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Goergen, M.; Renneboog, L.D.R.; Zhang, C.

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**DO UK INSTITUTIONAL SHAREHOLDERS MONITOR THEIR
INVESTEES FIRMS?**

By Marc Goergen, Luc Renneboog, Chendi Zhang

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Do UK institutional shareholders monitor their investee firms?

Marc Goergen^{a,c} Luc Renneboog^{b,c} and Chendi Zhang^a

^a University of Sheffield Management School

^b Tilburg University

^c European Corporate Governance Institute (ECGI)

ABSTRACT

As institutional investors are the largest shareholders in most listed UK firms, one expects them to monitor the firms they invest in. However, there is mounting empirical evidence which suggests that they do not perform any monitoring. This paper provides a new test on whether UK institutional investors engage in monitoring. The test consists of an event study on directors' trades. If institutional shareholders act as monitors, their monitoring activities convey new information about a firm's future value to other outside shareholders and reduce the informational asymmetry between the managers and the market. As a result, directors' trades convey less information to the market, and the stock price reaction is weaker. However, our results show that institutional shareholders do not have any significant impact on the stock price reaction which stands in marked contrast with the impact that families, individuals and other firms have on stock prices.

JEL codes: G14, G39

Keywords: Insider trading, institutional investor monitoring, shareholder activism, corporate governance, ownership and control

Corresponding author: Marc Goergen, University of Sheffield Management School, 9 Mappin Street, Sheffield S1 4DT, UK; email: m.goergen@shef.ac.uk.

1. Introduction

There is now a wealth of empirical studies which show that control of listed UK firms is very different from that of Continental European firms. The European Corporate Governance Network (ECGN), the precursor of the European Corporate Governance Institute (ECGI), undertook a project analysing the control of 8 Continental European countries¹, the UK and the US. The results, which were published in Barca and Becht (2001), show that most listed UK and US firms are widely held whereas the vast majority of Continental European firms have a large dominant shareholder. Also, the types of shareholders that predominate are different. In most of Continental Europe, family control as well as control by other firms is important. In contrast, in the UK, institutional shareholders are the most common type of large shareholder, followed by directors who own large minority stakes in most quoted firms.

The Japanese and German corporate governance systems have now somewhat fallen into disrepute with the advent of shareholder protection and the weak economic performance of both countries over the past 15 years. However, in the past, one of the major comparative advantages of these systems was thought to be the monitoring of firms by banks. Although the empirical evidence on the effectiveness of such monitoring is not entirely conclusive, there are several papers which suggest that banks have a positive impact on firm performance as well as dividend policy. For example, Cable (1985) reports that firms with bank control perform better than those without. There is also evidence that when the large universal banks provide most of the debt financing to listed German firms the firms' total factor productivity increases. The beneficial influence of these universal banks is especially apparent in the wake of poor performance (Köke and Renneboog 2005). Further, Goergen *et al.* (2005) find that firms controlled by banks benefit from more flexibility in terms of their dividend policy, as the need for costly dividend signalling is less pronounced.

Conversely, one of the main shortcomings of the UK system is thought to be passiveness of institutional investors and the resulting high discretionary power of directors. Although institutional shareholders control a large proportion of votes, they are often reported to abstain from voting in AGMs or rubber-stamp the management's motions (see e.g. Goergen and Renneboog 2001). As a result, managers are left with substantial levels of discretion as to how they run the firm. Recent outcries in the popular press about the levels of managerial

¹ The 8 Continental European countries are Austria, Belgium, France, Germany, Italy, the Netherlands, Spain and Sweden.

compensation and payments for bad-performance (so called golden handshakes) have called for a more substantial involvement of institutional investors in companies' affairs.

However, tests on the degree of involvement of institutional investors in the firms they invest in are notoriously difficult to conduct for at least two reasons. First, institutional investors may act behind the scenes rather than vote at the AGM. This would make their involvement virtually invisible to outsiders. Second, ownership and control patterns in general, and institutional ownership and control in particular, may be endogenous to firm performance. This is an issue central to studies which analyse the impact of ownership and control on firm performance.

The aim of this paper is to perform a new test of whether UK institutional investors engage in monitoring or not. The test consists of an event study on directors' trades. If institutional shareholders are monitors, their presence as major shareholders should convey value-relevant information to other outside shareholders and reduce the informational asymmetry between the managers and all the shareholders. Directors' dealings should then have lower informational value and this should in turn be reflected in a weaker market reaction.

The remainder of the paper is structured as follows. Section 2 compares the ownership and control of UK firms to that of Continental European firms. It also reviews the literature on monitoring by institutional investors and the other main types of shareholders in the UK. Section 3 reviews the literature on insider trading and presents a brief overview of the UK regulation on directors' dealings. The following section formulates the conjectures which are then tested in Section 5 and discusses the data sources and methodology employed in the event study. Section 6 concludes.

