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Institutional Investor Activism and Engagement Conference Report

Israel, 10 – 11 December 2017

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European Corporate Governance Institute

Overview

Summary Report

by

Oded Cohen and Efrat Dressler

Academic research on the subject of 'Institutional Investor Activism and Engagement' was the focus of a two-day conference in Israel. The event, which was organised in collaboration with European Corporate Governance Institute (ECGI), took place in both Tel-Aviv and Jerusalem on 10 - 11 December. It was co-organised and hosted by Bar-Ilan University and The Hebrew University of Jerusalem.

Institutional Investor Activism and Engagement is a topic of increasing importance globally and more particularly in the context of freeze out tender offers in Israel. The papers presented at the conference examined a broad range of issues including the effects of passive investors, the benefits of short-horizon investors, hedge fund activism, voice and exit, corporate political activism and more.

The conference, which was attended by senior academics from Boston College, London Business School, Solvay Brussels Business School, Bocconi University, ESMT Berlin, University of Pennsylvania, Stockholm School of Economics, and Duke University among others, addressed many important aspects of the current debate, introduced new findings and provided a number of suggested directions for future research.

The Allocation of Corporate Power Between Shareholders and Managers

Presented by Prof. ***Clifford Holderness*** *(Boston College and ECGI)*

This talk describes different approaches to allocate the corporate power between the shareholders and the managers. Today, by contrast to the past, the allocation of the corporate power among the different firms has little variation. The author suggests several possible explanations to this phenomenon.

During the discussion Prof. Holderness remarked that he has no accurate answer to the question what is the optimal allocation of control or what is the optimal corporate governance structure. His goal is rather to point out that the entrepreneurs and the institutional investors do not deal with those issues, as they should. One of the participants mentioned a case in which the institutional investors used their power and narrowed the variation in corporate governance structure, between firms. Specifically, in Britain, companies with Dual Class Shares were common in the 1950s. The institutional investors used their power and pushed the stock exchanges to not allow these companies to get into the indexes. This pressure resulted in a disappearing of the firms with dual class shares so that today, there are no such companies in Britain. Finally, there was a discussion in regard to a regulators' intervention that aims to force the institutional investors to be more involved in corporate governance decisions, which are taken by the firm. Prof. Holderness answered that basically there is no place for regulators' intervention. This is mainly because the regulator himself does not know what the optimal extent of institutional intervention is.

Corporate Governance Through Voice and Exit: Evidence from Standard Life Investments

Presented by Prof. ***Hannes Wagner*** *(Bocconi University)*

Discussant: Prof. ***Bernard Black*** *(Northwestern University)*

The paper is based on a big dataset originated from one of the big 50 fund managers in the UK, including discussions between the fund managers and company's management, as well as all voice and exit actions taken by the fund manager. A suggestion from the audience was to try to find the effect of the discussions in the data. One remark noted the assumption that an institutional investor wants to change things in the company in its portfolio, while there is a possibility that the discussions are made for the institutional investors just to receive information in order to understand what is going on. Another issue is the driver of those discussions, that might be the poor performance of companies, and not only the governance flags, as suggested by the authors.

An issue that raised a discussion among respondents is the relations of voice and exit: it is not clear that an exit is in response to a non-effective voice. It is possible that the companies respond to the investors' voice (as in the case of S.O.P). In this case, the prediction would be that an investor would wait a few months with his exit decision. Second, a reverse causality problem might arise since a vote against can be motivated by the previous decision to sell, even if the exit happened in a delay, after the vote.

Public Pension fund and Corporate Political Activism

Presented by Prof. ***Jörg Rocholl*** *(ESMT Berlin)*

Discussant: Prof. ***Yishay Yafeh*** *(Hebrew university)*

The paper examines the effect of a court decision from 2010, which lifts bans on firms to advocate in favor or against a political candidate. The authors examine this question using a difference in set-up by taking advantage of the fact that some states had bans only on the federal political activity while other states have bans on both, the state and the federal political activity. The findings indicate that after the decision, the political connected companies have lost their comparative advantage and thus they experienced negative abnormal returns. However, these negative returns were concentrated only in firms with public pension funds ("PPF") holdings. Additionally, the authors show evidence that the PPF have a preference for the more traditional form of political activism. Specifically, they show that after the decision, the portfolio companies of the PPF in the ban states did not decrease their number of state political connections; the PPF increased their ownership in politically connected firms in the ban states.

