

The Unintended Governance Consequences of Regulatory Oversight: Evidence from Institutional Investors^{*}

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Abstract

This paper examines how regulatory scrutiny affects institutional investors' ability to act as stewards of their portfolio firms. We show that institutional investors distracted by regulatory investigations exhibit lower portfolio trading activities, and we propose “regulatory scrutiny” as a novel measure of institutional distraction. This distraction, as an external shock to institutions' attention, reduces their monitoring effectiveness in preventing self-interested managerial decisions in the firms they hold. Specifically, we find that firms with a larger share of distracted institutions are more likely to increase CEO compensation and to pursue value-destroying acquisitions, with under-performance persisting for up to four years. This distraction also carries costs for the institutions themselves, which are less likely than peers to exit firms after value-destroying actions, consistent with scrutiny diverting attention from value-relevant information. Taken together, our findings indicate that while regulatory oversight of financial intermediaries is crucial for promoting market fairness and systemic stability, it may inadvertently weaken institutions' capacity to monitor corporate behavior.

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1 Introduction

Institutional investors play an important role as external monitors and disciplinarians of corporate governance, either through active oversight or voting with their feet, to align managers' decisions with shareholder interests. However, investors have limited capacity to process all available information simultaneously ([Hirshleifer and Teoh, 2003](#)), making attention a valuable and constrained resource in financial decision-making. Recent studies extend the limited attention framework, showing that shocks to a particular stock in an institutional investor's portfolio draw its attention away from its other holdings. Using these internal portfolio shocks as a proxy for institutional distraction, this literature examines the consequences to their investee firms. At the same time, institutional investors' attention can also be diverted by shocks unrelated to their portfolio holdings characteristics. As subjects of regulatory oversight, institutional investors are monitored by various government agencies, such as the Securities and Exchange Commission (SEC), and occasionally face disciplinary actions.

When an institutional investor becomes the target of a regulatory investigation or enforcement action, a significant portion of its resources and attention is diverted to managing that process. A particular yet illustrative case of large-scale distraction under regulatory oversight is Wells Fargo's fake accounts scandal. It triggered an unprecedented wave of regulatory interventions for the company from 2016 to 2020, including over \$5 billion in settlements, three CEO changes, and an asset cap imposed by the Federal Reserve. Simultaneously, the bank's anti-money laundering systems went unmonitored and failed, going undetected by the bank itself until the bank was later also charged with deficient implementation and testing of that very system. This raises the natural question of whether such organization-wide distraction due to regulatory scrutiny also impairs institution's capacity to monitor the firms in its portfolio and, consequently, undermines its role in corporate governance. Our paper aims to examine this novel and crucial question: *What are the unintended governance consequences when the oversight imposed on corporate monitors compromises their capacity*

to oversee others?

Specifically, we investigate how regulatory oversight of institutional investors affects their stewardship role in corporate governance. Regulatory scrutiny of institutions, while necessary for market integrity, distracts them from their core responsibilities, including their key role of effectively monitoring the firms in which they invest, creating negative externalities in their investee firms. This question is relevant on two fronts. First, it is of particular relevance to regulators, who must weigh the benefits of oversight against its unintended costs to governance. Second, it speaks to the broader literature on institutional investors whose collective monitoring role on corporate governance is essential in mitigating the agency problem. The financial and reputational consequences of a regulatory investigation create an attention deficit that reduces the institution’s capacity to engage in active governance. Understanding whether and how regulatory oversight affects institutions’ attention, and, in turn, their monitoring effectiveness, provides valuable insights into the unintended costs of oversight. Lastly, it also raises questions about how regulation can uphold accountability in financial markets while minimizing negative spillovers on corporate governance.

To examine these questions, we develop a measure of regulatory distraction based on institutional investors’ disciplinary interactions with regulatory bodies. Registered investment advisors, which account for more than 70% of 13(f) institutional investors, are required by the SEC to disclose detailed information about their company’s business operations in their Form ADV. This includes the disclosure of any criminal, regulatory, or civil judicial action related to investments or investment-related businesses that have occurred within the last ten years. Of particular relevance to our study are the initiation and resolution dates of the disciplinary actions reported in this form. We use this information to construct our measure of institutional distraction, classifying an institution as distracted between the initiation and resolution dates of a disciplinary event.

The shareholder distraction measure based on regulatory scrutiny offers multiple advantages. First, because the disciplinary history of institutional investors is required information,

it is directly observable for each individual institution. Second, regulatory scrutiny serves as an external shock to institutional investor attention, since it stems from factors unrelated to characteristics of the firms in their investment portfolios. This is in contrast to existing portfolio-related measures of attention, such as portfolio weight (Ward, Yin and Zeng, 2018), fraction of holdings with earnings announcements (Schmidt, 2019), and industry-level performance (Kempf, Manconi and Spalt, 2017). Third, disciplinary action against an institutional investor is unrelated to economic conditions and is idiosyncratic to the institution, offering both cross-sectional and temporal variation.

Before addressing our main research question, we first validate our identification strategy and confirm that distracted institutions behave in ways consistent with empirical predictions. Specifically, prior to scaling back their monitoring role, we expect distracted institutions to curtail their trading activity. Consistent with this expectation, we find that the portfolio churn rate declines significantly as institutional distraction increases. We further validate our identification strategy by confirming that, prior to regulatory scrutiny, the portfolios of the institutions under investigation are not meaningfully different from those of other institutions. The one notable exception is the portfolio size, which, is expected considering that larger institutions attract more regulatory attention. This balance supports the interpretation that selection into regulatory investigations is unlikely to confound our main results.

We hypothesize that regulatory scrutiny, as an external shock to institutions' attention, diverts it from their portfolio holdings, which in turn may reduce their effectiveness in preventing value-destroying managerial decisions in the firms they hold. If strong shareholder monitoring constrains managerial discretion, then a reduction in the intensity or effectiveness of such monitoring is expected to increase the likelihood of firm decisions that favor managerial self-interest at the expense of shareholder value.

To capture managerial self-interest, we examine CEO compensation, since pay contracts are directly negotiated between managers and boards and are particularly prone to serving

the CEO's self-interest. Therefore, compensation is susceptible to managerial influence when external monitoring weakens. When effective oversight from institutional shareholders is absent, executives have greater latitude to extract rents through compensation arrangements that are only loosely tied to performance, making CEO pay a direct and observable setting in which weakened governance can manifest.

Our findings are consistent with the hypothesis that disciplinary actions against institutional investors have unintended spillover effects on their portfolio holdings. We find that firms with higher distracted institutional ownership are significantly more likely to pay higher and more opportunistic CEO compensation. Specifically, temporary shareholder distraction due to regulatory scrutiny is associated with higher overall CEO compensation, driven by flexible compensation components (bonuses, stock options, and lucky grants). As expected, we find no changes in salary, as it is a predetermined component of CEO compensation and is not easily modified. Robustness tests using increases in compensation, abnormal compensation (compensation unexplained by common firm characteristics), and above-median abnormal compensation confirm the robustness of our results. Furthermore, we find consistent evidence that the effect of shareholder distraction on CEOs' ability to extract higher compensation is significantly greater among CEOs who hold power over their board. Lastly, when institutional shareholders are distracted, CEOs are less likely to be punished for poor performance.

If regulatory distraction genuinely impairs institutional monitoring, its effects should not be confined to CEO compensation but should extend to other corporate decisions where managerial self-interest and institutional monitoring both matter. We examine acquisition announcements as a second setting in which managerial self-interest may manifest. Acquisitions are among the most consequential and discretionary decisions a manager can make, and value-destroying deals are frequently interpreted as evidence of empire building rather than shareholder value maximization. When institutional monitoring is weakened by distraction, managers face fewer constraints in pursuing such deals, making acquisitions a natural setting

for observing the consequences of reduced oversight. This setting also allows us to relate our findings to recent literature on institutional distraction, such as [Kempf et al. \(2017\)](#), which shows that firms with shareholders distracted by shocks in stocks in their portfolio in other industries are more likely to announce value-destroying acquisitions. By examining acquisitions in the context of regulatory-driven distraction, we extend this line of work and, in addition to providing evidence on the unintended consequences of regulatory scrutiny, we broaden the scope of the institutional distraction literature by showing that its effects extend beyond portfolio-driven shocks to include institution-wide sources of distraction.

