

# **Block Diversity and Governance**

By Ryan Israelsen, Miriam Schwartz-Ziv, and James Weston

# Motivation

- Debate on extent financial institutions are involved in the firms they manage

Passive investors, not passive owners

IR Appel, TA Gormley, DB Keim

Journal of Financial Economics 121 (1), 111-141

[\[PDF\] Passive investors are passive monitors](#)

[D Heath, D Macciocchi, R Michaely...](#) - SSRN Electronic ..., 2018 - [staff.lusem.lu.se](http://staff.lusem.lu.se)

- Limited literature on nonfinancial blocks.
- Edmans and Holderness (2017) → There is a need to explore block diversity.

# Motivation cont.

- We test whether **different kinds of blockholders** drive **different corporate governance practices**. We focus on **financial** versus **committed** i.e., non-financial blocks.

Walmart 



 TARGET

 **Fidelity**  
INVESTMENTS

- Financial institutions typically act as **agents** for a large number of clients, which raises the marginal cost of delegated monitoring and increases agency cost.

# Preview of Findings

- Committed (non-financial) blockholders are 6 times more likely to file as **active investors** than financial blockholders.
- Analyze 13D filings for all types of blockholders. Filings reveal that nonfinancial blocks tend to govern through **tailored actions**, while financial blocks tend to follow **generic performance measures**.
- When firms for which close monitoring is likely to be valuable (i.e., small, volatile, and illiquid firms) are **matched** to a non-financial blockholder the market responds especially positively.
- Implications for **Russell** discontinuity studies - previous conclusions about the governance of passive blocks may actually reflect variation in unobserved **committed block** ownership, leading to a different **economic interpretation**.

# Data Sources

- We obtain **13D** and **13G** filings from the SEC's EDGAR website.
- Annual snapshot of blockholdings from **Factset**, which documents all 5% ownership positions revealed in any public financial (Schwartz-Ziv and Hadlock (2019)).
- Financial data are collected from CRSP, Compustat, MSCI, and Seek Edgar.

# Committed vs. Financial Blocks

Table 1



	Blockholder Type	
	Committed	Financial
Agent for other investors?	No	Yes
Average number of blocks held	1.18	10.68
Block size / outstanding shares (%)	15.7	8.1
Implied duration of block (years)	3.57	2.7
Blockholder within 50 miles of firm (%)	12.4	7.0
Total shares held by blockholder (%)	13.88	13.98
Firms with at least one such block (%)	52.44	64.18
Average firm market capitalization (Billions)	15.53	28.45
Average firm age (since IPO)	13.9	17.8

These differences should drive significant patterns in the **mechanisms** shareholders employ to **mitigate the agency costs** that stem from the separation of ownership and control. 6

# Governance by Committed vs. Financial Blocks

- Committed blockholders typically hold a **single large** block in a **young** firm, while financial blockholders own an average of **10 smaller** blocks in large and **mature** firms. Committed blocks also tend to be **geographically** closer to the firms they hold.
- These differences suggest that committed blocks may **govern** the firms they hold **more closely**.

# Frequency of 13D and 13G Filings by Type of Block Owner

Table 2

Filing Type	Investor Type (2 groups)		Investor Type (4 groups)			
	Committed	Financial	Individual	Hedge Funds	Other Private	Institutional
13D (%)	45.4	7.13	51.2	9.6	45.2	6.6
13G (%)	54.5	92.9	48.8	90.4	54.8	93.4
Total	88,729	119,164	38,036	91,403	40,039	38,344
13D/A (%)	48.3	10.7	49.9	14.3	51.3	8.3
13G/A (%)	51.7	89.3	50.1	85.7	48.7	91.7
Total	221,729	360,389	92,300	271,484	98,581	119,753

A 13D filing is filed by an active investor.

A 13G is filed by a passive investor who does not have an intention to exert control over the company.



