

Behind the Scenes: The Corporate Governance Preferences of Institutional Investors

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ABSTRACT

We survey institutional investors to better understand their role in the corporate governance of firms. We document widespread behind-the-scenes intervention and governance-motivated exit. Both governance mechanisms are viewed as complementary devices, in which intervention typically occurs prior to an eventual exit. We find that long-term investors and investors that are less concerned about stock liquidity intervene more intensively. Finally, most investors use proxy advisors and believe that their information improves their own voting decisions.

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Theoretical and empirical research on corporate governance makes assumptions and draws inferences regarding the role of institutional investors. Yet, we have little direct knowledge about how institutional investors engage with portfolio companies because many interactions occur behind the scenes.¹ That is, unless institutions publicly express their approval or disapproval of a firm’s activities or management, little is known about their preferences and private engagements with portfolio firms. Our goal in this paper is to rectify this knowledge gap by conducting a survey among institutional investors.

As early as Hirschman (1970), researchers have highlighted the two active choices that institutional investors have when they become unhappy with a portfolio firm: (i) they can engage with management to try to institute change (“voice” or direct intervention); or (ii) they can leave the firm by selling shares (“exit” or “voting with their feet”). Subsequently, theoretical models have documented the governance benefits of corrective actions through voice.² These theories have recently been complemented by models showing that the threat of exit can also discipline management.³ This raises the question of whether institutional investors, in response to dissatisfaction with portfolio firms, take actions that support the validity of these theories.

The 143 respondents to our survey, mostly very large institutional investors with a long-term focus, indicate that voice, especially when conducted behind the scenes, is highly important. For example, 63% of the respondents state that, in the past five years, they have engaged in direct discussions with management, and 45% have had private discussions with a company’s board *outside* of management’s presence.⁴ In addition, we find evidence that investor horizon makes a difference. First, long-term investors intervene more intensively than short-term investors. Second, investors who choose engagement do so more often because of concerns over a firm’s corporate governance or strategy than over short-term issues. Both

¹ For some recent anecdotal evidence on behind-the-scenes activism, see Burr (2012).

² See, for example, Shleifer and Vishny (1986), Huddart (1993), Admati, Pfleiderer, and Zechner (1994), Maug (1998), Kahn and Winton (1998), Bolton and von Thadden (1998), and Faure-Grimaud and Gromb (2004).

³ See Admati and Pfleiderer (2009), Edmans (2009), and Edmans and Manso (2011).

⁴ In the survey we explicitly asked about *engagement* through discussions, rather than casual conversations at, for example, investor relations events.

findings support the view that interventions are not primarily conducted by short-term, myopic activists who intend solely to reap short-term gains (e.g., Bebchuk, Brav, and Jiang (2014)).

Nevertheless, the institutional investors also indicate that they face impediments to their activism, with the most important hurdles being free rider problems (as in Shleifer and Vishny (1986)) and legal concerns over “acting in concert” rules. Our results also show that investors who are more concerned about liquidity (and hence probably hold more liquid stocks) use voice less intensively. This is consistent with Coffee (1991), Bhide (1993), and Back, Li, and Ljungqvist (2014), who argue that market liquidity discourages intervention.

A central challenge arises in testing whether institutional investors use the threat of exit and whether it is effective in bringing about changes in management behavior. The challenge is that the *threat* of exit is, by definition, unobservable. In fact, if the threat is credible, exit itself does not take place. Our survey sheds light on the exit mechanism because we can ask institutions (i) whether they use exit as a governance device; and (ii) whether they believe that the exit threat is an effective disciplinary device.

The investors in our survey view exit as a viable strategy with 49% (39%) stating that they had exited because of dissatisfaction with performance (governance) in the past five years. Based on their experience with portfolio firms, 42% of the investors believe that the exit threat is effective in disciplining management. As our respondents tend to be dedicated, long-term investors who engage privately, it is plausible that their potential exit truly is a threat. The investors further indicate that exit is a complement to a voice strategy rather than a substitute, and intervention typically occurs prior to an eventual exit. The survey results further suggest that the effectiveness of the exit threat depends on investors’ equity stake size, whether other investors also exit for the same reason, managerial equity ownership, and whether other large shareholders are also present.

Finally, we consider an increasingly controversial role in corporate governance: the role of proxy advisors.⁵ Although the respondents raise some concerns over conflicts of interest in proxy advisory firms, arising from the offering of consulting services, they find their advice to be of value. 60% of the respondents use proxy advisors, and about half of these respondents actually use the services of more than one advisor. The investors report that proxy advisors help them make better voting decisions, but that they remain their own decision makers. Further, investors that use proxy advisors engage their portfolio companies more intensively through voice, rather than substituting the proxy advice for their own voice. Contrary to some regulatory and media beliefs, this suggests that the use of proxy advisors does not necessarily imply that investors take a passive governance role. These results are in line with Aggarwal, Erel, and Starks (2014) and Iliiev and Lowry (2015), who find that proxy voters do not uniformly follow the recommendations of proxy advisors.

We contribute to the literature by providing direct evidence of institutional investors' preferences and actions. The few related studies also using direct evidence have examined activism either by one specific investor or by hedge funds. The studies that focus on one activist show that private interventions are often successful.⁶ Given that each of these studies focuses on a single institution, the extent to which this evidence can be generalized is unclear. The studies on hedge funds show that their activism is met with abnormal target returns, leads to more innovation and higher performance, and even disciplines non-targeted firms.⁷ Although this evidence is important, hedge funds are one type of investor that has particularly strong incentives to engage, can take more concentrated positions, and faces fewer conflicts of

⁵ This role has been assailed by institutional investors, regulators and politicians. SEC Commissioner Daniel M. Gallagher, for example, states that he has "...grave concerns as to whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms" (Gallagher (2013)). In 2014 the SEC issued guidance on the use of proxy advisors and the European Commission drafted a proposal for a Directive with the goal of enhancing the reliability and quality of advice by proxy advisors.

⁶ For example, Smith (1996) studies CalPERS, Carleton, Nelson, and Weisbach (1998) study TIAA-CREF, Becht et al. (2009) study the Hermes UK Focus Fund, and Dimson, Karakas, and Li (2014) study another U.K. activist.

⁷ See Brav et al. (2008a), Brav, Jiang, and Kim (2015), Bebchuk, Brav, and Jiang (2014), Brav et al. (2014), and Gantchev, Gredil, and Jotikasthira (2014).

interest (Brav, Jiang, and Kim (2010)). Thus, our evidence is important in providing a more generalizable view of institutional investor motives and activities. The widespread use of behind-the-scenes engagement we document highlights the importance of our survey approach and suggests that many investors might be more active than would be inferred from observational data only.

Section I describes the survey. Section II presents results on engagement channels. Section III studies the exit threat. Section IV presents results on impediment and triggers of engagement, Section V reports results on proxy advisors, and Section VI concludes.

I. Survey Design

A. Survey Development and Delivery

We developed our survey by considering questions that would provide insights into outstanding issues in research on shareholder engagement. We used both an online and a paper version of the survey. The survey questions are provided in Internet Appendix IA.I, and details on the survey design are in Internet Appendix IA.II.

We used three delivery channels. First, we distributed the paper version of the survey at three conferences: (1) the International Corporate Governance Network (ICGN) Dinner Debate in Rotterdam in December 2012, which had about 40 participants, from which we received 10 responses; (2) the ICGN Annual Event in New York in June 2013, from which we received 26 responses⁸; and (3) the Istanbul Pension Funds Conference in July 2013, which had about 50 participants, from which we received 8 responses.

Second, we sent invitations to participate in the online survey in a targeted emailing in July 2013. A very large and governance-sensitive institutional investor provided us with contact details for 54 CIOs or senior corporate governance specialists at other large institutional investors. We sent personal emails to these contacts, inviting them to participate in the survey.

⁸ Although this conference had participants in the hundreds, many of the participants were not institutional investors and thus could not complete the survey.

We also sent emails to about 50 personal contacts of the authors who worked at different institutional investors. From these two sets of emails we received 67 responses.

Third, using the FactSet database, we sent invitations to participate in the online survey to approximately 3,000 portfolio managers and received 32 responses.

In total we had 143 responses to all invitations, implying a response rate of about 4.3% across the three delivery channels and relative to the approximately 3,300 invitations. This response rate is a little lower than that of some other surveys in finance (e.g., 5.3% in Brav et al. (2008b); 5.4% in Dichev et al. (2013)). However, it is approximately equal to the 4.5% response rate in the quarterly CFO survey by Duke University.⁹

In a survey of the opinions of economic agents such as this one, we naturally face the risk that respondents answer in a strategic or untruthful fashion. To mitigate these concerns, we conducted the survey anonymously and did not require (or ask) respondents to reveal their names or employers. We further emphasized that individual responses would be treated as confidential. Conversations with a number of respondents also indicated that they would not spend time filling out the survey if they intended to answer untruthfully.

