

Institutional ownership and non-financial misconduct: Evidence from U.S. federal violations

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Abstract

Using a novel, comprehensive dataset on penalties assessed by 47 U.S. federal agencies for non-financial misconduct, we examine the effect of institutional investors on firms' non-financial performance. We find that institutional ownership is associated with a lower likelihood of firms receiving federal penalties, especially for labor-related violations. This finding suggests that institutional investors view non-financial misconduct as value-destroying in the long run and thus exert influence to reduce the likelihood of violations. In support of this argument, we find that our results are primarily driven by the presence of long-term investors. Finally, to understand potential channels through which institutional investors can exert influence as well as potential consequences of non-financial misconduct, we consider the role of boards of directors and voting on shareholder proposals. This paper adds to the literature examining the role of institutional investors beyond capital markets.

Keywords: Institutional Ownership, Non-Financial Misconduct, Corporate Social Responsibility, Environmental, Social, Labor, Violation

1. Introduction

A large literature examines institutional investors' role in capital markets. Prior research has documented a link between institutional ownership and numerous aspects of firms' financial behavior, including mandatory and voluntary disclosure, corporate governance, tax planning, and dividend policy (e.g., Ramalingegowda and Yu, 2012; Boone and White, 2015; Appel, Gormley, and Keim, 2016; Chen, Huang, Li, and Shevlin, 2018). The central finding of this literature is that institutional investors improve shareholder value by exerting influence over managers' decision-making processes.

However, there is little prior research on institutional investors' impact on parties other than capital market participants. In light of a growing push by investors and regulators for additional disclosures pertaining to Corporate Social Responsibility (CSR), our paper answers a key question related to CSR: how do institutional investors influence firms' *non*-financial behavior? We answer this question by taking advantage of a unique, comprehensive dataset called *Violation Tracker* that contains comprehensive information on penalties assessed by 47 U.S. federal agencies. We examine whether institutional ownership affects firms' tendency to commit various forms of non-financial misconduct (e.g., violating employee safety laws, illegally underpaying employee wages, or violating environmental regulations).

A handful of recent papers have moved beyond capital market effects to study how institutional shareholders can affect firms' CSR performance. Dyck, Lins, Roth, and Wagner (2018) study a global dataset on firms' environmental and social (E&S) ratings from 41 countries, concluding that institutional ownership drives firms' E&S performance. Dimson, Karakas, and Li (2015, 2018) provide evidence suggesting that institutional investors actively engage with firms to promote better ESG practices. Our study extends this emerging literature in two key ways. First, we examine the effect of institutional investors on other stakeholders. Second, prior

literature typically focuses on non-financial performance as measured by commercially available CSR or E&S ratings. These ratings are often computed using data vendors' proprietary algorithms using public information extracted from firms' own filings and disclosures. To that end, these ratings likely reflect researchers' and data vendors' subjective and diverse views on what matters in CSR. In contrast, we focus on explicit negative actions taken by firms, i.e., violations of federal laws. Our approach thus provides a more transparent, uniform, and objective measure for firms' non-financial performance.¹

It is not ex-ante obvious what the effect of institutional ownership on firms' non-financial misconduct would be. On one hand, institutional shareholders may view employee and customer satisfaction as long-run value-enhancing attributes. Consistent with this view, prior studies have documented evidence suggesting a positive association between employee and customer satisfaction and shareholder value (e.g. Edmans, 2008; Servaes and Tamayo, 2013). If this reflects institutional shareholders' view, then we should find a negative association between institutional ownership and the likelihood of firms' non-financial misconduct. On the other hand, institutional investors may also view generous employee compensation packages as wasteful and CSR activities as reflecting agency problems (Cheng, Hong, and Shue, 2013; Masulis and Reza, 2015). While tightening their monitoring over management, they may at the same time reduce a firm's CSR activities to divert more money back to shareholders. Moreover, unlike in the case of financial misconduct, most federal agencies lack discretion in setting penalty amounts, which are formulaic and capped. While penalties are higher for more severe violations, the direct monetary penalties for violations typically do not come close to offsetting

¹ For example, different researchers and data vendors may define employee satisfaction differently for different firms and industries; it is often not possible to know what a given score is measured with respect to. Conversely, employee protections for wages and safety are clearly codified under rules set by the various agencies of the Department of Labor (the Occupational Safety and Health Administration, Wage & Hour Division, National Labor Relations Board, etc.). For example, hourly workers are required by law to be paid 1.5 times their normal hourly rate for overtime work. Similarly, employees working more than 30 hours a week (at large firms) are classified by law as full-time and are thus required to be provided with access to healthcare. Were a firm not to provide healthcare to such an employee, it would be a clear violation of federal law; yet, it would be difficult to know the extent to which such non-provision of healthcare affects "employee satisfaction" ratings.

the economic impact of these violations in the way that financial misconduct penalties and settlements can. Thus, in contrast to the case of financial misconduct, there is unlikely to be a major direct financial impact if a firm is caught committing non-financial misconduct. Institutional shareholders may therefore encourage firms to take “negative CSR” or employee-unfriendly activities if, net of the additional expected fines, doing so would increase shareholder value. This view predicts a positive association between institutional ownership and the likelihood of firms’ non-financial misconduct.

Using a sample of 14,489 firm-years (1,360 distinct firms) from 2004 to 2015, we find that institutional ownership is negatively associated with firms’ non-financial misconduct, measured by the likelihood and size of federal agency penalties. This result is robust to whether we use levels specifications with firm fixed effects or first-differences models that instead use industry-by-year fixed effects. These results appear to be driven primarily by labor-related violations.² This finding is consistent with the first view that institutional investors view labor violations as detrimental to shareholder value in the long run. In further support of this view, we find that federal agency penalties are negatively associated with subsequent firm value, as measured by Tobin’s q .

A feature of using federal agency penalties as a measure for firms’ non-financial misconduct or E&S performance is that the fine amount is relative small; the mean (median) penalty assessed in our sample is \$37.2 million (\$47,548), representing a mean (median) of 0.15% (0.001%) of firm sales. Therefore, the direct monetary cost of committing non-financial misconduct is immaterial. Our results are thus unlikely to be driven by institutional investors’ financial concern for the direct litigation costs associated with non-financial misconduct. Con-

² Common examples of labor-related violations include underreporting workers’ hours or mis-classifying workers as exempt to either avoid paying them overtime or provide them with benefits (e.g., healthcare); infringing upon employees’ right to unionize; or failing to maintain a safe workplace (e.g., not providing safety equipment).

sistent with this view, we find that *conditional on* violating federal laws, institutional ownership is not associated with the size of penalty. However, it is possible that violation of federal laws may increase the likelihood of future lawsuits filed by other stakeholders, such as employees and local community, which could be material and costly to shareholders.³

We next explore heterogeneity in the effect of institutional ownership on firms' non-financial misconduct. Starks, Venkat, and Zhu (2018) find that investors with long-term investment horizons prefer firms with strong environmental, social and governance (ESG) performance, because ESG tends to pay off in the long run. Consistent with this view, we find our results are mainly driven by long-term oriented institutions with a low portfolio churn ratio. Chen, Harford, and Li (2007) find that independent institutions with long-term investments specialize in monitoring and exert influence over firms' management. Consistent with their argument, we find our results are stronger among these monitoring institutions.

We also explore channels through which institutional investors could reduce firms' non-financial misconduct. Prior literature suggests shareholder voice as a dominant mechanism to drive corporate governance as well as E&S changes in the firm (Appel, Gormley, and Keim, 2016; Crane, Michenaud, Weston, 2015; Dyck, Lins, Roth, and Wagner, 2018). Institutional investors could exercise voice via three channels: (1) influencing the board of directors, (2) voting at annual general meetings (AGM), and (3) private engagements with the target firm. While (3) is not publicly observable, we are able to test (1) and (2). To test the first channel, we explore the cross-sectional variations in state-level legislation of corporate constituency statutes. Prior to 2004, 33 U.S. states enacted laws that allow directors of public firms to consider the interests of non-shareholder stakeholders (Orts, 1992; Flammer and Kacperczyk, 2016).⁴ Boards of companies incorporated in states with constituency statutes are therefore

³ We intend to incorporate lawsuit data in future versions of this paper to test this possibility.

⁴ Texas introduced such laws in 2006; no other state has done so since. Because the number of firms incorporated in Texas for our sample is relatively small (157 firm-years out of our total sample of 14,489), we are unable to

more “stakeholder-friendly”, as directors are more likely to incorporate other stakeholders’ interests into their decision-making process. Consistent with this argument, we find that the negative effect of institutional ownership on non-financial misconduct is stronger among firms incorporated in states with constituency statutes. This finding is also consistent with the idea that institutional investors may have exercised their influence over corporate decision-making via the board of directors. We next examine the second channel of voting at AGMs. We find that institutional ownership is positively associated with the likelihood of initiating new shareholder proposals related to E&S topics, as well as the percentage of votes in favour of such proposals once they are put to vote at AGMs. Although E&S-related shareholder proposals generally do not pass (only 12 out of 1,446, or less than 1%, of E&S proposals in our sample receive more than the 50% votes required to pass), we find that they are more likely to be withdrawn when institutional ownership is higher. A withdrawal may indicate that an agreement was reached between the parties before the proposals advanced to the voting stage; these results therefore suggest shareholders’ dissent on E&S issues may have contributed to the reduction in legal violations.

