

Voting WITH THEIR FEET

Institutional investors shy away from dual-class firms.

BY KAI LI, HERNÁN ORTIZ-MOLINA AND XINLEI ZHAO

In dual-class firms, insiders hold the majority of the shares with superior voting power, meaning they are able to control the firm without holding large equity stakes. As a result, they are largely isolated from external control pressures. In this scenario, outside investors have limited control rights even when their fractional ownership may give them substantial cash-flow rights. In stark contrast, in single-class firms each share carries one vote and thus outside investors' cash-flow and control rights are identical. Because of these features, dual-class voting arrangements are criticized by important institutional investors and are the subject of debate throughout the world.

We study institutional investor preferences for the stock of U.S. firms with dual-class shares. Dual-class firms constitute about 6% of all firms and 8% of the total market capitalization in the U.S. In Canada, between 20% and 25% of companies listed on the Toronto Stock Exchange (TSX) employ dual-class share structures and include some of Canada's largest and most renowned companies: Bombardier Inc., Magna International Inc., Rogers Communications Inc., Shaw Communications Inc., Alliance Atlantis Communications Inc., Power Corporation, Telus Corporation, Quebecor, and Onex Corp., to name only a few. Since insiders of dual-class firms hold the majority of the shares with superior voting power, they are able to control the firm without holding large equity stakes and are mostly isolated from external control pressures such as takeover threats. As a result, in dual-class firms, outside investors have

limited control rights even when their fractional ownership may give them substantial cash-flow rights. In stark contrast, in single-class firms, each share carries one vote. Thus, outside investors' cash-flow and control rights are identical.

A priori, it is unclear whether the lack of voting rights to shareholders in dual-class firms should affect institutional investment decisions. On one hand, various arguments suggest that dual-class share structures may not significantly affect institutional investment. First, previous research has indicated that institutional investment decisions are primarily driven by past stock returns, and the empirical evidence regarding performance differences between dual- and single-class firms is largely inconclusive. Second, the U.S. possesses very stringent securities laws designed to protect shareholder rights and sets high standards for corporate governance practices. Moreover, there is no evidence that minority or outside shareholders are expropriated in the U.S. Third, although some important institutional investors publicly voice their concerns about dual-class structures, the extent to which such voting arrangements may affect their investment decisions is not obvious. For example, institutions cannot avoid stocks that are part of major market indices, and some stocks may be important for portfolio diversification. Thus, institutional ownership in dual-class firms might not significantly differ from that in single-class firms.

On the other hand, there are arguments that support institutional managers' reluctance to invest in the stock of dual-class companies. First, unlike individual investors,

Kai Li is the W.M. Young Professor of Finance at the Sauder School of Business, University of British Columbia, BC; Hernán Ortiz-Molina is an Assistant Professor of Finance at the Sauder School of Business, University of British Columbia, BC; Xinlei Zhao is an Associate Professor of Finance at Kent State University, OH. This article is a condensed version of the article "Do Voting Rights Affect Institutional Investment Decisions?: Evidence from Dual-Class Firms," *Financial Management*, 37, 2008, pp. 713-745.

institutional managers are subject to prudence standards that constrain their investment decisions. If the courts that enforce prudent-man laws perceive investment in dual-class firms to be a lack of prudence, then institutions may avoid these stocks to minimize their exposure to legal liabilities. Second, given the arguments against dual-class structures, the manager of a poorly performing portfolio may find it difficult to justify the *ex-ante* soundness of an investment strategy with large weights on the stock of dual-class firms and thus be more likely to be dismissed. As a result, portfolio managers may avoid the stock of dual-class firms to protect their careers. Third, institutions may prefer the stock of single-class firms over that of dual-class firms as they can use the voting power conveyed by their large stakes to influence corporate decisions. This may be especially true when institutional selling of poorly performing stocks could be costly due to the potentially large impact on stock prices. All of these scenarios suggest that institutions might choose to hold less of the stock of dual-class firms.

