2)	(3)	(4)
Fraction of shares held by blockholders	0.0519*** (.000)	0.0552*** (.000)	0.0579*** (.000)	0.1054*** (.000)
Total compensation of CEO t-1 (in millions)	-0.0016** (.029)			
Total compensation of executives t-1 (in millions)		-0.0056*** (.001)		
Predicted CEO compensation t-1			-0.0241*** (.007)	
Residual of CEO compensation t-1			-0.0016** (.029)	
Predicted executives compensation t-1				-0.1844*** (.009)
Residual of executives compensation t-1				-0.0056*** (.001)
R-squared	0.601	0.599	0.601	0.599
N	4,612	4,610	4,612	4,610

# SOP Vote Outcomes

- The larger the fraction of shares held by blockholders the larger the SOP support rates
- The contradiction between the institution and fund level versus the aggregate level implies, once again, that the blockholders are likely those voting in support of SOP

# Are the Results Robust Across Subsamples?

	Fund voted for SOP			
	(1)	(2)	(3)	(4)
Institution's portfolio weight (in fraction)	12.4071*** (.000)	0.5351* (.092)	1.1049** (.033)	3.0572** (.031)
Fraction of company's shares held by institution	1.1738*** (.000)	0.1610*** (.008)	0.5303*** (.000)	0.2255 (.225)
Fund's portfolio weight (in fraction)	0.8691** (.032)	0.0563 (.440)	0.4189*** (.005)	0.6370* (.053)
Fraction of company's shares held by fund	-0.1112 (.845)	0.2785** (.034)	0.0447 (.806)	-0.4833 (.310)
Subsample	ISS recommend against	ISS recommend For	Non-index funds	Index funds
Year, industry, and fund FE	Yes	Yes	Yes	Yes
R-squared	0.548	0.372	0.161	0.326
N	30257	226677	56047	95879



# Are the Results Robust Across Subsamples?

- We find that the pattern we document— institutions are likely to vote in support of SOP for the large-scale holdings—is prevalent across these and other subsamples, although it is more stronger in certain subsets.

# CARs around SOP Votes

Window	[-1, 1]	[-3, 3]	[-4, 4]	[-5, 5]	[-10, 10]
	(1)	(2)	(3)	(4)	(5)
<b>Fraction</b>	0.0088**	0.0144***	0.0170***	0.0171**	0.0171*
<b>voted for</b>	(.018)	(.008)	(.006)	(.010)	(.063)
<b>Constant</b>	-0.0074**	-0.0121**	-0.0151***	-0.0154**	-0.0140*
	(.032)	(.015)	(.008)	(.012)	(.097)
<b>N</b>	7,123	7,123	7,122	7,121	7,117

A one S.D. in the SOP support rate is expected to lead to a 0.21% CAR decrease using a nine day window around the vote  
 (For example, in 2011, Talbots received only 47.41% support on the SOP vote, and experienced a -15.42% CAR in a nine-day window surrounding the vote)

# Holdings around the Russell 1000-2000 discontinuity

	Fraction of company's shares held by institution	Weighted average of the institution's SOP support rate	Fraction of company's shares held by fund	Fund voted for SOP
	(1)	(2)	(3)	(4)
<b>Russell 2000</b>	0.0023***		0.0002***	
	(.000)		(.002)	
<b>Fraction of company's shares held by institution</b>		5.5339*		
		(.095)		
<b>Fraction of company's shares held by fund</b>				24.2601**
				(.011)
<b>Stage</b>	First	Second	First	Second
<b>Bandwidth</b>	250 companies on each side of the Russell 1000-2000 cutoff			
<b>Year and industry FE</b>	Yes	Yes	Yes	Yes
<b>Post 2006 banding variables</b>	Yes	Yes	Yes	Yes
<b>Angrist-Pischke F-test</b>	13.79		21.52	
<b>R-squared (centered)</b>		0.1486		0.1315
<b>N</b>	6,579	6,579	32,344	32,344

# Do Companies Demonstrate Responsiveness to the SOP Vote?

- Companies that have a non-executive blockholder and receive low support rates for the SOP vote are significantly more likely to:
  - (1) Experience CEO turnover within 12 months of the SOP vote
  - (2) Pick more reasonable (modest) peer-companies for determining executive compensation
  - (3) Decrease the growth rate of the excess compensation

# Endogeneity

- Holdings weight may be driven by investor belief about a firm's quality, thus, funds may self-select into stocks
- Two results provide some comfort:
  - 1. Index funds exhibit a similar positive relation between holding magnitude and SOP support
  - 2. Holdings weight increases in index funds caused by the R1000/R2000 border discontinuity result in even higher support of SOP for top R2000 stocks

# Endogeneity

- However, suppose that we ignore these results, and entertain that funds all self-select into the stocks they like
  - For a given stock, large holders like the firm more than small holders, simply due to heterogeneous beliefs (either rational or not)
  - Our results can still be interpreted as SOP giving the small holders increased voice
    - Thus, stocks with more dispersed share ownership (large and small investors) are more affected by the existence of the SOP vote
  - Perhaps encourages more ownership by dissenting small investors?

