How is corporate governance influenced by 'behind the scene' investors?

| RESEARCH QUESTION |
How did the Covid crisis impact corporate governance 'behind the scene'?

Dhriti Bhutani
School of Law, Guru Gobind Singh Indraprastha University, India

Abstract
The Board of Directors, working away from the public's eye, towards achieving the vision of the company play an important role in the Corporate Governance. The institutional investors who are more inclined towards increasing the profitability of the company instead of liquidity in the form of dividend, usually has 2 types of choices according to acamidicians, such as voice theory and exit theory. The voice theory is considered to be the most effective out of all of them as the board of directors directly voice their opinion regarding the matters in question and solutions are derived faster. Second theory is called exit theory, it is indistinguishable as the threat can't be segregated from real of fake. Threat to take back the investment or resign from the company keeps the others working alongside them behind the scenes on their toes and can help them get their desired results as it is impossible to know if they actually plan to leave or just making a false threat. The COVID situation left no stone unturned. It affected all aspects of the market, the companies, stock market, investors, banks, inflation, resources, etc. This paper talks about the Pre-covid period from the perspective of the investors onlooking the stock market and the Post-covid period recovering from the damage caused by the world wide pandemic.

Keywords: *Corporate, Governance, Voice, Exit, Pandemic, Institutional Investors, Covid, Market, Theory.*

Introduction

Corporate governance[1] can be defined as a system of rules, processes, and practices which is used to direct and control a company. It is used to facilitate effective, prudent, and entrepreneurial efforts to help the organization achieve its vision. It provides the skeleton for the company's long-term objectives. Corporate governance raison d'être is the board of directors. It is all about what and how the board of directors does it and it is to be differentiated from the day-to-day operations of the top management. Good corporate governance aids by creating long-term investment opportunities for market participants by promoting financial viability. It entails 4 principles that are, accountability, transparency, fairness, and responsibility.

Who is "Behind the scenes"?

The person who works behind the scenes of a company has the power to change how the company works. They work privately, away from the public eye turning the company's goals in line with their agendas. They can also be called Institutional Investors[2], a third party, whether a company or organization that invests on others' behalf in the company. Also known as the whales on Wall-street as they trade substantial blocks of stocks.

There are different types of institutional investors with different goals in their minds. Some might seek steady long-term growth instead of a volatile short term one while their fund
managers may want to exploit short term volatility for their benefit instead of focusing on the
long term objectives, on the other hand, for some investors seeking short-term growth then those objectives might cause undesirable short-termism in the investee companies.

As early as Hirschman (1970), Academicians has focused on 2 active choices that the institutional investors often use behind the scenes of the company.

Voice Theory

It has been documented by the theoretical models that voice theory helps in governance benefits of corrective measures. It has been noted in empirical research conducted that most long-term investors signalled that the use of voice, especially when used behind the scenes is highly effective. Referring to the literature given on voice theory, we can say that various potential determinants relate to the intensity of the voice strategy.

Liquidity

Investors who are more into liquidity do not exercise this choice as intensively as compared to institutional investors interested in more profits compared to liquidity. This argument falls right in line with others such as Coffee (1991), Bhide (1993), And Back, Li, and Ljungqvist (2014) who have argued before that market liquidity discourages intervention by the institutional investors. Both Coffee and Bhide believed that stock liquidity has a limiting effect and encourages the investors to "cut and run" instead of intervening, while Back, Li, and Ljungqvist modeled this idea more formally and also argued that liquidity harms activism on part of the investor.

Intervention and Horizon of Institutional Investors

In an argument, some researchers have said that investors with longer horizons have stronger incentives to intervene as they are more interested in long term profits, they will hang around for a longer period to realize the corresponding benefits and they will have more time to study about the firm to intervene more effectively. However, some argue that activism is more actively performed by short-term investors (like hedge funds), who intervene to procure short-term investors. It is also believed that short term investors push for actions that are detrimental to the firm in the long run but profitable in short term (Bratton and Wachter (2010))

Size of the Holding

Investors with larger holdings are awarded stronger investment incentives because the firm allows the investor to keep a larger share of benefits if the engagement is successful. Larger funds generally have more resources to engage. They may trade more profitably based on the information collected through private engagement. Engagement may vary because of variations in regulation, compensation structure, expertise, and conflict of interest. Hence, investor type and geographical location are included.