B. Respondent Characteristics

Table I provides summary statistics on the respondents. As not all respondents provided information on investor or investment characteristics, the number of observations falls below the 143 total. Table I, Panel A shows that, given their position, our respondents should be very knowledgeable about their firms' preferences and actions with regard to shareholder engagement. The largest numbers of respondents are either corporate governance experts (29%) or portfolio managers (27%). Moreover, about one-third of the respondents are very senior in their organizations, being either CIOs (18%) or board members (14%). The large

⁹ The low response rate is primarily the result of the mass emailing using the FactSet database. If we exclude the mass emailing, the response rate is substantially higher (closer to 33%).

presence of senior managers is useful because the views of these decision makers are particularly relevant.

About half of the respondents work for asset managers, 21% for mutual funds, 12% for pension funds, and a smaller number for hedge funds (4%). Our respondents tend to work for large investors, which is beneficial for our analysis because these investors are most likely to have the resources for and interest in shareholder engagement. Specifically, a total of 34 respondents—35% of the sample—work for institutions with assets under management of more than \$100 billion. Given that only 128 institutional investors had more than that amount in assets under management by the end of 2012 (Towers Watson (2013)), our survey provides a good representation of these very large investors' views.

The respondents represent a number of different regions of the world: 36% are from Continental Europe, 24% from the United States, 16% from the United Kingdom, and the rest are from other parts of the world.

We asked the investors for the typical holding period of the investments in their portfolios. Respondents could classify their holding periods into three categories: short (less than six months), medium (six months to two years), and long (more than two years). Table I, Panel B shows that, although none of the investors typically hold shares for less than six months, 29% have medium average holding periods and 71% have long average holding periods. The respondents hold most of their investments—75% on average—in active rather than purely passive (indexed) positions. Finally, we asked respondents to indicate the importance of stock liquidity when they consider buying or selling shares. Liquidity considerations are considered to be either somewhat important (53%) or very important (37%) by most of our respondents. Correlations across respondent characteristics are reported in Internet Appendix IA.IV. Given the responses, we are confident that in almost all cases we have only one observation per institutional investor.¹⁰ We should note that our respondent group is probably biased toward

¹⁰ The reason is that in 89% of all observations, we have sufficient responses to determine that none of the following identifying variables coincide: (i) location; (ii) assets under management; (iii) institutional investor type;

the more activist and long-term investors among the population of institutional investors. This outcome is the result of both the survey delivery methods and the fact that such investors would be more disposed to filling out such a survey. However, understanding the preferences of these investors is particularly important because they are more likely to shape the governance of firms. In addition, their activities may be a catalyst for other investors.

II. Shareholder Engagement Channels

A. Prevalence of Voice and Exit Channels

Traditional theoretical models of corporate governance focus on the benefits of direct intervention (“voice”), while more recent models focus on governance through exit. These theories raise the question of how widely voice and exit are actually contemplated or used by institutional investors. Addressing this question through archival research methods is problematic because many interventions may take place behind the scenes, making their observation and measurement difficult. Similarly, exit that results from dissatisfaction with a portfolio firm is empirically difficult to distinguish from exit resulting from other motives, such as liquidity or portfolio rebalancing needs. Thus, to shed light on these issues, respondents were asked to indicate what shareholder engagement measures they had taken in the past five years with their portfolio firms. To measure the importance of exit, investors could indicate two options: (i) whether they exited because of dissatisfaction with performance; and (ii) whether they exited because of dissatisfaction with corporate governance. We did not ask about exit resulting from other considerations unrelated to governance.

Table II reports the percentage of respondents that used a particular measure, as well as the results of *t*-tests that determine whether the percentage for a given measure is equal to the percentages of each of the other measures. We rank results based on their relative frequency.

(iv) investor horizon; (v) active investments (+/- 10% variation in the variable); and (vi) proxy advisor. (We explain this sixth variable below.) In the remaining 11%, we cannot exclude the possibility that respondents work for the same institutional investors, but the responses are sufficiently different to discount that possibility with some degree of assurance.

The findings indicate a generally very high level of engagement by our respondents, which, as discussed, may reflect our sample selection: Only 19% of the survey respondents have not taken any corrective actions in the past five years. The responses also indicate that investors use multiple channels to engage, relying primarily on voice, but also using exit. Discussions with management are the most frequently used engagement channel, with 63% of the respondents indicating that they have used it in the past five years. Moreover, 45% of the respondents conducted discussions with members of the board of directors *outside* of management's presence (the fourth most important response).

Our findings of the widespread use of private discussions support the view that investors first try to engage firms behind the scenes through direct negotiations, and take public measures (e.g., shareholder proposals, public criticism) only after the private interventions have failed. Our results might therefore help explain why many shareholder proposals filed by institutional investors are eventually withdrawn before the shareholder meeting, and why stock markets often do not react positively to shareholder proposals (e.g., Gillan and Starks (2000, 2007)).¹¹

Our results are consistent with the studies of individual institutions that engage behind the scenes with management (Carleton, Nelson, and Weisbach (1998), Becht et al. (2009), and Dimson, Karakas, and Li (2014)), and with Brav et al. (2008a) who document that many hedge funds (48% of their sample) are very active in seeking communication with management. Our results thus suggest that private discussions with management are not restricted to these particular investors or investor types, but rather are a more general phenomenon. We find that 53% of the respondents report voting against management as a shareholder engagement measure. This result is consistent with Iliev et al. (2015), who show that shareholder voting is an effective way through which corporate governance is exercised. Interestingly, submissions of shareholder proposals have only been used by 16% of the respondents. This low percentage

¹¹ A shareholder proposal is good news in that it indicates increased monitoring. But it also signals that institutional investors could not negotiate a behind-the-scenes agreement with management.

stands in stark contrast to the high frequency of behind-the-scenes discussions among our respondents. Two explanations for the infrequent use of shareholder proposals could be the rather low passage rates of proxy proposals (e.g., Gillan and Starks (2000, 2007)) and the fact that proxy fights are expensive (e.g., Gantchev (2013)). Moreover, if investors submit proposals only after discussions with management fail, this result would also suggest a rather high success rate for behind-the-scenes activities. In fact, representatives of both Vanguard and Blackrock have pointed out that they prefer engagement behind the scenes to the submission of shareholder proposals. Michelle Edkins, global head of corporate governance and responsible investment at Blackrock, is quoted as saying, “In our experience (private engagement) has a fair degree of traction with management. And we can raise (an) issue without having to dictate how management should address it. In a way, that’s always the weakness of the shareholder proposal route” (Burr (2012)).

The responses in Table II also indicate that selling shares in portfolio firms because of dissatisfaction with performance or corporate governance (i.e., exit as a governance mechanism) is used by 49% and 39% of the respondents, respectively (56% of the investors have used one or the other exit mechanism).

Very extreme engagement channels also show relatively high usage, with 15% of the respondents having taken legal actions and 13% having publicly criticized their portfolio companies. These responses are consistent with recent evidence surrounding specific firms; for example, the buyout of Dell caused a number of institutional investors to publicly criticize the transaction and to take legal action (Benoit et al. (2013)). The overall observation that investors prefer private negotiations to public engagement is consistent with recent theoretical evidence in Levit (2014). In his model, if an activist’s information becomes public, the activist loses credibility and the ability to influence the manager’s actions.

B. Determinants of Voice Intensity

Theories of voice make different (often conflicting) predictions about the effects of investor or investment characteristics on the willingness to intervene. To examine the determinants of institutions' intensity of voice (where we consider intensity to reflect the different actions an investor takes), we construct a composite investor-specific "voice index". This index sums the different types of voice actions an investor has taken. Our survey has 11 possible intervention measures, implying that the voice index can vary between 0 and 11. Institutions with higher index numbers have shown a stronger tendency to engage along multiple dimensions. The average investor used three different types of interventions over the past five years.

In examining the potential determinants of an investor's voice intensity, we turn to the theoretical literature for guidance. The first characteristic we consider is the liquidity of a portfolio firm's stock, which researchers have argued is important for the intervention decision, although the direction of the effect is theoretically ambiguous.¹² On the one hand, Coffee (1991) and Bhidé (1993) argue that stock liquidity has a limiting effect because it encourages investors to "cut and run" rather than intervene. Back, Li, and Ljungqvist (2014) model this idea more formally and predict that liquidity harms activism. Similar predictions come from exit theories, which show that liquidity makes the exit threat more credible, reducing the need to govern through direct intervention (e.g., Edmans and Manso (2011)).

On the other hand, Faure-Grimaud and Gromb (2004) predict that higher stock liquidity results in more intervention. In their model, a shareholder is more likely to engage in monitoring when liquidity is higher. The reason is that liquidity makes it easier to exit at a price which reflects the engagement activities if the shareholder has to sell her stake prematurely. In addition, Maug (1998), Kahn and Winton (1998), and Collin-Dufresne and Fos (2014) show that liquidity facilitates block formation, which incentivizes intervention.

¹² For a more extensive review of the theories relating liquidity to shareholder intervention, see Edmans (2014).