We find supporting evidence for acquisition activity. Firms with distracted institutional shareholders engage in value-destroying activities, indicating weakened external governance or increased managerial opportunism in the absence of institutional oversight. Specifically, we find that firms with distracted institutional shareholders are more likely to announce value-destroying acquisitions that undermine long-term value creation, such as diversifying, cash-financed, and bad acquisitions (i.e., those associated with lower cumulative abnormal returns around the announcement date). We show that acquisitions completed by these firms have lower abnormal returns at announcement, higher premiums, and lower synergies. This suggests that weakened monitoring, resulting from regulatory scrutiny, enables managers to pursue acquisitions that primarily serve their own interests, rather than those of shareholders. Importantly, we document a long-lasting underperformance of up to four years among firms with distracted institutional investors.

Lastly, we examine whether such distraction carries any costs for the institutions themselves. Research suggests that following such value-reducing corporate decisions, institutional investors, as sophisticated and informed monitors, respond by “voting with their feet,” that is, reducing or exiting their positions in the firm. We find that following unfavorable firm outcomes, distracted institutional investors are less likely to reduce or exit their positions in these firms. Such findings are consistent with our hypothesis that, while temporarily distracted by ongoing disciplinary actions, institutions lose, at least in part, their monitor-

ing capacity and thus tend to respond less effectively to management value-reducing events compared to their undistracted counterparts. Together, these results highlight that although regulatory scrutiny of institutional investors is an important component of market fairness and efficiency, such actions interfere not only with institutions' corporate governance monitoring but also with another of their positive roles in the market: impounding information into prices. This has meaningful consequences for firm behavior and long-term value.

This paper contributes to several strands of literature. First, our study builds on research that examines the limits of institutional investor attention, providing new evidence that external regulatory demands can exacerbate these limitations, albeit unintendedly. [Kempf et al. \(2017\)](#) capture institutional distraction in a firm as industry-level shocks to other firms in their portfolio. [Ward et al. \(2018\)](#) use a firm's weight in an institution's portfolio to capture their attention. [Schmidt \(2019\)](#) measures institutional distraction as the fraction of portfolio stocks that have an earnings announcement. Our approach differs in both scope and mechanism. Specifically, our measure captures an organization-wide distraction driven by regulatory scrutiny, whereas existing measures are the result of within-portfolio events or firm characteristics. Regulatory investigations involve direct engagement with government agencies, triggers reputational risks, and threatens financial consequences for the institution, which might divert senior management attention away from routine portfolio monitoring. Furthermore, existing portfolio-specific measures impact multiple institutions at the same time, whereas regulatory distraction is specific to the institution under investigation and thus offers exogenous variation.

Second, our study contributes to work on corporate governance and investor monitoring, showing that the quality of shareholder monitoring varies not only with shareholder type or ownership structure, but also with the type of exogenous shocks to the shareholder base. Third, our findings speak to the ongoing policy debate surrounding the trade-offs in regulatory enforcement. Although efforts to monitor financial intermediaries are crucial for promoting market stability, such oversight may inadvertently weaken their capacity to serve

as effective monitors of corporate behavior. Thus, regulatory actions intended to strengthen market discipline may come at the cost of diminished corporate governance. Acknowledging the negative externalities associated with disciplinary events of institutional investors could help regulators to adjust their procedures during such times.

Fourth, our findings relate to the literature on the effects of regulatory enforcement actions, which, till lately largely focused on consequences for the targeted institution itself, such as their reputational damage and executive turnover (Egan, Matvos and Seru, 2022). We join this literature showing that enforcement affects not only the institution under investigation but also the firms in its portfolio, revealing a spillover channel through which regulatory actions can affect third parties with no direct involvement in the underlying misconduct (Bhandari, Mammadov and Zykaj, 2023; Bonsall Iv, Mammadov and Zykaj, 2025).

Lastly, we point to promising avenues for future research on the role of regulatory scrutiny on institutional investors and price efficiency. Institutional investors, especially investment advisers, are widely viewed as informed traders who help impound information into prices, including by exiting positions in response to adverse firm outcomes. We provide some preliminary evidence that this channel is disrupted by regulatory distraction as institutions are less likely to trade during that period. This suggests that regulatory scrutiny can temporarily impair not only monitoring but also the price-discovery function that institutions serve.

2 Data, Variable Construction, and Research Design

The data used in this study come from multiple sources. Institutional investment managers overseeing portfolios larger than \$100 million are required under Section 13(f) of the Exchange Act of 1934 to file quarterly disclosures with the SEC on Form 13F.¹ Our data on institutional investors' 13(f) quarterly portfolio holdings are from Whale Wisdom. The historical disciplinary actions against institutional investors are from the RIAs' required Form

¹These filings must report all holdings exceeding \$10,000 in value and are to be submitted within 45 days of the quarter-end.

ADV filings from the SEC website. We obtain CEO compensation data from Execucomp, Mergers and Acquisitions data from SDC, and all other firm characteristics from Compustat.

We form our CEO compensation sample by selecting CEOs (*CEOANN* variable) in the ExecuComp database. As measures of CEO’s compensation, we include details of their salary, bonus, long-term incentive plan payouts, stock and option grants, and other compensation reported in the firm’s proxy statement.

We identify acquisition announcements using the SDC Transaction database and calculate cumulative abnormal returns (CAR) around each announcement, as well as acquisition premiums and synergies for deals involving public targets. We construct an annual panel of firms in the CRSP/Compustat universe with sufficient financial data to calculate our key variables: total assets, cash holdings, book-to-market ratio, free cash flow, leverage, age, and operating ROA (detailed definitions appear in Appendix A). We exclude firms in the financial and utilities industries (SIC codes 6000–6999 and 4900–4999), as well as firms lacking the data needed to construct these measures. Our sample spans from 2001 to 2022, beginning in 2001 when electronic filing of Form ADV was introduced, and comprises 8,110 firms whose stocks are held by 10,852 institutions, capturing the vast majority of the U.S. equity investment universe held by institutional investors.

2.1 Disciplinary History of Institutional Investors

Institutional investors with more than \$25 million in assets under management that provide investment advice must file their initial Form ADV when first registering as registered investment advisers (RIAs). The ADV Form includes detailed information about the company, including assets under management, governance structure, advisory activities, and advisory affiliates, as well as the firm’s disciplinary history. Of particular relevance to our study is the section of the form in which RIAs are required to disclose any disciplinary events involving the RIA, its advisers, and key personnel within 10 years of preceding the filing date. A disciplinary event is defined as any criminal, regulatory (i.e., federal, state, or foreign),

and/or civil judicial action. It refers to instances in which the SEC, or other regulatory agencies, have found the RIA in violation of rules or regulations, or imposed a monetary penalty related to investment-related activities.

Under SEC rules, annual amendments to Form ADV must be filed within 90 days of the end of the advisor’s fiscal year and should include any updated information for that year. If important firm information, such as disciplinary events, becomes materially inaccurate, RIAs must submit an interim update.² We follow [Bonsall Iv et al. \(2025\)](#) and manually match the RIA’s disciplinary information from Form ADV with the 13(f) institutional holdings database using the institution’s name, address, and phone number. Using this conservative matching approach, which ensures accurate matching of institutions between the two databases, we find that around 64 percent of the 13(f) institutional investors in the sample are RIAs (i.e., they file the required Form ADV).