# Do Committed and Financial Blocks Self-identify as Activists?

- 45.4% of committed blocks **self-identify as activists**, compared to 7.13% of financial block → committed blocks are **6+** times more likely than financial blockholders to self-identify as **active** shareholders.
- This difference suggests that:
  - Committed blocks are more likely to view themselves as **active** and involved shareholders who use their **voice**.
  - Each of the two types of blockholders have different economic motivations and different **perceptions** on their role as shareholders.

# How do Blockholders State that They Will Govern?

- We follow the approach of Brav, Jiang, Partnoy, and Thomas (2008) and examine how blockholders **state** they plan to be active after they acquire their block (conditional on a 13D filing).
- Using textual analysis of all **48,863 13D** filings between 1994 and 2018.
- We employ a **textual analysis** of **Item 4** (Purpose of Transaction) of the 13D filing. We measure the most **common words** and the most common two-, three-, and four-word phrases.

# 13D Example

## Item 4. Purpose of Transaction

The Reporting Persons acquired the Common Stock and options for the purposes described in this Item 4. The Reporting Persons may cause the Pershing funds to make further acquisitions or dispositions of securities of the Issuer including Common Stock or derivative securities at any time. The Reporting Persons acquired a 9.3% stake in the Issuer because of their belief that the market price of the Common Stock is substantially less than the intrinsic value of the Issuer on a per share basis. Representatives of the Reporting Persons intend to meet with management and other representatives of the Issuer and may make one or more proposals with respect to potential changes in the operations, capital structure, or business strategy of the Issuer in an effort to enhance shareholder value. These proposals may include, but would not be limited to, a proposal that the Issuer spin off one or more divisions of the Issuer, commence certain asset sales and refranchisings, initiate a restructuring which may include a conversion to a real estate investment trust, and/or a recapitalization of the Issuer. The Reporting Persons may engage investment bankers, consultants, accountants, attorneys, or other advisors to assist it, and may contact other shareholders of the Issuer to discuss any and all of the above. The Reporting Persons have no current intention of acquiring control of the Issuer.

# Analysis of 13D Filings

- Using textual analysis tools, we find that financial blocks focus on **standard performance measures**, while committed blockholders discuss topics more consistent with internal **active management** of corporate policies.

I. Examine the content of 13-D filings.

# Textual Analysis of 13D Filings: Stated Objectives by Investor Type

Table 5 Panel A

Item 4 Topic	2 Investor Types			4 Investor Types			
	Committed	Financial	Difference (Com.-fin)	Individual	Hedge Funds	Other Private	Institutional
Maximize Shareholder Value	0.8	4.9	-4.1***	0.5	4.6	0.8	2.4
Undervalued	2.7	21.9	-19.2***	1.8	20.6	2.8	11.2
Max. Sh. Value / Undervalued	3.3	25.3	-22***	2.2	23.8	3.4	12.9
Economic/Market/Industry	7.5	14.1	-6.6***	5.3	16.6	8.6	6.4
Capital Structure	2	16.5	-14.5***	1.2	16.8	2.1	4.6
Dividend	34.3	26.1	8.2***	37.3	29.3	31.5	22.8
Repurchase	2.1	3.8	-1.7***	0.9	3.6	3	4.9
Restructuring	1.5	10.1	-8.6***	0.8	10.5	1.7	2.2
Elect/Nominate	10.4	11.7	-1.3***	6.8	12.6	13.1	14
Vacancy	25.4	10.4	15***	29.8	11.8	22.2	13.5
Elect/Nominate/Vacancy	32.8	19.8	13***	34.2	21.5	31.9	25.3
Operations	14.5	42.3	-27.8***	10.8	45.4	15.7	18.3
Number of Observations	30,353	6,716		13,909	6,809	13,654	2,019

Committed blockholders mention in 32.8% of their 13D filings at least one of the words “elect/nominate/vacancy” (typically used to discuss electing a director), while financial blocks do so in only 19.8% of their 13D filings. On the other hand, financial blockholders use more arms-length and transactional language, suggesting they govern as passive monitors through the threat of exit. For example, 25.3% of the financial blocks use the term “maximize shareholder value” or “undervalued”, but only 3.3% of committed blocks do so.