Similar to liquidity, the relation between intervention and the horizon of the institutional investor has diverse predictions. Some argue that investors with longer horizons have stronger incentives to intervene. For example, such investors may be more interested in long-term profits; they may be more likely to remain shareholders of a firm long enough to realize the corresponding benefits; or they may have more time to understand and learn about a firm in order to intervene effectively (e.g., Burkart, Gromb, and Panunzi (1997), Faure-Grimaud and Gromb (2004), Gaspar, Massa, and Matos (2005), Chen, Harford, and Li (2007)). These views imply that investors with longer horizons intervene more often. However, others argue that activism is more often performed by short-term investors—in particular, hedge funds—who intervene in order to procure short-term profits. It is claimed that short-term investors push for actions that are profitable in the short term but are detrimental to firm value in the long term (e.g., Bratton and Wachter (2010)). These views imply that investors with shorter horizons intervene more often.

The size of an institutional investor can also be important for the use of voice. Larger investors are more likely to have larger stakes in their portfolio firms, and larger holdings provide stronger engagement incentives because they allow an investor to keep a larger share of the benefits if engagement is successful (Grossman and Hart (1980), Shleifer and Vishny (1986)). Larger funds generally also have more resources to engage.

Firms with large passive investments might also have stronger incentives to engage as they find it more difficult to use exit as a governance mechanism because of indexing or tracking error considerations. Alternatively, investors with large active holdings may trade more profitably on information collected through private engagement, which increases their incentives to engage (e.g., Maug (1998)). Finally, engagement might vary across institutions because of differences in regulation, compensation structure, expertise, or conflicts of interest. We therefore include investor type and geographical location as control variables.

Table III, Columns 1 to 5 report regressions that relate voice intensity to investor and investment characteristics. The results show that voice intensity is significantly negatively

related to the institutions' preferences for liquidity, which suggest that investors who care more about stock liquidity, and who arguably hold more liquid stocks, use voice less intensively. This implies that theories in which liquidity discourages voice are more strongly supported; liquidity either allows investors to cut and run, or it causes investors to use exit rather than voice. Our liquidity findings support empirical evidence on hedge fund activism showing that, conditional on block formation, liquidity discourages voice, which is measured using either 13D filings (Edmans, Fang, and Zur (2013)) or activist campaigns (Back, Li, and Ljungqvist (2014)).

Our results also show that investors with longer holding periods use voice more intensively, possibly because their long-term orientation provides them with stronger incentives to monitor. This finding is inconsistent with the view that activism is primarily used by short-term-oriented investors, but it supports the arguments in Bebchuk, Brav, and Jiang (2014). In terms of economic significance, the ordered logit coefficient of 1.25 in Column 5 indicates that as the investor horizon changes from medium to long term, the odds of engaging along an additional voice dimension increase by 149%, holding the other variables constant. (In an OLS framework, we find that long-term investors use 1.6 more voice channels than medium-term investors.)

We also find weak evidence that investors with more active holdings use voice more intensively. Surprisingly, we find no evidence that intensive use of voice is confined only to large investors. However, because the investors in our sample are rather large, we do not want to over-interpret this result. Also, note that we interpret all regression coefficients as suggestive evidence with respect to the underlying theoretical arguments but not as tests of causality.

C. Voice and Exit: Substitutes or Complements

We next study whether exit and voice are used as complements or substitutes based on the information revealed by the investors. A number of authors argue that exit and voice are complements. For example, Hirschman (1970, p. 82) states that "the chances for voice to function effectively...are appreciably strengthened if voice is backed up by the threat of exit."

This idea has been modeled by theories that integrate exit and voice. For example, Edmans and Manso (2011) show that blockholders may engage both in intervention and exit. Levit (2014) shows that the option to exit improves the effectiveness of voice, even if a manager is not concerned about the short-term stock price. In his model, exit and voice are complements because the possibility of exiting improves the ability of an activist to influence the manager. Similarly, Dasgupta and Piacentino (2014) show that exit and voice can complement each other. In their model, voice comes in the form of costly shareholder proposals and managers only listen to shareholders if voice is backed up by a threat of exit. All three models predict that investors should rely both on exit and voice across portfolio firms.

Meanwhile, an argument also exists that exit and voice could be substitute measures, at least for some investors (e.g., Kahn and Winton (1998)). For example, some investors might lack expertise for intervention or face other impediments for engagement and, thus, rely on exit in their portfolios. Moreover, investors might face capital gains liabilities when exiting, which discourages exit but encourages voice (Jin (2006), Dimmock et al. (2014)).

To investigate these competing views, we create a dummy variable, which equals one if an institutional investor used exit as a governance mechanism over the past five years (because of dissatisfaction with corporate governance or performance). The regressions in Table III, Columns 6 and 7 relate the previously defined voice intensity index with this exit dummy. We find that both variables are positively and statistically significantly correlated, which means that investors that use exit as a governance mechanism also show a higher intensity of voice. This finding supports the theories that model exit and voice as complementary mechanisms.

III. The Threat of Exit

A. Measuring the Exit Threat

Exit models argue that blockholders can govern even if they do not actively intervene (e.g., Admati and Pfleiderer (2009), Edmans (2009), Edmans and Manso (2011)). The idea behind these models is that blockholders can collect private information on the fundamental value of a

firm, and this information can be impounded in the stock price through trading. If managers care about the stock price, for example because of equity-based pay or takeover fears, they want to avoid exit by informed blockholders. The threat of exit therefore induces managers to increase firm value, and exit will not take place if the exit threat is credible. Empirically, Parrino, Sias, and Starks (2003) show that exit can have beneficial effects because selling by institutional investors is associated with higher CEO turnover. Leuz, Lins, and Warnock (2009) find that foreign investors leave firms that do not improve governance.

A key challenge to testing exit models and evaluating the effectiveness of governance-motivated exit is that the threat of exit is unobservable. Our survey offers three alternative ways to address this challenge. First, we asked investors whether they engage management before they exit a firm because of their dissatisfaction with management. Knowing about such prior engagement is important because exit models assume that blockholders are informed about the fundamental value of a firm. Informed trading is more likely after prior engagement. Moreover, engagement prior to exit reinforces the exit threat by reminding management of the possibility that an informed investor will sell. Consistent with these models' assumptions, Table IV, Panel A shows that, prior to exiting, the large majority of investors first engage management (either sometimes (51%) or often (27%)). Second, we ask the investors whether they believe, based on their experience, that the threat of exit, rather than exit itself, causes management to change behavior (e.g., to take certain actions or perform better). The responses in Table IV, Panel B show that 42% believe that the threat of selling shares causes management to change behavior. Given that our respondents tend to be dedicated, longer-term investors that usually interact with management in private, it is plausible that their potential exit truly is a threat to firms.

Third, we try to understand the importance of investors' equity stake size for the threat of exit. Exit theories predict that stake size has two opposing effects. If stake size increases, an informed blockholder can sell more shares upon collecting negative information about the manager, and the incentives to collect information in the first place increase as well. Both

effects imply that the exit threat increases with stake size. However, if stake size becomes too large, selling the entire stake upon negative information becomes difficult because the price impact will be too large. This counter effect implies that an optimal stake size exists. Conditional on believing in the exit threat, we find in Table IV, Panel B that more than two-thirds of the respondents believe that the equity stake size should be at least 2% for the exit threat to be effective. Only a quarter of respondents think that the stake size should be beyond 10%. This relatively smaller number probably reflects that the exit threat is less credible if the stake is too large. However, these beliefs are not universal as 20% of respondents report that stake size does not matter, which implies that the exit threat can be effective even with small stakes. (The same effectiveness can be seen with relatively large ones, but institutional investors rarely hold stakes beyond 10%.)

Overall, these three results support the notion that the threat of exit is an important disciplinary governance mechanism, which is consistent with exit models.

B. Exit Threat: Determinants of Effectiveness

Theory predicts that the effectiveness of the exit threat depends not only on stake size, but also on a set of other factors. We use our survey in order to ask the investors to evaluate the importance of these factors. In addition to block size, other factors identified by exit models are a stock's liquidity, management's equity incentives, the existence of other blockholders (which could also be threatening to sell), investor flow concerns, and tracking error considerations.

Exit theories hypothesize that a stock's liquidity is central to the effectiveness of exit. For example, in Edmans (2009), liquidity increases the exit threat because it encourages blockholders to collect information on firm fundamentals; allows blockholders to trade more aggressively on that information; and leads to larger initial blocks. These positive effects counter a negative effect of liquidity, which is that liquidity reduces the price impact of a given blockholder's informed trade. Exit is also considered to be more credible if a firm's managers have greater equity ownership; managers then experience a larger loss if the stock price is

depressed because of a blockholder's exit. Edmans and Manso (2011) show that the exit threat is more effective if multiple informed blockholders hold shares in a firm because their trading then incorporates more information about the fundamental firm value into the stock price.

Some factors are hypothesized to weaken the threat of exit. For example, if institutional investors follow an index, they increase tracking error when they sell shares in a firm, which can make the exit threat less credible. In fact, tracking error considerations might even force investors to buy shares in situations where they would prefer to sell. Dasgupta and Piacentino (2014) show that the threat of exit can also be weaker if institutional investors care about investor flows (e.g., if the ultimate investors chase short-term performance). Thus, investors might not sell for fear that such an action makes their clients think that they initially bought the wrong stocks. In effect, the signaling role of exit then impairs its potential as a disciplinary threat.

