

Block Trades, Market Reaction and Monitoring Role: Evidence from India

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1. Background and Research Questions

On March 2016, Infosys shares slumped 3% as promoters sold 75 lakhs shares in block deals. On November 2017, Bain Capital, a private equity firm, sold 2.12% of their holding in L&T Finance, bringing down the stock price by 1.9%. In the same month, Bharti Airtel reported inter-se transfer of shares between promoters, and the stock price hit a 10-year high. These instances show that block deals⁸ are important stock market trades among diverse category of blockholders that include, promoters, investment firms, mutual funds, financial institutions such as banks and insurance companies, corporate entities, or simply individual investors. These diverse categories of blockholders have their own determinants and incentives to trade, thus impacting the share price in different ways.

In this study, we examine the relation between diverse class of blockholder trades (purchases and sales) and short-term stock market returns using a large sample of block trades spanning from 2005–2015, in Indian family firms. Considering blockholders as a homogenous class overlooks interesting relationships at more granular levels. Therefore, we categorize blockholders into three types, and hypothesize the impact of their trades (net-purchases) on shareholder returns:

(a) Pressure-resistant: Investment firms, hedge funds, mutual funds, pension funds, private equity, investment advisory and brokerage firms, foreign institutional investors, individual investors (includes HUF), and financial institutions that include commercial banks and insurance companies. These blockholders are known as pressure-resistant due to their fiduciary responsibility to protect

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⁸ SEBI vide its circular no. MRD/DoP/SE/Cir-19/05 dated September 2, 2005 issued guidelines for execution of block trades on the stock exchanges that explains; A trade, with a minimum quantity of 5,00,000 shares or minimum value of Rs. 5 crores executed through a single transaction on a separate window of the stock exchange will constitute a “block deal”.

their investments and economic incentive to actively monitor target firms. For example: nominees of pension funds or mutual funds on corporate boards have fiduciary duty to represent the interests of their investors, and given their large holdings, they have economic incentive to monitor the firm's operations and management. We hypothesize that market reaction towards net-purchases by pressure-resistant blockholders shall be positive and significant.

(b) Pressure-sensitive: We recognise corporations (private and public limited firms) as pressure-sensitive blockholders because corporates enjoy certain private benefits emerging from either current or potential business interests and product-market synergies. Hence, these blockholders might not be as effective in monitoring and less likely to object questionable practices for fear of losing business. For example, Essar shipping has a business relation with Factor Steel limited while purchasing large blocks of shares in the firm. The power gained from ownership stake maybe negated by their dependence on the firm for business activity. Hence, the market reaction to net-purchases by pressure-sensitive blockholders will be either negative or insignificant.

(c) Insiders: In India, the family firm setting characterised with concentrated promoter ownership allows us to identify insiders (promoters, promoter group companies, promoter trusts) as a separate and third class of blockholders. The literature on insider ownership identifies two broad countervailing effects. The alignment of interest hypothesis suggests that concentrated ownership has a positive effect on shareholder value because blockholders have the incentive, the power, and the resources to effectively monitor a firm's managers. In contrast, the entrenchment hypothesis suggests that concentrated insider-ownership provides both the incentive and the opportunity to the insiders to expropriate minority shareholders, especially when the insider-blockholders participate in the management of the firm. Since our insider category includes individual promoters as well as promoter groups and trusts (we cannot separate ownership and management among institutions), we maintain that benefits from insider monitoring dominate the entrenchment effect. To further analyse the trade-off between alignment and entrenchment, we study blockholder trades in the context of family managed and professionally managed firms. The above discussion and typology of blockholders leads us to highlight our first hypothesis as follows.

- Hypothesis 1a: Block trades by pressure-resistant blockholders will be positively associated with abnormal returns (CAR).
- Hypothesis 1b: Block trades by pressure-sensitive blockholders will be negatively associated with abnormal returns (CAR).
- Hypothesis 1c: Block trades by insider blockholders will be positively associated with abnormal returns (CAR).

2. Institutional Setting

Edmans and Holderness (2017) suggest that the differences in institutional setting and regulatory environment in different countries makes it interesting to study the role of blockholders in effectively monitoring management. In this study, we exploit two interesting institutional specificities that is unique to an emerging economy like India.

First, the Indian corporate sector witnessed a series of corporate governance reforms in the period 2005 to 2015. Among various reforms, the SEBI amendment to Clause 40A in 2010 resulting in minimum public shareholding of 25% among private listed firms, changed the institutional landscape in India leading to dilution of promoter holding in family firms. This provided an opportunity for outsider blockholders (financial institutions and corporations) to increase their ownership in family firms. Moreover, 2011—2015 sample period, witnessed enhanced transparency and public reporting of promoter and promoter groups shareholding due to the Clause 35 and 41 being amended by SEBI in 2009. Therefore, the period, 2011—2015 provides a natural setting to test the impact of regulatory interventions on the role of diverse blockholder trades.

Hypothesis 2: Block net-purchases by *pressure-resistant* and *insider* blockholders will be positively associated with abnormal returns in the post reforms period (2010-2015) than compared to pre-reforms period (2005-2010).