2. Ownership, Control and Monitoring by Institutional Shareholders

One of the main differences between the UK on one side, and Continental Europe and Japan on the other side, is the much higher dispersion of ownership in the UK. Figure 1 shows that in Continental Europe a majority of firms have a shareholder owning at least a blocking minority of the votes, i.e. 25%. The UK and USA are exceptional in the sense that they have the opposite pattern with the vast majority of their listed firms being widely held.

The UK also differs from Continental Europe in terms of the relative importance of the largest shareholder. Table I shows that, on average, the largest shareholder has virtually uncontested control over the firm given the small stake held by the second largest shareholder. In contrast, in the UK and the US, the largest shareholder tends to face another large minority

shareholder. Further, table II shows that, in Continental Europe, families, other firms, and the government dominate whereas, in the UK, it is institutional investors (mainly insurance companies and investment funds) followed by directors.

[INSERT FIGURE 1 AND TABLES I AND II ABOUT HERE]

Although institutional investors are the largest owners of UK listed firms, they have been accused by the Cadbury (1992), Hampel (1998) and Newbold (2001) corporate governance committees of being too passive investors. In a review of institutional investments in the UK, Myners (2001) points out that UK institutional investors are ‘unnecessarily reluctant’ to take an activist stance in relation to corporate underperformance. Stapledon (1996), Goergen and Renneboog (2001), and Faccio and Lasfer (2000) argue that institutional investors do not normally intervene for two reasons. First, they lack the monitoring expertise. Second, they may want to maintain the liquidity of their investments as insider-trading regulation prevents monitors from rebalancing their portfolios. In contrast, recent anecdotal evidence suggests that, even though institutional shareholders do not publicly intervene, they do act behind the scenes. Moreover, surveys on the actual voting behaviour of investment funds reveal that vote casting by institutions has been improving rapidly. Some institutions have established voting policies committing themselves to cast their votes on e.g. major investment decisions in their investees (for examples, see Mallin 1999), and have recently begun to set even agendas for shareholder activism (Mallin *et al.* 2005).

The empirical evidence seems to be virtually unanimous in agreeing on an absence of monitoring by institutional investors in the UK.² Franks, Mayer and Renneboog (2001) investigate whether the presence of blockholders in poorly performing UK companies is related to increased board restructuring. They find no such evidence. The only consistent relation they find is a significantly negative link between managerial ownership and executive board turnover. They interpret this finding as clear evidence of managerial entrenchment: managers with a substantial degree of control are able to ward off successfully any attempts to remove them. Crespi and Renneboog (2002) analyse whether voting coalitions are formed by shareholders in order to take corporate governance actions such as the disciplining of the

² In contrast, there is a sizeable body of literature which suggests that German banks which own large minority stakes in otherwise widely held firms perform monitoring tasks and that this monitoring is not a recent phenomenon (see, e.g., Cable 1985, Gorton and Schmid 2000, Correia *et al.* 2004 and Goergen *et al.* 2005). However, empirical studies fail to find evidence of a consistent, positive impact of German banks on firm performance (Chirinko and Elston 1996, 2000) and on board turnover in poorly performing companies (Franks and Mayer 2001).

incumbent management. They use Shapley values to capture the relative power of shareholder coalitions by category of owner (e.g. institutional investors). They show evidence of successful resistance by executive directors against board restructuring in cases where the executive directors as a group can combine their ownership stakes to form a substantial block of voting power. However, investment trusts, pension funds and funds managed by banks do not seem to play a role in the management replacement process.

Goergen and Renneboog (2001) investigate whether investment spending by UK firms is sensitive to the availability of internal funds. In particular, the authors analyse whether the relationship between corporate investment and free cash flow depends on the control structure of the firms (and hence the relative importance of institutional investors). Control is expected to influence the relation between investment and financing for two reasons. First, due to asymmetric information, the existence of a link between liquidity and investment may cause underinvestment. Firms may turn down some projects with otherwise positive net present values because of the inflated cost of external funds. Second, from an agency perspective, the management may not perceive external funds to be too expensive but may perceive internal funds (free cash flow) to be too inexpensive. Goergen and Renneboog's research shows that, when industrial companies own large shareholdings, there is evidence of a relationship between cash flows and investment in their investee companies. This relation is strong when the relative voting power (measured by the Shapley values) of the combined equity stakes of industrial companies and the Herfindahl index of industrial ownership are high. This suggests that a coalition of industrial companies causes excessive investment spending.³ In contrast, large institutional holdings reduce the positive link between investment spending and cash flow and hence mitigate the underinvestment problem. This paper is one of the few studies based on large data sets suggesting that the presence of institutional shareholders does matter and leads to increased (investment) efficiency.

