The Value of Blockholders (Large Shareholders)

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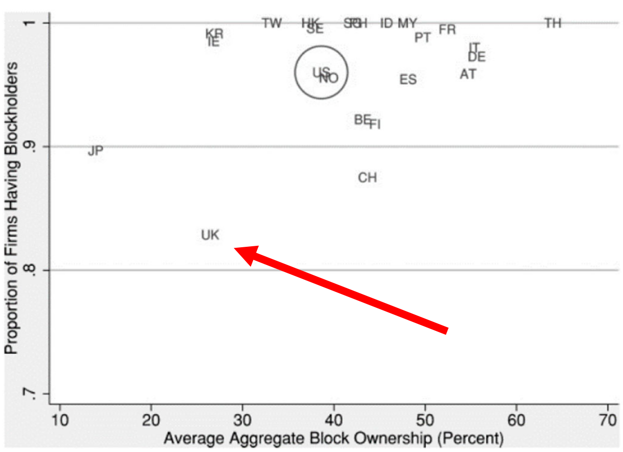
This is taken from my 16/2/17 response to the UK Government's Green Paper on Corporate Governance (full response at http://bit.ly/AlexCorpGov) and my 17/4/17 response to the UK Government's Green Paper on Industrial Strategy (full response at http://bit.ly/AlexIndStr.)

1.1 One potential driver of underinvestment is the UK's fragmented shareholder structure. Blockholders (large shareholders) are critical to supporting long-run investment. However, the following chart from Holderness (2009) shows that the UK is a global outlier in having few blockholders (defined here as a 5% shareholder):



1.2 Moreover, blockholders can improve corporate governance generally, over and above "say-on-pay" voting. Blockholders can promote long-term value creation in two ways:

1.2.i Engagement / Voice. A blockholder's large stakes give him both the *incentives* to engage with a firm (since he has skin-in-the-game) and the *power* to do so (due to voting rights). Engagement can involve not only disciplining management (e.g. curbing short-termism), but also advising management (e.g. on long-term investment strategies). There is significant evidence on the benefits of engagement for shareholder and stakeholder value.[1]

1.2.ii Monitoring / Exit. A fragmented shareholder has too little "skin-in-the game" to analyse a company's intangible assets (such as culture). He will thus focus on freely-available

[1] Becht, Franks, Mayer, and Rossi (2009), Carleton, Nelson, and Weisbach (1998), Dimson, Karakas, and Li (2015), Brav, Jiang, Partnoy, and Thomas (2008), Brav, Jiang, and Kim (2015), Brav, Jiang, Ma, and Tian (2016).

short-term earnings – "the market sells first and asks questions later." In contrast, blockholders' large stakes give them the incentives to ask questions first and analyse long-term value (Edmans (2009)). If a firm has delivered low earnings due to investment, blockholders will not sell (and may buy more). Informed blockholders insulate managers from the need to cater to short-term pressures, and free them to focus on long-term purpose. Warren Buffett is an example.

Blockholders also discipline managers against pursuing the short-term. With fragmented shareholders, a manager may inflate the short-term stock price by cutting investment. An informed blockholder will notice such myopic behaviour and sell her stake. The threat of such disciplinary "exit" deters a firm from acting myopically to begin with.

Key to exit is that the blockholder displays *conditional*, not unconditional loyalty. A blockholder who remains with the firm, even if it acts myopically (such as VW's shareholders), will not exert governance. Indeed, Buffett sells if the firm has not built its brand after several years. Causal evidence shows that stock liquidity improves firm value since it enhances blockholder discipline.[2] Contrary to misperception, selling in the short-term does not mean taking a short-term perspective. What matters is not whether an investor *trades* in the short- or long-term, but whether she trades on short-term or long-term *information*. Blockholders, due to their large stakes, have incentives to gather long-term information. Uber's customers recently deleted their accounts to discipline management[3]; similarly, shareholders who sell their shares in a non-purposeful company are exerting discipline rather than being short-termist. We should promote *large* shareholders with long-term perspectives, not *long-term* shareholders who entrench management by remaining with the firm regardless of performance.

1.3 Potential ways to encourage blockholding are as follows, which are taken from The Purposeful Company's Policy Report (Chapter 4: Blockholding)[4]. Note that, before considering any such policies, it is critical to ensure that their adoption does not disadvantage minority shareholders (in particular retail shareholders). The discussion of the merits of blockholders does not all

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[2] Fang, Noe, and Tice (2009), Bharath, Jayaraman, and Nagar (2013), Edmans, Fang, and Zur (2013).

[3] I am not taking a stand as to whether Uber's actions merited such discipline; merely emphasising that customers had the disciplinary device of "exit" available to them and that customer discipline is typically seen as desirable.

[4] http://biginnovationcentre.com/media/uploads/pdf/TPC_Policy%20Report.pdf

imply that retail shareholders have no value, merely that skin-in-the-game gives more incentives and clout:

1.3.i Disclosure Relaxation. At present, investors have to disclose when they have acquired a 3% stake. This makes it costly for an investor to build (say) a 5% stake. After he has acquired 3%, he must disclose her stake. This pushes up the stock price and makes it more expensive for him to buy the remaining 2%. As a result, shareholdings typically cluster at 2.9%. 46% of FTSE 100 companies have at least one investor with a 2.9% stake.

- The UK's disclosure requirements are abnormally stringent compared to the US and EU, where the lowest disclosure threshold is 5%.
- In the UK, directors are required to call a general meeting only if requested by the holders of 5% of shares. This engagement threshold is inconsistent with the 3% disclosure threshold and means that, 3%, in some firms, no single shareholder has the power to call for meetings.
- The US introduced a more relaxed disclosure requirement (Schedule 13G) for investors that do not seek to take control, and so there is less concern with minority shareholder expropriation. Yet, such blockholders can still monitor, and so should be encouraged. The UK should consider a relaxed disclosure requirement for such blockholders. Edmans, Fang, and Zur (2013) show that 13G blockholders significantly improve operating performance.

1.3.ii Structured Access. Investors have substantial concerns about receiving intangible information in company meetings, even though such information may aid engagement and monitoring. Clarifying what information they can and cannot receive without violating insider trading laws would improve engagement and monitoring for the benefit of minority shareholders (and society) also. This must be done in a way that does not disadvantage minority shareholders.

1.3.iii Collective Engagement. Active engagement often involves collaboration between shareholders. Many institutional investors are wary about collaborating as it may (unintentionally) lead to information sharing and thus being classified as an insider. The Investor Forum has significantly facilitated collaboration for intensive and wide-ranging engagements, but there is no similar framework for routine or specific engagements. It would be useful to both clarify and, if necessary, weaken any restriction on collaboration.

- An example of a weakening of restrictions is the SEC's relaxation of proxy rules in 1992[5], allowing shareholders to communicate freely. This led to institutional ownership improving innovation (Aghion, Van Reenen, and Zingales (2013)).

1.3.iv <u>Voting With Borrowed Stock.</u> Some commentators have expressed concerns that the stock lending market allows arbitrageurs to borrow votes and sway decisions (e.g. M&A outcomes), even if they have a small actual stake in the firm. However, Christoffersen et al. (2007) show that stock lending can lead to votes going to informed investors, and may potentially address the "low turnout" issue. One potential way to prohibit "bad" stock lending but not "good" stock lending is to allow borrowed stock to be voted only if it is borrowed by blockholders, who have skin-in-the-game and are likely to be informed.

[5] This relaxation exempted shareholder communications such as public statements of their voting intentions and/or voting rationale (including public speeches, press releases, newspaper advertisements, and internet communications) from the definition of a proxy solicitation