Our analysis of institutional investment in U.S. dual-class firms thus sheds light on whether voting rights, which are arguably the most important type of shareholder rights, influence institutional investment decisions. More generally, our results suggest that corporate governance mechanisms are an important determinant of institutional investment decisions. Although our study focuses on dual-class firms listed in the U.S., our evidence is especially relevant for Canadian institutional investors given that dual-class firms represent almost 25% of the companies listed on the TSX (e.g., Bombardier, Magna International, and Rogers Communications).

SAMPLE AND EMPIRICAL RESULTS

We start with the merged CRSP-Compustat universe for the period 1995-2002. We focus on this period because we can accurately identify the dual-class firms each year using the data collected and made available to us by Gompers, Ishii and Metrick (2007). This data is the most comprehensive U.S. dual-class dataset available. To our initial sample, we then merge institutional investors' holdings data from the Thomson Financial's CDA/Spectrum Database, stock market data from CRSP, accounting data from Compustat, and analyst coverage data from IBES. CDA/Spectrum identifies five types of institutions: 1) bank trust departments, 2) insurance companies, 3) investment companies, 4) independent investment advisors, and 5) others. The institutions in this

last group are a mix of ESOPs, university endowments, foundations, and private and public pension funds. Our final sample consists of 614 dual-class firms (2,694 firm-year observations) and 8,360 single-class firms (37,503 firm-year observations) for the period 1995-2002.

To explore whether institutional ownership differs across single-class and dual-class firms, we run pooled OLS regressions of institutional ownership (IO) on a dummy variable indicating a firm's dual-class status (Dual) and control variables. For both dual-class and single-class firms, we define IO as the percentage of a firm's equity value held by institutions. When the superior-voting classes are not traded, we follow Gompers et al. (2007) and assume that they have the same price as the traded inferior-voting shares. Dual equals one if the firm has multiple share classes outstanding, and zero otherwise. The control variables include determinants of institutional investment identified in previous research. These are the logarithm of market capitalization defined as the dollar value of all share classes ($\text{Ln}(\text{Mktcap})$), stock return defined as the value-weighted average of the returns across traded classes (Return), dividend yield defined as total payout to shareholders divided by stock price (Divyield), stock return volatility (Retvol) defined as the value-weighted average of the stock return volatility across traded classes using monthly stock returns over the prior year, share turnover ratio (Turnover) defined as the value-weighted average of the ratio of the trading volume to the number of shares outstanding at the end of the previous year across all traded classes, market-to-book ratio (M/B) defined as the market value of assets divided by the book value of assets, total leverage ratio (Leverage) defined as the ratio of total debt to the market value of assets, firm age (Firmage) defined as the number of years since the firm first appears in CRSP, the logarithm of the share price ($\text{Ln}(\text{Price})$) defined as the value-weighted average of the stock price across traded classes in 2002 dollars, S&P 500 membership (S&P500) which equals one if the firm is in the S&P 500 Index, and zero otherwise, and the number of analysts covering the stock (#Analysts). We further include 48 Fama-French industry dummies and year dummies. Throughout our regression analysis, we account for serial correlation and heteroskedasticity of the error term by clustering the standard errors at the firm level. Table 1 reports the results.

The first column shows a negative and statistically significant effect of dual-class status on aggregate institutional ownership. The magnitude of the effect is also

Table 1: The Effect of Dual-Class Status on Institutional Ownership

The table reports OLS regressions of *IO* on *Dual* and control variables. We also include 48 Fama-French industry dummies and year dummies. The standard errors given in brackets are adjusted by the clustering of observations at the firm level. *, **, and *** mean statistically significant at the 10%, 5%, and 1% level, respectively.