A suggestion from the audience was to look also on labor unions since the court decision also removed restrictions on contributions that they make. Another participant remarked that if the PPF push the firm to have a non-optimal political activism, he expects the share price to increase after a selling of shares by the PPF. This hypothesis can be examined using an event study. Another comment was that the matching between the PPF and the firms is not randomly assigned.

Specifically, there is a possibility that the PPF choose firms with better corporate governance in which their disclosure level regarding the political donations is better. The last comment was that the decisions of pension funds regarding the vote on governance are made separately from their investments decisions. In regard to the discussant's comment, Prof. Rocholl

mentioned that the political connections matter because of their longer-term nature. This is by contrast to donations and lobbing that are perceived as more opportunistic short-term actions.

A Collaborative Theory of the Corporation and its Implications for Corporate Structure

Presented by Prof. ***Jill Fisch*** *(University of Pennsylvania)*

Discussant: Prof. ***Assaf Hamdani*** *(Tel Aviv University)*

The paper introduces a new theory of the corporation in which shareholders and management collaborate rather than confront or run battles, as the old theory assumes. The paper explains how collaboration can be more efficient than confrontation as a response to the partial information problem by allowing shareholders and insiders to aggregate their information. The paper demonstrates how existing practice is becoming increasingly collaborative and identifies key areas in which corporate law should respond to a collaborative model. The discussion began with an inquiry into a more precise definition of collaboration. Prof. Fisch distinguished the collaboration model from the delegation model, in which the shareholders elect board members to govern the company, indicating that shareholders have a more active role of sharing information, bringing discussions to the table and being involved in operating decisions, rather than just electing representatives. A suggestion was made to start the model by discussing collaboration between board and management, as they too do not collaborate well. A discussion took place regarding the desirable balance of power between shareholders and insiders over corporate decisions. A question was raised about the extent to which shareholders and managers have different objective functions or whether, even among shareholders, there are different objective functions. A further question concerned the legitimacy of shareholder action in cases in which shareholders have an objective function other than maximizing share price.

Institutional Investor' Impact on the Outcome of Freeze-out Tender Offers

Presented by Prof. ***Beni Lauterbach*** *(Bar-Ilan University)*

Discussant: Prof. ***Miriam Schwartz-Ziv*** *(Michigan State University)*

The paper examines the impact of the institutional investors in going private offers by controlling shareholders in Israel. The authors present three main findings: in accepted offers the premium increases with the institutional investors' holdings; institutional investors' holdings increase the likelihood that the offer is rejected; the CAR around a rejected offer is close to the offer's premium both for firms with and without institutional holdings. The last finding is consistent with a strategic response of the institutional investors to freeze-out offers.

At the beginning of the discussion, one of the participants noted that the paper asks whether the institutional investors are good for the shareholders. However, reasonably there is no one definite answer. In particular, the answer depends on the attributes of a specific institutional investor, on the coalition between them, etc. Hence, to answer the question, the authors have to open the "black box" and distinguish between different sorts of institutional investors. The second comment regarded the concern of a potential endogeneity. This concern exists if the higher premium and the higher probability of rejection are because the institutional investors elect firms with certain characteristics. The participant suggested to focus on the repeated offers and check what is the likelihood of accepting, given that the previous offer was rejected. In addition, he suggested comparing between firms with and without institutional investors. Another comment noted that the fact that only five percentage points of the shareholders may block the tender offer is interesting. It would be interesting to examine whether the results are changed in other countries with different thresholds. Next, there was a discussion in regard to the adequate approach to examine hypothesis 3 (strategic behavior). It seems that the optimal approach is looking on the institutional investors' reactions to repeated offers, which referred

to a certain firm. However, it is not obvious that there are enough repeated offers in the database used by the authors.