To summarize, the literature suggests that UK institutional investors are mostly passive shareholders.

³ Related literature on the corporate governance role of French holding companies, which constitute the dominant shareholder category in France, suggests that the presence of financial and industrial holding companies as major shareholders reduces corporate performance (Banerjee, Leleux and Vermaelen 1997). In Belgium, firms whose ultimate blockholder is a holding company do not experience increased executive board turnover, whereas firms whose ultimate blockholder is an industrial or commercial company experience board restructuring when their accounting and share price performance declines (Renneboog 2000).

3. Insider Trading

Under asymmetric information, insiders, that is managers and members of the board of directors, of publicly traded corporations hold more information about their company than small, outside shareholders. The informational advantage of insiders and its exploitation via insider trading raises the question as to the fairness and efficiency of financial markets. Lakonishok and Lee (2001) highlight the importance of this question. Based on a data set covering all the companies traded on the Amex, NYSE, and Nasdaq over the period of 1975-95, they report that insider trading is frequent as it occurs in more than 50% of the stocks in each year. On average, insider purchases (sales) per year amount to 0.6% (1.3%) of a company's market capitalization. Lakonishok and Lee (2001) show that the insider trades are largely ignored by the market upon announcement, but that insiders are able to make significantly positive returns over the long term. The major argument in favour of permitting insider trading is that it is believed to convey new information on the firm to the market. Consequently, given that share prices incorporate better information, shareholders require lower returns and bear less risk. Similarly, Leland's (1992) model predicts that allowing insider trading results in higher share prices on average due to the improved informational efficiency and reduced risk.

Although an insider purchase conveys straightforward, positive information about the firm's prospects, the information conveyed by an insider sale is less evident. Indeed, an insider sale may be less informative given that the reason behind the sale may be a need for liquidity rather than the insider's belief that the firm's future value will be lower than what the market anticipates. Also, an insider may sell shares because of the exercise of stock options. Such option-related sales of shares may contain little or no information about the firm's future value as they tend to form part of the insider's remuneration package.

A vast body of empirical literature confirms the above predictions as to the market reaction to insider purchases and sales. Seyhun (1986), Lin and Howe (1990), and Chang and Suk (1998) report positive abnormal returns on insider purchases for the case of the USA. King and Röell (1988), Pope *et al.* (1990), Gregory *et al.* (1994), and Gregory *et al.* (1997) confirm the existence of positive abnormal returns for the UK over horizons of 6 to 12 months following directors' purchases. More recent studies by Friederich *et al.* (2002) and Fidrmuc *et al.* (2006) corroborate the findings of the previous studies for UK companies over the short term. They find positive abnormal stock price reactions to directors' purchases and negative ones to sales.

In the UK, the 1977 Model Code of the London Stock Exchange (LSE) and the 1985 Companies Act regulate insider trading. According to the Misuse of Information Act, insider information is information that is new, material, and not known by the market. The Criminal Justice Act makes trading on insider information – i.e. information not regularly available and obtained through insiders – a legal offence subject to prosecution. The Financial Services and Markets Act (FSMA) of 2000, which became effective as of 1 December 2001, further refines the definition of illegal insider trading⁴ and specifies a dual prosecution track that facilitates the procedures to bring insider trading violations to court. Lack of disclosure, violation of trading bans, and misuse of inside information can be prosecuted under the Misuse of Information Act using either a civil law or a criminal law procedure.⁵ Our paper does not deal with illegal trading on insider information, but focuses on directors' dealings, the legal trading by directors of the company as defined in the Listing Rules of UK Listing Authority, a division of the Financial Services Authority.

A trading ban of two months prior to a preliminary, final or interim earnings announcement and one month prior to a quarterly earnings announcement applies to companies trading on the LSE. Directors still require clearance to trade from the chairman of the board of directors outside these trading bans.⁶ The UK Model Code requires the members of the board of directors to inform their company as soon as possible after a transaction and no later than the fifth business day after the transaction has been carried out for their personal account or on behalf of their spouses and children (Friederich *et al.* (2002)). The company is then required to inform the LSE of the transaction without delay and no later than the end of the business day following receipt of the information by the company. The LSE disseminates this information immediately to data vendors as well as via its own news service, the Regulatory News Service (RNS). The company is also required to enter this information in its company register, which is available for public inspection, within three days after the transaction has been reporting by the director.

⁴ “Any person who does act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments” (FSMA 2000, s.397).

⁵ In 2000, the London Stock Exchange's authority to impose administrative penalties was transferred to the Financial Services Authority (FSA). The LSE passes any information raising the suspicion of insider trading on to the FSA for further investigation.

⁶ Clearance may be given to a director to sell (but not to purchase) securities during a trading ban in exceptional circumstances where this is the only reasonable course of action available to the director. However, Hillier and Marshall (1998) report that such exceptions are very rare.