This paper contributes to the literature in several ways. First, it adds to the literature on the determinants of firms’ non-financial misconduct (e.g., Cohn and Wardlaw, 2016; Caskey and Ozel, 2017; Raghunandan, 2019). These three papers outline the role of financial incentives in firms’ decisions to commit labor-related violations, specifically identifying short-term incentives as a key driver (e.g., meet-or-beat behavior with respect to analyst forecasts). Our study suggests that institutional investors, especially those with a long-term investment horizon and monitoring incentive, could mitigate the incentives to commit labor-related violations. Second, our study adds to the literature on the role of institutional shareholders in shaping firm

use a difference-in-differences specification. We therefore partition the sample into states that do and do not have such statutes during our sample period, omitting Texas.

behavior, especially with respect to CSR activities. Our findings suggest that institutional shareholders can use their influence over firms' management and shareholder proposals to avoid poor corporate practices.

2. Literature Review and Hypothesis Development

A large literature in accounting and finance examines the effect of institutional investors on capital market participants and firms' financial behavior. Ajinkya, Bhojraj, and Sengupta (2005) examine the influence of institutional investors on voluntary disclosure and find that higher institutional ownership is associated with more management forecasts. Ramalingegowda and Yu (2012) examine the influence of institutional ownership on accounting attributes and find that higher ownership by institutions, especially those that tend to monitor managers, is associated with more conservative financial reporting. Boone and White (2015) and Bird and Karolyi (2016) examine the effect of institutional ownership on firms' information and trading environment. They find that institutional ownership is positively associated with higher quantity and quality of management disclosure and more analyst following. Appel, Gormley, and Keim (2016) examine the effect of institutional ownership on corporate governance. They find that passive institutional investors influence firms' governance choices by appointing more independent directors, removing anti-takeover provisions, and requiring for more equal voting rights. Crane, Michenaud, and Weston (2015) find that institutional investors influence firms' payout policy by promoting higher dividends. Chen, Huang, Li, and Shevlin (2018) and Khan, Srinivasan, and Tan (2017) find that institutional investors improve firms' tax planning and increase tax avoidance.

All of the studies described above find that institutional investors have positive effects on firms' capital market behavior, which, in turn, increases institutional investors' return on investment. One notable exception is Burns, Kedia, and Lipson (2010), who find that firms

with higher levels of institutional ownership are more likely to engage in financial misreporting. Their results are mainly driven by institutions with short investment horizons, as these institutions lack incentives to monitor portfolio firms' behavior. One goal of the current paper is therefore to test whether these findings extend to the case of *non*-financial misconduct.

There is little prior research examining how institutional investors influence parties other than capital market participants, such as employees and the local community. Existing theory provides countervailing arguments on the effect of institutional ownership on firms' non-financial misconduct. On one hand, institutional shareholders, especially those with a long-term focus, may view other stakeholders as part of the business. They believe that having happy employees and satisfied customers enhances long-run shareholder value. Several studies have documented evidence consistent with this view. Edmans (2008) finds that employee satisfaction is positively associated with long-term stock returns. Servaes and Tamayo (2013) find that CSR is positively associated with firm value, especially among firms with high customer awareness. Albuquerque, Koskinen, and Zhang (2018) find that CSR increases firm value by reducing firms' systematic risk, especially among firms with high product differentiation. Although the monetary value of direct federal penalties for non-financial misconduct is relatively small, federal violations may signal poor CSR practices and harm a firm's reputation (i.e., federal violations may have indirect effects). Federal violations may also trigger future lawsuits from shareholders, customers, or employees. These events represent potentially value-destroying risks, and to that end institutional investors may try to decrease the likelihood of these events occurring. This view thus predicts a negative association between institutional ownership and the likelihood of non-financial misconduct.

On the other hand, institutional investors may view generous employee compensation packages as reflective of inefficiencies. If institutional investors are primarily focused on share-

holders, they may promote practices to “trim the fat” and return cash to shareholders. Consistent with this view, Brav, Jiang, and Kim (2015) find that employees at firms subject to activist hedge fund interventions experience significant subsequent deteriorations in their overall compensation packages, including stagnation in work hours and wages as well as a decrease in fringe benefits. Popular press portrays institutional investors as working in “a microcosm of the struggle between a financial sector fixated on short-term returns and corporate managements who are trying to run profitable business while sharing some of the gains with their workers and communities” (Wall Street Journal, 2014).⁵ Furthermore, institutional investors may also view CSR activities as a reflection of managerial agency problems or insider-initiated corporate philanthropy. Under this view, CSR reflects managers’ own desire to engage in philanthropy rather than being motivated by stakeholders’ demands (Benabou and Tirole, 2010). Consistent with this view, Masulis and Reza (2015) find that corporate donations are positively associated with CEOs’ personal charity preferences and negatively associated with corporate governance quality. Cheng, Hong, and Shue (2016) find that higher incentive alignment between managers and shareholders and better corporate governance are both negatively associated with firms’ CSR performance. As a result, while institutional investors may positively affect a firm’s corporate governance, they may at the same time reduce its CSR activities if they regard the latter as value-destroying. As previously mentioned, since penalties for non-financial misconduct are immaterial relative to firm size, if institutional shareholders believe reducing employee benefits or increasing pollution could enhance firm value, they may force the firm to do so even if such practices violate federal regulations. This view thus predicts a

⁵ A vivid example, illustrated in the article, is Timken Corp. Timken was forced by Relational Investors, an investment firm that manages pension funds, to split into two firms, in the name of “unlocking value”. Before being targeted by Relational Investors, workers at Timken Corp. were paid \$23 an hour, a rate that is “higher than at any of Timken’s specially-steel rivals,” and “workers receive the equivalent of another \$20 an hour in benefits.” However, in the aftermath of the split, the new bearing firm’s pension contributions dropped from nearly a third of cash flows to near zero, while its share of cash flows dedicated to share buybacks were quadrupled.

positive association between institutional ownership and the likelihood of non-financial misconduct.

3. Research Design

3.1 Data

3.1.1 Non-Financial Misconduct

By non-financial misconduct, we refer to any federal violation that a securities regulator would not be concerned with. Examples of such violations include labor-related violations (for example, creating an unsafe workplace or underpaying workers) and environmental violations (for example, improperly disposing of hazardous waste). We obtain this data from a new, comprehensive database on federal agency penalties called Violation Tracker published by the non-profit organization Good Jobs First.

As of this writing, Violation Tracker is comprised of data on penalties for nearly 300,000 unique violations of federal laws assessed by 47 U.S. federal agencies.⁶ The most common type of violation pertains to workplace safety; more than one-third of Violation Tracker is comprised of fines assessed by the Occupational Safety & Health Administration (OSHA). Other common types of violations include labor and wage-related misconduct – reflected in enforcement actions by agencies such as the National Labor Relations Board (NLRB), Wage & Hour Division (WHD), and Equal Employment Opportunity Commission (EEOC) – as well as environmental misconduct. The most common cases of environmental misconduct relate to water or air pollution, which are reflected in penalties assessed by the Environmental Protection Agency (EPA). These violations provide a transparent and objective measure for firms' non-financial performance – which can, alternatively, be interpreted as corporate social *irresponsibility*.

⁶ We refer the reader to Raghunandan (2019) for a more detailed description of the data available in the Violation Tracker database.

3.1.2 Other Data and Sample Selection

We obtain financial data (firm size, return on assets, leverage, and sales) from Compustat North America. We then hand-match Violation Tracker to Compustat at the parent company-year level by comparing firm names provided in Compustat with parent company names provided in Violation Tracker, using information on industry and location to resolve any ambiguity.⁷ We merge this data (by CUSIP) with institutional ownership data from Thomson Reuters' 13-F Holdings database as well as analyst forecast data from I/B/E/S. As our measure of analyst coverage, we use the number of unique analysts providing earnings forecasts for the given fiscal year.

3.1.3 Sample Composition and Descriptive Statistics

There are several data limitations that restrict the size of our sample. Foremost among these is a limitation on the scope of coverage in Violation Tracker that restricts our analysis to larger firms. In Violation Tracker, data are at the subsidiary company level; Good Jobs First only provides parent-subsidiary matches for roughly the largest 2,500 firms traded in the United States by market capitalization. We therefore limit the sample to those firms that were among the largest 2,500 by market capitalization at the end of 2015.

Beyond limiting our sample to large firms, we impose two additional restrictions that further reduce our sample size. First, we limit the sample to firms with available data from Compustat for at least 5 years of the sample period to allow for the inclusion of firm fixed effects and to mitigate the influence of outliers. Second, we omit firms for which data on

⁷ Of note is the fact that Violation Tracker provides incorrect parent-subsidiary matches for companies that have been involved in an acquisition at some point. Specifically, Violation Tracker lists the *current* (i.e., as of the last update) parent rather than the parent at the time of violation. For example, suppose that Subsidiary X committed a violation in 2010, and was owned by Parent A at the time. If Parent B were to acquire Parent A (and, as a result, Subsidiary X) in 2015, Violation Tracker would list Subsidiary X's parent company for the 2010 violation as Parent B – even though the parent company *at the time of violation* was actually Parent A. We manually correct all such instances (accounting for roughly 12% of the portion of Violation Tracker for which parent-subsidiary linkages are available), merging Compustat data with violation data based on the parent company at the time a violation was committed.

institutional ownership is not available through the Thomson Reuters 13F database. This restriction is responsible for the majority of omitted firm-year observations among the set of large firms. Imposing these three restrictions ultimately restricts our analysis to 1,360 unique firms representing 14,489 firm-years over the time period 2004-2015. We provide an overview of our sample construction in Table 1.