I. Examine the content of 13-D filings.

# Textual Analysis of 13D Filings: Language Usage of Stated Objectives

Table 5 Panel B

Language Measure	Investor Type (2 groups)		Investor Type (4 groups)			
	Committed	Financial	Individual	Hedge Funds	Other Private	Financial
Specificity	6.3%	4.9%	6.06%	4.92%	6.67%	5.73%
Weak Modal	7.1	11.3	6.7	11.7	7.1	9.2
Strong Modal	2.4	1.8	1.8	2.0	3.1	2.1
Weak minus Strong Modal	4.7	9.5	4.9	9.7	4.0	7.0
Negative	8.8	7.7	8.8	7.9	8.8	8.0
Positive	3.9	5.6	3.5	5.6	4.3	4.9
Negative minus Positive	4.8	2.1	5.3	2.3	4.5	3.1
Uncertainty	8.4	13.2	7.8	13.7	8.5	10.6
Number of Observations	30353	6716	13909	6809	13654	2019

**Financial** blocks tend to use **positive, standard, vague, and cautious language** in their filings. We view these findings as indicating that financial blocks use the filings as an opportunity to **cautiously portray themselves in a positive light**, although they are **not specific** on the actions they intend to take.

\*Specificity - alludes to specific places, people, organizations, dates, times, and quantities

# Market Reaction to Block Entries

(DGTW-adjusted returns during [0,5] window around 13-D filings.)

Table 5

## High vs. Low Volatility

Characteristic	Committed	Financial	Individual	Other Private	Hedge Funds	Institutional
high volatility	0.017 (0.003)***	0.015 (0.004)***	0.023 (0.004)***	0.009 (0.003)***	0.022 (0.005)***	0.011 (0.009)
low volatility	0.003 (0.002)*	0.011 (0.002)***	0.004 (0.003)	0.002 (0.003)	0.010 (0.002)***	0.012 (0.004)***
Difference high - low	0.014 (0.004)***	0.004 (0.004)	0.019 (0.005)***	0.007 (0.005)***	0.012 (0.006)***	-0.001 (0.009)
N	5155	2287	2055	2568	2322	497

- Demsetz and Lehn (1985) hypothesize that the benefits of **monitoring** are elevated in **high-risk environment** in which there is uncertainty.
- The market response to committed block entry is significantly more positive and larger in high volatility firms.

# Market Reaction to Block Entries

(DGTW-adjusted returns during [0,5] window around 13-D filings.)

Table 5

## Large vs. Small Firm

Characteristic	Committed	Financial	Individual	Other Private	Hedge Funds	Institutional
Large firms	-0.001 (0.002)	0.013 (0.002)***	0.004 (0.004)	-0.002 (0.003)	0.010 (0.002)***	0.013 (0.004)***
Small firms	0.017 (0.002)***	0.018 (0.004)***	0.022 (0.004)***	0.011 (0.003)***	0.022 (0.003)***	0.016 (0.01)
Difference large - small	-0.018 (0.003)***	-0.005 (0.004)	-0.017 (0.006)***	-0.013 (0.005)	-0.012 (0.004)***	-0.003 (0.011)
N	5295	2249	2187	2520	2317	520

- **Less public information** is available for small firms, therefore, the marginal cost of **close monitoring** in small firms may be higher, (Helwege, Pirinsky, and Stulz (2007))
- Indeed, especially when a committed block enters a small company, abnormal return are negative.



# Market Reaction to Block Entries

(DGTW-adjusted returns during [0,5] window around 13-D filings.)

