The Role of Institutional Investors in Corporate and Entrepreneurial Finance

Thomas J. Chemmanur[*] Gang Hu[**] K.C. John Wei[***]

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[*] Professor of Finance and Hillenbrand Distinguished Fellow, Fulton Hall 336, Carroll School of Management, Boston College, Chestnut Hill, MA 02467, USA. Phone: +1-617-552-3980. E-mail: chemmanu@bc.edu.

[**] Associate Professor, School of Accounting and Finance, Hong Kong Polytechnic University, M1038, Li Ka Shing Tower, Hung Hom, Kowloon, Hong Kong. Phone: +852-3400-8455. Email: gang.hu@polyu.edu.hk.

[***] Chair Professor and Associate Dean, School of Accounting and Finance, Hong Kong Polytechnic University, M1043, Li Ka Shing Tower, Hung Hom, Kowloon, Hong Kong. Phone: +852-2766-4953. Email: john.wei@polyu.edu.hk.

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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&As, 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 that 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 fruit 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.

Keywords: Institutional Investor; Corporate Finance; Trading; Abel Noser Data

JEL Classification: G12; G14; G23

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 the 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). Hence, institutional investors play an increasingly important role in all aspects of the 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 corporate events? Building on the literature and seminal works such as Gillan and Starks (2000), this special issue of the *Journal of Corporate Finance* seeks to further our understanding of the fundamental role institutional investors play in all aspects of corporate finance in a contemporary and global setting. This collection of papers was further selected from those presented at the *JCF* Special Issue Conference held at the Hong Kong Polytechnic University in December 2018. Because of a policy change by the publisher, special issue papers were not published in one printed volume, but were instead published in scattered volumes as they were accepted. Therefore, we have organized and put all of the special issue papers into context to highlight the overall theme: the important roles of institutional investors in corporate finance.

In his keynote address at the conference, "State pricing, effectively complete markets, and corporate finance," Mark Grinblatt discussed how event study, panel regression, and difference-in-difference techniques, although 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. The other special issue papers are organized under six topics based on the different roles institutional investors play 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 tend to be highly information intensive and sensitive periods for both acquirers and targets.

Ismail, Khalil, Safieddine, and Titman (2019) find that institutional investors tend to accumulate shares of firms that announce acquisitions, especially when the acquirer discloses synergy forecasts. Such accumulations of shares are stronger when the disclosed synergies are greater. The authors interpret these findings as evidence consistent with the idea that institutional investors are attracted to situations in which their superior access to management and analysts provides an informational advantage. They also find that these patterns are stronger for hedge funds, which are typically believed to possess a greater informational advantage. In addition, stock prices respond favorably in the quarter following an acquisition announcement when higher institutional holding is revealed.

Also in the context of M&As, Chang, Lin, and Ma (2020) identify an important channel, the acquisition of public targets, through which governance through trading (GTT) by institutional investors improves firm value via the better acquisition of public targets. The authors further find that the effect of GTT is stronger when managers' contractual incentives are better aligned with shareholders, that firms with higher GTT also have better operational performance and valuation and lower default risk, and that 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 more than 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 the agency costs of free cash flow to be 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 effect of institutional investor preferences on corporate capital structure decisions.

2.2 Institutional Investors, Bonds, and Loans

Fixed-income securities such as bonds and loans, although less studied compared with equity, are just as important for firms' financing. Institutional investors also play an active role in the 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 this evidence, 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 whether banks worry about expropriation when an activist hedge fund targets their borrowers, or alternatively, whether 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 with similar, non-target firms. Targets with high stock returns around activism face tighter loan terms afterward. The authors argue that higher interest rates and greater collateral requirements reflect the increased credit risk of these borrowers partly because of the possibility of wealth expropriation by their shareholders. The evidence suggests that an increase in equity value because of an activist's targeting may be partially based on wealth expropriation by creditors.

In the setting of insurance companies, Chen, Sun, Yao, and Yu (2020) examine the hypothesis that investors facing more operating risk may be more risk averse in their 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 that 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.

[1] For details about 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

2.3 Institutional Investors and Corporate Governance

Following seminal works such as Gillan and Starks (2000), a stream of academic literature has developed that examines the important role institutional investors play 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 for informed insider trades, and that this effect is stronger in firms with higher litigation risk, for insider sales, and in firms that are 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 of Taiwanese firms, they find that greater family ownership is associated with a more advisory board, whereas 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 of the multidimensional nature of the relation between large shareholder ownership types and board governance.

2.4 Institutional Investors and Entrepreneurial Finance

Institutional investors have been playing an increasingly important role in the early-stage financing of entrepreneurial and private firms. Using Abel Noser institutional trading data, Nefedova and Pratobevera (2020) find results indicating that some institutions hide their sell trades and break their laddering agreements with their underwriters. The authors find that institutions buy IPO shares through lead underwriters but sell them through other brokers in the aftermarket, and that 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 venture capitalists' (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 that this 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 that VC-backed platforms are less likely to default.

Using a manually collected dataset of 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 benefits side, the authors find that companies backed by politically connected VCs are more likely to obtain IPO approval. However, 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 IPO.

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 datasets 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, and 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 effects 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 the 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 the 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 that use the historical cost method. The authors find that managers do not have superior skill after including transaction costs for trades with a 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. The authors also provide evidence of potential behavioral biases by institutional traders, such as the disposition effect and overconfidence.

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 that this 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 that 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 increased regulatory attention reduces portfolio pumping by U.S. mutual funds, and causes spikes in fund indices, fund holdings, and institutional trading to decline. Such declines are largest around year-ends and for small-cap and better-performing funds,

and occur faster for funds headquartered near SEC regional offices. These findings are consistent with and reconcile 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&As, 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, we have demonstrated that institutional investors, a traditional focus of academic research in investments, play important roles in almost all areas of corporate finance that are 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 fruit for researchers, as successfully demonstrated by some of the 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 a good example. Originally a market microstructure dataset, it is now widely used in all areas of finance: corporate finance, investments, and market microstructure. In addition, the data are increasingly used in accounting. The Abel Noser data page (http://ganghu.org/an) currently lists 94 (and counting) publications using Abel Noser data thus far, compared with the 55 publications listed in Hu et al. (2018). In other words, there have been 39 new publications using Abel Noser data within the last two years, compared to 55 publications during the previous 26 years, 1993−2018. We anticipate that this strong publication trend will continue in the foreseeable future, as many research topics, in corporate finance and otherwise, can be reexamined 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 the quarter- and year-end trading activities of institutional investors, all using Abel Noser data.

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