We provide descriptive statistics for our sample in Table 2. Panel A indicates that firms in our sample are large, and the fact that even the 10th percentile of ROA (Tobin's q) is positive (is greater than 1) indicates that our sample firms are generally profitable. Moreover, perhaps because we focus on large and generally stable firms, the median firm in our sample has a sales growth rate of 7.5% and relatively low leverage, i.e., a debt-to-equity ratio of 16.8%. The mean (median) firm in our sample is covered by 9.3 (7) distinct analysts making earnings forecasts, indicating high capital market interest in the firm's financial performance.

Panel B also indicates that 26.4% of firm-years in our sample incur at least one violation of non-financial laws. The number is slightly lower for labor violations, with 20.8% of firm-years committing at least one labor violation. Firms are less likely to commit environmental violations; only 8.0% of firm-years incur at least one environmental violation. This disparity reflects the fact that environmental violations are concentrated in certain industries, while labor violations are common across most industries. Table 2, Panel B reports the sample distribution by industry of the violating firm. Environmental penalties appear to primarily occur in the agriculture, construction, manufacturing, mining, and utility industries but are relatively rare in other industries. By contrast, labor penalties occur relatively frequently in all industries except for financial services. The retail and wholesale trade industries are particularly illustrative of the difference in how labor and environmental violations are distributed across industries; in these two major industry groupings, environmental penalties occur in less than 5% firm-years while labor penalties occur 20-30% of the time.

Table 2, Panel C presents average violation levels and institutional ownership over time. There does not appear to be a strong time trend for violations. There also does not appear to be a significant increase in the number of violations assessed subsequent to 2009. The latter result is somewhat surprising in light of the fact that the political party in power in the U.S. changed from Republican to Democrat in early 2009 with the election of Barack Obama to the presidency. As the U.S. President is tasked with appointing the heads of federal agencies, it might be expected that the more pro-regulation Democratic party would introduce regulators and regulations resulting in more frequent sanctions against corporate misconduct; however, it does not appear that this is the case. The similarity in violation frequency across the two presidential administrations also suggests that politically-driven changes in enforcement intensity are unlikely to explain our results. From this panel, we also see that institutional ownership is nearly monotonically increasing throughout our sample period. The year-over-year change in institutional ownership is positive for all years except during the 2007-09 financial crisis, and typically between 1 and 2 percent. This result is consistent with prior literature that documents the increasing role that institutional investors are playing over time in publicly traded firms and underscores the importance of including time effects in our estimations.

3.2 Empirical Approach

One challenge we face is that institutional ownership is relatively sticky over time. To that end, it may be difficult to draw causal inferences from simply regressing an outcome variable on the percentage of a company's shares held by institutional owners, because any results could be driven by inherent firm characteristics. Several recent papers on institutional ownership in the United States (e.g., Appel et al., 2016; Khan et al., 2017) get around this empirical limitation by using Russell index reconstitution as an identification method. Briefly, these papers rely on the fact that Russell reconstitutes its Russell 1000 and Russell 2000 indices each

June based on end-of-May market capitalization. Many quasi-indexer institutional owners track the Russell index, and so reconstitution serves as a “shock” for firms just above or below the Russell 1000 and Russell 2000 index cutoffs. However, because of several changes introduced by Russell starting in 2007 (see Appel et al., 2018), the sample period in all of those studies ends in 2006. Because the bulk of our violation data reflects a period subsequent to 2006, we are unable to use this approach. We cannot identify a clear, plausible instrument for our sample period that would otherwise serve as an exogenous shock to institutional ownership.⁸ Rather than potentially incurring a weak instrument problem, we therefore design our main tests using a linear probability framework with firm and year fixed effects.⁹ This approach follows Dyck, Lins, Roth, and Wagner (2018), who face similar issues with respect to the unavailability of an appropriate instrument for institutional ownership. The basic regression that we estimate is

$$NONFIN_{i,t+1} = \beta_0 + \beta_1 IO_{it} + \beta_2 CONTROLS_{it} + \gamma_i + \theta_t + \varepsilon_{it} \quad (1)$$

where $NONFIN_{i,t+1}$ is an indicator that takes the value of 1 if firm i violates federal law in year $t + 1$ and IO_{it} represents the proportion of firm’s shares held by institutional owners in year t . The variables γ_i and θ_t denote firm and year fixed effects, respectively. We include control variables based on prior studies of institutional ownership and shareholder activism (e.g., Brav et al., 2015; DeHaan et al., 2019). These include firm size (measured using natural logarithm of total assets), return on assets (ROA), sales growth rate, leverage, level of analyst coverage (measured using the number of distinct analysts providing forecasts for that firm-

⁸ If a higher proportion of firms’ shares were held by foreign institutional ownership, then there would be two approaches we could take. First, we could follow Godsell, Lel, and Miller (2018) and use the introduction of the Foreign Investment and National Security Act (FINSA); FINSA forced a sudden change in foreign ownership for firms in a subset of industries. Second, we could follow Bena, Ferreira, Matos, and Pires (2017) and use inclusion in the MSCI All Country World Index, as a number of foreign quasi-indexing institutional investors track this index. However, in our sample, on average only 6% of shares are held by foreign institutions while 67% of shares are held by U.S. institutions. Thus, even if we were to find results using FINSA as a shock, it would be difficult to rule out potential co-movement in domestic institutional ownership as a confounding factor.

⁹ Another alternative would be to use a probit or logit specification. However, in our view, the benefits of the fixed effects specification outweigh the drawbacks of using a linear probability model in lieu of a binary-choice model.

year), and Tobin's q . Apart from analyst coverage, which is obtained from I/B/E/S, all control variables are constructed using data from Compustat. We measure $NONFIN_{it}$ in three ways: (i) using all federal violations; (ii) considering only labor-related violations; and (iii) considering only environmental violations. We construct (ii) and (iii) by manually classifying each federal agency available in Violation Tracker as pertaining to labor regulations, environmental regulations, or neither; our full classification by agency is provided in Appendix B. Our basic specification does not differentiate amongst types of institutional shareholders. However, in additional tests, we separate IO_{it} by type of institutional owner. We provide further detail on this in Section 4.2.

One notable feature of the non-financial misconduct data is that, by and large, penalties are statutory. Although most federal agencies lack the discretion to set penalty amounts for individual instances of non-financial misconduct, we still observe substantial variation in the size of penalties in our sample. This is because penalty amounts are primarily formulaic and capped. For example, when a company commits minimum wage over overtime pay violations, it is fined (as of 2017) \$1,925 per underpaid employee by the WHD (i.e. the punitive damages) regardless of whether the company underpaid its employees by \$0.10 per hour or by \$1.00 per hour. Similarly, OSHA classifies penalties as either "Other-than-Serious", "Serious", or "Repeat or Willful". The penalty for a "Repeat or Willful" violation is set at 10 times the penalty for a "Serious" violation, even though the difference in actual impact for a "Serious" violation could be far greater. This contrasts with the case of financial misconduct, where securities regulators' substantial discretion over the size of fines enables them to assess the impact of a misconduct on a case-by-case basis.¹⁰ Securities regulators also can (and do) take the extent of

¹⁰ The large discretion afforded to by securities regulators may sometimes result in their playing favorites; for example, Correia (2014) finds that politically connected firms are subject to less severe penalties for similar types of financial misconduct.

damages into account when choosing penalties; this was made explicit in the 2006 *Statement of the Securities and Exchange Commission Concerning Financial Penalties*.¹¹

Violation Tracker also contains some inconsistencies with respect to how additional requirements bundled with penalties are treated. For example, sanctions for both NLRB and WHD violations require employers to provide back pay to affected employees in addition to any punitive damages. However, while back pay is included in the total penalty amount reported in Violation Tracker (in addition to any fines) for NLRB violations, it is not included in the computation of WHD penalty amounts. Similarly, when the EPA penalizes a firm, it may in some cases require, in addition to any fines assessed, for the firm to make additional investments toward future compliance (e.g., investing in technology to adhere to the Clean Air Act). The size of penalties in Violation Tracker is therefore a somewhat noisy measure of the economic impact of non-financial misconduct.

Despite these limitations, however, the penalty amount reported in Violation Tracker is nonetheless a reasonable proxy for the severity of a violation; it is, for example, possible to use these reported amounts to argue that one NLRB violation is more serious than another. We therefore estimate whether institutional ownership can affect the size of penalties using the following regression:

$$\log(1 + PENALTIES_{i,t+1}) = \alpha_0 + \alpha_1 IO_{it} + \alpha_2 CONTROLS_{it} + \gamma_i + \theta_t + \varepsilon_{it} \quad (2)$$

where $PENALTIES_{i,t+1}$ denotes the dollar value of all penalties assessed at the firm-year level. Because the distribution of $PENALTIES_{i,t+1}$ (conditional on a penalty having occurred) is skewed, we use the log rather than the raw value. As in the case of the non-financial misconduct indicator, we construct $PENALTIES_{i,t+1}$ based on (i) all violations, (ii) only labor violations, and (iii) only environmental violations. We estimate Equation (2) in two ways: (i) for the full sample, and (ii) on the sub-set of observations where a violation occurred (the “conditional

¹¹ See <https://www.sec.gov/news/press/2006-4.htm>

sample”). The former approach pools violation observations with non-violation observations to directly estimate whether institutional ownership influences the expected fines portfolio companies pay. The latter approach tests whether, conditional on a violation having occurred, institutional ownership helps the firm pay lower fines.