4. Conjectures, Data and Methodology

This section outlines the conjectures which will be tested in the following section. It also reviews the data sources and the methodology used.

Conjectures

We start by testing the classic conjecture that directors' trades convey information to the stock market and that, consequently, the market reacts to these trades. By purchasing shares in their firm, directors convey a positive signal about the future value of the firm to the market. The signal is costly, and therefore credible to outsiders, as the directors put their own wealth at stake and bear the cost of holding less than optimally diversified investment portfolios. Conversely, directors signal negative news when selling shares.

Conjecture 1:

- a) *There is a positive market price reaction to directors' purchases.*
- b) *There is a negative market price reaction to directors' sales.*

Next, we distinguish between two types of outside shareholders: institutional investors, and other shareholders (mainly families or individuals not related to the firm's directors and other firms).⁷ If institutional investors monitor the firms they invest in, their monitoring activities will be at least partially visible to other outside shareholders⁸ who consequently have more information on the firms' future value⁹ and benefit from less asymmetric information and a better alignment of their interests with those of the management. Given the lower informational asymmetry, directors' trades are a less important signal to outside shareholders and contain less informational value. Such firms will then experience a less substantial market

⁷ There are only a few companies controlled by the government or the directors.

⁸ For example, the Institutional Shareholders' Committee, the association of the four major institutional shareholder associations in the UK, states "[m]onitoring (by institutional investors) may require sharing information with other shareholders or agents and agreeing a common course of action" (Statement of Principles, September 2005, page 2). In addition, in a case study of the Hermes UK Focus Fund, Becht *et al.* (2006) report that in more than 80% of its monitoring and activism cases the Fund contacted other institutional shareholders to communicate its engagement objectives and to solicit support for its activities.

⁹ It is important to note that the new information that monitoring activities generate is usually not insider information about the firm. Processing insider information would preclude institutional investors from rebalancing their portfolios and lock in their investments (Goergen and Renneboog 2001). The Institutional Shareholders' Committee states that "institutional shareholders and/or agents may not wish to be made insiders (by monitoring). Institutional shareholders and/or agents will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement" (Statement of Principles, September 2005, page 3). Furthermore, Becht *et al.* (2006) find that the returns of the Hermes activist fund are not generated by trading on insider information.

reaction to directors' trades. To summarize, the presence of monitoring shareholders is expected to reduce the magnitude of the share price reaction to directors' dealings. Given the empirical and anecdotal evidence, we expect UK institutional investors to be passive and not to influence the share price reaction to directors' trades, whereas we expect other shareholders (families or individuals not related to the directors and other firms) to monitor the firms they invest in and reduce the share price reaction.

Conjecture 2:

- a) *Families or individuals not related to the directors and other firms will reduce the positive share price reaction to directors' purchases.*
- b) *Families or individuals not related to the directors and other firms will reduce the negative share price reaction to directors' sales.*

Conjecture 3:

- a) *Institutional investors will not influence the positive share price reaction to directors' purchases.*
- b) *Institutional investors will not influence the negative share price reaction to directors' sales.*

Data and methodology

The data on directors' dealings are for the second half of the 1990s and are sourced from the Regulatory News Service. We aggregate multiple purchases (or sales) by the same director on a given day (e.g. we consider one purchase of 2,000 shares and another one of 5,000 shares to be equivalent to a single purchase of 7,000 shares). We also net purchase and sale transactions made by the same director on the same day (e.g. a purchase of 4,000 shares and a sale of 12,000 shares constitute a net sale of 8,000 shares). As the market is not likely to react to very small share transactions, we concentrate on (net) transactions accounting for at least 0.1% of a firm's market capitalisation. We are left with 1,094 purchases and 1,087 sales. Company name changes during the period of study, the annual numbers of shares outstanding and the industry codes for the firms were obtained from the London Share Price Database (LSPD). Information on ownership was sourced from Worldscope which records all direct ownership stakes of 5% or more. We distinguish between stakes held by the directors, other firms, institutional investors, and individuals or families not related to the directors. Finally, share prices, dividends and data on the FTSE All Share Index were obtained from Datastream.

