

The Role of Institutional Investors in Corporate and Entrepreneurial Finance

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Abstract

Institutional investors, collectively the majority shareholders of most publicly-traded corporations, play important roles in almost all aspects of corporate finance. This special issue puts together sixteen papers covering a wide range of topics such as M&A, capital structure, bonds and loans, corporate governance, IPOs, VCs, SEOs, broker/underwriter relationships, behavioral finance, corporate disclosure, and regulation. These special issue papers demonstrate that institutional investors, a traditional focus of investments research, are worthy of continued and further academic inquiry in many corporate finance topics. In terms of directions for future research, we believe the availability of new datasets (or existing datasets not yet widely used in corporate finance) and the application of new or unique research methodologies could bear fruits for researchers, as demonstrated by some papers in this special issue. In terms of datasets, the success of Abel Noser institutional trading data serves as a good example.

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1. Introduction

Over the last several decades, institutional investors, such as mutual funds, hedge funds, endowment funds, retirement or pension funds, insurance companies, sovereign wealth funds, and private equity firms, have come to dominate global financial markets. In the U.S., institutional investors' stake in the average firm rose from 20% in 1980 to 60% in 2014 (see, e.g., Bai, Philippon, and Savov (2016)). As a result, institutional investors play an increasingly important role in all aspects of financial markets.

If institutional investors are collectively the majority shareholders of most publicly-traded corporations, what roles do they play in corporate financial decision making, corporate governance, and various corporate events? Building on prior literature and seminal works such as Gillan and Starks (2000), this *Journal of Corporate Finance* special issue seeks to further our understanding of the fundamental role played by institutional investors in all aspects of corporate finance in a contemporary and global setting. The collection of papers published were further selected from those presented at the *JCF* special issue conference held at Hong Kong Polytechnic University in December 2018. Due to a policy change by the publisher, special issue papers were not published in the same printed volume, instead the papers were published in scattered volumes as they were accepted. We, therefore, organize and put all special issue papers into context so as to highlight the overall theme: the various important roles played by institutional investors in corporate finance.

In his keynote address, "State pricing, effectively complete markets, and corporate finance," Mark Grinblatt discusses how event study, panel regression, and difference-in-difference techniques, though widely used in corporate finance, may be inappropriate if corporate events are anticipated to some degree, as most events are. Grinblatt and Wan (2020) propose options as an additional model-free source of information to identify the likelihood and impact of corporate events. Other special issue papers are organized under six topics based various roles played by institutional investors in corporate finance.

2. Institutional Investors and Corporate Finance

2.1 Institutional Investors, M&A, and Capital Structure

M&As are perhaps one of the most significant corporate events and they tend to be highly information intensive and sensitive periods for both acquirers and targets. Ismaila, Khalila, Safieddinea, and Titman (2019) find that institutional investors tend

to accumulate shares of firms that announce acquisitions in general, and especially so when the acquirer discloses synergy forecasts. Such accumulations of shares are stronger when the disclosed synergies are higher. The authors interpret these findings as evidences consistent with the idea that institutional investors are attracted to situations where their superior access to management and analysts provides an information advantage. They also find that these patterns are stronger for hedge funds, which are typically believed to possess higher information advantage. In addition, stock prices respond favorably in the quarter following the acquisition announcement when higher institutional holdings are revealed.

Also in the context of M&As, Chang, Lin, and Ma (2020) identify an important channel, acquisitions of public targets, through which governance through trading (GTT) by institutional investors improves firm values via better acquisition of public targets. They further find that the effect of GTT is stronger when managers' contractual incentives are better aligned with shareholders; firms with higher GTT also have better operation performance and valuation and lower default risk; and the effect of GTT only exists for less financially-constrained firms and non-all-cash M&As.

In a rather unique survey study, Brown, Dutordoir, Veld, and Veld-Merkoulova (2019) report that over 82% of institutional investors believe they influence corporate capital structure decisions, especially for smaller, younger, and more financially constrained firms. Unlike corporate managers, institutional investors consider agency costs of free cash flow important drivers of capital structure. Institutional investors' responses also support pecking order and market timing theories. Most institutional investors find financial constraints important, with components of the Kaplan–Zingales and Whited–Wu indexes dominating other proxies. Overall, their findings suggest a first-order impact of institutional investor preferences on corporate capital structure decisions.

2.2 Institutional Investors, Bonds, and Loans

Fixed-income securities such as bonds and loans, though less studied compared to equity, are just as important for firms' financing. Institutional investors also play an active role in corporate bond and loan markets. Using Abel Noser (ANcerno) institutional trading data, Bhattacharya, Wei, and Xia (2019) find that a set of small institutional investors consistently follow credit ratings issued by an investor-paid

rating agency in their trading decisions.¹ Although rating information is credit related, the authors find that these institutional followers often respond more strongly to investor-paid ratings than to other influential trading signals, such as earnings announcements, analysts' earnings forecast revisions, and recommendation changes. Institutional followers outperform non-followers, and show improved trading performance after becoming followers. Based on these evidences, the authors conclude that investor-paid rating agencies offer small institutional investors a cost-effective alternative to in-house research.