Table 5

## High vs. Low Liquidity

Characteristic	Committed	Financial	Individual	Other Private	Hedge Funds	Institutional
Low liquidity	0.018 (0.002)***	0.014 (0.003)***	0.023 (0.004)***	0.012 (0.003)***	0.017 (0.003)***	0.011 (0.009)
High liquidity	0.002 (0.003)	0.015 (0.002)***	0.011 (0.005)	-0.002 (0.004)	0.013 (0.003)	0.012 (0.004)
Difference low - high	0.016 (0.004)***	-0.001 (0.004)	0.012 (0.006)***	0.014 (0.005)	0.004 (0.004)***	-0.001 (0.01)
N	5219	2226	2175	2469	2284	517

- Bhidé (1993) and Holmström and Tirole (1993) argue that **stock liquidity discourages internal monitoring** by reducing the costs of ‘exit.’ As a result, financial institutions may shun low liquidity firms if they expect a more costly exit on the margin.
- Indeed, especially when a committed block enters a low liquidity company, abnormal return are negative.

# Governance by Committed vs. Financial Blocks

Table 3

Regressions control for log market capitalization, ROA, Tobin's Q, log sigma, Year FE, Industry FE, and cluster on the firm-year level.

Companies with a committed block are 14% (-0.0070/0.05) less likely to be targeted by a shark attack relative to the unconditional mean.

	Was there a shark attack (1)	Shareholders proposal submitted (2)	Campaign resulted in board seat for activist (3)	Average support rates directors (aggregate level) (4)	Average support rates say-on-pay (aggregate level) (5)	Poison pill (6)	Merger vote (7)
Committed block exists	<b>-0.0070*</b> <b>(-2.008)</b>	-0.0267*** (-3.677)	<b>-0.0384*</b> <b>(-2.004)</b>	<b>0.0050*</b> <b>(1.837)</b>	<b>0.0123*</b> <b>(2.091)</b>	<b>-0.0710**</b> <b>(-2.891)</b>	-0.0373** (-3.031)
Financial block exists	<b>0.0128***</b> <b>(4.085)</b>	-0.0532*** (-4.287)	<b>0.004</b> <b>(.185)</b>	<b>-0.0091***</b> <b>(-5.741)</b>	<b>-0.0081</b> <b>(-1.460)</b>	<b>0.0421**</b> <b>(2.875)</b>	-0.0319* (-2.077)
R-squared	0.02	0.251	0.013	0.032	0.033	0.129	0.09
N	47,111	16,952	2,251	16,208	6,600	22,907	22,405
Unconditional mean	0.05	0.1359	0.1655	0.9412	0.8951	0.2343	0.2261

- Committed companies are less likely to be targeted by an **activist**, or to have a shareholder **proposal** submitted.
- When an activist targets the company, the **activist is less likely to succeed** in appointing his director to the board.
- Committed firms have less **mechanisms** in place to block external governance, for example, <sup>18</sup> committed companies are less likely to have takeover defenses such as a **poison pill**.