Daily returns are defined as follows:

$$R_{i,t} = \frac{NP_{i,t} + D_{i,t} - P_{i,t-1}}{P_{i,t-1}} \quad (1)$$

where i and t relate to firm i and day t , respectively, P and D are the daily price and the dividend (if any) from Datastream and N is the number of new shares for each old share in case of a stock split. The abnormal return $AR_{i,t}$ for firm i on day t is based on the market model and is calculated for each day within the period starting with the 20th day prior to and finishing with the 20th day after the event day (day 0). It is defined as follows:

$$AR_{i,t} = R_{i,t} - (\hat{\alpha}_i + \hat{\beta}_i R_{m,t}) \quad \text{for } t = -20, \dots, 20, \quad (2)$$

where $R_{i,t}$ is the return on firm i on day t as defined in equation (1), and $R_{m,t}$ is the market return on day t proxied by the FTSE All Share index excluding investment trusts. The parameters $\hat{\alpha}_i$ and $\hat{\beta}_i$ are obtained by regressing $R_{i,t}$ on $R_{m,t}$ over the period of 200 to 21 days before the event day. We also checked whether our results are robust to the correction of the small-firm size effect and alternative specifications for the benchmark model underlying the calculation of the abnormal returns (such as the market-adjusted model). Although the results based on these robustness checks are not reported in the paper, we can safely say that they confirm the results reported in the following section.

The abnormal returns for individual firms are then summed up over different time windows to form the cumulative abnormal returns (CAR). Finally, the average CAR (ACAR) is the cross-sectional average of the CAR for a given window.

5. Results

Figure 2 and table III for purchases and figure 3 and table IV for sales show the results from the event study. Figure 2 shows the cumulative abnormal returns (CAR) for all purchases, for purchases in firms whose largest shareholder is a family or other firm, and for purchases in firms whose largest shareholder is an institutional investor, respectively. The average CAR for all purchases over the window starting 20 days before the event day, day 0, and ending 20 days thereafter is 5.11%. Panel A of table III shows that the average CAR for all purchases is positive and significantly different from zero for all the event windows starting with the event day. This confirms conjecture 1 a) that directors' purchases cause positive stock price reactions. Another interesting observation relates to the timing of purchases. Figure 2 as well as panel A of table III (the pre-event CAR over the window $(-20, -1)$) is significantly

negative) suggest that directors successfully time their purchases to follow a period of declining share prices.

[INSERT FIGURE 2 AND TABLE III ABOUT HERE]

For the case of sales, figure 3 and panel A of table IV strongly corroborate conjecture 1 b): sales are accompanied by a negative market reaction as the average CAR drops from 3.5% on the event day to about 1.5% 20 days later. Although the CAR is still positive over the entire window starting from day -20 to +20, it has dropped substantially after the event day. The CAR earned over the window ranging from day 0 to day 21 is negative with -1.85% and highly significant. Hence, if CARs are measured from the event day onwards, they turn out to be significantly negative. This provides support for conjecture 1 b) about the negative market reaction to directors' sales. Similar to purchases, directors seem to time their sales so that they follow a period of increases in share prices (the pre-event CAR over the window from day -21 to day -1 is positive with 3.44% and highly significant). Comparing figure 2 and panel A of table III to figure 3 and panel A of table IV shows that the absolute value of the market reaction to sales (for the window ranging from day 0 to day 21) is lower than the market reaction to purchases. As previously discussed, this may be due to the fact that company directors do not only sell their shares if they hold bad news about the firm's prospects, but also sell for other reasons such as liquidity needs and the exercise of options forming their remuneration package (Lakonishok and Lee 2001, and Friederich *et al.* 2002). As a result, the informational signal conveyed by a sale is more opaque than that conveyed by a purchase.

[INSERT FIGURE 3 AND TABLE IV ABOUT HERE]

Figure 2 and panel B of table III report the average CARs for purchases with firms whose largest shareholder is a family or other firm. Similar to all purchases, the CARs for firms controlled by families or other firms are positive. However, the CAR for the window ranging from the event day to day 21 is lower for the firms controlled by families, individuals or other companies: the CAR amounts to only about 6% (panel B) as compared to 7.5% for directors' purchases for the firms which are not controlled by these types of shareholders (panel C). The difference in CARs is statistically significant at the 1% level. This suggests that purchases by directors are significantly less informative in firms controlled by families, individuals or companies and that the monitoring by these types of shareholders reduces the informational asymmetry between the management and the market. Consequently, we cannot reject conjecture 2 a).

If one compares the CARs in Figure 3 on share sales in firms with dominant ownership by families, individuals or other firms with those on sales in all firms, one can clearly see that the negative share price reaction starting with day 0, the event day, is much less pronounced when there is ownership by families or other firms. Further, panels B and C of table IV show that the CAR for the window ranging from the event day to day 21 is much less negative for the firms controlled by families, individuals or other companies (about -1%) than those which are not controlled by these types of shareholders (-2%), where the difference is statistically significant at the 1% level. This result provides support for conjecture 2 b) which states that the negative price reaction is less severe in the presence of a monitoring shareholder.