Finally, we note that institutional ownership by firm is sticky; as evidence of this, the autocorrelation coefficient from estimating an AR(1) model of institutional ownership is 0.856. Moreover, institutional ownership exhibits an upward trend over time. For example, the mean level of institutional ownership at the beginning of our sample period (2004) is 66.4%; by the end of our sample period (2015), the average level of institutional shareholding for firms in our sample is 78.4%. Inclusion of firm and year fixed effects mitigates the potential issue that any relation we find between institutional ownership and non-financial misconduct may simply reflect inherent firm characteristics. Nonetheless, to further address the concern that our results may be driven by the choice of specification, we re-estimate our main tests using a specification where we first-difference all control variables, but not the binary dependent variable. This is because changes in institutional ownership are much less sticky than institutional ownership itself; as evidence of this, the autocorrelation coefficient from estimating an AR(1) model of the change in institutional ownership – i.e., the autoregression of $(IO_{it} - IO_{i,t-1})$ on $(IO_{i,t-1} - IO_{i,t-2})$ – is only -0.096. We therefore estimate the following:

$$NONFIN_{i,t+1} = \beta_0 + \beta_1 \Delta IO_{it} + \beta_2 \Delta CONTROLS_{it} + \beta_3 INDYEAR_{it} + \varepsilon_{it} \quad (3)$$

We include industry-by-year fixed effects, $INDYEAR_{it}$, because firm fixed effects are differenced out; inclusion of industry-by-year fixed effects therefore controls for the variation in non-financial misconduct by industry. The regression coefficient β_1 captures whether a larger increase in institutional ownership leads to a higher or lower likelihood of a violation.

4. Results

4.1 Baseline Specification

Results from estimating the baseline specification in Equation (1) are presented in Columns (1)-(3) of Table 5, Panel A. Our key finding is that firms with higher levels of institutional ownership are less likely to engage in non-financial misconduct. This effect is economically meaningful: the coefficient of -0.0605 in Column (1) of Table 5 suggests that firms in the top 10 percentile of institutional ownership (99.73%) are 3.9% less likely to engage in non-financial misconduct compared with those in the bottom 10 percentile of institutional ownership (35.37%). We observe similar magnitudes and significance when considering only labor-related violations (column 2). The majority of labor-related violations in our data pertain to workplace safety (OSHA violations) and illegal underpayment of wages (WHD violations). Recent literature documents that firms may commit labor-related misconduct in response to short-term pressures, such as meeting or beating earnings targets (Caskey and Ozel, 2017; Raghunandan, 2019). Our results suggest that these incentives may be less important for institutional investors, especially those with longer-term investment horizons. Conversely, we do not observe a statistically significant result for environmental violations (column 3). This may be because environmental violations often reflect longer-term firm incentives (e.g., using improper waste disposal practices to reduce the long-term marginal cost of producing a good). If the primary way in which institutional investors reduce misconduct is by lessening firms' *short-term* incentives, then institutional ownership is unlikely to affect firms that engage in misconduct primarily in response to longer-term incentives. It is also possible that the lack of statistical significance reflects a power issue; less than 8% of our sample had environmental violations. One possible interpretation of our main result, therefore, is that institutional ownership affects firms' proclivity to engage in misconduct by reducing short-term incentives. If this is the case,

then we should find that our results are primarily driven by institutional investors with a longer investment horizon; we explore this possibility in Section 4.2.

Results from estimating Equation (3) are presented in Columns (4)-(6) of Table 5, Panel A. These results are qualitatively similar to our main findings in Columns (1)-(3). In particular, the effect of institutional ownership is again negative and significant whether we consider all violations or only labor-related violations. The coefficient of -0.1308 in Column (4) suggests that firms in the top 10 percentile of institutional ownership change (9.70%) are 2.0% less likely to engage in non-financial misconduct compared with those in the bottom 10 percentile of institutional ownership change (-5.34%).

Results for control variables appear to be sensitive to our choice of specification, although this is most pronounced in the case of firm size and firm ROA. We find that firm size is positively associated with non-financial misconduct in the levels specification; however, firm size is not significant in the changes specification. This may be because our sample is limited to large, relatively stable firms that do not substantially grow or shrink year-over-year. Conversely, we find no statistically significant relation between levels of ROA and non-financial misconduct in the levels specification, but that changes in ROA are positively associated with the likelihood of non-financial misconduct. While this may seem counterintuitive at first – a well-performing firm should be less likely to need to engage in misconduct – changes in ROA are more closely related to benchmarks that a firm may seek to hit. A firm with a significant increase in ROA between year $t - 1$ and year t may, therefore, feel pressure to attain another such increase for year $t + 1$ relative to year t ; this in turn creates a performance incentive that could induce misconduct.

Table 5, Panel B reports the results from estimating Equation (2). Consistent with the results in Panel A, we find in Columns (1) – (3) that institutional ownership is associated with

lower penalties for non-financial misconduct in general and for labor-related violations; however, we find no result for environmental violations. Firm size is also positive and significant in all columns of Panel B, implying that larger firms tend to incur higher fines for both labor and environmental violations. This finding is consistent with the formulaic way in which federal agencies often determine the size of a penalty. If a large firm and a small firm both commit labor violations of equal severity, for example, the violation committed by the large firm is likely to affect more employees even if the proportion of employees affected in both firms is similar; to that end, a penalty amount may partially reflect firm size rather than the severity of misconduct.

We next present results using the subsample conditional on a violation occurring in Columns (4)-(6). For all three specifications (all penalties, labor only, environmental only), the coefficient on institutional ownership is statistically insignificant. Taken together with the results in Table 5, Panel A, this suggests that the result given in Columns (1)-(3) of Table 5, Panel B is primarily driven by the fact that firms with higher institutional ownership are less likely to subsequently commit non-financial misconduct. Conditional on committing misconduct, institutional ownership appears to have no effect on penalty amounts. This again highlights the fact that penalty size is a noisy measure for the economic impact of non-financial misconduct, due to the legally-imposed disconnect between the severity of a violation and the associated penalty amount.

4.2 Types of Institutional Ownership

Our next tests consider differences across various types of institutional owners. We first classify institutional investors into long-term and short-term oriented based on their portfolio turnover. Relying on the logic that short-term institutions trade frequently, while long-term institutions hold trading positions unchanged for a considerable length of time, we identify

long-term institutions as those having a low portfolio turnover (Gaspar, Massa, and Matos, 2005). Specifically, we calculate each institution i 's churn ratio at quarter t as

$$CR_{it} = \frac{\sum_{j \in Q} |N_{j,i,t}P_{j,t} - N_{j,i,t-1}P_{j,t-1} - N_{j,i,t-1}\Delta P_{j,t}|}{\sum_{j \in Q} \frac{N_{j,i,t}P_{j,t} + N_{j,i,t-1}P_{j,t-1}}{2}}$$

where $P_{j,t}$ is the stock price of firm j at the end of quarter t , $\Delta P_{j,t}$ is the change of stock price from quarter $t-1$ to t for firm j , and $N_{j,i,t}$ is the number of firm j 's shares held by institution i at the end of quarter t . We then use each institution's average churn ratio over the past four consecutive quarters as its current churn ratio. Finally, we rank all institutions' average churn ratio at each quarter. An institution with below-median churn rate is considered to be long-term focused, while an institution with above-median churn rate is considered to be short-term focused.

Panel A of Table 6 presents our results using this partition. We find that our main result in Table 5 appears to be driven by long-term investors. Moreover, unlike in the case of our main results, we find that long-term focused institutional ownership is associated with a reduction in environmental violations. This latter result is consistent with environmental violations reflecting longer-term actions undertaken by the firm; we would not expect to observe any relation between short-horizon investors and violations for which the "benefits" take time to materialize. Overall, the results in this table are consistent with the argument that institutional investors believe good CSR practices boost long-term firm value.

We next partition institutions based on the extent to which they are expected to actively monitor portfolio firms. Prior studies suggest that monitoring institutions likely exert influence over firms' decision-making processes (Chen, Harford, and Li, 2007; Ramalingegowda and Yu, 2012). We define monitoring institutions as having two characteristics: (i) they are independent (rather than "grey"), and (ii) they have a long-term investment horizon. Following

Chen, Harford, and Li (2007), we classify investment companies, investment advisors, and public pension funds as independent institutions.¹²

Panel B of Table 6 presents our results using this partition. Consistent with the predictions above, we find that ownership by monitoring institutions reduces the likelihood of non-financial misconduct; this result holds for both labor and environmental violations. Conversely, there appears to be no effect of ownership by non-monitoring (either grey, or independent but short-term focused) institutions.

4.3 Channels of Institutional Investor Influence

We have thus far documented that higher levels of institutional ownership appear to be related to a lower likelihood of engaging in non-financial misconduct. In this section, we therefore attempt to identify the channel through which institutional owners may influence firms' non-financial conduct. We focus on two channels: (i) influence over the board of directors and (ii) shareholder proposals.