To evaluate these factors, respondents were asked to indicate their importance for the effectiveness of the exit threat on a scale of 1 (not at all important) to 5 (very important). The results are provided in Table IV, Panel C. Investors state that the three most important factors influencing the effectiveness of an exit threat are: (i) selling by other investors for the same reason (72% consider this factor somewhat or very important); (ii) managerial equity ownership (70%); and (iii) the presence of large shareholders in the firm (67%). Interestingly, we find that even more subtle effects, such as investor flow considerations, are considered to be important by one out of four respondents. These findings support the mechanisms that have been highlighted in exit models.

IV. Impediments and Triggers to Shareholder Activism

A. Impediments to Shareholder Activism

Although some prominent intervention cases (e.g., Microsoft or Dell) have been highlighted recently in the news, some researchers argue that institutional investors too rarely initiate activism through voice (e.g., Black (1990)). In fact, there is an extended policy debate about

how to incentivize investors to be more active.¹³ This raises the question of why institutional investors would not be more active in pursuing changes in the companies in which they invest. While one explanation might be that investors govern more effectively through exit, additional reasons could be economic or legal impediments that hinder activism. Understanding these impediments is important for researchers trying to model the behavior of institutional investors, as well as for those who want to encourage more engagement.

A number of arguments have been made as to why investors do not engage more actively with their portfolio companies. These arguments focus on four potential areas: incentives to engage; conflicts of interest; legal barriers; and investment management industry structure. Grossman and Hart (1980) and Shleifer and Vishny (1986) argue that large investors face disincentives in becoming activists because of a “free rider” problem. That is, they would incur large costs from intervention, which would be borne solely by the activist, but any benefits from the activities would be spread among all shareholders. Theory predicts that this free rider problem decreases with stake size because a larger stake allows an investor to capture a bigger share of the value increase resulting from the intervention. Theory further predicts that the probability of successful intervention depends on the ownership structure of a firm, which can help or hinder intervention. For example, a larger number of blockholders reduces free rider problems and positively influences the effectiveness of voice (Winton (1993), Noe (2002), Edmans and Manso (2011)). However, management or insider control of voting rights reduces incentives to engage because such control decreases the probability that, for example, a proxy fight is successful.

Engagement might also be hindered by investors’ conflicts of interest. Duan, Hotchkiss, and Jiao (2014) show that business ties provide valuable information to fund managers and can lead to profitable trades in the related stocks. Investors’ concerns over existing or future business

¹³ See, for example, the Corporate Governance Green Paper issued by the European Commission (2011).

relations with the targeted firms also can inhibit intervention (Brickley, Lease, and Smith (1988), Cvijanovic, Dasgupta, and Zachariadis (2014)).¹⁴

In addition, investors might not intervene if they fear that they will breach legal rules. For example, diversification requirements for mutual funds or pension funds might not allow investors to take a stake that is sufficiently large to incentivize engagement. In addition, rules on “acting in concert” can discourage engagement because such rules imply a legal risk when investors coordinate engagement (e.g., the risk of violating Rule 13D in the U.S., or the risk of having to make a public offer in Europe). Finally, disclosure regulations (e.g., the U.S. “Regulation Fair Disclosure”) might discourage investors or managers from engagement.

Apart from these factors, intervention can also be impeded because of the structure of the investment management industry. Fund managers might not engage if their own investors do not sufficiently reward activism or if the investment process is outsourced to other asset management firms. Further, some investors might not consider shareholder engagement to be part of their mandate, in which case they take a more passive stance. Finally, some investors might believe that corporate governance is not important to a firm’s financial performance.

These arguments suggest that a number of impediments can prevent institutional investors from engaging a firm. To understand the importance of these impediments, we used two survey techniques. In one version of the survey, we asked respondents to indicate the importance of different factors on a scale of 1 (not at all important) to 5 (very important). In another version we asked respondents to mark on a list with the same factors their top four choices. The second technique circumvents the problem that many investors might indicate a high or very high importance for many different factors, making identification of the key mechanisms difficult.

The results for both techniques are provided in Table V. Consistent with the discussions in theory and practice, we don’t find one single, very important reason for not engaging. This

¹⁴ However, Davis and Kim (2007) and Ashraf, Jayaraman, and Ryan (2012) find no evidence that business ties with portfolio firms influence voting.

finding means that academics wishing to model or measure investors' behavior must consider a range of impediments and their interplay. In addition, regulators who would like to encourage more engagement face a difficult challenge; they must address a range of economic and legal aspects because simple solutions do not seem to exist. Among the different hurdles, the most important ones identified are related to incentives: Respondents indicate they do not engage because the benefits from engagement are too small; their stakes in firms are too small; they have limited resources (personnel); and they have too many firms in their portfolios. These findings imply that free rider problems limit broad shareholder engagement, even for very large institutional investors like the ones in our respondent group.¹⁵

Investors also indicate that legal reasons, especially rules against concerted actions, discourage engagement. Thus, despite recent regulatory changes (Choi (2000)) and court rulings (e.g., CSX Corp. v. TCI case) that provide greater latitude for cooperation, legal concerns over coordinated engagement remain important. A further impediment is the belief that engagement makes receiving information from targeted firms more difficult; the implication is that conflicts of interest are deemed to be of some importance. Finally, our results indicate that the belief that corporate governance matters to firm performance is not universal: 19% of the respondents do not engage as they believe corporate governance does not affect performance.

B. Triggers of Shareholder Activism

We currently have little evidence on the actual triggers of shareholder activism. The reason is that engagement triggers are difficult to observe and need to be inferred from characteristics of targeted firms or information in SEC filings (e.g., Brav et al. (2008a)). To understand which firms are targeted, we asked respondents to indicate the importance of different potential intervention triggers. We again applied two techniques. In the first one, respondents were

¹⁵ CalPERS, for example, focuses its activism only on the 300 firms of which it has the largest holdings (The Economist (2013)).

asked to indicate the level of importance of different triggers on a scale of 1 (not at all important) to 5 (very important). In the second one, they could indicate their top four triggers.

The results in Table VI show that the investors view a number of different triggers as important for engagement. Using the first technique, ten triggers receive an average score of 4 or higher. Consistently across both techniques, the main triggers—following the extreme case of fraud—are governance and strategy.¹⁶ More specifically, inadequate corporate governance and excessive compensation are considered by 88% of the respondents as somewhat or very important triggers, which reflects the importance of these topics in the public debate. Another important trigger for shareholder activism is disagreement with a firm’s strategy. We find that 89% of the respondents consider poor corporate strategy and 82% large diversifying mergers or acquisitions as somewhat or very important triggers. However, the latter was named as a top-four trigger in only 5% of the responses under the second technique. Overall, these results indicate that investors not only engage over short-term issues (e.g., equity issues or low dividends) but also, and even more so, over long-run strategic issues.¹⁷

Consistent with a recent wave in shareholder proposals that ask companies to be more transparent about their political donations (Financial Times (2014)), we find that 40% of the respondents consider financial contributions to politicians as a somewhat or very important intervention trigger. Interestingly, dissatisfaction with company performance does not appear to be a key driver of shareholder engagement, although it is still considered to be somewhat important. This finding is consistent with Karpoff, Malatesta, and Walkling (1996), who study targets for shareholder proposals.

¹⁶ Interestingly, although fraud scores high as an intervention trigger when we use the first survey technique, it is not of first order importance when we use the second technique, which indicates that although fraud is an important concern, it is not expected to be a prevalent problem.

¹⁷ These results support Bebchuk, Brav, and Jiang (2014), who find no evidence that interventions by hedge funds are mostly motivated by short-term objectives. They are further consistent with Cornelli, Kominek, and Ljungqvist (2013), who find that managers are fired not because of incompetence or moral hazard, but because of a corporate strategy mismatch. They also line up with the finding in Brav et al. (2008a) that hedge fund activism targeting the sale of the company or changes in strategy is associated with the largest announcement returns.

V. Outsourced Shareholder Activism? The Role of Proxy Advisors

An important channel of shareholder activism is voting at the annual shareholder meeting (e.g., Iliev et al. (2015)). As we found earlier, 53% of the respondents have voted against management in their proxy votes as shareholders. Further, proxy voting itself is important for regulatory and fiduciary reasons, and some institutional investors are required (or voluntarily choose) to disclose their proxy votes, as well as their voting policies. However, proxy voting entails costs, particularly given that many investors have to cast votes on several thousand securities. As a result, institutional investors commonly rely on proxy advisors, at least for voting platforms in which the investors provide proxy advisors with instructions on how they want their shares voted. In addition, many institutions also rely on proxy advisors for information on which to base their vote. As a result, the proxy advisory industry has grown substantially during the past decade. The two major players in the U.S. are Institutional Shareholder Services (ISS) and Glass, Lewis & Co.