Soft Shareholder Activism

*Presented by **Prof. Doron Levit** (Wharton)*

*Discussant: Prof. **Sivan Frenkel** (Tel Aviv University)*

The paper develops a theoretical model on the different tools of activism and behind the scenes negotiations between the board and the activist shareholders. The discussant raised two questions: First is whether it is reasonable for the activist to want a change even in a value destroying situation. Prof. Levit answered that this possibility is present in the model since the paper does not take a position regarding the activist, but rather stays neutral, and leaves all possibilities open. It shows that, regardless of the agenda the activist holds, dialogue can be effective. The second question was whether the paper is about communication between activist (and other shareholders) and the board, or rather the correct word would be negotiation. Prof. Levit answered that since communication is about information transition per se, the paper is about communication.

Activist Directors and Information Leakage

Presented by Prof. ***Robert Jackson*** *(Columbia Law School)*

Discussant: Prof. ***Ehud Kamar*** *(Tel Aviv University)*

Activist intervention ends with settlement agreement; typically it includes an appointment of board members representing the activist. In exchange, the board gets peace from the activist. Two issues are relevant to the discussion: The first is whether the activist is a hedge fund or another kind of activist, and the second is whether the agreement infers the firm's revelation of information to the market. The authors find significant higher CAR for settlements that include appointments of activist directors who are not hedge-fund employees, and significant higher CAR for settlements with an explicit rule on information sharing in the agreement. The authors define "leakage" – the way the information finds its way to the market and find that hedge fund's employees on board drive the leakage. A question was raised regarding the reason the leakage decreases at the 6 months' period preceding the director's appointment as can be seen in figures in the paper and in the presentation.

A phenomenon the authors find, and is mentioned to be a puzzle, is that bid-ask spread widens as a response of market makers to the leakage, but it doesn't narrow over time. A suggestion was made to look if bid-ask spreads changes are due to changes in the volume of trade, or due to other issues. Prof. Jackson responded that any issue that affects the bid-ask spread would have to occur in the same time. Another suggestion was to run lags of leakage measures and bid-ask spread measures and compare the different sub-groups. A comment on the methodology has suggested that using the matching method, on different financial variables, would do a better job than controlling over all non-targeted firms. Another suggestion was to use a control group of firms that recently experienced board turnover, but were not targeted by hedge funds. The last remark from the audience was that the authors should look for direct evidence for leakage, for example, changes in coverage, or insider trading.

Activism, Strategic Trading, and Liquidity

Presented by Prof. ***Vyacheslav Fos*** *(Boston College)*

Discussant: Prof. ***Zvi Weiner*** *(Hebrew University)*

Activism and market liquidity are endogenous. The effect of market liquidity on activism is not clear: liquid market enables the big shareholders to sell down their positions rather than to improve the firm's corporate governance. On the other hand, a liquid market enables the small shareholders to accumulate enough shares to become active. Activism could also affect market liquidity. The paper uses a model that obtains the equilibrium for both of the activism technology: one with a binary outcome and another with a continuous outcome.

At the beginning of the discussion Prof. Fos responded to three comments that were raised by the discussant. First, he noted that to include T in the equations such that it will be endogenously determined turns the equations to be unsolvable. Second, in regard to the argument that trading in order to change the share's value is illegal, he argued that this is exactly what activists do. Third, Prof. Fos noted that previous models show that it is efficient to look at a specific point in time without considering the history. In addition, in all these models, there is just one period. One participant remarked that the microstructure literature distinguished between two types of information: information regarding the firm itself and information regarding the order flow. This participant has asked whether a market maker, who has the information about the order flow, has not embedded this information in the share's price so that it is harder for the activist trader to gain a profit.

How does Hedge Fund Activism Reshape Corporate Innovation?

Presented by Prof. ***Alon Brav*** *(Duke University)*

Discussant: Prof. ***Andrew Ellul*** *(Indiana University)*

The paper's main finding is that activist intervention results in improvement in innovation efficiency at target firms. Participants noted that it would be interesting to see how this affects optimal contracts. Of course, there are data limitations since the different ways hedge funds intervene at target firms in order to create value is hard to observe. One idea was to compare activist actions that improve innovation versus those that push for a sale to the highest bidder. Since some companies drop from the sample once they go private, a suggestion for future work was to match pairs of companies and drop both of them from the sample once either one of them disappears.