Exit Theory

The threat of exit is unobservable. If the threat is credible, exit doesn't itself take place. Two questions arise in an investor's mind when one thinks about the exit theory, that is,

(i) Do they exit used as a governance device
(ii) Do they believe that exit is an effective disciplinary device

Many interventions take place behind the scene which makes analyzing the exit theory more difficult than the voice theory. Investors exit due to two reasons that are, dissatisfaction with a portfolio firm and other motives such as liquidity or portfolio rebalancing. A question comes up when we discuss the 'Behind the Scene' scenario why many shareholder proposals filed by Institutional Investors are eventually withdrawn before the shareholder meeting, and why the stock market does not react positively to a shareholder proposal. A shareholder proposal is a good news, in that it indicates increased monitoring. But it also signals that a shareholder could not negotiate a behind-the-scenes agreement with management. (Gillan and Starks 2000,2007). The result of a survey conducted suggests that private discussions with management are not restricted to these particular investors or investor types, but rather are a more general phenomenon. Global head of corporate governance at Blackrock, Michelle Edkins said that "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).

Now the main question that still stands is, How did the Covid crisis impact corporate governance 'behind the scene'?

Early Perspective

After the 2008 crisis, many Institutional Investors were prepared to face another financial crisis and decided that "correction of some sorts" was inevitable and necessary and had positioned their portfolios defensively. The situation would have been way worse if they didn't take this step. In comparison to the 2008 crisis, there is less panic, greater investment discipline, and more continuity. Even though investors prepared their portfolios with defenses, no one will survive the pandemic unscathed. As the pandemic affected the market late, many had already started reallocation of assets to prioritize liquidity.

Leaders of these institutions underscore the importance of holding on to high-quality assets as markdowns occur and the portfolios begin to exceed policy allocations- even if this strategy means raising debt. Investing in the debt market may render low returns but it has a low-risk profile which makes it perfect to survive in a worldwide pandemic where each sector is affected. It would not be considered wise of the investors to de-risk themselves at the bottom of the market and then try to minimize the losses.

The playing field for institutional investors is not even, and the crisis may highlight and widen those disparities. In the case of Public Pension Funds, the gap in resources between the leaders and laggards has widened considerably. Many faced huge funding deficits before the crisis, if markets continue to fall, such gaps will probably widen further as these funds are forced to liquidate investments to pay beneficiaries or as contributions falter.

A decade ago, during the 2008 crisis, many institutional investors were burned in the private market, but the investors were not restricted just to the private sector. They invested when the market was at its peak, deploying their capital at the wrong time, and ended up selling at a discount. They ended up swarming in losses and then had to sit on the side-lines to recover from the losses. This time they plan to follow a 3-part playbook to deal with the crisis -

Maintain Shareholder's trust
Trust is a key factor in the corporate world. The shareholders of the company may have discussed in advance how to deal with a crisis. They also have the most knowledge about how the firm works and what the risk: return ratio of all the investments in the portfolio is. A timely and descriptive strategy will aid in getting through the crisis with the least amount of damage possible.

Defuse Portfolio Risk
Investors have been studying their portfolios while waiting for the pandemic to hit the market to reduce the risk. Sectors affected by Covid 19 have been concerned about an uncertain amount of future. The real estate sector which is illiquid, whose valuations typically lag is a topic of concern.

Be Alive to Possibilities
Only a few investors actively took part in the dislocation, while others believe that 30-50% of the market was overvalued. These periods lead to outstanding investment opportunities for the people with liquidity and the stomach to capture them.

Later Perspective

The onset of the pandemic left only a few untouched. Stock Markets plunged, as predicted. In the first quarter of 2020, when the Covid-19 shock caused extreme uncertainty in the financial market. What happened beyond the initial phase is also of interest, however, as it may reveal something about the mechanisms behind the effects observed in the crisis. In particular, a classic feature of a fire sale is the reversal of the trading decisions after the crisis.

Results of a study indicate that in the second quarter of 2020 institutional investors did not revert their portfolios to the pre-COVID status, despite a massive injection of liquidity by the Fed and the aggregate market rally. In particular, the fact that institutional investors did not relax their concerns about financially weak firms is a signal of the uncertainty that prevailed among financial market participants at the time concerning economic growth and corporate debt.

After the outbreak of COVID-19, the combination of institutional equity sales to meet redemptions and an institutional run for financially strong firms contributed to fire sales externalities. This amplified the stock price drops beyond just the losses from the deterioration of the fundamental outlook for many firms. Institutional investors' quarterly portfolio changes in the first quarter of 2020 confirm that this set of market participants were the marginal investors driving prices in the COVID-19 crash.

Conclusion

The relationship between the board of directors and the corporate governance of the company is affected by various factors. The directors and the institutional investors make two types of choices, whether to use their voice to voice their opinion in a meeting or to make a threat to exit from the company or to take back the investments made in the company. The pandemic affected the company and the investors' behaviour. The perspective from both before the COVID and after COVID is discussed about.

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