# Summary and Conclusions

1. Funds are likely to oppose management when their holdings are small, and when other large blockholders are present.
2. Low cost monitoring opportunities such as the say-on-pay vote can serve as a coordination mechanism when shareholder structure is dispersed.



# Summary

1. Particularly investors with small-scale investments will use the SOP to oppose management. (Large shareholders may be using SOP as a threat to negotiate with management before the SOP vote.)
2. For the SOP vote, institutions determine particularly on the institutional level, and to a lesser extent on the fund level, how they should vote.

**Thank you for your attention  
and comments!**

# Peer Companies

- Companies select peer companies to determine the compensation of their executives.
- Do the peer companies change following a SOP vote that received low support rates?

# SOP Vote and Peer Companies

Table 9 in paper

	New peer added	Peer excluded	New peer inflation below that of prior year			
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Fraction voted against SOP</b>	0.1079** (.032)	0.0294 (.569)	0.1260** (.036)	0.2951 (.682)	0.0714 (.447)	0.1615** (.039)
<b>Fraction of shares held by 5% blockholders</b>	0.0171 (.681)	0.0782* (.078)	-0.0136 (.818)		0.0793 (.343)	-0.0397 (.663)
<b>Fraction of shares held by executives</b>	0.0762 (.157)	0.0736 (.313)	0.0939 (.196)	0.2595 (.256)	0.1682* (.057)	0.0821 (.935)
<b>CEO age</b>	(.042)	(.238)	(.011)	(.233)	(.014)	(.510)
<b>Type of companies included</b>	All	All	All	No blockholders	Insiders block	Non-insider block
<b>Company and industry fixed effects</b>	Yes	Yes	Yes	Yes	Yes	Yes
<b>R-squared</b>	0.031	0.489	0.022	0.033	0.032	0.034
<b>N</b>	43,270	40,134	9,023	361	4,382	4,497

Additional control variables not reported on slide, reported in paper: ROA of company t-1, Abnormal return, Market capitalization in millions, CEO tenure, CEO age

# SOP Vote and Peer Companies

Table 9 in paper

Companies that received lower support for SOP:

- Tend to add new peer-companies.
- Choose, in the following year, less “inflated” (i.e., more reasonable) peer companies--only if a non-executive blockholder is present.

# SOP Vote and Percentage Change in Excess Compensation

Table 10 in paper

	Change in excess compensation			
	(1)	(2)	(3)	(4)
<b>Fraction voted against SOP</b>	-11.7088** (.037)	4.954 (.967)	-16.0781 (.187)	-15.2141** (.042)
<b>Fraction of shares held by executives</b>	-0.7648 (.772)	-12.3581 (.541)	1.8233 (.719)	-24.728 (.564)
<b>Fraction of shares held by blockholders</b>	0.401 (.949)	-4563.4386 (.681)	18.5808 (.267)	-11.3818** (.010)
<b>Type of companies included</b>	All	No blockholders	Insiders block	Non-executive block
<b>Company and industry fixed effects</b>	Yes	Yes	Yes	Yes
<b>R-squared</b>	0.012	0.473	0.035	0.024
<b>N</b>	2,016	65	782	1,216

# SOP Vote and Percentage Change in Excess Compensation Table 10 in paper

- [Do not decrease (excess) compensation]
- Following a SOP vote with low support rates, companies decrease the growth rate of the excessive compensation if a non-executive blockholder is present.