4.3.1 Board Influence

Our first test, relating to institutional owners' potential influence over the board of directors, is based on cross-sectional variation in state-level corporate constituency statutes. Constituency statutes explicitly require directors of publicly traded firms to consider the interests of non-shareholder stakeholders (e.g., employees or customers) in deciding on strategic plans. Prior literature documents that the introduction of corporate constituency statutes can shift firm-level strategic priorities; for example, Flammer and Kacperczyk (2016) find an increase in corporate innovation and patenting for firms affected by such statutes.

As a result of corporate constituency statutes, boards of companies incorporated in constituency statute states have greater capability to take stakeholder-friendly strategic actions.

¹² Due to a mapping error, the institution type in Thomson Reuters' 13F dataset is inaccurate after 1998. We thus use the type definition compiled by Brian Bushee (<http://acct.wharton.upenn.edu/faculty/bushee/IIclass.html>).

Thus, if institutional investors care about non-financial misconduct, they are more likely to be able to convince the board to take actions to reduce non-financial misconduct – even if these actions result in lower shareholder value.¹³

Even though institutional ownership is associated with positive changes in corporate governance (Appel, Gormley, and Keim, 2016), we study constituency statutes rather than more traditional measures of board effectiveness from the corporate governance literature. We do so because the link between traditional measures of governance, such as board independence, and non-financial misconduct is unclear. For example, in a financial reporting context, higher board independence is often thought of as indicative of better governance and monitoring capability (e.g., Beasley, 1996; Chen, Cheng, and Wang, 2015); the increased monitoring, in turn, deters financial misconduct. While it is possible that this deterrence effect applies to non-financial misconduct as well, there are two key reasons that the effect of board independence is ambiguous in the non-financial misconduct setting. First, directors' obligations vary; a director who only has fiduciary obligations toward shareholders may implicitly endorse harm to other stakeholders (i.e., non-financial misconduct) if the financial benefits outweigh potential penalties. Second, independent directors are not employees of the firm, and as such may have weaker incentive to ensure a positive work environment. Insider directors may therefore have stronger incentives to reduce non-financial misconduct.

We construct our stakeholder orientation tests by partitioning firms based on their state of incorporation. Prior to 2000, 33 states had introduced corporate constituency statutes. Texas introduced such a statute in 2006; no state has done so subsequent to 2006.¹⁴ We omit the 157

¹³ Note that constituency statutes apply based on a company's incorporation state, not its headquarters state. For example, numerous companies are incorporated in Delaware but have their headquarters located elsewhere. Because Delaware does not have a constituency statute, these firms are not subject to constituency laws – even if the states where these firms' actual headquarters are located have constituency statutes.

¹⁴ Flammer and Kacperczyk use the staggered introduction of constituency statutes in the 1980s and 1990s to construct a staggered difference-in-differences test. Because we do not observe temporal variation in the presence of constituency statutes over our sample period (other than for a small set of firms incorporated in Texas), we cannot employ a difference-in-differences approach. Nonetheless, we view our approach as the most econometrically appropriate; a difference-in-differences specification assumes that firms' states of incorporation do

firm-years in our sample are incorporated in Texas and partition the remaining firm-years based on whether their state of incorporation had corporate constituency laws. We then re-estimate Equation (1) separately for each of these two sub-samples.

We present results from this approach in Table 7. Panel A uses overall institutional ownership. Panel B instead separates institutional ownership based on institutional owners' independence and investment horizon, analogous to the construction in Section 4.2. We find, across both specifications, that the link between institutional ownership and non-financial misconduct is stronger in states that have corporate constituency statutes. This link also appears to be present for labor-related violations, and appears to be even stronger; the difference in coefficients is statistically significant for labor violations across the two subsamples. Consistent with Table 5, we do not find statistically significant results for environmental violations. The results in Panel B suggests that the result in Panel A can be explained by the role of independent, long-term focused institutional investors; while both types of institutional ownership are associated with a reduction in labor-related violations, we find that violations as a whole are primarily explained by independent-long-term investors. Moreover, as with Panel A, these results hold only in states with constituency statutes. The results in Table 7 thus support of the argument that institutional investors affect firms' non-financial conduct via influencing the board of directors.

4.3.2 Shareholder Proposals

As another potential channel through which institutional investors may influence firms' non-financial conduct, we consider shareholder proposals related to environmental and social (E&S) issues. It is difficult to draw a direct link from E&S proposals to subsequent violations

not change subsequent to the introduction of the treatment. This assumption gives rise to a potential endogeneity concern, however; large firms can change their state of incorporation (most commonly switching from their headquarters state to Delaware) with relative ease.

(or the lack thereof), particularly because less very few E&S proposals actually pass. To that end, our main goal in this section is not to document a direct link between E&S proposals and violations; rather, we seek to provide further evidence of the channel through which institutional investors may influence firms' non-financial conduct. We cannot observe direct engagements between institutional investors and portfolio firms; nonetheless, in light of the fact that institutional investors increase support for governance-related shareholder proposals (Appel, Gormley, and Keim, 2016), if institutional investors care about non-financial conduct then we should see an increase in support for E&S-related shareholder proposals as well.

Table 8 presents results from three tests of institutional investors' influence on E&S-related shareholder proposals. In Panel A, we estimate the likelihood of an E&S proposal being tabled at the annual general meeting (regardless of whether it passes, fails, or is withdrawn). Shareholder proposals are sticky; the probability of initiating an E&S proposal in year t is 62% conditional on having initiated an E&S proposal in year $t - 1$, but only 5% conditional on not having initiated an E&S proposal in year $t - 1$. We therefore use as the dependent variable the introduction of a proposal conditional on no proposal having being tabled the prior year. We label this variable, in Table 8, as a "new" proposal. We find that firms with higher institutional ownership are more likely to have new proposals, consistent with the idea that institutional investors (i) care about E&S issues and (ii) exert influence over E&S issues via shareholder proposals.

Columns (2) and (3) of Table 8 further support the idea that institutional investors influence E&S issues via shareholder proposals. In Column (2), we limit the sample to firm-years with E&S proposals (all proposals, not just new proposals) and test whether institutional ownership affects the likelihood of a proposal being withdrawn. While we cannot observe the reasons for each withdrawal, withdrawals frequently reflect a settlement between the parties being reached prior to a vote taking place. We find that withdrawals are more

likely to occur for higher levels of institutional ownership. Finally, in Column (3), we limit the sample to proposals that were actually voted on. While most proposals fail, we find that institutional ownership is associated with an increase in the percentage of votes received by these proposals. This is consistent with institutional investors voting their shares in favor of E&S-related proposals. On the whole, the results in Table 8 suggest that institutional ownership is positively associated with both the likelihood of E&S proposals being tabled and better outcomes when these proposals are tabled. This, in turn, supports the broader idea that institutional investors care about, and may take active steps to improve, their portfolio firms' non-financial conduct.

5. Conclusion

Using a novel dataset that tracks penalties assessed by 47 U.S. federal agencies for non-financial misconduct, we examine the effect of institutional investors on firms' non-financial performance. We find that firms with higher levels of institutional ownership have a lower likelihood of receiving fines for violations of federal law. We further find that the results are stronger among institutional investors with long-term investment horizons and monitoring incentives; these institutions are more likely to exert influence over management. Our main results are driven by labor-related violations, although we find weak evidence that firms with a higher proportion of independent, long-term focused institutional investors also commit fewer environmental violations. Our findings suggest that institutional investors view non-financial misconduct as value-destroying in the long run.

In additional analyses, we study potential channels through which institutional investors may influence firms' non-financial behavior. Although our setting precludes using typical proxies for corporate governance, by exploiting differences in stakeholder orientation laws across states we find evidence consistent with institutional investors exerting influence over the board of directors. We also document that institutional ownership is positively associated

with outcomes of environmental and social shareholder proposals, suggesting further that institutional investors appear to care about – and take steps to influence – their portfolio firms’ non-financial conduct.

Our findings expand the literature on institutional investors. Prior work typically focuses on the role of institutional investors in the capital markets; we instead provide evidence that institutional investors may have an impact on firms’ non-financial conduct as well. Moreover, prior studies that link ownership structure with CSR measures typically use black-box CSR or E&S ratings from data providers such as MSCI or RepRisk; it is difficult to ascertain how various aspects of a firm’s behavior may contribute to these ratings. Our study avoids this issue by using an objective measure of non-financial performance that reflects specific firm actions; we are therefore able to better identify potential effects of institutional ownership.

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Appendix A: Variable Definitions

We define below each of the variables used in our regression specifications.