Figure 2 shows that, for the case of purchases, ownership by institutional shareholders seems to make little difference as the average CAR is virtually identical to that for all purchases. Comparing panels D and E of table III shows that the CAR (0,21) for the firms controlled by institutional shareholders (6.9%) is statistically indifferent from that for the firms which are not controlled by institutional shareholders (7.3%). Hence, the presence of institutional investors does not seem to mitigate problems of agency and asymmetric information in their investee companies. Therefore, we cannot falsify conjecture 3 a). Figure 3 shows that, for the period starting with the event day and ending with day 20, the average CAR for directors' sales in firms with institutional ownership is very similar to that for all the sales. Similar to the evidence obtained from the purchases, institutional investors do not seem to have a significant impact on the market reaction to directors' sales. The CARs in panels D and E of table IV confirm this pattern: the CAR (0,21) for the firms controlled by institutional shareholders (-1.7%) is not statistically different from that for the firms which are not controlled by this type of investor (-2%). Hence, we cannot reject conjecture 3 b). However, it is interesting to note that the presence of institutional investors has a small economic impact, albeit not statistically significant, on the market reaction to directors' trades.

To summarise, our results suggest that institutional shareholders do not mitigate problems caused by asymmetric information and/or agency as they do not have an impact on the informational content of directors' dealings. In contrast, we find evidence that other types of shareholders, mainly families and other companies, reduce the informational content of these trades. This suggests that these latter types of shareholders engage in monitoring the management of the firms they invest in and thereby reduce the informational asymmetry between the management and the market.

6. Conclusions

Anecdotal and empirical evidence suggests that institutional shareholders refrain from monitoring the firms in their portfolios and prefer to follow passive investment strategies. However, corporate governance actions by institutional investors – as well as other large shareholders – may be difficult to trace. For example, it may be in the interest of the large shareholders not to vote against any directors' motion they oppose at the AGM. If they do so, then this may cause a drop in the firm's share price which in turn reflects badly on the performance of their investment portfolio. Hence, they may prefer to act behind the scenes and avoid that such motions make it to the AGM in the first place. The aim of this paper was to test whether UK institutional shareholders directly or indirectly monitor the management of their investee firms.

We test whether institutional shareholders engage in monitoring by conducting an event study on directors' transactions in the shares of their own firm. If institutional investors are efficient monitors, then their monitoring activities will convey new information about the firm's future value to other outside shareholders and reduce the informational content of directors' trades. More specifically, their presence will decrease in absolute value the negative cumulative abnormal returns triggered by directors' sales as well as the positive effect of directors' purchases. In contrast, if institutional investors do not monitor, the share price reactions should not be different from those for firms without institutional investors. Furthermore, if institutional investors do not monitor, but rather follow the insiders' trades, the share price reactions will be stronger (in absolute terms).

Our main findings are as follows. First, similar to existing UK and US studies, we find that directors' trades are informative as they cause share price reactions. Second, we report that institutional shareholders do not have a significant impact on the market reaction to purchases and sales. Third, other types of shareholders, mainly families and other firms reduce the market reaction to both directors' purchases and sales. This suggests that these latter types of shareholders, to the opposite of institutional investors, engage in monitoring and thereby decrease the informational value of directors' dealings.

However, recent developments in corporate governance in the UK (such as the Myners (2001) report) have put pressure on institutional investors to become more active. For example, the Institutional Shareholders' Committee (2002) issued a statement on the responsibilities of institutional shareholders, and anecdotal evidence suggests that some institutions have begun

to set clear agendas for shareholder activism (Mallin *et al.* 2005). This suggests an interesting line of future research on the impact of regulatory environment on monitoring by institutional investors.¹⁰

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**Table I: Average largest stakes held in
European, UK and US firms**

The table reports the average largest and second largest control stake. For all countries, the data are for 1996, except for Belgium (1994) and the UK (1993). The sample companies in all countries are listed, except for Austria where the sample consists of both listed and unlisted companies.

| | Sample | Note | Stakes | |
|-------------|--------|------|---------|--|
| | | | Largest | 2 nd largest |
| Austria | 600 | (1) | 82.2 | 9.5 |
| France | 403 | (1) | 56.0 | 16.0 |
| Italy | 214 | (1) | 52.3 | 7.7 |
| Netherlands | 137 | (2) | 28.2 | 9.2 |
| Spain | 394 | (1) | 38.3i | 11.5 |
| UK | 248 | (2) | 14.0 | 8.3 |
| US-NYSE | 1,309 | (2) | 8.5 | 3.7 |
| US-NASDAQ | 2,831 | (2) | 13.0 | 5.7 |
| | | | Largest | 2 nd + 3 rd largest |
| Belgium | 135 | (1) | 55.8 | 6.9 |
| Germany | 402 | (1) | 59.7 | 8.6 |

Notes (1): based on both direct and indirect shareholdings; (2): based on direct shareholdings only. Source: based on research by the European Corporate Governance Network

Table II: Distribution of largest shareholders in Europe.