Regulatory scrutiny of RIAs and the resulting disciplinary actions are reported with striking frequency in their Form ADV filings. In our sample, we have 738 disclosed investigations from 2001 through 2022. [Figure 1](#) presents the number of regulatory events per year, showing that these events are evenly distributed across the sample and do not appear to cluster in any particular year. The figure also shows that regulatory investigations were not primarily driven by a political party, as the highest levels occurred between 2015 and 2017, covering both Democratic and Republican administrations. Similarly, while one might expect litigation to cluster in the years following market downturns, the figure indicates that the number of cases does not appear to correlate with market outcomes.

Investigations conducted by regulatory agencies and potential litigation can take a considerable amount of time, ranging from months to even years. Involvement in an investigation by a regulatory body, such as the SEC, diverts company resources and the executive team’s attention for the duration of the ongoing investigations and legal battles.

This dynamic is well illustrated by the case of Wells Fargo, a scandal involving the

²See [Bhandari et al. \(2023\)](#) for an extended explanation on the ADV Form.

creation of fake accounts that may have harmed more than 2 million consumers and attracted scrutiny by financial regulators and Congress.³ Figure 2 shows the timeline of Wells Fargo’s regulatory investigations and disciplinary outcomes by Congress, SEC, FINRA, and the CFPB from 2016 to 2022, demonstrating their prolonged and complex nature that diverted the firm’s attention away from its core business operations. In its 2022 charges against Wells Fargo, the SEC concluded that the firm failed to file at least 34 Suspicious Activity Reports (SARs) in a timely manner between April 2017 and October 2021. The SEC attributed the delays to flaws in the new anti-money laundering (AML) monitoring system Wells Fargo adopted in January 2019, while already under investigation.⁴ This example demonstrates how institutions under intense scrutiny by regulatory bodies fail to effectively monitor their own internal processes and operations. Therefore, their capacity to serve as active monitors of corporate governance may be impaired. Our running hypothesis is that since attention is a limited resource, an institutional investor’s attention to the management of its portfolio and holding firms is compromised during these disciplinary events.

Our approach of relying on the oversight-induced shocks that draw institutional investors’ attention offers multiple advantages. First, these shocks are directly observable for each individual institution. Second, disciplinary actions against an institutional investor are neither motivated by political ideology nor economic conditions and market performance. Third, and most importantly, regulatory scrutiny serves as an external shock to institutional investor attention since it stems from factors unrelated to institutions’ portfolio holdings and characteristics. Our measure is therefore distinct from portfolio-related proxies of attention, such as portfolio weights (Ward et al., 2018), the fraction of holdings with earnings announcements (Schmidt, 2019), and industry-wide performance (Kempf et al., 2017), which capture distraction arising from within the portfolio itself.

This distinction is visible in Table 1, where we show that the likelihood of getting targeted

³See <https://www.congress.gov/crs-product/IF11129> for a detailed description of the events.

⁴SEC’s press release related to this matter is available at <https://www.sec.gov/newsroom/press-releases/2022-85>

by a regulatory oversight scrutiny in a given quarter is unrelated to past portfolio characteristics of up to four quarters. Specifically, we define $Targeted_{j,t}$ as an indicator variable equal to 1 if an investigation is initiated against institution j at quarter t . Then, we regress it on past portfolio performance, portfolio size, churn rate, turnover ratio, and fund flows over the past four quarters. We find that investigations occur more often in larger institutions, as measured by portfolio size. Importantly, other portfolio characteristics such as performance, flows, and trading patterns do not carry any predictive power. Interestingly, we find some evidence that institutions' portfolio performance during the quarter of the investigation is negative, providing some preliminary evidence of institutional distraction. In brief, these results show that the portfolios of institutions under regulatory scrutiny are not meaningfully different from those of other institutions. Therefore, it is unlikely that treated institutions are somehow different.

2.2 A Measure of Regulatory Distraction

We classify an institution as regulatorily distracted during periods of scrutiny from regulators, courts, and other oversight entities. Specifically, we record the initiation and resolution dates of each disclosed disciplinary event from Form ADV and define $Distracted_{j,t}$ as an indicator variable equal to 1 if institution j is subject to regulatory scrutiny in quarter t , defined as a quarter falling between the event's initiation and resolution dates. In some cases, the initiation and resolution dates are reported as the same day, typically the day of the press release. While this might suggest a one-day inquiry, these instances typically involve regulatory authorities engaging in private negotiations to expedite resolution. In these cases, our measure, conservatively sets $Distracted_{j,t}$ equal to one for only one quarter. We provide further discussion and additional analyses of these cases in [Section 6](#).

2.2.1 Validity of regulatory distraction measure

Our main hypothesis is that an institution involved in regulatory scrutiny and/or litigation redirects part or most of its attention away from monitoring its portfolio firms and towards the investigation(s). In this section, we provide empirical evidence supporting this hypothesis. If our hypothesis holds, institutional investors should also trade less of their portfolio holdings during periods of regulatory scrutiny. To test this, we regress measures of portfolio activity on $Distracted_{j,t}$ and past portfolio characteristics, including portfolio size, performance, and flows, using up to four lags. We include calendar quarter fixed effects to absorb common market conditions that affect portfolio trades, and institutional investor fixed effects to absorb institution-specific trading propensities and patterns.

We report our results in Table 2. In column 1, our dependent variable is $Churn\ Rate_{j,t}$, which is defined as the lesser of total buy or total sell dollar value scaled by average of assets under management quarters t and $t - 1$ (Yan and Zhang, 2009). We find that distracted institutions have 0.36 percentage points lower churn rate. In column 2, we examine portfolio turnover using $Turnover_{j,t}$ defined as the mean of the last four quarters portfolio churn rate, including the current quarter (Gaspar, Massa and Matos, 2005). We find that distracted institutions have 0.34 percentage points lower portfolio turnover. Given that the median churn rate and turnover in our sample are 5.9 and 12.4, respectively, these effects translate to 6.1% and 2.8% decline in churn rate and portfolio turnover relative to the median. These measures exclude the effects of capital flows and thus directly show how actively the institution trades its portfolio positions. In columns 3 and 4, we examine the effect of regulatory distraction on $Entry/Exit_{j,t}$, the fraction of equity holdings involving an entry or exit trade (a new position or full liquidation) and on $Trade_{j,t}$, the fraction of holdings experiencing full or partial trade. We find evidence supporting our theory that when investors are distracted, they are likely to trade less. Specifically, the fraction of new or liquidated positions is lower by 0.71 percentage points (column 3) and the fraction of partially traded holdings is 0.39 percentage points lower (column 4) for distracted institutions.

The findings in Table 2 show that institutional investors’ trading activity decreases significantly when they face litigation or regulators’ scrutiny. This finding aligns with Schmidt (2019), which shows that institutional investors distracted by the earnings announcement of one of their portfolio holdings are less likely to trade the remainder of their portfolio.

2.2.2 Firm-level distraction measure

Our main variable of interest is a firm-level measure capturing the level of distraction of the “representative” institutional investor at a given firm-period. Our measure is similar in intuition to Kempf et al. (2017)’s measure of distraction induced by attention-grabbing events in other industries held in the institution’s portfolio. We differ from their measure in two ways. First, distracting events in our setting stem from litigation and regulatory investigations that are *unrelated* to the institution’s portfolio holdings, offering a plausibly exogenous shock to attention that is less likely to be correlated with portfolio-related factors. Second, regulatory distraction for an institutional investor is a binary treatment in our setting, whereas industry portfolio distraction is a continuous treatment in Kempf et al. (2017) that depends on the institution’s industry portfolio weights.