Next, prior studies show that blockholders' incentive to govern could differ between family managed and professionally managed firms. Hence, studying the role of diverse categories of blockholders in the context of family managed and professionally managed firms may provide insights different from those based on dispersed ownership (e.g. US). Our primary definition of family firm is when promoter equity holding is greater than 20%. We further categorise family firms as family owned and family managed (FOFM) firms and family owned and professionally managed (FOPM) firms. In FOFM firms, at least one family member/promoter is the chairperson of the board and holds executive position such as CEO or MD. We further distinguish between FONFM firms where the promoter retains a strategic non-executive position (promoter is the chairperson of the board but not CEO or MD) and FOPM firms where the promoter has neither executive nor non-executive positions. We also account for a situation where family holds only operational control without the strategic position (FONPM). That is, the promoter is CEO or MD, but not the chairperson of the board. In our setting, the widely held firms are defined as non-family firms (NFOPM), where family ownership is less than 20% and family member is neither chairperson on the board, nor CEO or MD.

We hypothesize that net-purchases by pressure-resistant blockholders would be considered value-enhancing in family managed firms, because they can mitigate expropriation by insiders through voice. Nonetheless, there is contrasting evidence that outside blockholders fail to be effective in family managed firms because of complete control. Alternatively, insiders would have a larger role to play in professionally managed firms because family has skin-in-the-game and alignment of interest with minority shareholders. In contrast, the role of insiders is attenuated in family managed firms due to increase in entrenchment.

Hypothesis 3: Net-purchases by pressure-resistant blockholders is perceived favourably by the market across all categories of family firms. In contrast, insider net-purchases has positive impact on shareholder wealth only when the firms are professionally managed than when they are family managed.

3. Data and Methodology

Our sample consists of block trades (buy and sell trades) of 636 listed Indian firms (excludes financial and utility firms) spanning the period December 2005—March 2015, obtained from CMIE Prowess. To categorise block trades into different blockholder categories (pressure-resistant, insider and pressure-sensitive), we use comprehensive reports on shareholding pattern available on the Bombay Stock Exchange. Our initial sample consists of 2547 buy-side and 2320 sell-side block trades that account for multiple block trades on a given date, by all possible blockholder categories. However, for different regression analyses requiring information on board size, independent and executive directors, financial variables, ownership structure and stock prices, the sample sizes decrease to approximately 1300 block trades. Our primary dependent variable is 3-day cumulative abnormal returns (CAR)⁹ using the Fama-French three-factor model. Our independent variable is blockholder categories (pressure resistant, pressure sensitive and insider blocks). In our analysis, we control for percentage deal size, corporate governance (board size, percent of independent and executive directors on board), firm level financials (total assets, PB and leverage), industry and year fixed effects.

⁹ To calculate CAR, we define a 3-day event window around the date of block trade and define the estimation period as 120 days starting from 30 days prior to the block trade date. For this period, we calculate the abnormal return for each firm and block trade date combination. These abnormal returns are then aggregated to obtain cumulative abnormal return.

4. Main Findings

Our main findings are as follows:

- (a) The three-day CAR for pressure-resistant and insider block purchases is positive and significant (5.2% and 4.6% respectively) compared to pressure-sensitive blocks (-1.2%).
- (b) The shareholder returns (3-day CAR) is greater for family managed firms (FOFM) than for professionally managed firms (FOPM).
- (c) The relation between the increase in CAR and block purchases by pressure-resistant blockholders is positive and significant only when family has operational control (outsider is the chairperson), and insignificant when family has complete control. This result implies that institutional blockholders are more effective when the chairman of the board is independent (non-family) and the promoter is CEO/MD.
- (d) Impact of an increase in block purchases by insider category on CAR is positive and highly significant only when the family has ownership but neither operational nor strategic control. Hence, trades by insiders is considered value-enhancing by the market, when there is alignment of interest (large ownership), rather than when the insider has operational or strategic control, leading to situations of entrenchment.
- (e) Increase in block purchases by pressure-resistant and insider blockholders has a positive and significant impact on CAR post-2010, thus supporting the contention that improved transparency and information impacts effective monitoring by diverse blockholders.

5. Conclusion and Policy Implications

Overall, our results bring to focus different institutional characteristics shaping the role of relational blockholders (i.e. insiders) and transactional blockholders (i.e. financial institutions and corporations) while participating in a firm. Block trades by pressure-resistant blockholders is considered value-enhancing in family managed firms, when the family has operational control but the chairman of board is independent. In contrast, block trades by insiders is considered value-enhancing in professionally managed firms, and value-decreasing in firms where the promoter has complete control.

The Indian setting allows us to test the changes in corporate governance landscape that effect blockholder ownership. An important regulatory amendment to this effect was the minimum public shareholding of atleast 25% that allowed dilution of promoter control in these firms. Our findings

show positive impact of this regulatory amendment on trades by pressure-resistant and insider blockholders post 2010. Moreover, this period also experienced greater transparency in disclosures about insider holding. These results support the contention that SEBI's role in increased public shareholding as well as greater transparency in disclosures about insider holding, has improved the impact of blockholder trades.