This table reports the sum of shareholdings of at least 5% held by different shareholder types. For all the countries the data are for 1996, except for Belgium (1994) and the UK (1993).

| | | | Families | Banks | Insurance companies | Investment. funds | Other firms | Govern- ment | Directors |
|-------------|--------|---------------|----------|-------|------------------------|----------------------|-------------|-----------------|-----------|
| | Sample | Notes | | | | | | | |
| Austria | 600 | (2) | 38.6 | 5.6 | 0.0 | 0.0 | 33.9 | 11.7 | 0.0 |
| Belgium | 155 | (2) | 15.6 | 0.4 | 1.0 | 3.8 | 37.5 | 0.3 | 0.0 |
| France | 402 | (2) | 15.5 | 16.0 | 3.5 | 0.0 | 34.5 | 1.0 | 0.0 |
| Germany | 402 | (2) | 7.4 | 1.2 | 0.2 | 0.0 | 21.0 | 0.7 | 0.0 |
| Italy | – | (1), (2), (4) | 68.6 | 7.2 | 0.0 | 0.0 | 24.2 | 0 | 0.0 |
| Netherlands | 137 | (3) | 10.8 | 7.2 | 2.4 | 16.1 | 10.9 | 1.3 | 0.0 |
| Spain | 394 | (2) | 21.8 | 6.6 | 8.8 | 0.0 | 32.6 | 0.0 | 0.0 |
| UK | 248 | (3) | 2.4 | 1.1 | 4.7 | 11.0 | 5.9 | 0.0 | 11.3 |

Notes (1): The Italian sample includes both listed and unlisted companies whereas all other country samples contain only listed firms; (2): covers both direct and indirect shareholdings; (3): covers only direct shareholdings; (4) most of the Italian firms classed as firms owned by other firms are ultimately owned by the government.

Source: based on research by the European Corporate Governance Network

Table III: Average cumulative abnormal returns for directors' purchases*Panel A: Cumulative abnormal returns for all directors' purchases (1094 observations)*

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|-------|-------|-------|
| ACAR | 5.11% | -1.98% | 7.10% | 2.63% | 3.69% | 4.15% |
| t(ACAR) | 6.75 | -3.47 | 14.10 | 10.30 | 12.30 | 12.40 |

Panel B: Cumulative abnormal returns for directors' purchases in firms controlled by families or other firms (302 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|-------|-------|-------|
| ACAR | 4.19% | -1.81% | 6.00% | 2.45% | 3.32% | 3.88% |
| t(ACAR) | 3.05 | -1.81 | 6.69 | 5.63 | 6.36 | 6.13 |

Panel C: Cumulative abnormal returns for directors' purchases for firms Not controlled by families or other firms (792 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|-------|-------|-------|
| ACAR | 5.46% | -2.04% | 7.52% | 2.70% | 3.83% | 4.25% |
| t(ACAR) | 6.45 | -3.29 | 13.13 | 10.35 | 12.39 | 11.72 |

Panel D: Cumulative abnormal returns for directors' purchases for firms controlled by institutional investors (544 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|-------|-------|-------|
| ACAR | 4.73% | -2.18% | 6.91% | 2.65% | 3.45% | 4.06% |
| t(ACAR) | 4.63 | -2.91 | 10.00 | 8.42 | 9.25 | 9.27 |

Panel E: Cumulative abnormal returns for directors' purchases for firms Not controlled by institutional investors (550 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|-------|-------|-------|
| ACAR | 5.49% | -1.78% | 7.29% | 2.61% | 3.93% | 4.24% |
| t(ACAR) | 5.39 | -2.21 | 10.26 | 7.25 | 9.28 | 8.98 |

Note: The ACAR is the cross-sectional average cumulative abnormal return (CAR). The CARs are based on the market model. The t(ACAR) is Barber and Lyon's (1997) test statistic. It is Student-t distributed with N-1 degrees of freedom and approaches the normal distribution as N increases.

Table IV: Average cumulative abnormal returns for directors' sales*Panel A: Cumulative abnormal returns for all directors' sales (1087 observations)*

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|--------|--------|--------|
| ACAR | 1.59% | 3.44% | -1.85% | -0.37% | -0.45% | -0.62% |
| t(ACAR) | 2.57 | 6.96 | -5.70 | -3.38 | -3.18 | -3.51 |

Panel B: Cumulative abnormal returns for directors' sales in firms controlled by families or other firms (182 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|--------|--------|--------|
| ACAR | 4.68% | 5.70% | -1.02% | -0.75% | -0.63% | -0.86% |
| t(ACAR) | 2.22 | 3.23 | -1.21 | -2.59 | -1.70 | -1.96 |

