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# Local investors and corporate governance ☆

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ABSTRACT

This paper shows that local institutional investors are effective monitors of corporate behavior. Firms with high local ownership have better internal governance and are more profitable. These firms are also less likely to manage their earnings aggressively or backdate options and are less likely to be targets of class action lawsuits. Further, managers of such firms exhibit a lower propensity to engage in "empire building" and are less likely to "lead the quiet life". Examining the local monitoring mechanisms, we find that local institutions are more likely to introduce shareholder proposals, increase CEO turnover, and reduce excess CEO pay.



## 1. Introduction

An emerging literature in accounting and finance demonstrates the economic benefits of geographical proximity. For example, both retail and institutional investors are able to benefit from their superior information about local firms (e.g., Coval and Moskowitz, 1999, 2001; Ivković and Weisbenner, 2005; Baik et al., 2010; Bernile et al., 2010), although this informational advantage has disappeared after Regulation Fair Disclosure (Bernile et al., 2011).[3] Another distinct strand of literature on shareholder activism shows that large institutional investors may influence corporate policies (e.g., Bushee, 1998; Hartzell and Starks, 2003; Parrino et al., 2003; Chen et al., 2007).

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[3] For additional evidence of local preference in investment decisions, see Huberman (2001), Grinblatt and Keloharju (2001), Massa and Simonov (2006), Bodnaruk (2009), Teo (2009), and Seasholes and Zhu (2010).

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In this study, we link these two strands of research and examine whether physical proximity between firms and investors allows large institutions to monitor corporate activities more effectively. Specifically, we examine whether firms with more local shareholders are better governed and are less likely to engage in corporate misbehavior. We also investigate whether monitoring activities of local investors affect the profitability of local firms. Although there is an obvious free-riding problem associated with the monitoring of geographically proximate firms, the potential benefits from monitoring can outweigh the monitoring costs, especially for large shareholders (e.g., Grossman and Hart, 1980; Shleifer and Vishny, 1986).

Our key conjecture is that in an economic setting where monitoring costs vary inversely with distance, firms with high local institutional ownership would have better governance characteristics. In particular, firms with more proximate shareholders would exhibit a lower propensity to engage in undesirable corporate behavior like option backdating or aggressive earnings management. As a result of better monitoring, firms with high local institutional ownership would have a lower propensity to be a target of class action lawsuits. Further, because of geographical proximity, local institutions are more likely to attend shareholder meetings and introduce shareholder proposals, facilitate CEO turnover, or limit excess CEO pay.[4] This form of local activism could also have an indirect influence on the selection of board members and the structure of compensation contracts.

There are several reasons why monitoring costs and benefits might be correlated with distance to institutional shareholders. For example, local institutions are likely to have lower communication costs, lower information gathering costs, and may even have easier access to firm-level information. Unlike remote institutions, local institutions may directly inspect a local firm and more easily acquire knowledge about the management and internal operations (e.g., Lerner, 1995). In addition, the local media is likely to provide greater coverage of local firms and increase the awareness of those firms among local investors, including institutions (e.g., Engelberg and Parsons, 2011; Gurun and Butler, 2012). Local institutions are also more likely to belong to the social networks of local managers (e.g., they may be members of the same country club), which might give them easier access to ‘‘soft’’ information and allow them to exert greater influence on corporate policies.[5]

Beyond these visible channels, due to their geographical proximity, local institutions may be in a better position to seek quiet agreement on governance changes. And they may informally approach the board and express displeasure about corporate policies and governance changes. Due to data limitations, we cannot precisely identify all these channels through which local institutions could affect corporate governance, but we present several pieces of evidence to establish the causal relation between shareholder proximity and corporate governance.

To measure shareholder proximity, we use the portfolio holdings of 13(f) institutional investors during the 1980–2007 period. For each firm, at the end of each year, we compute the mean distance between the firm's headquarters to the ten largest institutional shareholders. This measure captures both geographic proximity as well as stake of the institution in the firm. For robustness, we also consider other measures of local ownership, including a measure of firm ownership by institutions located within 250 miles of a firm, ownership by institutions located within a state, and the mean distance to all institutional investors.

We first examine whether monitoring activities of local institutions impact the governance of a firm. Motivated by Chhaochharia and Grinstein (2007), our internal governance proxies include a board independence score which captures the degree to which the board and the committees have a majority of independent directors. Following Yu (2008), we consider a measure of discretionary accruals to capture the firm's propensity to manage earnings. In addition, we examine whether, through its impact on internal governance, shareholder proximity affects a firm's propensity to engage in potentially fraudulent activities such as option backdating. These forms of risky firm behavior in turn could affect the firm's likelihood of being a target of class action law suits.

To study the potential indirect benefits of governance, we investigate whether local institutions influence financial outcomes such as operating performance and accounting measures that proxy for ‘‘empire building’’ by the manager and the extent to which a manager might ‘‘enjoy the quiet life’’, as defined in Bertrand and Mullainathan (2003) and Giroud and Mueller (2010). To identify some of the channels through which institutions monitor local firms, we investigate whether local institutions are more likely to introduce shareholder proposals, affect CEO turnover, and influence excess CEO compensation.

Our results indicate that firms with high local institutional ownership are more profitable and have more independent boards. Managers of those firms are less likely to engage in ‘‘empire building’’ and less likely to ‘‘lead the quiet life’’. In addition, firms with local shareholders are less likely to engage in undesirable corporate activities such as aggressive earnings management or option backdating. Consequently, they exhibit a lower propensity to be a target of class action lawsuits. Examining the mechanisms through which local institutions monitor, we find that local institutions are more likely to introduce shareholder proposals, increase CEO turnover, and reduce excess CEO compensation. Taken together,

[4] Becker et al. (2011b) show that retail investors from the local community are more likely to attend shareholder meetings. In a related setting, Masulis et al. (2009) show that foreign independent directors who are located far away from corporate headquarters are less effective monitors because they are less likely to attend board meetings or perform on-site visits, and do not have access to ‘‘soft’’ information through local social networks.

[5] Fracassi (2012) shows that firms with stronger social networks have better corporate policies and exhibit better overall performance. In another related study, Kedia and Rajgopal (2009) find that local social interactions influence the option grant policies of local firms.