The current debate about proxy advisors centers around two issues: the quality of their voting advice and their conflicts of interest. Diverse views emerge in relation to the first issue. One view holds that proxy advisors are a reliable source of informed voting advice because they collect information, perform delegated monitoring, and use their expertise and experience to make informed voting recommendations (e.g., Ertimur, Ferri, and Oesch (2013)). Thus, the services of proxy advisors reduce investors' voting costs, leading to better and more informed voting decisions. The alternative view holds that the recommendations of proxy advisors are too standardized and ignore firm-specific circumstances (e.g., Gordon (2009)). Moreover, their recommendation criteria entail a lack of transparency, making the assessment of the quality of voting recommendations difficult. Both issues are a particular concern when investors use the advisors primarily to fulfill their duty to vote, but are not too concerned about the quality of their recommendations. In this case proxy advisors may have incentives to conduct only low-cost analyses (Larcker, McCall, and Ormazabal (2014)).

The second major issue of concern is whether proxy advisors have conflicts of interests in arriving at their recommendations. For example, ISS serves as a consultant, advising firms on how they can improve their corporate governance; at the same time, ISS makes recommendations about how investors in these firms should vote. Some researchers maintain that this dual role may give rise to recommendations that are affected by conflicts of interest (Yermack (2010), Alexander et al. (2010)). Counterarguments are offered by ISS, which argues that it has reduced conflicts of interest by structurally separating the voting advice from its consulting business. In addition, Li (2014) argues that the industry structure, consisting of only two main players, also reduces conflicts of interests.

These diverse views show that we need a better understanding of how investors view the role of proxy advisors. Our analysis proceeds in three steps. First, we examine the extent to which institutional investors use proxy advisors. Table VII, Panel A shows that 60% of our respondents use at least one proxy advisor, and almost half of these respondents employ the services of more than one advisor. Thus, many investors rely on more than one source of information when forming their views on voting matters.

Second, we study whether the use of proxy advisors substitutes or complements for governance through intervention. To this end, we create a dummy variable that equals one if an investor uses at least one proxy advisor, and zero otherwise. We then regress this variable on the previously defined voice index, which captures the intensity of intervention. The results are reported in Table VII, Panel B. We find that investors who employ the services of proxy advisors use direct intervention through voice more intensively, which implies that intervention and the services of proxy advisors are complements rather than substitutes. In terms of economic significance, the probit coefficient of 0.19 in Column 3 indicates that a one-unit increase in the voice index increases the odds of using a proxy advisor by 20%. The view that investors outsource activism to proxy advisors and then remain passive when it comes to engagement is thus refuted by these data.

Third, we address how institutional investors assess the role of proxy advisors in their own decision-making. In particular, we try to understand whether investors are worried that their recommendations are too standardized and reflect conflicts of interests, or whether they help them in making more informed voting decisions. These issues are difficult to answer using data on voting recommendations and votes because evaluating whether recommendations simply reflect investor preferences or actually influence them is challenging. The results are reported in Table VIII. We find that 55% of the respondents agree or strongly agree that proxy advisors help them make more informed voting decisions. Less than one-third of the respondents agree or strongly agree that their advice is too standardized. These results suggest that proxy advisors do not just aggregate shareholder preferences or coincide with them, but actually influence voting decisions in a positive way. These views are consistent with our finding that engagement and the use of proxy advisors are complements.¹⁸ They are also in line with Iliev and Lowry (2015) who find that most mutual funds take ISS recommendations into account but do not simply follow them, and Aggarwal, Erel, and Starks (2014) who find increasing divergence between proxy advisors and institutional investors in their voting choices over time.

The investors also raise some concerns about the work of proxy advisors; 52% agree or strongly agree that proxy advisors are sometimes exposed to conflicts of interest. Possibly as a result of this concern, 22% of the respondents agree or strongly agree that proxy advisors should be regulated.

VI. Conclusions

We use survey methodology to provide insights into the corporate governance preferences and actions of institutional investors. We focus on the two active choices investors have when they are unhappy with a firm: exit and voice. Guided by theoretical models and previous empirical evidence, we develop survey questions that directly assess institutional

¹⁸ As Michelle Edkins of Blackrock has stated in the media about proxy advisors, “They are really an important part of the process and help us identify the companies that we should be focusing our efforts on” (Burr (2012)).

investors' preferences and actions. Such knowledge can be captured only with a survey methodology. Thus, our survey allows us to validate existing theories and inferences made from indirect empirical tests of shareholders' preferences and actions regarding corporate governance.

Most importantly, through the survey we find institutional investors' preferences and actions to be largely consistent with the theoretical literature. Our survey shows that institutional investors frequently employ voice in their shareholder engagements. The most common engagement channels are behind-the-scenes discussions with management and boards of directors. Nevertheless, we find that investors still face several engagement impediments, principally because of liquidity concerns, free rider problems, and legal concerns. In addition, we show that investor horizon matters for engagement. First, long-term investors intervene more intensively than short-term investors. Second, engagements are primarily triggered by concerns over a firm's corporate governance or strategy rather than over short-term issues.

We then show that more than 40% of our respondents report that they believe the exit threat disciplines management. The effectiveness of this threat depends, according to our survey results, on investors' equity stake size, whether other investors also exit for the same reason, managerial equity ownership, and whether other large shareholders are also present. Moreover, exit and voice are related, as the surveyed investors believe that both governance mechanisms are complementary strategies.

Finally, we shed light on the controversial role of the proxy advisor, which has been a concern for many. Our survey responses indicate that proxy advisors do not just aggregate shareholder preferences or coincide with them, but actually influence voting in a positive way.

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Table I
Summary Statistics on Respondents

Panel A contains information on the characteristics of the institutional investors for which the respondents work. We report the respondents' position or job title, institutional investor types, assets under management, and location. Panel B contains information on the characteristics of the investments of the institutional investors. These characteristics include investor horizon, investment structure (percentage of the portfolio that is actively, rather than passively, invested), and stock liquidity. We obtained 143 responses to our survey, but not all respondents provided information on investor or investment characteristics.

Panel A: Institutional Investor Characteristics

Position of Respondent (N=97)	# Respondents	% Respondents
Corporate Governance or Proxy Voting Specialist	28	29%
Portfolio Manager	26	27%
Chief Investment Officer	17	18%
Board Member	14	14%
Other	12	12%
Institutional Investor Type (N=100)	# Respondents	% Respondents
Asset Manager	48	48%
Mutual Fund	21	21%
Pension Fund	12	12%
Hedge Fund	4	4%
Other	15	15%
Assets under Management (N=98)	# Respondents	% Respondents
More than \$100bn	34	35%
Between \$1bn and \$100bn	31	32%
Between \$100m and \$1bn	25	26%
Less than \$100m	8	8%
Location (N=102)	# Respondents	% Respondents
Continental Europe	37	36%
US	24	24%
UK	16	16%
Rest of World	25	25%

Panel B: Investment Characteristics

Investor Horizon (N=95)	# Respondents	% Respondents
Short (less than 6 months)	0	0%
Medium (6 months to 2 years)	28	29%
Long (more than 2 years)	67	71%
Investment Structure (N=91)	Mean	Median
Active Investments	75%	90%
Stock Liquidity (N=103)	# Respondents	% Respondents
Not at all important	2	2%
Somewhat unimportant	4	4%
Neither important nor unimportant	4	4%
Somewhat important	55	53%
Very important	38	37%

Table II
Prevalence of Exit and Voice Channels

Respondents were asked to indicate what measures they have taken in the past five years with their portfolio companies. Responses were not mutually exclusive. Column 3 reports the percent of respondents that took a certain measure. Column 4 reports the number of respondents. Column 5 reports the results of a *t*-test of the null hypothesis that the percentage for a given measure is equal to the percentage for each of the other measures, where only significant differences at the 5% level are reported.

Statement	Shareholder engagement measures taken in the past five years:	% that took this measure	# Respondents	Significant differences in Mean Response vs. Rows
(1)	Discussions with top management	63%	142	2-14
(2)	Voting against management	53%	142	1, 4-14
(3)	Selling shares because of dissatisfaction with performance	49%	142	1, 5-14
(4)	Discussions with board of directors outside of management	45%	142	1-2, 6-14
(5)	Selling shares because of dissatisfaction with corporate governance	39%	142	1-3, 8-14
(6)	Proposing a specific action to management	35%	142	1-4, 8-14
(7)	Aggressively questioning management on a conference call	30%	142	1-4, 8-13
(8)	Criticizing management and the board at the annual meeting	18%	142	1-7, 13
(9)	Publicizing a dissenting vote	18%	142	1-7, 13
(10)	Submitting shareholder proposals for the proxy statement	16%	142	1-7, 13
(11)	Legal action against management	15%	142	1-7, 13
(12)	Publicly criticizing management in the media	13%	142	1-7, 13
(13)	Changing SEC filings from Schedule 13G to 13D	1%	142	1-12, 14
(14)	None	19%	142	1-6, 13