Nevertheless, although the regulatory distraction is binary at the investor level, its effect on a given firm’s monitoring should vary continuously across firms: higher levels of distraction among a firm’s shareholders should be associated with looser monitoring, at least temporarily. Fich, Harford and Tran (2015) shows that institutional investors, on average, spend more time and effort on the largest positions in their portfolio. In addition, managers are likely to care more about their largest shareholders, who also have the largest incentive to monitor. Therefore, we posit that two variables play a role in determining how intensely regulatory distraction at institution j leads to temporary lapses in monitoring at firm i . We expect institutional investor j ’s distraction to have a greater effect on monitoring intensity in firm i if investor j owns a large fraction of firm i ’s outstanding shares, and if firm i is a large fraction of investor j ’s portfolio. Therefore, we define $D_{i,t}$ for firm i and year t as:

$$D_{i,t} = \sum_{j \in K_{t-1}} \frac{\omega_{i,j,t-1} \times \psi_{j,i,t-1} \times Distracted_{j,t}}{\omega_{i,j,t-1} \times \psi_{j,i,t-1}} \quad (1)$$

where K_{t-1} denotes the set of firm i 's institutional shareholders at the end of year $t - 1$. $Distracted_{j,t}$ is an indicator variable equal to 1 if institutional investor j is under regulatory scrutiny during year t . $(\omega_{i,j,t-1})$ is the fraction of firm i 's shares owned by investor j . $(\psi_{j,i,t-1})$ is firm i 's weight in investor j 's portfolio, $(\psi_{j,i,t-1})$. Thus, when investor j is distracted by regulatory scrutiny, our measure of regulatory distraction in firm i is higher if investor j is important to firm i (high ownership), and if firm i is important to investor j (high portfolio weight).

2.3 Empirical Design

This paper examines the impact of institutional investor distraction, induced by regulatory oversight, on their monitoring role in corporate governance. To assess the cost of institutional distraction, we examine firm-level outcomes established in prior literature as commonly influenced by institutional monitoring. Specifically, we focus on CEO compensation and turnover as well as acquisition activity. Our analysis focuses on periods of exogenous shocks to a firm's monitoring level, when an institutional investor is under investigation by a regulatory entity that diverts the institution's attention away from its portfolio firms. Our empirical approach relies on regressing firm-level outcomes on the firm-level institutional investor distraction. Specifically, we estimate the following OLS regression:

$$Y_{i,t} = \beta \times D_{i,t} + \delta \times IO_{i,t} + \Pi \times X_{i,t-1} + \lambda_j + \gamma_t + \epsilon_{i,t} \quad (2)$$

where $Y_{i,t}$ is an outcome variable, such as CEO compensation or an acquisition, for firm i in year t . $D_{i,t}$ is the measure of distraction among firm i 's institutional investors during year t , defined in Section ?? . $X_{i,t-1}$ is an array of firm characteristics that are used as control variables. Specifically, we control for institutional ownership, total asset, cash holdings, book-

to-market ratio, free cash flows, leverage, and firm age in all model specifications. Depending on the outcome variable, we may include additional control variables in our models. All independent variables, except for distraction, are lagged by a year relative to the dependent variable. Appendix A provides detailed definition of all variables. Additionally, we control for industry fixed effects (λ_j) and year fixed effects (γ_t) to account for variations that are due to specific industries or general market conditions. Industries are defined using 2-digit SIC codes.

Equation 2 relates firm outcomes to institutional shareholder distraction during the same year allowing us to most directly identify the effect of shareholder distraction on managerial decisions. This specification assumes that managers can opportunistically detect and respond to shareholder distraction within the year. The assumption of prompt and timely managerial response is reasonable for the outcomes we investigate. We believe that a contemporaneous regression of firm outcomes on distraction is the most appropriate model to examine the timely effect of institutional distraction on firm decisions. Nonetheless, our results are similar and supportive of our conclusions when we lag distraction by one year or use the average between the lagged and current distraction. The robustness of the relationship between firm decisions and lapses in institutional shareholders’ monitoring is expected because the regulatory investigations that trigger such lapses usually take years to resolve and thus distracted investors are usually *distracted* for more than one year.

3 Executive Compensation and Turnover

This section presents our main empirical results on whether government scrutiny-induced distraction diminishes an institution’s established role as a corporate governance monitor. Our primary focus in this section is executive compensation. In particular, the weakened monitoring caused by distracted institutions can also impact CEO compensation, as reduced oversight can exacerbate agency problems and thereby affect CEO pay.

Executive pay is set by the board of directors. This arrangement has the potential to worsen the agency problem, as directors may have incentives to favor executives. Typically, the market for corporate control is expected to impose constraints, but these can be loose, facilitating large deviations from efficient contracting (Bebchuk, Fried and Walker, 2002). Hartzell and Starks (2003) and Edmans and Holderness (2017) find evidence that institutional investors influence the structure of executive compensation in a firm, highlighting their monitoring role in mitigating agency conflicts between shareholders and managers. In a survey of directors, Edmans, Gosling and Jenter (2023) reports that directors believe shareholders, especially large institutional investors, place constraints on unconventional CEO compensation structures even when higher pay might increase shareholder value. This suggests that directors perceive institutional investors as more resistant to unconventional pay arrangements than directors themselves believe is optimal for shareholder value.

Building on this evidence, we conjecture that temporary shareholder distraction due to disciplinary actions may provide the firm with an opportunity to increase CEO compensation without facing shareholder pushback. We examine multiple aspects of the structure of CEO compensation, including total CEO compensation, bonuses, and CEO options granted. Moreover, in addition to pay level, we examine increases in CEO compensation. If distraction impairs institutional monitoring effectiveness, then we would expect to find a positive relation between the level of shareholder distraction and CEO compensation and/or increases in CEO compensation.

We also examine the effect of shareholder distraction on CEO dismissal and its sensitivity to poor performance. Although the board of directors has the responsibility of choosing and monitoring the firm’s CEO, without shareholder pressure, boards may be ineffective at disciplining CEOs. Institutional investors use Activist campaigns or Exit – large decreases in holdings – to demand major changes in corporate strategy or top management (Brav, Jiang and Kim, 2015; Edmans, 2009). Our hypothesis is that if institutional investors in a firm suffer from regulatory distraction, then they are less able to drive changes in corporate

strategy and demand management dismissal. In other words, if shareholders are distracted CEO are less likely to be punished for bad performance. To test this hypothesis, we examine the effect of distraction on subsequent executive turnover and the sensitivity of CEO dismissals to past performance.

3.1 CEO Compensation

We test this hypothesis by estimating Equation 2, where the dependent variables are measures of CEO compensation. We report our results in Table 3. In column 1, the dependent variable is *Total Comp._{i,t}*, defined as the natural log of total CEO compensation, which includes salary, bonus, equity, options, and deferred compensation. The results show that total CEO compensation is positively related to distracted institutions. The economic magnitude of the effect is significant in that a one standard deviation increase in distraction is associated with 2.58% ($100 \times 0.444 \times 0.058$) increase in total compensation.

Total compensation can be influenced by several firm characteristics. A potential concern arises that firms with more distracted investors may have higher levels of compensation. For example, high-compensation firms may have greater representation of investors that are more likely to get distracted by disciplinary actions, either because such firms align with their investment preferences or because they operate in sectors that are inherently more favorable to them. Although our main specification addresses this problem by including common firm characteristics and industry fixed effects, we attempt to address this concern by examining “Abnormal” compensation, which is the compensation amount that is unexplained by common firm characteristics. Specifically, we define *Abnormal Comp._{i,t}* as the residual from regression of Total Comp. on firm assets, operating performance, firm risk, and industry fixed effects. In column 2, we regress abnormal compensation on distraction and find that a one-standard deviation increase in distraction is associated with \$0.024 million (0.412×0.058) increase in abnormal compensation. This magnitude is significant given the median abnormal compensation in the sample is \$0.074 million. We also define *High Abnrml Comp._{i,t}* as an

indicator variable taking value of 1 if firm i Abnormal Comp. is above the sample median in year t . In column 3, we use this indicator as our dependent variable and find that firms with higher share of distracted investors are more likely to award their CEO's higher-than-normal compensation. To further mitigate this concern, we repeat our analysis using the year-over-year increases in CEO pay as the dependent variable. Specifically, we examine the likelihood of a large increase in CEO compensation during distraction periods. In doing so, we define *Increased Comp.* $_{i,t}$ is an indicator variable taking value of 1 if firm i CEO's total compensation increased by at least 20% in year t from the previous year. We find in column 4 that higher levels of investor distraction is associated with higher likelihood of large increases in CEO compensation. Examining whether increases in distraction are associated with subsequent increases in CEO pay allows us to test whether shifts in attention are related to adjustments in compensation, rather than being merely correlated with the firm's general compensation level. Our results in Table 3 are consistent with the notion that temporary shareholder distraction due to disciplinary actions provides the firm with an opportunity to increase CEO compensation.