	(1) Institutional Ownership	(2) Bank Trust Departments	(3) Insurance Companies	(4) Investment Companies	(5) Indep. Inv. Advisors	(6) Other Institutions
Dual	-3.597*** [0.826]	-0.270 [0.273]	-0.389*** [0.142]	-0.883*** [0.298]	-1.658*** [0.483]	-0.445*** [0.114]
Ln(Mktcap)	4.771*** [0.256]	0.815*** [0.053]	0.610*** [0.051]	1.287*** [0.087]	1.399*** [0.137]	0.662*** [0.047]
Return	-1.772*** [0.325]	-0.261*** [0.052]	-0.157*** [0.034]	-0.475*** [0.092]	-0.680*** [0.120]	-0.204*** [0.042]
Divyield	-1.576*** [0.144]	0.071* [0.040]	-0.111*** [0.027]	-0.505*** [0.047]	-0.894*** [0.080]	-0.146*** [0.023]
Retvol	-2.394*** [0.495]	-0.195*** [0.065]	-0.166*** [0.054]	-0.650*** [0.155]	-1.447*** [0.244]	0.049 [0.072]
Turnover	0.129*** [0.024]	0.010*** [0.002]	0.007*** [0.002]	0.043*** [0.008]	0.057*** [0.011]	0.014*** [0.003]
M/B	-0.658*** [0.061]	-0.071*** [0.009]	-0.039*** [0.006]	-0.116*** [0.019]	-0.355*** [0.033]	-0.080*** [0.009]
Leverage	4.944*** [0.881]	0.295 [0.223]	0.880*** [0.231]	0.677** [0.294]	3.140*** [0.537]	0.021 [0.155]
Firmage	0.055*** [0.020]	0.043*** [0.004]	0.007* [0.004]	-0.012* [0.007]	0.011 [0.010]	0.005 [0.003]
Ln(Price)	6.416*** [0.403]	0.488*** [0.071]	0.196*** [0.064]	1.848*** [0.126]	3.849*** [0.209]	0.067 [0.055]
S&P500	-0.441 [1.100]	2.318*** [0.259]	0.365* [0.188]	2.104*** [0.472]	-4.699*** [0.516]	-0.543*** [0.180]
#Analysts	0.438** [0.183]	0.064** [0.032]	0.035 [0.028]	0.528*** [0.071]	-0.209*** [0.078]	0.014 [0.025]
Intercept	-43.300*** [2.280]	-7.477*** [0.485]	-5.656*** [0.466]	-13.175*** [0.787]	-10.517*** [1.239]	-6.553*** [0.442]
# of obs.	40,197	40,197	40,197	40,197	40,197	40,197
Adjusted R ²	0.490	0.351	0.169	0.412	0.295	0.228

economically important. Aggregate institutional ownership in dual-class firms is 3.6 percentage points lower than it is in single-class firms. Since the average fractional holding of institutional investors in the single-class firms in the sample is about 33 percentage points over our sample period, this implies that institutional ownership is 11% lower in dual-class firms than in single-class firms. In sum, we find strong evidence that institutional investors tend to invest less in the stock of dual-class firms than they do in the stock of single-class firms.

The aggregation of institutional holdings, however, may mask important heterogeneity across different types of institutional investors (Brickley, Lease, and Smith,

1988; Del Guercio, 1996; Woitke, 2002; Chen, Harford, and Li, 2007). Investment companies and independent investment advisors are usually short-term investors that rebalance their portfolios often, have low levels of fiduciary responsibility, and do not engage in shareholder activism. Thus, these investors are likely to be the least sensitive to voting rights. Conversely, long-term investors with strong fiduciary responsibilities who are more likely to engage in shareholder activism, such as pension plans and university foundation endowments, are likely to be highly sensitive to shareholder voting rights. It is less clear whether voting rights should matter in the investment decisions of bank trust departments and insurance companies. Both

Table 2: Changes in Institutional Ownership Following Unification

The table reports OLS regressions of *ChgIO* on *Unify* and control variables. We also include 48 Fama-French industry dummies and year dummies. The standard errors given in brackets are adjusted by the clustering of observations at the firm level. *, **, and *** mean statistically significant at the 10%, 5%, and 1% level, respectively.