Table III
Determinants of Voice Intensity

This table reports ordered logit regressions. The dependent variable, *Voice*, is an index that counts the number of different voice channels an institutional investor has taken in the past five years with portfolio companies. The variable can vary between 0 and 11. *Stock Liquidity* is a variable that indicates the importance of the float or overall liquidity of shares when an institutional investor considers buying or selling shares. The variable ranges from 1 (not at all important) to 5 (very important). *Investor Horizon* is a variable that indicates the reported typical holding periods for investments in the portfolio of an institutional investor. The variable takes the values 0 (6 months to 2 years) or 1 (more than 2 years). *Assets under Management* is a variable that indicates the size of an institutional investor. The variable takes the values 1 (less than \$100m), 2 (between \$100m and \$1bn), 3 (between \$1bn and \$100bn), and 4 (more than \$100bn). *Active Investments* is a variable that measures the percentage of an institutional investor's portfolio that is invested actively. *Exit* is a dummy variable that equals one if an institutional investor used exit as a governance mechanism in the past five years with portfolio companies. We further include location and institutional investor type dummies. *t*-statistics, calculated based on robust standard errors, are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

	Voice						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Stock Liquidity	-0.39** (-2.24)				-0.54** (-2.11)		-0.61** (-2.39)
Investor Horizon		1.34*** (3.26)			1.25** (2.19)		1.30** (2.33)
Assets under Management			0.15 (0.71)		-0.09 (-0.30)		-0.10 (-0.31)
Active Investments				0.01 (1.34)	0.02* (1.79)		0.01 (1.59)
Exit						1.70*** (4.87)	1.05* (1.86)
US					0.33 (0.44)		0.61 (0.78)
UK					1.73** (2.18)		2.01** (2.16)
Continental Europe					-0.08 (-0.12)		-0.04 (-0.07)
Hedge Fund					1.35 (0.94)		1.38 (0.86)
Mutual Fund					1.27* (1.84)		0.70 (0.83)
Asset Manager					0.82 (1.18)		0.43 (0.54)
Pension Fund					2.12*** (2.65)		1.79** (2.07)
N	103	94	97	90	85	142	85
Pseudo R ²	0.009	0.026	0.001	0.005	0.089	0.047	0.100

Table IV
Effectiveness of the Threat of Exit

Panel A reports how often respondents engage management in an attempt to achieve changes *prior* to exiting due to dissatisfaction with management performance. Panel B reports whether respondents think that the *threat* of selling shares, rather than exit itself, causes management to make changes. If the answer was “Yes”, they could further indicate how large the equity stake in a portfolio firm would need to be at minimum for the threat of exit to cause management to make such changes. In Panel C respondents indicate the level of importance of different situations for the effectiveness of the threat of exit on a scale of 1 (not at all important) to 5 (very important). Column 3 reports the mean score, where higher values correspond to higher importance. Column 4 presents the percent of respondents indicating importance levels of 4 or 5 (somewhat important or very important). Column 5 reports the number of respondents. Column 6 reports the results of a *t*-test of the null hypothesis that the mean score for a given situation is equal to the mean score for each of the other situations, where only significant differences at the 5% level are reported. Column 7 reports the results of a *t*-test of the null hypothesis that each mean score is equal to 3 (neither important nor unimportant). ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: Engagement Prior to Exit

Engagement of Management Prior to Exit?			
Often	Sometimes	Never	# Respondents
27%	51%	22%	89

Panel B: Exit Threat: Effectiveness

Is the Threat of Exit Effective?							
No	34%						
Yes	42%	If “Yes”: Minimum Stake Size?					
		Does not matter	At least 0.5%	At least 2%	At least 5%	At least 10%	# Respondents
		20%	7%	22%	27%	24%	45
Don't know	24%						
# Respondents	105						

Panel C: Exit Threat: Determinants of Effectiveness

Statement	Importance for the threat of exit to be effective:	Mean Score	% with 4 or 5 Score	# Respondents	Significant differences in Mean Score vs. Rows	H ₀ : Mean Score = 3
(1)	Selling of other investors for the same reason	3.87	72%	86	4-6	***
(2)	Equity ownership of the firm’s management	3.76	70%	87	4-6	***
(3)	Existence of large shareholders in the firm	3.69	67%	88	5-6	***
(4)	Possibility to sell shares without affecting the price	3.40	56%	87	1-2, 5-6	***
(5)	Inference by clients about own stock picking ability	2.52	25%	87	1-4	***
(6)	Keeping shares to minimize tracking error	2.50	21%	84	1-4	***

Table V
Impediments to Shareholder Activism

This table reports survey responses based on two different techniques. Survey Technique A asked respondents to indicate the level of importance of different reasons for not conducting shareholder engagement on a scale of 1 (not at all important) to 5 (very important). Column 3 reports the mean score, where higher values correspond to higher importance. Column 4 presents the percent of respondents indicating importance levels of 4 or 5 (somewhat important or very important). Column 5 reports the number of respondents. Column 6 reports the results of a *t*-test of the null hypothesis that the mean score for a given reason is equal to the mean score for each of the other reasons, where only significant differences at the 5% level are reported. Column 7 reports the results of a *t*-test of the null hypothesis that each mean score is equal to 3 (neither important nor unimportant). Survey Technique B asked respondents to indicate the top four reasons for not conducting shareholder engagement. Column 8 reports the percent of respondents indicating a given reason as a top four reason for not conducting shareholder engagement. Column 9 reports the number of respondents. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Statement	Reasons for not conducting shareholder engagement:	Survey Technique A					Survey Technique B	
		Mean Score	% with 4 or 5 Score	# Respondents	Significant differences in Mean Score vs. Rows	H ₀ : Mean Score = 3	% Top 4 Reason	# Respondents
(1)	Benefits from engagement not large enough	3.4	61%	74	7-14	***	24%	41
(2)	Too small of a stake in a firm	3.4	61%	74	7-14	**	51%	41
(3)	Limited personnel	3.4	54%	74	7-14	**	56%	41
(4)	Rules on “acting in concert” discourage coordination	3.3	44%	72	7-14	*	24%	41
(5)	Too many firms in our portfolio	3.3	45%	75	7-14		27%	41
(6)	Management or insider control of voting rights	3.2	45%	74	7-14		27%	41
(7)	Investors in our fund do not sufficiently reward engagement	2.8	36%	74	1-6, 12-14		17%	41
(8)	Disclosure regulations discourage conversations	2.8	25%	73	1-6, 12-14		7%	41
(9)	Holdings by other institutional investors are not large enough	2.8	32%	74	1-6, 13-14	*	17%	41
(10)	Engagement is not considered part of our investment mandate	2.7	36%	73	1-6, 13-14	*	20%	41
(11)	Engagement makes it more difficult to receive information	2.6	28%	72	1-6, 14	**	22%	41
(12)	Regulation does not allow us to take a sufficiently large stake	2.5	22%	74	1-8	***	7%	41
(13)	Investment process is outsourced to other asset management firms	2.3	21%	73	1-10	***	10%	41
(14)	Corporate governance does not affect financial performance	2.2	19%	72	1-11	***	10%	41

Table VI
Triggers of Shareholder Activism

This table reports survey responses based on two different techniques. Survey Technique A asked respondents to indicate the level of importance of different triggers of shareholder engagement on a scale of 1 (not at all important) to 5 (very important). Column 3 reports the mean score, where higher values correspond to higher importance. Column 4 presents the percent of respondents indicating importance levels of 4 or 5 (somewhat important or very important). Column 5 reports the number of respondents. Column 6 reports the results of a *t*-test of the null hypothesis that the mean score for a given trigger is equal to the mean score for each of the other triggers, where only significant differences at the 5% level are reported. Column 7 reports the results of a *t*-test of the null hypothesis that each mean score is equal to 3 (neither important nor unimportant). Survey Technique B asked respondents to indicate the top four triggers for shareholder engagement. Column 8 reports the percent of respondents indicating a given trigger as a top four trigger for shareholder engagement. Column 9 reports the number of respondents. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Statement	Triggers for shareholder engagement:	Survey Technique A					Survey Technique B	
		Mean Score	% with 4 or 5 Score	# Respondents	Significant differences in Mean Score vs. Rows	H ₀ : Mean Score = 3	% Top 4 Triggers	# Respondents
(1)	Corporate fraud	4.5	89%	57	4-17	***	32%	37
(2)	Inadequate corporate governance	4.4	88%	56	6, 8-17	***	81%	37
(3)	Excessive management compensation	4.4	88%	56	8-17	***	41%	37
(4)	Poor corporate strategy	4.2	89%	56	1, 11-17	***	43%	37
(5)	Large diversifying merger or acquisition	4.1	82%	56	1, 12-17	***	5%	37
(6)	Poor absolute financial performance	4.1	80%	56	1-2, 11-17	***	22%	37
(7)	Poor financial performance relative to peers	4.1	79%	56	1, 12-13, 15-17	***	41%	37
(8)	Large related-party transaction by insiders	4.1	79%	56	1-3, 15-17	***	30%	37
(9)	Socially “irresponsible” corporate behavior	4.1	72%	57	1-3, 14-17	***	35%	37
(10)	Large equity issuance	4.0	82%	55	1-3, 12-13, 15-17	***	0%	37
(11)	Large negative earnings surprise	3.8	68%	56	1-4, 6, 16-17	***	5%	37
(12)	Uncooperative management	3.7	64%	56	1-7, 10, 16-17	***	8%	37
(13)	Suboptimal capital structure	3.7	68%	56	1-7, 10, 16-17	***	19%	37
(14)	Earnings restatement	3.7	68%	56	1-6, 10, 16-17	***	3%	37
(15)	Low payments to shareholders despite high cash holdings	3.7	71%	55	1-10, 16-17	***	19%	37
(16)	Financial contributions to political parties or politicians	3.2	40%	55	1-15		5%	37
(17)	The threat of a major shareholder to sell shares	2.8	27%	55	1-15		5%	37