Panel C: Cumulative abnormal returns for directors' sales in firms Not controlled by families or other firms (905 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|--------|--------|--------|
| ACAR | 0.97% | 2.99% | -2.02% | -0.29% | -0.41% | -0.57% |
| t(ACAR) | 1.90 | 8.31 | -6.05 | -2.51 | -3.14 | -3.58 |

Panel D: Cumulative abnormal returns for directors' sales for firms controlled by institutional investors (462 observations)

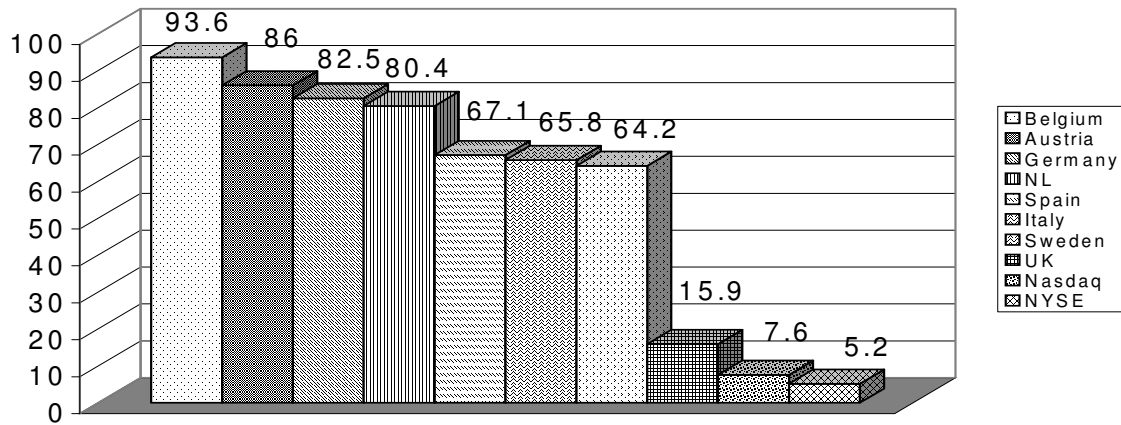
| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|--------|--------|--------|
| ACAR | 0.97% | 2.66% | -1.69% | -0.41% | -0.59% | -0.75% |
| t(ACAR) | 1.36 | 5.29 | -3.62 | -2.50 | -3.20 | -3.36 |

Panel E: Cumulative abnormal returns for directors' sales for firms Not controlled by institutional investors (625 observations)

| Window | (-20,20) | (-20,-1) | (0,21) | (0,1) | (0,3) | (0,5) |
|---------|----------|----------|--------|--------|--------|--------|
| ACAR | 2.05% | 4.02% | -1.97% | -0.34% | -0.35% | -0.52% |
| t(ACAR) | 2.51 | 6.16 | -4.60 | -2.36 | -1.86 | -2.25 |

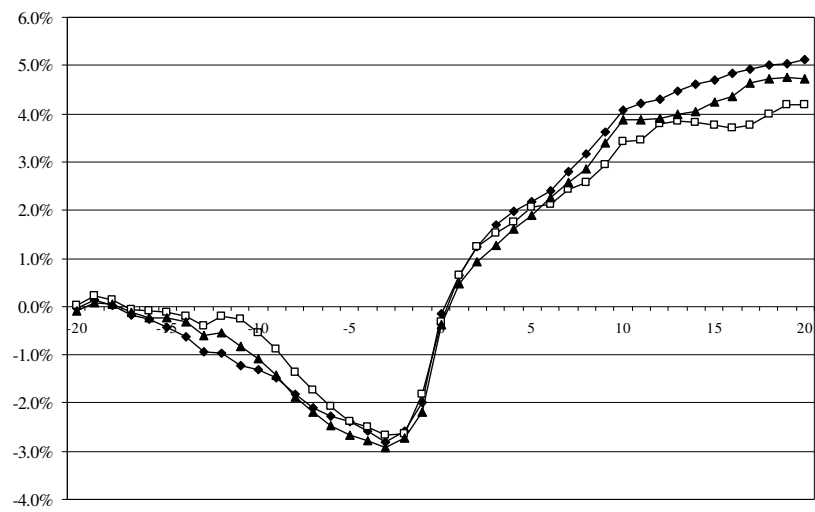
Note: The ACAR is the cross-sectional average cumulative abnormal return (CAR). The CARs are based on the market model. The t(ACAR) is Barber and Lyon's (1997) test statistic. It is Student-t distributed with N-1 degrees of freedom and approaches the normal distribution as N increases.

Figure 1: Percentage of Companies with a Blocking Minority of at least 25%



Source: based on research by the European Corporate Governance Institute

Figure 2 : Cumulative abnormal returns for directors' purchases



◆ All purchases □ Purchases in firms controlled by families or other companies ▲ Purchases in firms controlled by institutional investors

Figure 3 : Cumulative abnormal returns for directors' sales