Next, we investigate various components of CEO compensation to shed more light on the effect of distraction. We distinguish between flexible components, which are more likely to respond to shareholder distraction, and pre-determined components, which are less likely to change. The rationale is that institutional involvement in an investigation with a regulatory entity is unlikely to persist indefinitely; therefore, the duration of institutional distraction is expected to be temporary. If a firm were to exploit this lapse in monitoring, it would be more effective to do so through flexible compensation components. Despite the literature's primary focus on executives' stock and option holdings, most CEOs also receive bonuses. Although, some bonuses are pre-specified or formula-based, many firms award discretionary bonuses based on qualitative evaluations of executive performance (Murphy, 1999), thereby giving boards leeway in determining pay outcomes. However, CEO salaries are fixed values that are specified at times prior to the distraction period and thus are not expected to be

affected by distraction.

We examine the CEO’s bonus and salary separately and report our results in Table 4. In column 1 we study $Bonus_{i,t}$ as the dependent variable and find that CEOs receive larger bonuses in periods of investor distraction, consistent with our monitoring hypothesis. The economic magnitude of this effect is strong. Specifically, a one-percent decline in institutional investor attention leads to 9.46% ($100 \times 1.632 \times 0.058$) higher bonus. In column 2, we use $Salary_{i,t}$ as the dependent variable and, as expected, find no changes in salaries during periods of distraction. This is an important find as it shows the evidence related to other components is not simply an artifact of changes in compensation. Rather, it is related to the diminished monitoring role of investors.

Next, we turn our focus to stock options granted to CEOs. First, [Frydman and Saks \(2010\)](#) show that option grants are a substantial and important component of executive pay. Second, the valuation of options granted to CEOs is complex and relies on various assumptions, making the values opaque and harder to understand. Furthermore, firms actively manipulate the disclosure of information around CEO option awards, delaying the release of good news and accelerating the disclosure of bad news ([Aboody and Kasznik, 2000](#); [Chauvin and Shenoy, 2001](#)). Prior research shows that these practices are correlated with weak governance. For example, [Bebchuk, Grinstein and Peyer \(2010\)](#) show that opportunistic option timing is, among other things, associated with the absence of outside blockholders in the compensation committee.

Following this strand of literature, we study options granted to CEOs during periods of shareholder distraction. Our hypothesis is that a temporary investor distraction due to disciplinary engagements provides the firm an opportunity to maximize CEO compensation by granting options without facing shareholder opposition. In column 3 of Table 4, we use the natural log of the number of options “granted” to the CEO, $Options_{i,t}$, as the dependent variable and find that CEOs are granted more options during the year institutional investors are distracted.

The literature on CEO compensation has documented various rent-seeking behaviors tied to equity options such as inflating the value of executive option grants through spring loading (Yermack, 1997) and option backdating (Bebchuk et al., 2010). Bebchuk et al. (2010) define “lucky grants” as stock option grants awarded on days with the lowest stock price in a given month. For a prespecified number of stock options, such a timing pattern maximizes the value of the grant and, therefore, benefits managers at the expense of shareholders. Moreover, the timing of options awards reflects the deliberate choice by the firm that may be driven by self-interest. Therefore, our hypothesis is that institutional shareholders’ temporary inattention due to regulatory scrutiny provides the firm with an opportunity to maximize manager pay at the expense of shareholders by backdating the awarded option grants.

To test this hypothesis, we obtain data on lucky grants for between 2001 and 2005⁵ from Professor Lucian Bebchuk’s website.⁶ We define *Lucky Grants_{i,t}*, as an indicator variable taking value of 1 if at least one tranche of options granted to CEO in firm i during year t is granted on a day with the lowest stock price of the month. Column 4 of Table 4 shows that the likelihood of receiving a lucky grant increases when institutional shareholders are distracted. This increase is economically large: a one-standard deviation change in distraction increases the chance of a lucky grant by 1.8 percentage points ($100 \times 0.306 \times 0.058$). Given that the unconditional likelihood of receiving a lucky grant is 8% in our sample, the effect of shareholder distraction amounts to a 22% increase relative to the baseline.

3.2 CEO Turnover

A large body of literature documents a negative relation between CEO turnover and firm performance in large corporations (Weisbach, 1988; Jensen and Murphy, 1990; Kaplan, 1992; Huson, Parrino and Starks, 2001). Although the board of directors has the responsibility of choosing and monitoring the firm’s CEO, its willingness and effectiveness differ between

⁵Our sample of regulatory distraction begins in 2001. The practice of offering “lucky grants” (backdating) was gradually phased out after the SOX regulation tightened the backdating window. Therefore, we rely on the existing data that ends in 2005 and not extend it to 2022, the end of our sample.

⁶<https://lucianbebchuk.com/data.shtml>

firms depending on board incentives (Hermalin and Weisbach, 1988). For example, directors’ careers tend to be tied to the CEO’s, which gives them incentives to advance the CEO’s career regardless of performance (Hermalin and Weisbach, 2003). Moreover, directors who hold directorships at multiple firms are overextended and pay limited attention to the CEO and her performance (Fich and Shivdasani, 2006). Therefore, without shareholder pressure, boards may have little incentive to discipline CEOs.

Institutional investors, the largest monitors of firms, often use activist campaigns, motivated by disagreements with management, to demand major changes in corporate strategy or top management (Brav, Jiang, Partnoy and Thomas, 2008; Brav et al., 2015; Fos, 2017). However, such shareholder activism is not the norm, and many institutional investors use exit, rather than voice, to express their disagreement with managers’ actions (Bhude, 1993; Maug, 1998; Admati and Pfleiderer, 2009; Edmans, 2009). Institutional exits, even without direct engagement, can still discipline managers. Parrino, Sias and Starks (2003) introduces the “Wall Street Walk” channel, which argues that institutional exits in response to governance concerns create stock price pressure that conveys information to the board, prompting corrective action. The existing literature finds supporting evidence: large declines in institutional ownership are a likely predictor of executive turnover (Parrino et al., 2003; Helwege, Intintoli and Zhang, 2012; Jenter and Lewellen, 2021).

Our hypothesis is that if institutional investors in a firm are distracted by regulatory scrutiny, then they are less able to drive changes in management and corporate strategy. In other words, when shareholders are distracted, CEOs are less likely to be punished for poor performance.

To test this hypothesis, we examine the effect of distraction on subsequent executive turnover and the sensitivity of CEO dismissals to past performance. We define $CEO\ Turnover_{i,t}$ is an indicator variable taking value of 1 if the CEO of firm i is dismissed during year t . An important issue for this test is distinguishing voluntary from involuntary turnovers, since voluntary departures are unlikely to be related to poor performance. Following common

practice, we identify a turnover as involuntary if 1) the CEO is younger than 60 years old at departure, 2) the CEO does not appear as CEO of another firm the following year, and 3) the departure is not due to CEO death.

We start by examining the relation between shareholder distraction and executive dismissal by regressing $CEO\ Turnover_{i,t}$ on $D_{i,t}$, as well as common control variables. We report our results in column 1 of Table 5. We find evidence supporting our hypothesis that executives are less likely to be dismissed when shareholders are distracted due to regulatory scrutiny. Consistent with the existing literature, we also find that four-factor alpha during the preceding year is negatively related to probability of dismissal, indicating that CEOs are more likely to be dismissed following poor performance.