Table VII
Role of Proxy Advisors

Panel A provides answers to the question of whether the respondents use proxy advisors. Panel B provides probit regressions of the determinants of their use. The dependent variable, *Proxy Advisor*, is a dummy that equals 1 if an institutional investor uses at least one proxy advisor and 0 otherwise. *Voice* is an index that counts the number of voice channels that an institutional investor had taken in the past five years with portfolio companies. The variable can vary between 0 and 11. *Investor Horizon* is a variable that indicates the reported typical holding periods for investments in the portfolio of an institutional investor. The variable takes the values 0 (6 months to 2 years) or 1 (more than 2 years). *Assets under Management* is a variable that indicates the size of an institutional investor. The variable takes the values 1 (less than \$100m), 2 (between \$100m and \$1bn), 3 (between \$1bn and \$100bn), and 4 (more than \$100bn). *Active Investments* is a variable that measures the percentage of an institutional investor's portfolio that is invested actively. We further include location and institutional investor type dummies. *t*-statistics, calculated based on robust standard errors, are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: Use of Proxy Advisors

# Proxy Advisor (N=99)	# Respondents	% Respondents
None	39	39%
One	32	32%
More than one	28	28%

Panel B: Determinants

	Proxy Advisor		
	(1)	(2)	(3)
Voice	0.27*** (4.97)		0.19** (2.49)
Investor Horizon		1.20*** (2.84)	0.97** (2.11)
Assets under Management		0.30 (1.35)	0.36* (1.65)
Active Investments		0.01 (0.94)	0.00 (0.62)
US		0.59 (1.03)	0.61 (1.03)
UK		1.45** (2.15)	1.02 (1.44)
Continental Europe		-0.66 (-1.46)	-0.82 (-1.52)
Hedge Fund		1.80** (2.07)	1.46* (1.72)
Mutual Fund		1.42*** (2.59)	0.91 (1.59)
Asset Manager		1.74*** (3.28)	1.45** (2.44)
Pension Fund		2.65*** (3.24)	2.30** (2.57)
Constant	-0.68*** (-2.91)	-3.41*** (-3.47)	-3.58*** (-3.48)
N	98	85	84
Pseudo R ²	0.198	0.416	0.459

Table VIII
Assessment of Proxy Advisors

Respondents were asked to indicate the level of agreement with different statements about proxy advisors on a scale of 1 (strongly disagree) to 7 (strongly agree). Column 3 reports the mean score, where higher values correspond to higher agreement. Column 4 presents the percent of respondents indicating agreement levels of 6 or 7 (agree or strongly agree). Column 5 reports the number of respondents. Column 6 reports the results of a *t*-test of the null hypothesis that the mean score for a given statement is equal to the mean score for each of the other statements, where only significant differences at the 5% level are reported. Column 7 reports the results of a *t*-test of the null hypothesis that each mean score is equal to 4 (neither agree nor disagree). ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Statement	Proxy advisors:	Mean Score	% with 6 or 7 Score	# Respondents	Significant differences in Mean Score vs. Rows	H ₀ : Mean Score = 4
(1)	Are sometimes exposed to conflicts of interest	5.29	52%	95	3-4	***
(2)	Allow us to make more informed voting decisions	5.22	55%	96	3-4	***
(3)	Offer too standardized advice	4.50	30%	96	1-2, 4	***
(4)	Should be regulated	4.06	22%	95	1-3	

Internet Appendix IA.I

Survey on Shareholder Engagement, Shareholder Voting, and Proxy Voting Advisors

Introduction

We are a team of professors from [XXX]. This survey is part of a research project that seeks to attain a better understanding of the views and actions of institutional investors with regard to engagement with the managers and boards of corporations in their investment portfolios.

We take the confidentiality of your responses very seriously. We will not share your responses with anyone, nor will individual firms or respondents be identified. Only aggregate data will be made public. Moreover, we will not link the survey responses to any other data.

If you would like to comment on any question in the survey, please do so at the space near the question or at the end of the survey.

If you have any questions, please contact us: [\[XXX\]](#) or [\[XXX\]](#).

Please send the survey back to one of our email addresses or to the following postal address:

[XXX]

Thank you very much for participating in this survey.

Part A: Shareholder Engagement

A1: What measures of shareholder engagement have you taken *in the past five years* with any of your portfolio companies? (Choose all that apply)

- | | |
|--|---|
| <input type="checkbox"/> None | <input type="checkbox"/> Submitting shareholder proposals for the proxy statement |
| <input type="checkbox"/> Selling shares because of dissatisfaction with performance | <input type="checkbox"/> Discussions with members of the board of directors outside of management |
| <input type="checkbox"/> Selling shares because of dissatisfaction with corporate governance practices | <input type="checkbox"/> Discussions with top management |
| <input type="checkbox"/> Voting against management at the annual meeting | <input type="checkbox"/> Publicizing a dissenting vote |
| <input type="checkbox"/> Aggressively questioning management on a conference call | <input type="checkbox"/> Criticizing management and the board at the annual meeting |
| <input type="checkbox"/> Publicly criticizing management in the media | <input type="checkbox"/> Changing SEC filings from Schedule 13g (“passive ownership”) to 13d (“active ownership”) for U.S. investments |
| <input type="checkbox"/> Legal action against management (e.g., file a lawsuit, participate in a class action, file a “books and records” request) | <input type="checkbox"/> Proposing a specific action to management (e.g., sell assets, fire the CEO, increase payout, stop equity offering) (please also indicate the proposed action): |
| <input type="checkbox"/> Other (please explain): | |

A2: Which of the following do you view as the top four reasons for not conducting shareholder engagement? (Please rank #1, #2, #3, #4)

- | | | | |
|--------------------------|---|--------------------------|--|
| <input type="checkbox"/> | Corporate governance does not affect financial performance | <input type="checkbox"/> | Shareholder engagement is not considered part of our investment mandate |
| <input type="checkbox"/> | Expected benefits from shareholder engagement are not large enough to cover costs/expenses | <input type="checkbox"/> | Limited personnel to achieve shareholder engagement |
| <input type="checkbox"/> | Too small of a stake in a firm | <input type="checkbox"/> | Our investment process is outsourced to other asset management firms |
| <input type="checkbox"/> | Too many firms in our portfolio | <input type="checkbox"/> | Management or insider control of voting rights in the company is too large to allow achievement of the desired results |
| <input type="checkbox"/> | Holdings by other institutional investors are not large enough for sufficient pressure to get the desired results | <input type="checkbox"/> | Rules on “acting in concert” discourage coordinating shareholder engagement with other institutional investors |
| <input type="checkbox"/> | Disclosure regulations such as “Regulation Fair Disclosure” discourage conversations between management and investors | <input type="checkbox"/> | Shareholder engagement would potentially make it more difficult to receive information from company management |
| <input type="checkbox"/> | Regulation does not allow us to take a sufficiently large stake in a company | <input type="checkbox"/> | Other (please explain): |
| <input type="checkbox"/> | Investors in our fund/institution do not sufficiently reward shareholder engagement | <input type="checkbox"/> | _____ |

A3: Which of the following corporate events or policies do you view as the top four triggers for shareholder engagement? (Please rank #1, #2, #3, #4)

- | | | | |
|--------------------------|---|--------------------------|--|
| <input type="checkbox"/> | Poor absolute financial performance | <input type="checkbox"/> | Poor financial performance relative to peers |
| <input type="checkbox"/> | Poor corporate strategy | <input type="checkbox"/> | Large equity issuance |
| <input type="checkbox"/> | Excessive management compensation | <input type="checkbox"/> | Large diversifying merger or acquisition |
| <input type="checkbox"/> | Earnings restatement | <input type="checkbox"/> | Suboptimal capital structure |
| <input type="checkbox"/> | Large negative earnings surprise | <input type="checkbox"/> | The threat of a major shareholder to sell shares |
| <input type="checkbox"/> | Financial contributions to political parties or politicians | <input type="checkbox"/> | Corporate fraud |
| <input type="checkbox"/> | Low payments to shareholders despite high cash holdings | <input type="checkbox"/> | Socially “irresponsible” corporate behavior (e.g., human rights violations or pollution) |
| <input type="checkbox"/> | Inadequate corporate governance | <input type="checkbox"/> | Large related-party transaction by insiders (e.g., sale of equity by management or sale of company assets to management) |
| <input type="checkbox"/> | Uncooperative management | <input type="checkbox"/> | |
| <input type="checkbox"/> | Other (please explain): | | |

Part B: Selling Shares Because of Dissatisfaction with Management Performance

B1: When you consider buying or selling shares, how important is the float or overall liquidity of the shares? (Check the appropriate box)

Not at all important	Somewhat unimportant	Neither important nor unimportant	Somewhat important	Very important
1	2	3	4	5
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

B2: Did you ever sell shares in companies, that is, exit the company's stock, due to dissatisfaction with management performance?