Dahiya, Hallak, and Matthys (2020) examine if banks worry about expropriation when an activist hedge fund targets their borrowers, or alternatively, banks are reassured that their borrowers will perform better after such targeting. The authors find that target firms pay higher spreads on post-activism loans, and are more likely to post collateral on post-activism loans. Target firms experience tighter loan terms compared to similar, non-target firms. Targets with high stock returns around activism face tighter loan terms afterwards. The authors argue that higher interest rates and greater collateral requirements reflect the increased credit risk for these borrowers partly due to the possibility of wealth expropriation by the shareholders. Their evidences suggest that an increase in equity value due to an activist's targeting may be partially due to wealth expropriation from creditors.

In the setting of insurance companies, Chen, Sun, Yao, and Yu (2020) examine the hypothesis that investors facing more operating risk may behave as if they were more risk averse in investment decisions. Specifically, the authors study how operating risk from underwriting insurance policies affects insurers' risk taking behavior in their portfolio investments. The authors find that insurers with greater operating risk have lower credit risk exposure in their bond investments and invest less in risky bonds and equities. They also find that insurer portfolio risk exposure is highly sensitive to permanent operating risk but insensitive to transitory operating risk, and transitory operating risk is significantly related to portfolio risk when insurers face tight financial constraints. Their findings suggest a substitutive effect of operating risk on investment decisions by financial institutions.

2.3 Institutional Investors and Corporate Governance

¹ For details of Abel Noser (ANcerno) institutional trading data, please see the "Abel Noser data paper," Hu et al. (2018), and the Abel Noser (ANcerno) data page: <http://ganghu.org/an>

Following seminal works such as Gillan and Starks (2000), a stream of academic research has developed in examining the important role played by institutional investors in corporate governance. Fu, Kong, Tang, and Yan (2020) examine the effects of shareholder investment horizons on insider trading. The authors find that long shareholder investment horizons reduce the propensity of informed insider trades, and such effect is stronger in firms with higher litigation risk, for insider sales, and in firms poorly monitored by other agents. Long-horizon shareholders are likely to impose policies that restrain insider trading and tend to foster a more transparent information environment.

Ho, Huang, and Karuna (2020) examine the relation between large shareholder ownership and board governance in firms. Using a dataset comprising Taiwanese firms, they find that greater family ownership is associated with a more advisory board, while greater institutional ownership is associated with a more monitoring board. They also find that types of institutional ownership influence board governance in different ways. Their study provides evidence on the multidimensional nature of the relation between large shareholder ownership types and board governance.

2.4 Institutional Investors and Entrepreneurial Finance

In recent years, institutional investors have been playing an increasingly important role in early-stage financing of entrepreneurial and private firms. Nefedova and Pratobevera (2020) find results indicating that some institutions hide their sell trades and break their laddering agreements with underwriters. The authors find that institutions buy IPO shares through lead underwriters, while selling them through other brokers in the aftermarket, and this behavior is pronounced in cold IPOs and is limited to the first month after the issue. They also find that the intention to flip IPO allocations is not an important motive for hiding sell trades from underwriters, hiding sell trades is an effective strategy to circumvent underwriters' monitoring mechanisms: the more institutions hide their sell trades, the less they are penalized in subsequent IPO allocations.

Li, Liao, Wang, and Xiang (2020) examine whether the certification effect of VCs extends to firm's potential customers, and whether, by certifying firms' values to potential customers, VCs provide value to firms. Using weekly trading data from P2P lending platforms in China, the authors find that lenders and facilitated loans increase after VC investment announcements, and such effect increases with VCs' reputation

and the extent of information asymmetry. They also find that this effect is beyond the effect of news, advertising, and funding, and VC-backed platforms are less likely to default.

Using a manually-collected dataset of venture capitalists' (VCs) political connections, Wang and Wu (2020) examine the impact of VCs' political connections on their portfolio companies and investigate the potential benefits and costs that politically-connected VCs bring to their portfolio companies. On the benefit side, the authors find that companies backed by politically-connected VCs are more likely to obtain IPO approval. On the other hand, these VCs are more likely to acquire equity in the company at a significant discount and to invest shortly before the IPO application. They also find that politically-connected VCs do not play a greater role in monitoring. Politically-connected VC-backed companies experience more underpricing at IPO, and politically-connected VCs exit earlier and their companies underperform after IPOs.

In recent years, institutional investors have started to invest increasingly in private firms, thus making private equity capital increasingly cheaper for such firms. This, along with the removal of regulatory barriers for raising venture capital at the state level that occurred in the late nineties (see, e.g., Ewens and Farre-Mensa (2020)), have had important consequences for the reduction in volume of IPOs in the U.S. post-2000 (see, e.g., Chemmanur, He, Ren and Shu (2020)). We expect the role of institutional investments in private firms to be an increasingly important research topic in the future as new data sets useful for this research become available.