# Governance by Committed vs. Financial Blocks

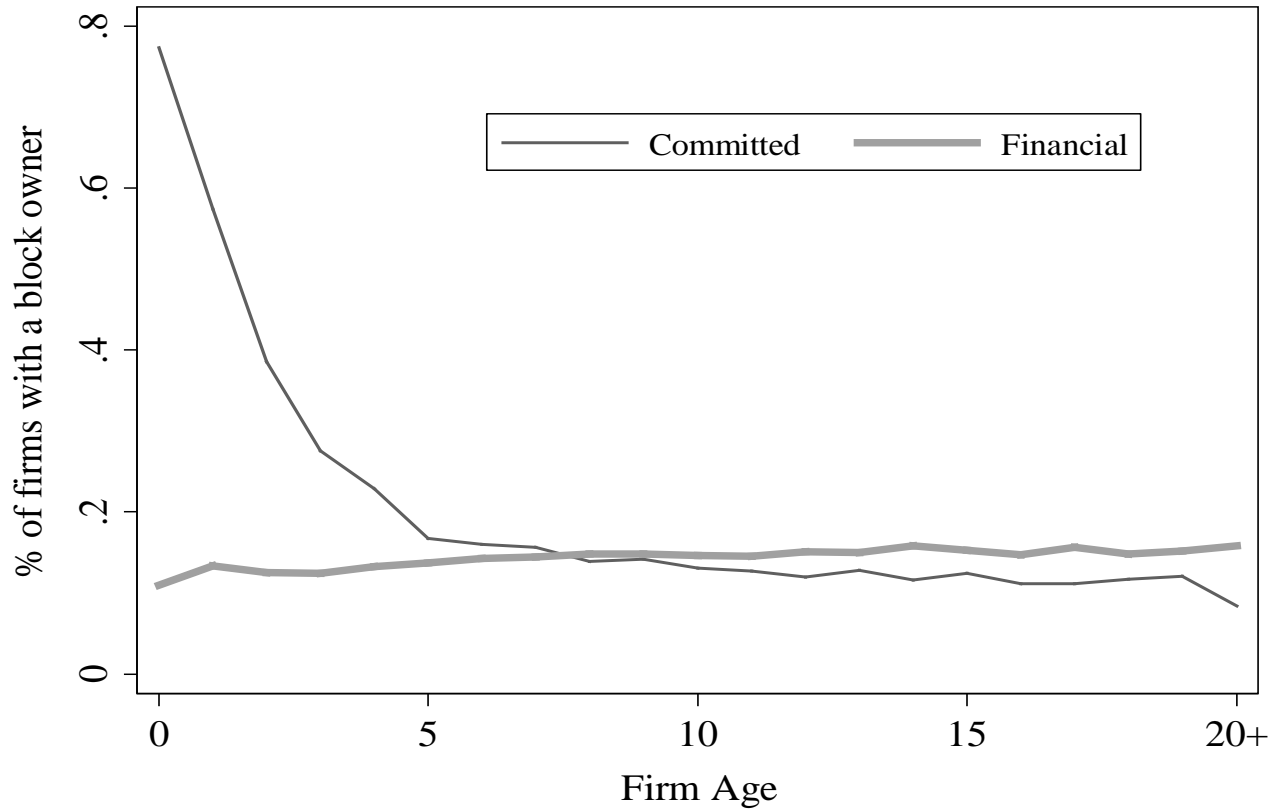
Table 3

- For most of the governance variables we test, we find **opposing** patterns for firms with committed blockholders versus firms with a financial block.
- Relative to firms with a financial block, firms with a committed blockholders use **less formal mechanisms** for monitoring, and they are more **immune** to external governance.

# Endogeneity

- The patterns we document could be driven by **endogenous** matching. Perhaps committed blockholders are **attracted** to firms that are best/ likely to be monitored via voice. We conduct several tests to gauge this challenge.
  - We focus on young firms in which founders likely design governance practices.

# The Life-Cycle of Firm Ownership



# Blockholders and Firm Life Cycle

- As firms **mature**, they adopt more **external governance mechanisms** that coincide with the **shift in share ownership** from committed blockholders to delegated portfolio managers.

# Stated Objectives of 13D for Young Firms

Table 7

	Young			
	Com.	Fin.	Diff.	T-stat
Maximize Shareholder Value	0.25	1.37	-1.12	-2.29
Undervalued	0.78	7.88	-7.10	-6.29
Economic/Market/Industry	15.86	15.75	0.11	0.06
Capital Structure	1.97	11.82	-9.85	-7.21
Dividend	28.89	28.25	0.64	0.31
Repurchase	1.07	2.23	-1.16	-1.80
Restructuring	1.27	7.02	-5.75	-5.32
Elect/Nominate/Vacancy	28.52	19.01	9.52	5.11
Elect/Nominate	9.34	7.36	1.98	1.61
Vacancy	21.43	13.53	7.91	4.82
Operations	14.96	33.22	-18.26	-8.79

## Stated Objectives of 13D Broken Down by Firm Age

- **The difference between committed blocks and financial blocks is large and persistent for almost all variables and all age terciles.**
- These findings demonstrate that even at different stages of a firm's life cycle, committed blocks **consistently envision a different governance** style relative to financial blocks.