	(1) Institutional Ownership	(2) Bank Trust Departments	(3) Insurance Companies	(4) Investment Companies	(5) Indep. Inv. Advisors	(6) Other Institutions
Unify	10.793*** [2.141]	1.393*** [0.497]	0.982** [0.409]	3.625*** [0.796]	3.871*** [1.088]	1.020** [0.419]
ChgShouts	0.913 [0.971]	-0.015 [0.247]	0.800*** [0.240]	-0.151 [0.511]	0.512 [0.557]	-0.200 [0.296]
Ln(Mktcap)	0.338 [0.211]	-0.003 [0.054]	-0.089 [0.063]	0.093 [0.099]	0.246* [0.129]	0.114** [0.047]
Return	1.959*** [0.393]	0.201*** [0.072]	0.208*** [0.053]	0.851*** [0.170]	0.667*** [0.216]	0.037 [0.079]
Divyield	0.093 [0.175]	0.008 [0.029]	0.046 [0.043]	0.064 [0.091]	0.012 [0.077]	-0.033 [0.022]
Retvol	-2.233*** [0.855]	-0.399** [0.172]	-0.191 [0.141]	-1.312*** [0.386]	-0.509 [0.394]	0.166 [0.323]
Turnover	0.061 [0.043]	0.016*** [0.006]	0.001 [0.007]	0.005 [0.019]	0.014 [0.018]	0.028*** [0.009]
M/B	0.051 [0.231]	0.039 [0.063]	0.025 [0.054]	0.214** [0.104]	-0.164 [0.102]	-0.077* [0.046]
Leverage	-0.248 [0.921]	-0.029 [0.209]	-0.148 [0.176]	-0.730* [0.407]	0.385 [0.520]	0.251 [0.239]
Firmage	-0.032* [0.019]	0.003 [0.003]	0.001 [0.006]	-0.019** [0.008]	-0.020** [0.010]	0.005 [0.003]
Ln(Price)	0.883** [0.408]	0.070 [0.076]	0.108** [0.052]	0.274 [0.166]	0.296 [0.199]	0.105 [0.090]
S&P500	-1.204 [0.849]	-0.08 [0.185]	0.025 [0.180]	0.698 [0.454]	-1.646*** [0.435]	-0.263 [0.176]
#Analysts	-0.172 [0.194]	0.017 [0.037]	0.023 [0.038]	-0.147 [0.105]	-0.021 [0.096]	-0.049 [0.033]
Intercept	-6.285*** [2.164]	-0.046 [0.571]	0.119 [0.649]	-0.929 [1.002]	-5.035*** [1.394]	-0.609 [0.527]
# of obs.	2,160	2,160	2,160	2,160	2,160	2,160
Adjusted R ²	0.133	0.039	0.024	0.095	0.084	0.082

types of institutions are long-term investors, and bank trust departments further have strong fiduciary duties, suggesting that shareholder voting rights should matter in their investment decisions. However, both types of institutions also have important potential business relations with the firms they invest in, and, as such, may not use their voting rights against management. This suggests that voting rights might be of little value to them.

Columns (2)-(6) of Table 1 use the ownership of each institution type in the CDA classification as the dependent variable, and thus examine whether dual-class

status affects the investment decisions of different types of institutions in different ways. We find that all types of institutional investors invest less in dual-class firms, except for bank trust departments where the coefficient on the Dual dummy is negative but not statistically significant. To assess the economic significance of this avoidance of the stock of dual-class firms and the relative importance across investor types, we normalize the coefficient on Dual by the average ownership in single-class firms by each institution type. This calculation shows that bank trust departments have ownership stakes in dual-class firms that

are 7.2% lower than those they have in single-class firms. Similarly, relative to institutional holdings in single-class firms, institutional ownership in dual-class firms is about 16.9% lower for insurance companies, 10.6% lower for investment companies, 10.3% lower for independent investment advisors, and 17.3% lower for the group of other investors. Thus, the group of other investors, which includes the most important shareholder activists, together with insurance companies, are the types of investors with the most pronounced avoidance of the stock of dual-class firms, followed next by independent investment advisors and investment companies, and lastly by bank trust departments. These results suggest that institutional investors with more stringent fiduciary responsibilities and longer investment horizons, as well as those more commonly associated with shareholder activism, are more sensitive to the lack of voting rights in dual-class firms.