2.5 Institutional Investors and Broker/Underwriter Relationships

Using Abel Noser institutional trading data, Anand, Irvine, and Liu (2019) investigate the influence of institutional trading on the likelihood of winning the lead underwriting mandate for a large sample of secondary offerings. The authors find that the intensity of the underwriting bank's trading on the likelihood of winning the lead underwriting mandate is positive and significant. Analyst coverage is an effective complement to trading intensity in winning the underwriting mandate, while bank reputation is a significant substitute. Lead bank trading intensity has a significant beneficial effect on the SEO pricing discount. Banks that do not have a high level of trading in the issuer's stock can effectively compete by adding a co-lead underwriter to the underwriting syndicate.

Chen, Sanger, and Song (2019) use earnings announcements to analyze the trading

behavior and associated price impacts of institutions that have a lending or underwriting relationship with client firms and also hold client firms' shares. The authors find that buying support from relationship institutions mitigates the negative impact of earnings surprises on client firms' stock prices, predicts subsequent negative earnings surprises, and is also associated with less selling by independent institutions holding the same firms' shares. Price reactions for firms without relationship institutions are significantly larger, and price support from relationship institutions appears to help resolve uncertainty accompanying clients' temporary earnings shocks, thus reducing noise in the capital markets.

2.6 Institutional Investors, Behavior, Disclosure, and Regulation

Using Abel Noser institutional trading data, Chakravarty and Ray (2020) examine short-term trading performance of institutional investors using a marked-to-market based "fair-value" method. Their findings differ significantly from and fall in between those using the "historical cost" method. The authors find that managers do not have superior skill after transaction costs for trades with holding period of four weeks or less. Institutional investors engage in short-term trading despite losses primarily for liquidity reasons, and pension fund and mutual fund managers have different trading behaviors.

Cheng, Huang, and Luo (2020) examine institutional investors' responses to corporate disclosure quality conditional on market states. The authors find that market states influence institutions' reactions to corporate disclosure quality, and such influence is stronger when investors' access to inside information is limited. They also find that corporate disclosures reduce information asymmetry to a greater extent in downturns, and transient institutional ownership in downturns provides price support and stabilizes volatility.

Also using Abel Noser institutional trading data, Duong and Meschke (2020) examine how increased regulatory attention affects the trading behavior of U.S. mutual funds, leading to the rise and fall of portfolio pumping. The authors find that regulatory attention reduced portfolio pumping by U.S. mutual funds, and spikes in fund indices, fund holdings, and institutional trading declined. Such declines are largest around year-ends, for small-cap, and better-performing funds, and occurred faster for funds headquartered near SEC regional offices. Their findings suggest that increased regulatory attention reduced portfolio pumping by U.S. mutual funds, consistent with and reconciling the findings in both Carhart, Kaniel, Musto, and Reed (2002) and Hu,

McLean, Pontiff, and Wang (2014).

3. Conclusion and Directions for Future Research

In conclusion, this *JCF* special issue includes a keynote address and sixteen papers examining the role of institutional investors in various aspects of corporate finance, such as M&A, capital structure, bonds and loans, corporate governance, IPOs, VCs, SEOs, broker/underwriter relationships, behavioral finance, corporate disclosure, and regulation.

Our sincere hope is that, by putting together a collection of such papers, all the paper authors and we have demonstrated that institutional investors, a traditional focus of academic research in investments, play important roles in almost all areas of corporate finance, worthy of continued and further academic inquiry. In terms of directions for future research, we believe the availability of new datasets (or existing datasets not yet widely used in corporate finance) and the application of new or unique research methodologies could bear fruits for future researchers, as successfully demonstrated by some papers in this special issue. For example, Brown, Dutordoir, Veld, and Veld-Merkoulova (2019) conduct a survey analysis to examine the role of institutional investors in corporate capital structure decisions.

In terms of datasets, the success of Abel Noser (ANcerno) institutional trading data serves as a good example. Originally a market microstructure dataset, it has now been widely used in all areas of finance: corporate finance, investments, and market microstructure. In addition, the data has also been increasingly used in accounting. The Abel Noser data page (<http://ganghu.org/an>) now lists 94 publications thus far using Abel Noser data, compared to 55 publications listed in Hu et al. (2018). In other words, 39 new publications using Abel Noser data within the last two years, compared to 55 in the previous 26 years, 1993-2018. We anticipate this strong publication trend to continue in the foreseeable future, as many research topics, in corporate finance or otherwise, can be re-examined more in-depth and/or from fresh angles with the data. For example, both Chemmanur, Hu, and Huang (2010), and Nefedova and Pratobevera (2020) study institutional trading around IPOs; both Chemmanur, He, and Hu (2009), and Anand, Irvine, and Liu (2019) examine institutional trading and SEOs; both Hu, McLean, Pontiff, and Wang (2014), and Duong and Meschke (2020) investigate quarter- and year-end trading activities of institutional investors, all using Abel Noser data.

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