Next, we examine if shareholder distraction has an effect of the sensitivity of CEO dismissal to past performance. Specifically, we include in our model an interaction of $D_{i,t}$ with a measure of past performance. In column 2, we use four-factor alpha as our firm performance measure. We find a positive and significant coefficient on this interaction term, which indicates that forced CEO turnover is less sensitive to prior performance when shareholders are distracted. The impact of distraction is economically meaningful. A one standard deviation increase in distraction reduces the performance sensitivity of CEO turnover by about 12% ($0.081 \times 0.058 / 0.039$).

Jenter and Lewellen (2021) argue that stock returns are a problematic performance measure in CEO turnover regressions because stock prices are forward-looking and they already reflect investors' assessment of the probability of a CEO turnover. To account for this concern, we examine the sensitivity of CEO turnover using accounting performance (column 3). Specifically, we define $Operating\ ROA_{i,t-1}$ as income before depreciation and interest in year $t - 1$ divided by total assets. Using the accounting-based performance measure, we again find a significant positive coefficient on the interaction term, consistent with our hypothesis that shareholder distraction erodes the sensitivity of CEO dismissal to prior performance. The economic magnitude of this impact is even stronger. A one standard deviation increase

in distraction reduces the sensitivity of CEO turnover to accounting performance by about 16% ($0.270 \times 0.058 / 0.097$).

3.3 CEO Power and Compensation

We document in Section 3.1 that CEOs extract additional benefits through higher compensation when institutional shareholders are distracted by regulatory scrutiny. In this section, we investigate *the role* of CEO power. Specifically, are powerful CEOs more likely to capture benefits during periods of high shareholder distraction?

In corporate law, the board of directors serves as the pivotal mechanism for monitoring the managers. After all, directors are elected by stockholders and owe them a fiduciary duty to protect their interests. The empirical literature, however, has documented various shortcomings in the board’s incentives and effectiveness in monitoring managers (Hermalin and Weisbach, 1998, 2003). CEO power, for example, increases the likelihood of opportunistic behavior by weakening the board’s ability to monitor, discipline, and replace the CEO (Shivdasani and Yermack, 1999; Adams, Almeida and Ferreira, 2005; Coles, Daniel and Naveen, 2014; Graham, Kim and Leary, 2020). This risk is especially relevant during periods of shareholder distraction, when a strong board can compensate for weakened shareholder monitoring. However, a weak board lacks the capacity to fill the monitoring gap, making it easier for the CEO to pursue self-interests.

We use two measures to capture CEO power. First, we use CEO Tenure in the firm as a proxy for her power over the board. Hermalin and Weisbach (1998) show theoretically that board independence and effectiveness in monitoring the CEO declines with CEO tenure. Long tenure increases power because the CEO accumulates firm-specific knowledge, social ties, influence over director appointments, and control over information. Second, we use whether the CEO also serves as chair of the board as a direct measure of structural power. Chair duality gives the CEO control over the board agenda, meeting process, and flow of information (Adams et al., 2005). Moreover, it reduces the board’s willingness to evaluate

the CEO independently (Graham et al., 2020).

To test our hypothesis that, following shareholder distraction, CEOs find it easier to obtain additional compensation when they have more power over the board, we include in Equation 2 an interaction term between $D_{i,t}$ and a CEO power indicator. We report our results in Table 6. In columns 1-4, the measure of CEO power is *High Tenure* $_{i,t}$, defined as an indicator variable equal to 1 if the CEO’s tenure at firm i during year t is above the sample median. The coefficient estimates on the interaction term are all positive and statistically significant, supporting our hypothesis.

In column 1 we find that while CEOs with short tenures receive 1.48% ($100 \times 0.255 \times 0.058$) more in total compensation after one standard deviation increase in distraction, CEOs with long tenures receive 3.43% ($100 \times 0.591 \times 0.058$)⁷ more in total compensation after similar increase in shareholder distraction. In columns 2 and 3, we find similar results when we examine abnormal compensation. In column 4, we find the strongest results when using options awarded to the CEO as additional compensation. Specifically, CEOs with long tenures receive 18.97% ($100 \times 3.271 \times 0.058$) more options granted to them during shareholder distraction periods.

We repeat our tests in columns 5 - 8 using CEO chair duality as our second measure of CEO power. Specifically, we define *CEO Chair* $_{i,t}$ as an indicator variable equal to 1 if the CEO at firm i serves as the chairman of the board in year t . Our results are even stronger for CEOs who also chair their own boards. Overall, we find that the effect of shareholder distraction on CEOs’ ability to extract higher compensation is significantly larger among CEOs who hold power over their boards. This evidence is consistent with Morse, Nanda and Seru (2011) that powerful CEOs induce boards to alter incentive contracts in ways that favor the CEO.

⁷We arrive at 0.591 by summing 0.255 (the baseline estimate) and 0.336 (estimate on the interaction term).

4 Mergers and Acquisitions

So far, we have shown that regulatory oversight of institutional investors has negative externalities on their monitoring role in executive compensation. However, if regulatory distraction genuinely impairs institutional monitoring, its effects should not be confined to compensation alone but should extend to other corporate actions. In this section, we extend our hypothesis and focus on the role of institutional investors' limited monitoring due to regulatory oversight in merger and acquisition activities for two reasons. First, M&A decisions are among the most consequential corporate actions with the potential to benefit managers at the expense of shareholders. And second, [Kempf et al. \(2017\)](#) show that portfolio-attention-based distraction affects M&A outcomes. We extend their findings by showing that our regulatory distraction measure is similarly associated with value-destroying acquisitions.

Mergers and acquisitions are among the largest discretionary investment decisions undertaken by public companies. These investments tend to intensify the inherent conflicts of interest between managers and shareholders in large public corporations ([Berle and Means, 1932](#); [Meckling and Jensen, 1976](#)). While M&A transactions are frequently justified in terms of synergy creation, market expansion, or cost efficiencies, managers may also pursue acquisitions for personal benefits, even when such deals do not create additional value for shareholders. In particular, managers may seek to expand the size and scope of the firm because larger firms often enhance their prestige, power, job security, and compensation ([Jensen, 1986](#)). Consistent with the empire-building hypothesis, [Lang, Stulz and Walkling \(1991\)](#) show that firms with high free cash flows are more likely to make value-destroying acquisitions, often reflecting managerial motives related to prestige or personal utility rather than maximizing shareholder wealth considerations. Similarly, [Morck, Shleifer and Vishny \(1990\)](#) show that some acquisitions, including diversifying ones, can benefit managers at the expense of shareholder value. Furthermore, some acquisitions may provide managers with entry into more glamorous industries, more board seats, or more sprawling operations that enhance their personal status even if they destroy shareholder value. For example, [Moeller,](#)

[Schlingemann and Stulz \(2005\)](#) find that U.S. public-firm takeovers during the dotcom bubble destroyed aggregate shareholder wealth of \$240 billion. These findings highlight how managerial motives can drive acquisitions that are misaligned with shareholder interests.

Motivated by this literature, we develop four empirical predictions regarding how regulatory distraction of institutional investors affects merger and acquisition activity. First, if regulatory oversight diminishes institutional investors' attention toward their investee firms, we expect firms to take advantage of this reduced monitoring and, as a result, the likelihood of announcing an acquisition to increase during these periods of distraction. Second, because firms can exploit shareholder inattention to pursue deals that would otherwise face pushback, we expect deals made during periods of investor distraction to be more likely to be value-destroying. As a result, we expect these deals to be accompanied by lower CARs at announcement. Third, when managers are motivated by self-interest, we would expect them to be more likely to overpay for a target. Consequently, acquisitions made during periods of distraction are more likely to be accompanied by higher premiums. Last, deals made during this period are less driven by value-maximizing between acquirer and target, so they should exhibit lower synergies compared to deals made outside periods of distraction.