# SOP Vote and CEO Turnover

Table 11 in paper

	Was CEO replaced within 12 months following the vote?			
	(1)	(2)	(3)	(4)
Fraction voted against SOP	0.0986** (.011)	-0.062 (.448)	0.0439 (.412)	0.1457*** (.009)
ROA of company t-1	0.0039 (.632)	0.0076 (.824)	0.0113 (.135)	-0.0325 (.436)
Abnormal return	-0.0573*** (.000)	-0.0216 (.373)	-0.0589*** (.000)	-0.0505*** (.001)
Market capitalization in millions	0 (.562)	0 (.741)	-0.0000** (.012)	0 (.695)
CEO tenure	-0.0011*** (.004)	0.0002 (.844)	-0.0013*** (.002)	-0.0002 (.719)
CEO age	0.0041*** (.000)	0.0041** (.024)	0.0034*** (.000)	0.0050*** (.000)
Vote examined	SOP	SOP	SOP	SOP
Period included	11'-13'	11'-13'	11'-13'	11'-13'
Companies included	All	No blockholders	Insiders block	Non-executive block
Company and industry fixed effects	Yes	Yes	Yes	Yes
R-squared	0.031	0.341	0.031	0.039
N	4,879	234	2,184	2,632



# SOP Vote and CEO Turnover

- Following a SOP vote with low support rates, companies are likely to experience CEO turnover if a non-executive blockholder is present. Perhaps, in these cases, CEOs are more likely to be held accountable.

# Votes on Directors Appointments and CEO Turnover

Panel B: Fraction of votes against directors before SOP era

	Was CEO replaced within 12 months following the vote?			
	(1)	(2)	(3)	(4)
Fraction of votes cast against director	0.0008 (.969)	-0.1912* (.059)	0.0191 (.539)	-0.0129 (.629)
Vote examined	directors	directors	directors	directors
Period included	08'-10'	08'-10'	08'-10'	08'-10'
Companies included	All	No blockholders	Insiders block	Non-insider block
Company and industry fixed effects	Yes	Yes	Yes	Yes
R-squared	0.013	0.063	0.031	0.026
N	14,765	1,423	6,737	7,379

Panel C: Fraction of votes against directors during SOP era

	Was CEO replaced within 12 months following the vote?			
	(1)	(2)	(3)	(4)
Fraction of votes cast against director	0.0571** (.020)	-0.3195*** (.008)	-0.0105 (.745)	0.1332*** (.000)
Vote examined	directors	directors	directors	directors
Period included	11'-13'	11'-13'	11'-13'	11'-13'
Companies included	All	No blockholders	Insiders block	Non-insider block
Company and industry fixed effects	Yes	Yes	Yes	Yes
R-squared	0.04	0.214	0.052	0.06
N	11,769	770	5,006	6,555

- CEO turnover did not occur in the pre-SOP era, but did occur in the SOP era.
- Suggests that SOP may have pressured companies to respond to votes.

# Summary Statistics

Table 2 in paper

<b>Variable name</b>	<b>Mean</b>	<b>0.25 percentile</b>	<b>Median</b>	<b>0.75 percentile</b>	<b>n</b>
<b>Fraction of shares held by blockholders</b>	<b>0.26</b>	<b>0.14</b>	<b>0.24</b>	<b>0.36</b>	<b>9,625</b>
<b>Fraction of shares held by executives</b>	<b>0.12</b>	<b>0.12</b>	<b>0.05</b>	<b>0.13</b>	<b>9,622</b>
<b>Fraction of company's shares held by fund</b>	<b>0.0021</b>	<b>0.0000</b>	<b>0.0002</b>	<b>.0013</b>	<b>600,306</b>
<b>Portfolio weight of fund's portfolio (in fraction)</b>	<b>0.0054</b>	<b>0.0003</b>	<b>0.0015</b>	<b>0.0059</b>	<b>668,741</b>
<b>Fraction of company's shares held by institution</b>	<b>0.0141</b>	<b>0.0006</b>	<b>0.0032</b>	<b>0.0169</b>	<b>112,856</b>
<b>Portfolio weight of institution's portfolio (in fraction)</b>	<b>0.0018</b>	<b>0.0001</b>	<b>0.0002</b>	<b>0.0011</b>	<b>112,856</b>

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"It's time for the executive performance reviews, Fenwick. I'll do you if you'll do me."

# Executive's Votes

- Executives vote in support of SOP.
- We estimate that Yahoo's 2012 SOP vote would have failed, if Yahoo's executives had not held 11.9% of Yahoo's stock
- This demonstrates that awarding large stakes to executives in an attempt to align management's interest to that of other shareholders, may also allow executives to block governance measures non-executive shareholders attempt to enforce

# Why do Small Shareholders Vote Against SOP?

Our interpretation:

- large-scale shareholders are less likely to challenge management through voting, because they have access to **management**. Brady (2012) quotes Daniel Ryterband, the president of pay consultant Frederic W. Cook, stating that the large SOP support rates underplay the drama taking place behind the scenes. He argues that boards are nervous about how proxy advisers will react to their pay packages, and therefore companies reach out to their large shareholders in advance of the vote.
- Low SOP support rates may lead to reduced stock return. This could pose a concern for large portfolio weight investments.