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Institutional Investors and Corporate Governance

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Full text available at: http://dx.doi.org/10.1561/0500000056

Foundations and Trends® in Finance

Published, sold and distributed by:
now Publishers Inc.
PO Box 1024
Hanover, MA 02339
United States
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The preferred citation for this publication is

A. Dasgupta, V. Fos and Z. Sautner. *Institutional Investors and Corporate Governance*. Foundations and Trends® in Finance, vol. 12, no. 4, pp. 276–394, 2021.

ISBN: 978-1-68083-879-4
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Institutional Investors and Corporate Governance

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ABSTRACT

We provide a comprehensive overview of the role of institutional investors in corporate governance with three main components. First, we establish new stylized facts documenting the evolution and importance of institutional ownership. Second, we provide a detailed characterization of key aspects of the legal and regulatory setting within which institutional investors govern portfolio firms. Third, we synthesize the evolving response of the recent theoretical and empirical academic literature in finance to the emergence of institutional investors in corporate governance. We highlight how the defining aspect of institutional investors – the fact that they are financial intermediaries – differentiates them in their governance role from standard principal blockholders. Further, not all institutional investors are identical, and we pay close attention to heterogeneity amongst institutional investors as blockholders.

Keywords: institutional investors; corporate governance; exit; voice; shareholder activism; proxy voting advisors.

Amil Dasgupta, Vyacheslav Fos and Zacharias Sautner (2021), “Institutional Investors and Corporate Governance”, Foundations and Trends® in Finance: Vol. 12, No. 4, pp 276–394. DOI: 10.1561/0500000056.

Full text available at: http://dx.doi.org/10.1561/0500000056

1

Introduction

Whenever the ownership of public corporations is dispersed amongst many shareholders, blockholders – owners of non-trivial percentages of a firm's shares – become central to good corporate governance. In contrast to small shareholders, who have neither the incentive nor the capacity to effectively monitor management, blockholders are able to govern firms to the benefit of all. The governance role of blockholders today must be viewed in the backdrop of the explosive growth of the asset management industry in recent decades, which has led to the large-scale *intermediation* of equity ownership.

Table 1.1 shows that 50 years ago households *directly* owned almost 80% of US corporate equity. Such direct ownership has declined dramatically over the years, reducing by more than a half, so that today only 38.3% of US corporate equity is directly owned by households. The remainder is *indirectly* held via different asset managers – commonly referred to as *institutional investors*. The table shows that such institutional ownership is dominated by four major types of domestic investors: Mutual funds (20.8%), exchange traded funds (ETFs) (6.6%), public pension funds (5.3%), and private pension funds (5.4%). The remaining institutional investors include insurance companies (1.9%), which

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Table 1.1: Ownership shares of the US stock market in percent

Sector	1950	1970	1990	2000	2010	2020
Private Pension Funds	0.0	8.1	16.2	11.2	7.8	5.4
Federal, State and Government Pension Funds	0.0	1.2	8.1	7.7	8.5	5.3
Insurance Companies	2.6	3.3	4.1	6.2	6.7	1.9
Mutual Funds	1.6	4.8	7.1	18.3	20.2	20.8
Closed-End Funds	0.9	0.5	0.5	0.2	0.4	0.2
Exchange-Traded Funds	0.0	0.0	0.0	0.4	3.6	6.6
Foreign Sector	1.6	3.3	6.9	9.3	13.7	16.4
Household Sector	92.8	78.2	56.5	45.6	37.2	38.3
Other	0.4	0.6	0.7	1.1	1.8	5.1

Source: Federal reserve statistical release data: Flow of funds data United States. Exchange-traded funds are first listed in December 7, 2001. The household sector includes bank personal trusts.

have become progressively smaller over time, and “other” unclassified domestic investors (5.1%), a catch-all category including hedge funds or the proprietary holdings of financial institutions. Finally, 16.4% is held by foreign institutional investors.[1] Thus, a majority of equity holders in public US firms are institutional investors. This phenomenon is not limited to the US: below we provide evidence of a similarly significant growth of institutional ownership in other major economies around the world.

Institutional investors are different from the standard blockholders of the classical corporate governance literature in a number of ways. They are larger than most private investors, often subject to extensive regulations, and – perhaps most fundamentally – they differ from private blockholders because they invest other people’s money. Given the preponderance of institutional investors in corporate equity ownership, it is important to understand the role they play in corporate governance.

In this review, we provide a comprehensive overview of the role of institutional investors in corporate governance. Our contribution has

[1]The measure of foreign ownership does not allow the separation between direct investments by households and institutional investors. However, the vast majority of this category likely originates from foreign hedge funds, pension funds, mutual funds, and sovereign wealth funds.