4.1 Acquisition Activity

When strong shareholder monitoring and governance act as a constraint on managerial discretion, less effective monitoring is expected to increase the likelihood of company decisions that favor managerial self-interest at the expense of shareholder value. [Masulis, Wang and Xie \(2007\)](#) find that entrenched managers complete worse acquisitions, supporting the hypothesis that managers who face weaker investor discipline are more likely to indulge in empire-building acquisitions that destroy shareholder value. [Kempf et al. \(2017\)](#) shows that when institutional investors are affected by shocks to the other parts of their portfolios, managers are more likely to complete deals, particularly bad ones.

We hypothesize that managers are more likely to announce acquisition deals when insti-

tutional investors are distracted with regulatory investigations and litigation, and thus their monitoring intensity is lower. To test this hypothesis, we estimate Equation 2 where the dependent variable is an indicator variable equal to 1 in years when the firm announces at least one acquisition. Table 7 reports the estimation results. In column 1, we look at all acquisitions and find that firms are more likely to engage in acquisitions when institutions are distracted by ongoing disciplinary actions. A one-standard deviation increase in institutional investor distraction is associated with a 7.4% ($100 \times 0.203 \times 0.058 / 0.159$) higher merger probability, relative to the unconditional average of observing an acquisition.

Our primary measure of institutional investor distraction is contemporaneous. Specifically, we relate acquisitions in a given year to institutional shareholder distraction in the same year, measuring managers' actions in response to temporary distraction in real time. The assumption that managers can act quickly upon observing shareholder distraction in the same year is reasonable as the median deal from announcement to completion takes approximately 10 weeks. Moreover, larger and more complex mergers require typically from six to nine months (Fischer, 2017).

While some acquisitions are motivated by managers' private benefits, they are often motivated by the creation of value for shareholders. Since shareholder monitoring is concerned with the former, we expect that a decline in monitoring intensity due to disciplinary distraction will mainly affect the acquisitions motivated by managerial self-interest, thereby exacerbating the firm's underlying agency problems. We test this hypothesis by examining samples of acquisitions that are more likely to be motivated by managerial self-interest, diversifying and cash acquisitions.

Roll (1986) argues that overconfident managers may overpay for targets due to their belief in their ability to successfully integrate the target and create synergies. Diversifying acquisitions involve a target that is in a different industry than the acquirer, often reflecting such hubris at the expense of shareholder value, while increasing managerial private benefits. Specifically, diversifying acquisitions may reduce CEO human capital risk, such

as employment risk (Amihud and Lev, 1981). They offer managers an opportunity into new lines of business, often fashionable and glamorous ones, to ensure firm survival even when shareholder maximization dictates otherwise (Morck et al., 1990). Furthermore, diversifying acquisitions may provide managers of conglomerates with access to more board appointments, significant prestige and social capital, and political connections.

Using the Fama and French 10 industries, we define diversifying acquisitions as those where the acquirer and target are from different industries. We estimate Equation 2 where the dependent variable is an indicator variable equal to 1 if at least one diversifying acquisition is announced during the year and report our results in column 2 of Table 7. We find an increase in diversifying deals when institutional shareholders are distracted. A one-standard deviation increase in institutional investor distraction is associated with a 5.8% ($0.049 \times 0.058 / 0.049$) higher merger probability, relative to the unconditional average of observing an acquisition.

Cash-financed acquisitions have been shown to deliver lower returns at announcement dates (Harford, 1999; Fuller, Netter and Stegemoller, 2002) and weaker post-merger performance (Oler, 2008). These types of acquisitions help acquiring managers to preserve their control and avoid further internal scrutiny. In stock-financed acquisitions, especially those involving relatively large targets, the transaction results in a new, larger shareholder base that has both the capacity and motivation to monitor the acquiring firm’s management after the merger. Prior literature suggests that large shareholders actively monitor managers through mechanisms such as voting at shareholder meetings (Agrawal and Mandelker, 1990) and their presence is correlated with better acquisition outcomes (Chen, Harford and Li, 2007). This implies that managers motivated by personal incentives may prefer to cash finance an acquisition to avoid external monitoring. Cash deals are also quicker to complete due to their simpler structure. Therefore, if a manager is pursuing an acquisition motivated by self-interest during periods of heightened investor distraction, bidding with cash can be advantageous as it increases the likelihood the transaction will be completed before the temporary distraction dissipates.

Based on this reasoning, we predict that the effect of institutional distraction on acquisition activity will be more pronounced for cash-financed deals. To test this hypothesis, we estimate Equation 2 where the dependent variable is an indicator variable equal to 1 only if at least one cash acquisition is announced during the year. The results are reported in column 3 of Table 7. We find a stronger increase in cash deals when institutional shareholders are distracted. A one-standard deviation increase in institutional investor distraction is associated with a 13.1% ($100 \times 0.199 \times 0.058 / 0.088$) higher merger probability, relative to the unconditional average of observing an acquisition.

An advantage of acquisitions is that their announcements are observable and thus the market reaction to these announcements can serve as a proxy for the expected value creation (or destruction) of the acquisition. Using cumulative abnormal returns (CARs) around the announcement date, we identify *Bad Acquisitions* as deals whose announcement CARs are lower than the sample median. The lower CARs reflect that the market expects the deals to create less value or even destroy shareholders' wealth. Given that acquisitions motivated by managerial self-interest are more likely to be bad acquisitions, we predict that the effect of institutional distraction on acquisition activity will be more pronounced for these deals. To test this hypothesis, we estimate Equation 2 where the dependent variable is an indicator variable equal to 1 if at least one bad acquisition is announced during the year. The results are reported in column 4 of Table 7. We find a stronger increase in bad deals when institutional shareholders are distracted. A one-standard deviation increase in institutional investor distraction is associated with a 10.7% ($100 \times 0.147 \times 0.058 / 0.079$) higher merger probability, relative to the unconditional average of observing an acquisition.

These patterns suggest that weakened institutional monitoring, resulting from government oversight, enables managers to pursue acquisitions that primarily serve their own interests rather than creating shareholder value, highlighting a potential unintended consequence of regulating institutional shareholders.

4.2 Announcement CARs

In the previous section, we document that firms are more likely to make acquisitions when their institutional investor base is distracted by government scrutiny of their portfolio holdings, and these acquisitions are mostly value-destroying. In this section, we provide additional empirical evidence to show that those deals are value-destroying for the firm. We use abnormal returns around deal announcements to evaluate the market’s expectation of value creation. Cumulative abnormal returns (CARs) around the announcement date of a merger are widely used as a market-based measure of the expected value creation (or destruction) of the deal. If the market expects the deal to create value for shareholders, we should observe higher CARs for the acquirer (and target) around the announcement. In contrast, if the deal is expected to destroy value, CARs will be lower. Since the source of distraction in our setting is regulatory investigations, disciplinary actions, or litigation involving one (or a few) large shareholders, other shareholders that are not involved will continue to perform their monitoring roles and thus respond to the acquisition announcements. Therefore, the short-term stock price reaction to a deal announcement, even when institutional shareholder distraction is high, reflects the deal’s expected value.

We compute cumulative abnormal returns (CAR) for three- and eleven-day windows around the acquisition announcement using a four-factor model estimated on 250 trading days ending 50 trading days before the acquisition announcement. Then, we study the effect of distraction on the value expected to be created or destroyed by an acquisition by comparing the announcement CARs of acquisitions with distraction above the median (*High D*) to acquisitions with distraction below the median at announcement (*Low D*).

We report our results in Table 8. Looking at the sample of all acquisitions, we find that acquisitions announced by firms held by highly distracted institutions have 0.81% and 0.82% lower CARs than deals announced by firms held by low distraction institutions around 3-day and 11-day periods, respectively. The economic magnitude of this effect is strong, as the average CAR for a 3-day window is only 1.1%.