<i>Variable name</i>	<i>Definition</i>
<i>Non-Financial Misconduct Variables</i>	
Any violation	Indicator for whether the firm was fined for any violation of federal law, excluding financial and securities laws
Labor violation	Indicator for whether the firm was fined for violations of federal labor laws. This variable is equal to 1 if the firm was fined by any of the following US federal agencies: • Employee Benefits Security Administration • Equal Employment Opportunity Commission • Federal Motor Carrier Safety Administration • Federal Railroad Administration • Department of Health & Human Services • Mine Safety & Health Administration • National Labor Relations Board • Occupational Safety & Health Administration • Office of Workers' Compensation Programs • Wage & Hour Division
Environmental violation	Indicator for whether the firm was fined for violations of federal environmental laws. This variable is equal to 1 if the firm was fined by any of the following US federal agencies: • Bureau of Safety and Environmental Enforcement • Department of Energy • Environmental Protection Agency • Federal Energy Regulatory Commission • Nuclear Regulatory Commission • Office of National Resources Revenue • Pipeline and Hazardous Materials Safety Administration • US Coast Guard
<i>Institutional Ownership Variables</i>	
Institutional Ownership (IO)	Proportion of shares held by institutional owners
Change in IO	Year-over-year change in proportion of shares held by institutional owners
Long-Term IO	Proportion of shares held by institutional investors with lower-than-median portfolio turnover, as measured by churn ratio
Short-Term IO	Proportion of shares held by institutional investors with higher-than-median portfolio turnover, as measured by churn ratio
Independent IO	Proportion of shares held by mutual fund managers and investment advisers
Independent & Long-Term IO	Proportion of shares held by independent, low-churn institutions
Grey & Short-Term IO	Proportion of shares held by either non-independent institutions or institutions with a short-term investment horizon
<i>Control Variables</i>	
Log assets	Log of firm's fiscal year-end assets
Sales growth rate	Percentage change in year-over-year sales
ROA	Return on assets
Leverage	Debt to equity ratio
Analyst Coverage	Number of unique analysts providing forecasts for the firm
Tobin's q	(Total Assets + Market Value – Book Value)/Total Assets
<i>Channel Variables</i>	
Constituency State	Indicator for whether the firm's state of incorporation has constituency laws (laws which explicitly require firms to consider stakeholders other than shareholders)
E&S Proposal Initiation	Indicator for whether E&S ("environmental & social") shareholder proposal was tabled, regardless of whether passed/failed/withdrawn.
New E&S Proposal Initiation	Indicator for whether <i>new</i> E&S shareholder proposal was tabled; we classify an E&S proposal as new if no E&S proposals were filed in the previous year
E&S Proposal Withdrawn	Indicator for whether a shareholder proposal was withdrawn before voting
E&S Proposal Vote %	Percentage of votes in favor of a shareholder proposal

Appendix B: Construction of Labor and Environmental Violation Variables

We construct labor and environmental violation variables based on the agency issuing those violations. We provide below a list of all federal agencies for which Violation Tracker data is available, indicating how we classify each agency (labor, environmental, or neither). We omit from this table four agencies for which we observe zero violations for firms in our sample. These are the Federal Maritime Commission, Fish and Wildlife Service, National Oceanic and Atmospheric Administration, and US Department of Agriculture.

Agency	Name	Type	Frequency (% of firm-years)
ACPD	Transportation Department Aviation Consumer Protection Division	Neither	0.21%
ATTTB	Alcohol and Tobacco Tax and Trade Bureau	Neither	0.03%
BIS	Bureau of Industry and Security	Neither	0.35%
BSEE	Bureau of Safety and Environmental Enforcement	Environmental	0.41%
CFPB	Consumer Financial Protection Bureau	Neither	0.11%
CFTC	Commodity Futures Trading Commission	Neither	0.17%
CMS	Centers for Medicare & Medicaid Services	Neither	0.08%
CPSC	Consumer Product Safety Commission	Neither	0.15%
DDTC	Directorate of Defense Trade Controls	Neither	0.07%
DEA	Drug Enforcement Administration	Neither	0.03%
DOE	Department of Energy	Environmental	0.04%
DOJ	Department of Justice	Neither	1.06%
EBSA	Employee Benefits Security Administration	Labor	0.17%
EEOC	Equal Employment Opportunity Commission	Labor	0.97%
EPA	Environmental Protection Agency	Environmental	6.87%
FAA	Federal Aviation Administration	Neither	1.02%
FCC	Federal Communications Commission	Neither	0.11%
FDA	Food and Drug Administration	Neither	0.12%
FDIC	Federal Deposit Insurance Corporation	Neither	0.06%
FED	Federal Reserve	Neither	0.08%
FERC	Federal Energy Regulatory Commission	Environmental	0.23%
FHFA	Fannie Mae	Neither	0.03%
FINCEN	Treasury Financial Crimes Enforcement Network	Neither	0.02%
FMCSA	Federal Motor Carrier Safety Administration	Labor	0.54%
FRA	Federal Railroad Administration	Labor	2.43%
FTC	Federal Trade Commission	Neither	0.12%
GIPSA	Grain Inspection, Packers & Stockyards Administration	Neither	0.01%
HHSOIG	Department of Health & Human Services Office of Inspector General	Labor	0.05%
HUD	Department of Housing and Urban Development	Neither	0.06%
MSHA	Mine Safety & Health Administration	Labor	1.32%
NCUA	National Credit Union Administration	Neither	0.02%
NHTSA	National Highway Traffic Safety Administration	Neither	0.02%
NLRB	National Labor Relations Board	Labor	2.90%
NRC	Nuclear Regulatory Commission	Environmental	0.12%
OCC	Office of the Comptroller of the Currency	Neither	0.19%
OFAC	Office of Foreign Assets Control	Neither	0.18%
OFCCP	Office of Federal Contract Compliance Programs	Neither	0.28%
ONRR	Office of Natural Resources Revenue	Environmental	0.04%

OSHA	Occupational Safety & Health Administration	Labor	13.44%
PHMSA	Pipeline and Hazardous Materials Safety Administration	Environmental	0.79%
USCG	US Coast Guard	Environmental	0.01%
WHD	Department of Labor Wage and Hour Division	Labor	4.03%

TABLES

TABLE 1: Sample Construction

This table details how we construct our sample. We note that our tests focus on large firms; this is because the Violation Tracker database provides data at the subsidiary company level. Violation Tracker provides parent-subsidiary matching only for (roughly) the largest 2500-3000 firms. A large portion of the parent-subsidiary matching was done in 2016, using (among other sources) a ranking of firm size by relative market value based on 2015 year-end rankings. We therefore consider only firms that were ranked in the top 2500 by market capitalization in 2015.

	Firm-Years	
	Obs. Dropped	Obs. Remaining
Start: All firm-years for 2,500 largest firms by market value as of 2015, with at least 5 years of data available between 2004 and 2015		24,321
Less: Firms missing from Thomson Reuters 13F Holdings data	(8,049)	16,272
Less: Firms missing ROA data	(1,370)	14,902
Less: Firms missing sales data	(294)	14,608
Less: Firms missing other Compustat data	(119)	14,489

TABLE 2: Descriptive Statistics

This table presents descriptive statistics (mean, median, standard deviation, 10th and 90th percentiles) for all variables in our final estimation sample. Panel A presents descriptive statistics for the overall sample. Panel B presents year-by-year descriptive statistics for our main non-financial misconduct variables and for institutional ownership; in Panel B, the violation variables are one-year ahead to mirror our main regression specifications (i.e., the row pertaining to 2004 reflects 2004 institutional ownership and 2005 non-financial misconduct). Although we use two-digit SIC industry-by-year fixed effects in our changes specifications, for brevity we tabulate this panel by major SIC industry grouping rather than by individual two-digit SIC codes. Panel C presents descriptive statistics on violations and institutional ownership by industry. For consistency with our main regressions, we use one-year-ahead incidences of penalties.

Panel A: Descriptive statistics

Variable	Mean	Median	Std. Dev	10 th %ile	90 th %ile
<i>Non-Financial Misconduct</i>					
Any violation (t+1)	0.264	0.000	0.441	0.000	1.000
Labor violation (t+1)	0.208	0.000	0.406	0.000	1.000
Environmental violation (t+1)	0.080	0.000	0.271	0.000	0.000
<i>Institutional Ownership</i>					
Institutional Ownership (IO)	0.730	0.796	0.241	0.354	0.997
IO Change	0.019	0.009	0.086	-0.053	0.097
Low-Churn IO	0.385	0.396	0.163	0.159	0.587
High-Churn IO	0.340	0.339	0.160	0.127	0.553
Independent & Low-Churn IO	0.439	0.443	0.182	0.190	0.674
<i>Control Variables</i>					
Log assets	8.024	7.822	1.547	6.295	10.120
Sales growth rate	0.114	0.075	0.267	-0.095	0.338
ROA	0.136	0.127	0.106	0.023	0.264
Leverage	0.201	0.168	0.183	0.000	0.439
Analyst Coverage	9.295	7.000	7.670	1.000	20.000
Tobin's Q	1.846	1.460	1.124	1.005	3.151
<i>Channel Variables</i>					
Constituency State	0.297	0.000	0.457	0.000	1.000
New E&S Shareholder Proposal	0.045	0.000	0.207	0.000	0.000
E&S Shareholder Proposal	0.109	0.000	0.312	0.000	1.000
E&S Proposal Withdrawn*	0.210	0.000	0.407	0.000	1.000
E&S Proposal Vote %*	20.27%	4.85%	14.39%	0.00%	34.60%

Note:

Panel B: Violation frequency by industry

Industry	% of Firm-Years			Firm-Year Average	
	All penalties (t+1)	Labor penalties (t+1)	Environmental penalties (t+1)	% IO (t)	Change % IO (t)
Agriculture (SIC codes 1-9)	31.25%	16.67%	18.75%	73.71%	1.88%
Construction (SIC codes 15-17)	49.09%	42.73%	9.55%	86.14%	1.99%
Manufacturing (SIC codes 20-39)	30.28%	24.51%	10.47%	78.50%	1.66%
Mining (SIC codes 10-14)	42.42%	30.46%	20.86%	71.75%	1.50%
Retail trade (SIC codes 52-59)	37.65%	34.22%	4.87%	77.63%	1.51%
Financial services (SIC codes 60-69)	7.83%	3.52%	0.46%	60.04%	2.23%
Services (SIC codes 70-89)	15.67%	13.57%	1.10%	79.09%	2.45%
Transportation and utilities (SIC codes 40-49)	37.39%	27.42%	15.19%	62.65%	1.47%
Wholesale trade (SIC codes 50-51)	27.38%	22.62%	3.93%	78.01%	2.00%
Overall	26.43%	20.77%	7.95%	73.03%	1.85%