Job Creation: The Role of Foreign Venture Capital

Presented by Prof. ***Thomas Hellman*** *(University of Oxford)*

Discussant: Prof. ***Eugene Kandel*** *(Hebrew University)*

The paper examines whether US VC investments generate more jobs in Sweden, relative to the domestic VC's. The authors find evidence that US VC's have a positive effect on jobs' creation in Sweden. The authors use two instruments: shocks to US fundraising environment; and distance to airport, and show that this effect is causal.

The first comment regarded the endogeneity concern. Specifically, VC financing in the US depends on world growth and on US growth, which are correlated with Swedish growth. Unless the authors control very carefully for these variables, they have another channel the funding comes in which is the growth prospect. Next, one of the participants noted that the development level of the Swedish market is not low. Hence, it would be useful to clarify what is the relative advantage that the US investors bring to the Swedish market. Third, one of the participants suggested using individual VC data in order to build an IV for exit. Specifically, these VC's have a maximum longevity of around ten years. VCs, which are close to their end of life, are under pressure to exit. In regard to the discussant's comments, Prof. Hellman responded that focusing on the nature of jobs that were created, i.e. their quality, type, etc., is a good idea. In addition, he noted that the regressions' results were similar, with and without fixed effects.

Adapting to Radical Change: The Benefits of Short-Horizon Investors

Presented by Prof. ***Mariassunta Giannetti*** *(Stockholm School of Economics)*

Discussant: Prof. ***Mike Weisbach*** *(Ohio State University)*

The paper shows evidence that short-term institutional investors respond faster to negative shocks. Specifically, the authors show that firms with ex-ante more short-term institutional investors react faster to a threat of increase in imports after reductions in import tariff rates. As a consequence, these firms perform better. These reactions include: increased advertising, differentiation of their products relative to the competitors, more M&As, and more executive turnover.

One of the participants asked whether it is possible that there is a matching between the type of the firm and the type of the investor: meaning, fast responded firms attract short-term investors. Another remark was that the mechanism that the paper highlights is an exit due to private information. However, it is difficult to argue that the short-term investors indeed have such information. Prof. Giannetti answered that the exit mechanism of block holders is indeed private information. However, the mechanism that drives the sell-off that is described in the paper is different. Basically, this mechanism is composed from small shocks in the market, which are publicly known. Finally, one of the participants noted that there is a range of short-term investors that are information-based e.g. high-frequency traders. These investors trade based on market conditions. In this context, this participant suggested that the authors examine whether other market conditions, that make the high frequency trading more profitable, changed after the change in tariff.

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

Presented by Prof. ***Russ Wermers*** *(University of Maryland) and* ***Miriam Schwartz-Ziv*** *(Michigan State University)*

Discussant: Prof. ***Yaniv Grinstein*** *(IDC)*

Large shareholders vote more for S.O.P votes, regardless of ISS recommendations.

A discussion on the data raised a few questions and suggestions: why use SOP votes and not director elections data? Prof. Schwartz-Ziv answered that they tried directors' election data, but the results were not as good as in SOP. The authors' think the reason for that is because SOP is where shareholders say their opinion on management, therefore this is the place to show unhappiness.

A suggestion was made to use both measures for relative size of the holdings by the fund manager: the percentage of holdings in the company, and the share of holdings in the fund's portfolio. Another suggestion was to examine the effect of a distance measure, for the location of the fund and the location of the company. The hypothesis is that local funds will not vote against management, even if they are unhappy with the proposal.

A remark was raised on the meaning of measuring CAR on voting "against": it can be meaningful and interesting only if there are consequences for the vote against. Otherwise, it is meaningless.

There is large literature in the legal area that might tell the story of institutional shareholders, as well as sharpen the hypothesis. Papers claim that there is a centralization of votes by big 3

fund managers: Blackrock, Fidelity and Vanguard, so there is no variation in their votes. SOP is an area in which there is a lot of communication between shareholders, reputation is taken into consideration, issuer perspective is important: there is an issuer – shareholder dialog. A lot of the above mentioned is consistent with the results of this paper, but not with the story it tells.

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