We next examine how the unification of a dual-class structure into a single-class affects institutional investment. The sample for our unification analysis includes both dual-class firms that remain so for the entire sample period and those that abandon their dual-class structures up to one year after the unification. The sample contains 79 unification events and 2,160 firm-year observations. In Table 2, we regress the change in the level of institutional ownership (ChgIO) on a dummy variable equal to one if the firm abandons its dual-class structure in the previous year and zero otherwise (Unify) and control variables. The control variables include the contemporaneous percentage change in the total number of shares outstanding (ChgShouts) and all the previously defined variables measured in the previous year: Ln(Mktcap), Return, Divyield, Retvol, Turnover, M/B, Leverage, Firmage, Ln(Price), S&P500, and #Analysts. The variable ChgShouts captures any new equity issues or repurchases following the unification that may affect the change in institutional ownership. It also controls for any effect that the exchange of shares as a result of the unification may have on institutional ownership. We further include 48 Fama-French industry dummies and year dummies, and we cluster the standard errors at the firm level.

The first column of Table 2 suggests that, following the unification of a dual-class structure into a single-class, there is a large increase in the institutional ownership of the unifying firms over and above the change in institutional ownership experienced by the control group of non-unifying dual-class firms. The unification is associated with a 10.8 percentage point increase in total institutional ownership which, when compared to the pre-unification fractional ownership by institutions (almost 35

percentage points), implies a 30.9% increase. Moreover, columns (2)-(6) show that after the unification, all types of institutional investors significantly increase their holdings in the unifying firms relative to the control group of non-unifying dual-class firms.

SUMMARY AND CONCLUSIONS

We find that institutional ownership in U.S. dual-class firms is substantially lower than it is in comparable single-class firms, and that this result holds for all types of institutions. This avoidance of the stock of dual-class firms is more pronounced for long-term investors with strong fiduciary responsibilities than for short-term investors with low levels of fiduciary responsibility. Following the unification of dual-class structures, institutions substantially increase their investment in the new single-class firms. Our findings suggest that shareholder voting rights are an important factor in institutions' portfolio decisions, and more generally they suggest that a firm's corporate governance attributes matter for institutional investment. Our study also suggests that although dual-class share structures may have some benefits for firms, such as allowing management to focus on long-term value without worrying about potential takeovers, they may also compromise firms' access to equity capital by discouraging investment by institutional investors. Finally, dual-class firms are far more common in Canada than they are in the U.S. Further research is needed to determine to what extent the avoidance of dual-class firms is also prevalent among Canadian institutional investors who may be less able to find comparable single-class companies that would suit their investment strategies. ■

ACKNOWLEDGMENTS

We acknowledge the financial support from the Social Sciences and Humanities Research Council of Canada and the Bureau of Asset Management of the Sauder School of Business.

REFERENCES

- Brickley, J.A., R.C. Lease, and C.W. Smith, Jr., 1988, "Ownership Structure and Voting on Anti-takeover Amendments," *Journal of Financial Economics* 20, 267-291.
- Chen, X., J. Harford, and K. Li, 2007, "Monitoring: Which Institutions Matter?" *Journal of Financial Economics* 86, 279-305.
- Del Guercio, D., 1996, "The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments," *Journal of Financial Economics* 40, 31-62.
- Gompers, P.A., J. Ishii, and A. Metrick, 2007, "Extreme Governance: An Analysis of Dual-Class Firms in the United States," Harvard Business School Working Paper.
- Li, K., H. Ortiz-Molina, and X. Zhao, 2008, "Do Voting Rights Affect Institutional Investment Decisions?: Evidence from Dual-Class Firms," *Financial Management* 37, 713-745 (Winner of the Best Paper Award at the 2007 Northern Finance Association Meetings).
- Woidtke, T., 2002, "Agents Watching Agents? Evidence from Pension Fund Ownership and Firm Value," *Journal of Financial Economics* 63, 99-132.