Panel C: Violation frequency and institutional ownership by year

Year	% of Firm-Years			Firm-Year Average
	All penalties (t+1)	Labor penalties (t+1)	Environmental penalties (t+1)	% Institutional Ownership (t)
2004	24.73%	17.94%	8.54%	66.42%
2005	23.59%	18.78%	7.31%	68.23%
2006	25.96%	20.45%	7.43%	70.65%
2007	23.99%	18.18%	7.66%	74.17%
2008	25.04%	20.25%	6.12%	71.78%
2009	25.91%	21.87%	7.67%	71.02%
2010	26.93%	21.73%	7.32%	71.76%
2011	28.19%	23.18%	7.98%	73.42%
2012	24.79%	20.12%	7.19%	74.57%
2013	27.38%	20.69%	8.73%	76.74%
2014	29.97%	21.79%	9.94%	77.36%
2015	29.90%	23.40%	9.54%	78.43%
Overall	26.43%	20.77%	7.95%	73.03%

TABLE 3: Correlations

This table presents correlations for the variables used in our main regression specifications. Pearson correlations are above the diagonal, while Spearman correlations are below the diagonal.

	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]
[1] Any violation (t+1)		0.86	0.49	-0.04	-0.04	0.37	-0.07	0.02	0.08	0.12	-0.14
[2] Labor violation (t+1)	0.86		0.26	-0.03	-0.04	0.31	-0.06	0.02	0.07	0.10	-0.12
[3] Environmental violation (t+1)	0.49	0.26		-0.07	0.00	0.30	-0.06	-0.02	0.07	0.09	-0.10
[4] Institutional Ownership (IO)	-0.10	-0.09	-0.11		0.10	-0.06	-0.01	0.04	-0.12	0.15	0.09
[5] IO Change	-0.03	-0.04	0.00	0.10		-0.07	0.07	0.03	-0.01	-0.04	0.08
[6] Log assets	0.36	0.30	0.27	-0.12	-0.05		-0.12	0.03	0.16	0.51	-0.17
[7] Sales growth rate	-0.08	-0.06	-0.07	0.05	0.06	-0.12		0.21	-0.03	0.01	0.24
[8] ROA	0.01	0.02	-0.02	0.04	0.02	-0.02	0.31		-0.09	0.17	0.34
[9] Leverage	0.13	0.11	0.10	-0.08	0.00	0.26	-0.09	-0.13		-0.08	-0.15
[10] Analyst Coverage	0.14	0.11	0.11	0.12	-0.03	0.50	0.04	0.20	-0.05		0.24
[11] Tobin's q	-0.12	-0.10	-0.09	0.08	0.08	-0.13	0.26	0.54	-0.23	0.26	

TABLE 4: Univariate Analysis

This table presents univariate differences for all variables used in our main regressions for violation and non-violation firm-years for our sample. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Variable	Non-Violation Firm-Year Mean	Violation Firm-Year Mean	Difference	t-statistic
Institutional Ownership (IO)	0.721	0.763	0.042	(4.73)
IO Change	0.020	0.012	-0.008	(-6.01)
Long-Term IO	0.378	0.415	0.037	(6.84)
Short-Term IO	0.337	0.342	0.005	(0.94)
Independent & Long-Term IO	0.256	0.272	0.016	(3.98)
Grey or Short-Term IO	0.433	0.455	0.022	(3.43)
Log assets	7.818	8.839	1.021	(13.72)
Sales growth rate	0.127	0.084	-0.043	(-8.34)
ROA	0.128	0.151	0.023	(6.62)
Leverage	0.201	0.237	0.036	(5.39)
Analyst Coverage	7.965	11.518	3.553	(11.51)
Tobin's Q	1.849	1.709	-0.140	(-3.95)

TABLE 5: Main Regression Specification

This table presents results from our main regression specification, testing the effect of institutional ownership on firms' proclivities to commit non-financial misconduct. Panel A presents results from using an indicator for the incidence of penalties as the dependent variable. Columns (1)-(3) use a levels specification with firm and year fixed effects, while Columns (4)-(6) use a specification where we first-difference all independent variables but not the dependent variable and use industry-by-year fixed effects. Panel B presents results from using the natural logarithm of one plus the dollar value of penalties as the dependent variable. All independent variables are as in Columns (1)-(3) of Panel A. Columns (1)-(3) of Panel B present results from estimating the model on the full sample and include firm and year fixed effects. Columns (4)-(6) restrict the analysis to the subsample where violations occurred, providing a test of whether institutional ownership can help mitigate the effect of violations *conditional* on violations having occurred; because this test is cross-sectional in nature we employ year fixed effects but not firm fixed effects. In both panels, we construct dependent variables to reflect either all federal violations received by a firm-year (Columns (1) and (4)), only labor-related violations (Columns (2) and (5)), or only environmental violations (Columns (3) and (6)). Please refer to Appendix A for more information on how we construct these classifications. The dependent variables in Panel A are indicators for whether firms received at least one federal penalty; in Panel B, the dependent variables are instead the log of the total dollar value of fines assessed at the firm-year level. All standard errors are clustered by firm. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Table 5 (continued)
Panel A: Penalty Indicators

<i>Dependent Variable:</i>	All Penalties	Labor Penalties	Environmental Penalties	All Penalties	Labor Penalties	Environmental Penalties
<i>Specification:</i>	Levels	Levels	Levels	Changes	Changes	Changes
Variable	(1)	(2)	(3)	(4)	(5)	(6)
Institutional ownership	-0.0605** [-2.24]	-0.0578** [-2.19]	-0.0278 [-1.42]	-0.1308*** [-3.41]	-0.1134*** [-3.15]	-0.0146 [-0.66]
Log assets	0.0496*** [4.91]	0.0338*** [3.62]	0.0200*** [3.32]	-0.0055 [-0.26]	-0.0082 [-0.44]	-0.0083 [-0.63]
Sales growth	0.0145 [1.46]	0.0186** [2.08]	-0.0118* [-1.78]	-0.0910*** [-5.71]	-0.0553*** [-3.93]	-0.0542*** [-5.40]
ROA	0.0479 [1.00]	0.0484 [1.31]	-0.0076 [-0.20]	0.1800*** [3.43]	0.1792*** [3.69]	0.0673** [2.02]
Leverage	-0.0576* [-1.69]	-0.0313 [-0.98]	-0.0102 [-0.51]	-0.0069 [-0.15]	0.0244 [0.58]	-0.0188 [-0.70]
Analyst coverage	0.0011 [1.27]	0.0000 [0.05]	0.0007 [1.27]	-0.0006 [-0.62]	-0.0007 [-0.75]	-0.0004 [-0.66]
Tobin's q	0.0082 [1.59]	0.0116** [2.57]	0.0031 [0.90]	-0.0001 [-0.02]	-0.0010 [-0.19]	0.0003 [0.09]
Observations	14,489	14,489	14,489	14,118	14,118	14,118
Adj. R-squared	0.4604	0.4281	0.3615	0.1717	0.1692	0.1452

Table 5 (continued)
Panel B: Log Penalty Values

<i>Dependent Variable:</i>	All Penalties	Labor Penalties	Environmental Penalties	All Penalties	Labor Penalties	Environmental Penalties
<i>Subsample:</i>	Full sample	Full sample	Full sample	Violation obs.	Violation obs.	Violation obs.
Variable	(1)	(2)	(3)	(4)	(5)	(6)
Institutional ownership	-0.6519** [-2.17]	-0.6015** [-2.28]	-0.3158 [-1.46]	-0.1016 [-0.36]	-0.2276 [-0.84]	-0.4939 [-1.36]
Log assets	0.6209*** [5.19]	0.3910*** [4.08]	0.2295*** [3.30]	0.6478*** [10.26]	0.2056*** [5.24]	0.3124*** [4.37]
Sales growth	0.1095 [0.95]	0.1986** [2.20]	-0.1521* [-1.94]	-0.2296 [-1.18]	0.0645 [0.47]	-0.3881 [-1.05]
ROA	0.5382 [0.98]	0.4354 [1.17]	-0.0817 [-0.19]	0.0230 [0.03]	0.9315 [1.45]	1.2347 [0.94]
Leverage	-0.4484 [-1.20]	-0.3193 [-1.00]	-0.0237 [-0.11]	-0.9704*** [-3.44]	-0.3131* [-1.71]	-0.1852 [-0.36]
Analyst coverage	0.0098 [0.91]	-0.0021 [-0.24]	0.0071 [1.09]	0.0006 [0.07]	0.0044 [0.75]	-0.0034 [-0.26]
Tobin's q	0.0820 [1.40]	0.1177*** [2.63]	0.0332 [0.84]	-0.0672 [-1.04]	-0.0998** [-2.02]	-0.3283** [-1.99]
Observations	14,489	14,489	14,489	3,829	3,010	1,152
Adj. R-squared	0.4837	0.4614	0.3846	0.1912	0.0653	0.0627