- No
 Yes

If your answer was "yes": Before you sold the shares, how often did you first try to engage management in an attempt to achieve changes?

- Often
 Sometimes
 Never
 Other (please explain): _____

B3: Do you think that the threat of selling shares, rather than the exit itself, causes management to make changes such as taking certain actions or performing better?

- No
 Yes, if the equity stake in a portfolio firm is high enough (please also check the appropriate box):
 At least 0.5% At least 2% At least 5% At least 10% Equity stake size does not matter
 Don't know

B4: How important do you consider the following situations to be in whether the threat of exit would be an effective disciplining mechanism? (Check the appropriate box)

Not at all important	Somewhat unimportant	Neither important nor unimportant	Somewhat important	Very important
1	2	3	4	5
1. The equity ownership and stock options of the firm's management team	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. The possibility to sell the shares in the market without affecting the price	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Whether other investors are selling shares in the firm for the same reason	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. The existence of large shareholders in the firm	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Keeping some shares to minimize tracking error (but reducing exposure)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. An institutional investor with a large position might be reluctant to exit that position because clients may infer that the investor picked the wrong stock	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

7. Other (please explain):

Part C: Proxy Voting Advisors

C1: Do you use an external proxy voting advisor?

- Yes, just one
- Yes, more than one
- No

C2: To what extent do you agree with each of the following statements regarding proxy voting advisors? (Check the appropriate box)

Strongly disagree	Disagree	Somewhat disagree	Neither agree nor disagree	Somewhat agree	Agree	Strongly agree
1	2	3	4	5	6	7

- 1. Proxy voting advisors allow us to make more informed voting decisions

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------
- 2. Proxy voting advisors are sometimes exposed to conflicts of interests if they offer consulting services to firms

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------
- 3. Proxy voting advisors should be regulated

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------
- 4. The advice of proxy voting advisors is too standardized and does not sufficiently take firm-specific circumstances into account

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Part D: General Information

D1: The fund/institution where I work can be best described as:

- Hedge fund
- Insurance company
- Mutual fund management company
- Asset manager for pension funds, endowments and other separate accounts
- Other (please specify):

- Pension fund
- Private equity fund
- Endowment, charity
- Bank

D2: Approximately what percentage of your portfolio is invested actively versus passively?

___ % in active investment
 ___ % in passive investment

D3: What is the total size of assets under management for your organization?

- Less than \$100 million
- Between \$100 million and \$1 billion
- Between \$1 billion and \$100 billion
- More than \$100 billion

D4: What is the typical holding period for investments in your portfolio, on average?

- Short (less than 6 months)
- Medium (6 months to 2 years)
- Long (more than 2 years)

D5: In what country are your headquarters based? _____

D6: How would you best describe your principal investment style? _____

D7: What is your position?

- Chief Investment Officer
- Portfolio Manager
- Corporate Governance or Proxy Voting Specialist
- Other (please explain): _____

Internet Appendix IA.II Survey Design

We developed an initial survey instrument by considering which questions would provide insights into important outstanding issues in corporate governance research. After designing an initial survey, we solicited feedback from 16 academics in finance and law and six practitioners (chief investment officers and corporate governance specialists at institutional investors). We also obtained feedback from two survey research experts on the design, wording, and execution of the survey.

The feedback from this group was sequential, so we were able to revise the survey multiple times and conduct beta tests to ensure that the questions would be properly understood and that the time required to complete the survey would be reasonable. Through this process, we adjusted the survey and deleted some questions. The final survey questions are provided in Internet Appendix IA.I.

The survey was designed to cover different aspects of corporate governance in three areas: Shareholder Engagement; Exit as a Governance Mechanism; and Proxy Voting Advisors. A final part of the survey was intended to gather investor demographic data. The survey also contained a section on Say on Pay, which is not covered in this paper because of space considerations. We did not require that institutional investors fill in all parts of the survey, and respondents could skip questions if they did not want to answer them.

We used both a paper version and an online version. The online version consisted of a series of linked webpages. To mitigate potential order-of-presentation effects, we randomly varied the order of choices within questions where we were concerned that such effects could be important (e.g., questions A1, A2, A3). Although we did not randomly order the response choices for the paper version of the survey, we did use two versions with two different orders of choices. We did not scramble the response choices for other questions where order appeared not to be an issue (e.g., for investor characteristics) or where a natural order of responses was logical (e.g., questions B2 and B3).

Internet Appendix IA.III compares the characteristics of the respondents to the online versus the paper versions of the survey. The appendix shows that continental European investors and mutual funds were the more likely respondents for the online survey, while pension funds were the more likely respondents for the paper version of the survey.

For two questions that aim at understanding the importance of different engagement impediments and triggers, we varied the survey design between two different techniques. In one version of the survey, we tried to discern the level of importance of different factors (e.g., reasons for not engaging) by asking respondents to indicate the importance of each factor on a scale of 1 (not at all important) to 5 (very important). In another version we asked respondents to mark on a list with the same factors their top four choices (e.g., top four reasons for not engaging). This survey version is included in the Internet Appendix IA.I. We included this second technique to enhance the validity of the responses and to circumvent the problem that many investors might indicate a high or very high importance for many different factors, making identification of the key mechanisms difficult.

Internet Appendix IA.III

Respondent Characteristics: Online versus Paper Survey

This table compares the characteristics of the respondents to the online and paper versions of the survey, respectively. *Investor Horizon* is a variable that indicates the reported typical holding periods for investments in the portfolio of an institutional investor. The variable takes the values 0 (6 months to 2 years) or 1 (more than 2 years). *Stock Liquidity* is a variable that indicates the importance of the float or overall liquidity of shares when an institutional investor considers buying or selling shares. The variable ranges from 1 (not at all important) to 5 (very important). *Active Investments* is a variable that measures the percentage of an institutional investor's portfolio that is invested actively. *Assets under Management* is a variable that indicates the size of an institutional investor. The variable takes the values 1 (less than \$100m), 2 (between \$100m and \$1bn), 3 (between \$1bn and \$100bn), and 4 (more than \$100bn). *Proxy Advisor* is a dummy variable that equals 1 if an investor uses at least one proxy advisor and 0 otherwise. We further report significance levels of *t*-tests of the null hypothesis that the mean values of the characteristics of the online and paper respondents are equal to each other. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

	Online		Paper		Difference Significant?
	Mean	Obs.	Mean	Obs.	
Investor Horizon	0.7	58	0.7	37	
Stock Liquidity	4.3	66	4.0	37	**
Active Investments	79%	54	70%	37	
Assets under Management	3.0	59	2.8	39	
US	24%	59	23%	43	
UK	12%	59	21%	43	
Continental Europe	46%	59	23%	43	**
Hedge Fund	2%	61	8%	39	
Mutual Fund	30%	61	8%	39	***
Asset Manager	43%	61	56%	39	
Pension Fund	4%	99	18%	44	***
Proxy Advisor	55%	60	69%	39	

Internet Appendix IA.IV

Correlations of Investor and Investment Characteristics

This table reports correlations between investor and investment characteristics. *Assets under Management* is a variable that indicates the size of an institutional investor. The variable takes the values 1 (less than \$100m), 2 (between \$100m and \$1bn), 3 (between \$1bn and \$100bn), and 4 (more than \$100bn). *Active Investments* is a variable that measures the percentage of an institutional investor's portfolio that is invested actively. *Stock Liquidity* is a variable that indicates the importance of the float or overall liquidity of shares when an institutional investor considers buying or selling shares. The variable ranges from 1 (not at all important) to 5 (very important). *Proxy Advisor* is a dummy variable that equals 1 if an investor uses at least one proxy advisor and 0 otherwise. * indicates significance at least at the 10% level.

	Assets under Management	Investor Horizon	Active Investments	Stock Liquidity	Proxy Advisor
Investor Horizon	0.36*	1.00			
Active Investments	0.00	0.08	1.00		
Stock Liquidity	-0.01	-0.19*	0.23*	1.00	
Proxy Advisor	0.28*	0.33*	0.08	0.05	1.00
US	0.19*	-0.06	0.07	0.06	0.19*
UK	-0.11	0.15	0.16	0.02	0.30*
Continental Europe	0.12	0.10	-0.11	-0.23*	-0.32*
Rest of World	-0.25*	-0.19*	-0.10	0.19*	-0.10
Hedge Fund	-0.20*	-0.21*	-0.05	0.02	-0.05
Mutual Fund	0.22*	0.05	0.09	-0.13	0.05
Asset Manager	-0.01	-0.15	-0.14	0.08	0.10
Pension Fund	-0.01	0.18*	-0.08	0.04	0.24*