# Corporate Governance Practices of Young Firms Broken Down by Committed Versus Financial Blocks

Table 6 Panel A

	Young			Dif in exp.
	Com.	Fin.	Dif.	Dir
Was there a shark attack	0.038	0.054	-0.016	Yes
Shareholders proposal submitted	0.018	0.037	-0.018	Yes
Campaign resulted in board seat for activist	0.163	0.080	0.083	No
Average support rates directors (aggregate level)	0.951	0.945	0.005	Yes
Average support rates say-on-pay (aggregate level)	0.938	0.929	0.009	Yes
Poison pill	0.050	0.085	-0.034	Yes
Merger vote	0.000	0.120	-0.120	Yes
CEO tenure	0.000	4.705	-4.705	Yes
Percent of directors over 15 years tenure	0.000	0.021	-0.021	No
Percent of outside directors	0.806	0.812	-0.006	No
Number of non-executive board meetings held	0.000	0.858	-0.858	Yes
No female on board (binary)	0.000	0.521	-0.521	Yes
Ln of number of words in 10-K filings	0.000	9.612	-9.612	Yes

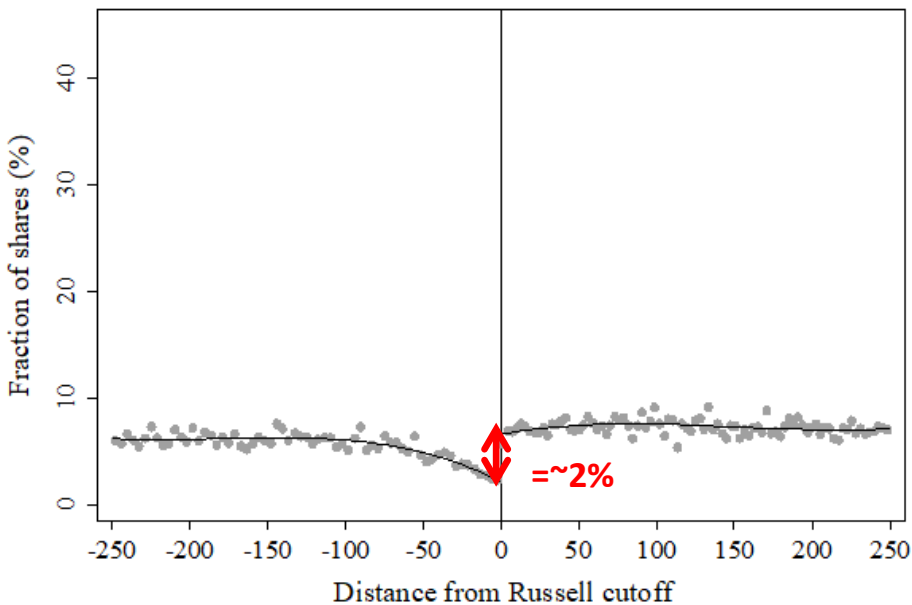
# How should we Interpret the Russell Discontinuities Studies?

- Since committed blockholders are often **removed** from calculations of a firm's public float, an index weight based the float will introduce a selection bias that is correlated with governance.
- We reconsider the findings of recent studies that exploit a **discontinuity in Russell** index weights as a source of exogenous variation in ownership (e.g., Boone and White (2015), Appel, Gormley, and Keim, (2016), Crane, Michenaud, and Weston (2016)). We show that the **float adjustment** made by Russell introduce a **selection bias** based on ownership by committed blocks. As a result, previous conclusions about the effect of passive investing may actually reflect variation in **unobserved committed block ownership**, leading to a starkly different interpretation.