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three main components. First, we trace the emergence of institutional investors as the modal concentrated owners of public firms in modern economies, using a wide variety of data sources to establish new stylized facts. Second, we provide a detailed characterization of key aspects of the legal and regulatory setting within which institutional investors operate with respect to the governance of their portfolio firms. Third, we synthesize the evolving response of the academic literature in finance to the emergence of institutional investors in corporate governance, attempting to link theoretical predictions to empirical findings.

Because of our focus on institutional investors as the holders of equity blocks we highlight the role that characteristics specific to this type of equity blockholder play in corporate governance. For example, we document how the defining aspect of institutional investors – the fact that they are financial intermediaries – differentiates them in their governance role from standard principal blockholders (e.g., individuals, families, and firms). As a result, we discuss how differences with respect to explicit and implicit incentives, organizational structures, and regulatory requirements shape their obligations, incentives and ability to govern. This focus leads us to highlight aspects of governance that are unique to institutional investors, for example, the institutions' voting processes, the role of proxy voting advisors, and conflicts of interests arising from business ties with portfolio firms.[2] Further, not all institutional investors are identical, and we pay close attention to *heterogeneity* amongst institutional investors as blockholders, arising because of differences in their incentives, size, investment horizons, preferred governance mechanisms, or regulatory constraints. We shine a light on heterogeneity across institution types by establishing stylized facts on ownership heterogeneity, and by synthesizing the emerging lessons from the theoretical and empirical literatures on the impact of such heterogeneity.

[2]Given our specific focus, we do not review the literature on the role of non-institutional blockholders, such as families or other corporations, which also play an important role in the governance of firms. While some aspects in our discussions also apply to these blockholders, notably the broader theories and the evidence on monitoring by institutional blockholders, most aspects in our review are specific to institutional blockholders.

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Hence, our monograph differs in two important ways from recent surveys that look at the role of blockholders *per se* in corporate governance (e.g., Edmans, 2014; Edmans and Holderness, 2017). First, we highlight governance issues specific to institutional investors, which can lead to substantial differences between the objectives of canonical blockholders who maximize the value of their blocks and the objectives of institutional investors. For instance, a labor union pension fund that manages pension accounts of a firm's employees might consider negative effects of a value increasing action on the employees and thus resist the action. Second, the main objective of a rising class of passive institutional investors is to not maximize the value of their investment but to rather track an index. For instance, with trillions of dollars in assets, the objective of most ETFs is to track the performance of a basket of securities. Investment companies managing ETFs are, however, required to vote in the best interest of their investors. Thus, there is an important gap between the fiduciary duties of ETF managers and their investment objectives.[3]

Though we do not focus on the role of non-institutional blockholders, such as families, wealthy individuals, or other corporations, we should note that these equity blockholders also play an important role in the governance of firms, both by themselves and in their interactions with institutional investors. Notably, in publicly traded firms in Germany or even the US (outside of the largest firms), family ownership remains a significant governance factor. Villalonga *et al.* (2015) review the literature on corporate governance in family-owned firms.

A few other recent surveys cover related issues. Yermack (2010) surveys the literature on shareholder voting, while we in contrast delve in detail on institution-specific aspects of proxy voting. Brav *et al.* (2010 and 2015a) provide surveys of activist hedge funds specifically. While activist hedge funds feature prominently in our review, they are only one part of the much wider landscape of the role of institutional investors in corporate governance that is of interest to us. Schmalz (2018) surveys the emerging literature on common ownership, a specific topic tied to

[3]Despite our different focus, we pick up on key themes highlighted in Edmans and Holderness (2017), namely the role of blockholder heterogeneity and evidence from institutional settings beyond the US.

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the existence of large institutional investors, which we only touch on briefly below. Institutional investors are sometimes under scrutiny for their role in environmental and social issues tied to corporate actions. In a recent review, Matos (2020) focuses specifically at this aspect of the role of institutional investors. Finally, Franks (2020) provides a contemporaneous review of institutional ownership around the world and discusses topics within their governance role.

The remainder of this monograph is structured as follows. Section 2 provides a series of new stylized facts on the evolution of institutional ownership and its heterogeneity in the US and outside of the US. Section 3 describes the legal and regulatory environment within which institutional investors operate, with a focus on the obligations, ability, and incentives of such investors to engage in the corporate governance of firms. Section 4 reviews the theoretical literature on institutional investors and corporate governance while Section 5 discusses the empirical literature. Section 6 concludes.

Full text available at: http://dx.doi.org/10.1561/0500000056

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