TABLE 6: Types of Institutional Ownership

This table separates out different types of institutional ownership. Panel A considers institutions with long-term vs. short-term focus, while Panel B considers independent, long-term institutional owners separately from all other types of institutional ownership. In both panels, the dependent variables are indicators for whether a firm received at least one federal violation of any type (Column (1)), a labor-related violation (Column (2)), or an environmental violation (Column (3)). Please refer to Appendix A for more information on how we construct these classifications. We include firm and year fixed effects in both panels. All standard errors are clustered by firm. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Long-Term vs. Short-Term Ownership

Variable	All Penalties (1)	Labor Penalties (2)	Environmental Penalties (3)
Long-term IO	-0.0879** [-2.32]	-0.0587 [-1.63]	-0.0487* [-1.81]
Short-term IO	-0.0241 [-0.75]	-0.0380 [-1.23]	-0.0180 [-0.85]
Log assets	0.0497*** [4.95]	0.0334*** [3.58]	0.0205*** [3.40]
Sales growth	0.0143 [1.44]	0.0188** [2.10]	-0.0121* [-1.83]
ROA	0.0411 [0.86]	0.0458 [1.23]	-0.0104 [-0.28]
Leverage	-0.0568* [-1.66]	-0.0304 [-0.95]	-0.0104 [-0.52]
Analyst coverage	0.0012 [1.36]	0.0001 [0.07]	0.0008 [1.37]
Tobin's q	0.0077 [1.49]	0.0114** [2.54]	0.0029 [0.84]
Observations	14,489	14,489	14,489
Adj. R^2	0.4604	0.4280	0.3615

Table 6 (continued)
Panel B: Independent & Long-Term Ownership

Variable	All Penalties (1)	Labor Penalties (2)	Environmental Penalties (3)
Independent & Long-Term IO	-0.1270*** [-2.80]	-0.0760* [-1.79]	-0.0566* [-1.79]
Other IO	-0.0246 [-0.83]	-0.0319 [-1.12]	-0.0221 [-1.13]
Log assets	0.0499*** [4.98]	0.0334*** [3.59]	0.0205*** [3.43]
Sales growth	0.0138 [1.39]	0.0186** [2.07]	-0.0122* [-1.84]
ROA	0.0370 [0.77]	0.0434 [1.16]	-0.0108 [-0.29]
Leverage	-0.0565* [-1.65]	-0.0300 [-0.94]	-0.0103 [-0.51]
Analyst coverage	0.0012 [1.34]	0.0000 [0.05]	0.0007 [1.33]
Tobin's q	0.0074 [1.44]	0.0112** [2.50]	0.0029 [0.83]
Observations	14,489	14,489	14,489
Adj. R^2	0.4606	0.4281	0.3616

TABLE 7: By State Stakeholder Orientation Laws

This table partitions the sample based on whether firms' state of incorporation had stakeholder orientation laws in place. We omit firms incorporated in Texas, because Texas introduced a stakeholder orientation law in 2006, i.e., during our sample period; all other states in our sample either implemented a stakeholder orientation law prior to 1999 or did not have such a law as of 2016. The dependent variable in all columns is an indicator variable for whether a firm had at least one violation of the given type (all violations, labor violations, or environmental violations). All specifications include firm and year fixed effects. All standard errors are clustered by firm. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A: All Institutional Ownership

<i>Dependent Variable:</i> <i>Subsample:</i> Variable	All Penalties (Has Law) (1)	All Penalties (No Law) (2)	Labor Penalties (Has Law) (3)	Labor Penalties (No Law) (4)	Environmental Penalties (Has Law) (5)	Environmental Penalties (No Law) (6)
Institutional ownership	-0.1484** [-2.26]	-0.0406 [-1.36]	-0.1635** [-2.48]	-0.0314 [-1.11]	-0.0398 [-0.98]	-0.0232 [-1.01]
Log assets	0.0522** [2.09]	0.0491*** [4.47]	0.0632*** [2.62]	0.0251** [2.50]	0.0247* [1.78]	0.0203*** [2.99]
Sales growth	0.0035 [0.15]	0.0136 [1.25]	-0.0032 [-0.17]	0.0229** [2.25]	-0.0099 [-0.84]	-0.0133* [-1.68]
ROA	0.1978* [1.71]	0.0176 [0.33]	0.1262 [1.29]	0.0351 [0.88]	-0.0791 [-1.01]	0.0002 [0.00]
Leverage	-0.0707 [-0.83]	-0.0588 [-1.60]	-0.0589 [-0.76]	-0.0287 [-0.83]	-0.0147 [-0.30]	-0.0078 [-0.36]
Analyst coverage	0.0030 [1.40]	0.0006 [0.64]	-0.0011 [-0.53]	0.0003 [0.38]	0.0018 [1.47]	0.0005 [0.90]
Tobin's q	-0.0156 [-1.21]	0.0111** [1.99]	-0.0041 [-0.34]	0.0119** [2.47]	0.0082 [0.96]	0.0025 [0.65]
Diff. in IO coefficients	-0.1078		-0.1321*		-0.0166	
t-statistic	[-1.43]		[-1.82]		[-0.41]	
Observations	4,341	9,993	4,341	9,993	4,341	9,993
Adj. R-squared	0.4240	0.4759	0.4092	0.4368	0.2985	0.3900

Panel B: Independent vs. Other Institutional Ownership

<i>Dependent Variable:</i> <i>Subsample:</i> Variable	<i>Dependent Variable Based On:</i>					
	All Penalties (Has Law)	All Penalties (No Law)	Labor Penalties (Has Law)	Labor Penalties (No Law)	Environmental Penalties (Has Law)	Environmental Penalties (No Law)
	(1)	(2)	(3)	(4)	(5)	(6)
Independent & Long Term IO	-0.3081*** [-3.08]	-0.0808 [-1.56]	-0.2186** [-2.40]	-0.0427 [-0.88]	-0.0789 [-1.21]	-0.0485 [-1.32]
Other IO	-0.0990 [-1.40]	-0.0114 [-0.34]	-0.1529** [-2.22]	-0.0032 [-0.10]	-0.0341 [-0.77]	-0.0181 [-0.83]
Log assets	0.0568** [2.30]	0.0488*** [4.47]	0.0652*** [2.71]	0.0243** [2.43]	0.0260* [1.91]	0.0207*** [3.07]
Sales growth	0.0035 [0.15]	0.0131 [1.20]	-0.0033 [-0.17]	0.0229** [2.25]	-0.0101 [-0.85]	-0.0138* [-1.73]
ROA	0.1689 [1.44]	0.0106 [0.20]	0.1171 [1.21]	0.0304 [0.75]	-0.0849 [-1.07]	-0.0023 [-0.05]
Leverage	-0.0754 [-0.88]	-0.0574 [-1.56]	-0.0595 [-0.76]	-0.0272 [-0.79]	-0.0161 [-0.33]	-0.0078 [-0.36]
Analyst coverage	0.0030 [1.42]	0.0007 [0.69]	-0.0012 [-0.55]	0.0004 [0.39]	0.0018 [1.47]	0.0006 [0.96]
Tobin's q	-0.0167 [-1.30]	0.0105* [1.88]	-0.0043 [-0.35]	0.0114** [2.39]	0.0079 [0.93]	0.0023 [0.60]
Coefficient diff. (Indep/LT)		-0.2273*		-0.1759		-0.0304
t-statistic		[-1.92]		[-1.64]		[-0.42]
Coefficient diff. (other)		-0.0876		-0.1497**		-0.0160
t-statistic		[-1.12]		[-1.99]		[-0.40]
Observations	4,341	9,993	4,341	9,993	4,341	9,993
Adj. R-squared	0.4247	0.4760	0.4093	0.4368	0.2986	0.3901

TABLE 8: Shareholder Proposals

This table presents tests that verify one potential channel through which institutional owners may exert influence over a firm's decision-making process: shareholder proposals. In column (1), the dependent variable is an indicator for whether the firm initiates a *new* shareholder proposal (defined as initiating a shareholder proposal in year $t + 1$ as well as not of the potential consequences of non-financial misconduct). This column is estimated over the period 2005-2014 (because our shareholder proposal data spans 2006-2015) and uses firm and year fixed effects. In columns (2) and (3) we focus on the subsample in which SRI-related shareholder proposals occurred. In column (2) the dependent variable is an indicator for whether the proposal was withdrawn (potentially indicating that a settlement might have been reached). In column (3) we consider only those observations where a vote occurred; our dependent variable is the percentage of votes received in favour of the proposal. Because Columns (2) and (3) reflect a cross-sectional rather than panel approach, we do not impose fixed effects. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

<i>Dependent Variable:</i>	New E&S Proposal Initiation (1)	E&S Proposal Withdrawn (2)	E&S Proposal Vote % (3)
Institutional ownership	0.0386** [2.28]	0.2163** [2.38]	14.1439*** [4.48]
Log assets	0.0289*** [4.23]	-0.0150 [-1.35]	-0.4915 [-1.22]
Sales growth	-0.0019 [-0.28]	-0.0385 [-0.47]	3.2973 [1.13]
Leverage	-0.0235 [-1.17]	0.0486 [0.51]	-8.1383*** [-2.65]
ROA	-0.0196 [-0.59]	0.3562* [1.93]	-7.5210 [-1.09]
Analyst coverage	0.0002 [0.22]	0.0035* [1.87]	0.0543 [0.77]
Tobin's q	0.0033 [0.89]	-0.0237 [-1.41]	-2.5804*** [-4.43]
Observations	12,271	1,451	818
Adj. R-squared	0.0484	0.0080	0.0619