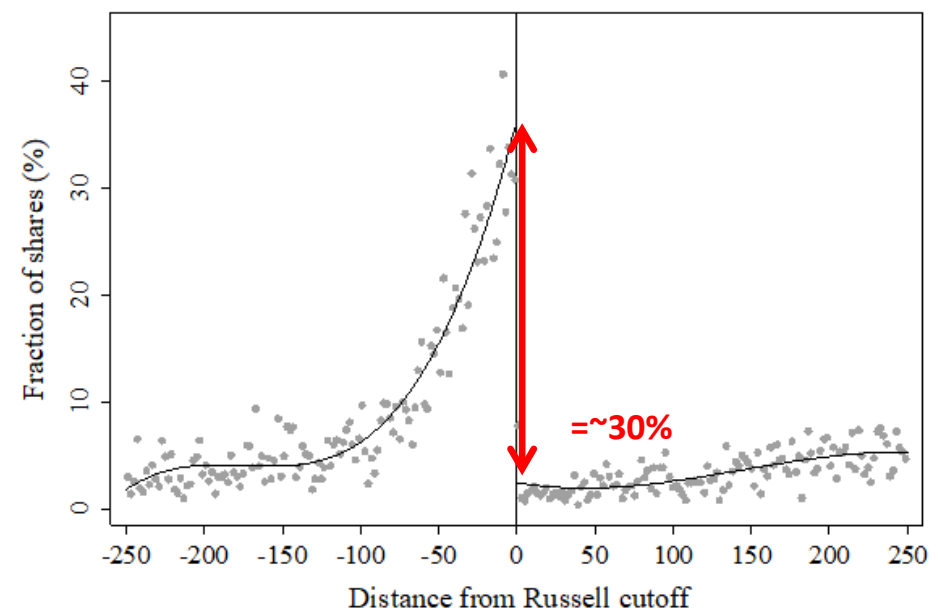
# Blockholdings around Russell Discontinuity

## Ranked by Russell's Weights

Index funds



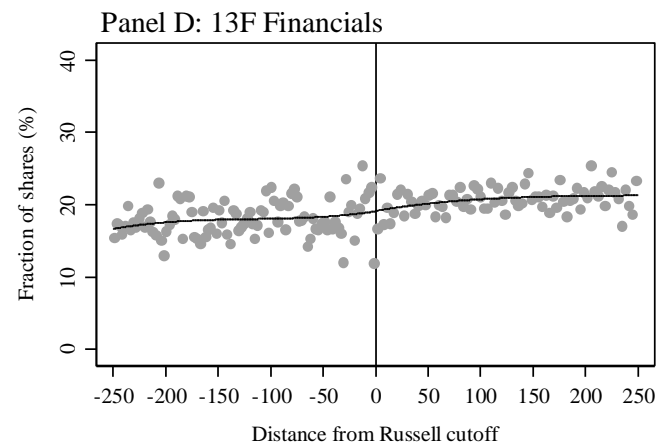
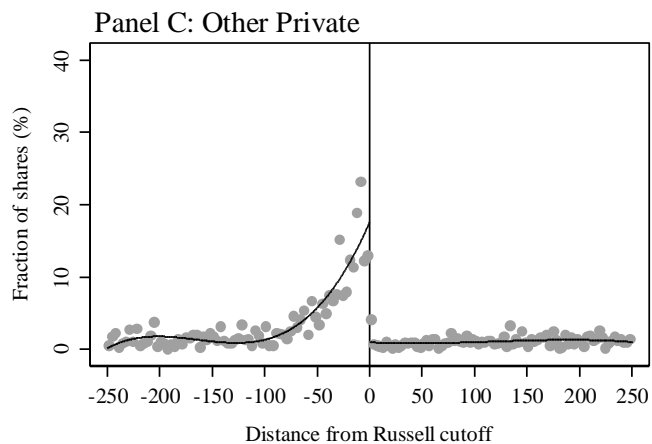
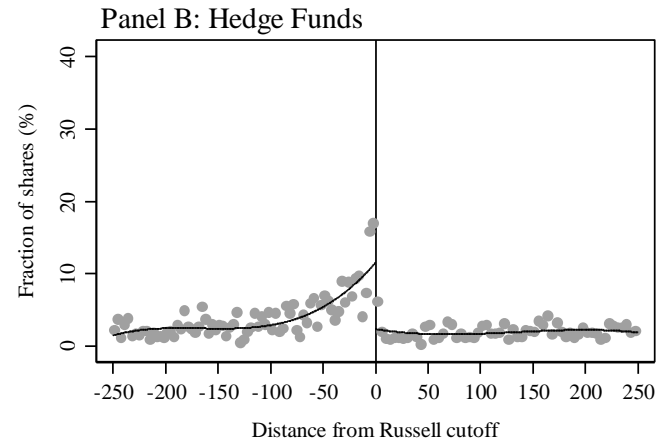
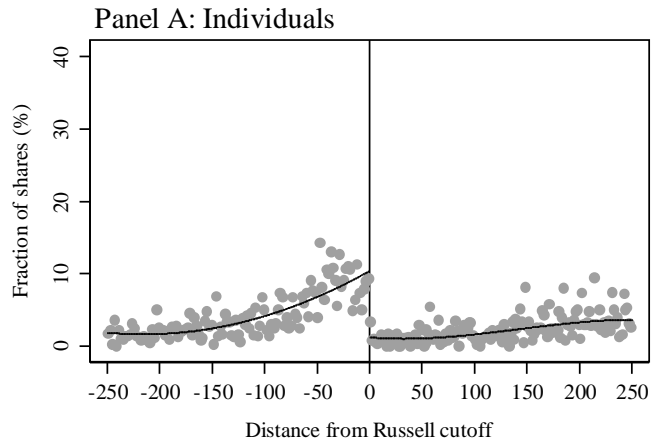
Committed blocks



Boone and White (2015), Appel, Gormley, and Keim (2016) Crane Michenaud and Weston (2016).

- Committed blockholders change public float calculations and contaminate measures of passive investing around index thresholds, changing the **economic interpretation**.
- Consider, as an example, the results in Appel, Gormley, and Keim (2016) who argue that passive investors monitor **aggressively**. Given the analysis above, it is not clear whether passive index funds take a more active role, or whether committed blockholders are less likely to engage in external monitoring because they monitor quietly behind the scenes.

# Block-type Ownership around Russell Discontinuity



# Performance of Committed versus Financial Blocks

- In a portfolio that takes a long position in firms with a **committed** blockholder, and a short position on firms with a **financial** blockholder, we find **no differences in returns**.
- Consistent with Demsetz and Villalonga (2001), our findings imply that the disadvantages of more passive ownership by financial blocks appears to be **offset by more formal contracting** mechanisms resulting in a lack of any systemic equilibrium relation between blockholder type and financial performance.

# Performance of Committed versus Financial Blocks

Model	Blockholder Type		
	Committed	Financial	Long-short
Excess return (VW)	0.003 (0.82)	0.005 (1.46)	0.002 (1.20)
Excess return (EW)	0.007 (1.67)	0.010 (2.21)	0.002 (1.30)
CAPM (VW)	-0.001 (-1.05)	0.001 (0.95)	0.002 (1.175)
CAPM (EW)	0.003 (1.05)	0.004 (2.67)	0.002 (1.03)
3-Factor FF (VW)	-0.001 (-0.93)	0.001 (0.64)	0.002 (0.97)
3-Factor FF (EW)	0.001 (0.40)	0.002 (2.45)	0.002 (0.88)

We find no differences in profitability or total return to stockholders for firms with committed blocks (returns are in monthly basis points).

# Is Block Diversity Detrimental?

- Volkova and Schwartz-Ziv (2021) find that diversity among large blockholders is detrimental to firm performance.
- They show that lagged disclosure, on exogenous predetermined dates, revealing an increase in block diversity, is followed by a negative market reaction.
- **Data on blockholding is posted a Kate Volkova's website.**

# Summary and Conclusions

- Demonstrate how **governance varies** depending on the block type. Our study is the first to examine, for *all* types of blockholders for all 13D filings. We demonstrate that financial blocks are more likely to **actively** monitor the firms they hold, and to **tailor** their governance practices, while committed blocks tend to focus on generic observables measures that “**maximize shareholder value**”.
- We show that when firms for which **close monitoring** is likely to be especially **valuable** (i.e., small, volatile, and illiquid firms) are matched to a blockholder who typically monitors closely (i.e., a nonfinancial blocks), the market responds especially positively.
- Uncover a limitation in the Russell index discontinuity design, potentially suggesting a new economic interpretation to prior Russell studies.