The median acquisition in our sample is only \$59 million, representing a small fraction of the size of the acquiring firms. Thus, the effect of distraction on announcement returns reported may be a lower estimate for deals that have non-trivial size relative to the acquiring firm. On one hand, managers are more likely to complete smaller acquisitions during distraction periods, hoping to keep them out of scrutiny. On the other hand, managers receive significant private benefits only if they complete sufficiently large acquisitions. To understand the effect of distraction on non-trivial deals, we investigate announcement CARs for a sample of *Large Acquisitions* exceeding \$250 million. We find that large deals announced by high-distraction firms have 1.19% (1.24%) lower abnormal returns during a 3-day (11-day) window, suggesting that investors expect lower value creation by these acquisitions. Moreover, the difference is larger than the sample of all acquisitions. We also examine a sample of *Large-target Acquisitions* defined as acquisitions with a relative size above the sample median. We compute relative size as the acquisition value divided by the acquirer’s market cap a week prior to announcement. Similarly, we find that large-target deals that are announced by high-distraction firms have 0.80% (0.84%) lower abnormal returns during a 3-day (11-day) window, suggesting that investors expect lower value creation by these acquisitions as well.

As discussed earlier, managers are more likely to announce cash-financed deals and diversifying acquisitions during periods of elevated investor distraction. These deals are more likely to be motivated by managers’ private interests and thus more likely to destroy shareholder value. We investigate the abnormal returns around the announcement dates of these transactions separately and find similar evidence. Cash deals announced during periods of high investor distraction have 0.64% (0.58%) lower abnormal returns during a 3-day (11-day) window. Diversifying acquisitions announced during periods of high investor distraction have 0.62% (0.64%) lower abnormal returns during a 3-day (11-day) window, suggesting that investors expect lower value creation by these acquisitions.

Overall, the results in Table 8 show that acquisitions made by firms with highly distracted institutional investors are value-destroying. These findings are consistent with the existing

literature that diversifying takeovers and cash acquisitions are generally associated with poorer wealth effects for acquiring firms' shareholders (Morck et al., 1990; Harford, 1999; Fuller et al., 2002; Oler, 2008; Harford, Humphery-Jenner and Powell, 2012). Putting it all together, the evidence suggests that when monitoring is weakened due to institutional investor distraction, not only do firms undertake more deals, but those deals tend to be less value-creating as reflected by lower CARs.

4.3 Acquisition Premiums and Synergies

We showed in Sections 4.1 that firms with distracted shareholders are more likely to complete acquisitions. In Section 4.2 we provide direct evidence that acquisitions made by firms with a highly distracted shareholder base destroy value. In this section, we investigate *how* these acquisitions destroy value.

Our first hypothesis is that managers may simply overpay for targets in these acquisitions. This is supported by several theories. Roll (1986) hypothesizes that managers may suffer from hubris, and thus simply overpay for their targets if external mechanisms such as shareholder monitoring fails to keep their hubris in check. Gorton, Kahl and Rosen (2009) argue that managers are willing to overpay for targets to preserve and extend their private benefits of control. Moreover, managers with empire-building incentives are more interested in completing the deal than in maximizing bidding shareholder value, and thus are willing to pay higher premiums. Therefore, when left unmonitored by distracted shareholders, managers may overpay for their targets and thus destroying value.

Our second hypothesis is that managers in firms with distracted shareholders may choose targets with which their firm has low synergies. This low synergy could be due to the CEO's overconfidence in her ability to exploit potential synergies and create value (Malmendier and Tate, 2008). The lack of synergies could also be due to a poor match between the target and the acquirer, driven by empire-building incentives and CEO's desire to preserve or extend private benefits of control (Harford et al., 2012).

To test our hypotheses regarding value-destruction, we use a sample of acquisitions with publicly-traded targets and examine their premiums and synergies with regards to shareholder distraction. Specifically, we compare the premiums and synergies of acquisitions by firms with distraction above the median (*High D*) to acquisitions by firms with distraction below the median (*Low D*). We define *Acquisition Premium* as the offer price scaled by the target share price 5 trading day before the announcement. Similarly, we define *Acquisition Synergy* as the sum of the changes in market value of the acquirer and the target. The change in market value is defined as market cap multiplied by announcement CAR. To take out the mechanical relationship between acquirer or deal size on this measure, we scale it by acquirer’s market cap. Hence, the *Acquisition Premium* and *Acquisition Synergy* reflect the value created or destroyed as a fraction of acquirer size.

Table 9, Panel A reports results on acquisition premiums. For the sample of all acquisitions, we find that the average premium paid by high-distraction acquirers is 56%, whereas the premiums paid by low-distraction bidders is only 50%.⁸ The difference between the two groups is 6 percentage points, indicating that acquirers with distracted shareholders, on average, overpay by 12% ($100 \times 6.24 / 50.21$) for their targets. We find similar results for the samples of large, large-target, and cash acquisitions with high-distraction acquirers paying 2.27 - 5.22 percentage points higher premiums to their targets. However, we find insignificant estimates for the sample of diversifying firms. This inconclusive estimate may be driven by measurement noise in premiums given we only 96 observations, and thus one outlier may sway the averages significantly (Officer, 2003).

Panel B of Table 9 reports acquisition synergies where we find stronger results. For the sample of all acquisitions, we find that the average synergy for mergers completed by high-distraction bidders is 1.52% , whereas the synergy in acquisitions of low-distraction bidders is only 3.45%. The difference between the two groups is -1.93 percentage points, indicating that acquisition synergies are lower by 55% ($100 \times 1.93 / 3.45$) when shareholders are distracted. We

⁸The numbers are in line with the premiums measured in the literature. See e.g., Officer (2003) and Officer (2007).

find similar results for the samples of large, large-target, cash, and diversifying acquisitions with acquisitions by high-distraction firms have 1.90 - 2.35 percentage points lower synergies.

Overall, our results in Table 9 suggest that when shareholders are distracted by regulatory scrutiny, managers are more likely to choose targets with which they have lower synergies and to overpay to complete the deal. This pattern is consistent with our hypothesis that, when left unmonitored by institutions due to regulatory scrutiny, managers engage in acquisitions that boost their self-interest and thus destroy shareholder value.

4.4 CEO Power and Acquisitions

We document in Section 4.1 that managers are more likely to announce acquisition deals when institutional investors are distracted with regulatory investigations and litigation, and in Sections 4.2 and 4.3 that these acquisitions are more likely to be motivated by managerial private benefits and thus destroy shareholder value.

Under normal monitoring conditions, the board and institutional investors complement each other, constraining these incentives by opposing such transactions, encouraging more aggressive negotiation over the purchase price, and increasing pressure for CEO replacement. When shareholders are distracted by their own regulatory scrutiny, their monitoring duties fall on the board of directors. However, acquisitions are complex and difficult to evaluate, so boards must rely on management to identify targets, estimate synergies, and determine appropriate acquisition prices. The power of the CEO further weakens the board's role in this process (Adams and Ferreira, 2007; Baldenius, Melumad and Meng, 2014). As a result, we expect that powerful CEOs are better positioned to exploit the temporary decline in shareholder monitoring and pursue value-decreasing acquisitions motivated by their own private benefits.

Similar to Section 3.3, we test our hypothesis by including in the regressions of acquisition activity on shareholder distraction an interaction term between $D_{i,t}$ and a CEO power indicator. We report our results in Table 10. In columns 1-4, the measure of CEO power

is measured by *High Tenure*_{*i,t*}, and in columns 5 - 8 by *CEO Chair*_{*i,t*}. The coefficient estimates on the interaction term are all positive and statistically significant, supporting our hypothesis.

Looking at the sample of all acquisitions, we show in column 1 that while CEOs with short tenures are 4.96% ($100 \times 0.136 \times 0.058 / 0.159$) more likely to announce an acquisition after one standard deviation increase in distraction, CEOs with long tenures receive 18.6% ($100 \times 0.510 \times 0.058 / 0.159$)⁹ more likely to announce an acquisition after similar increase in shareholder distraction. In columns 2-4, we find similar results when we examine diversifying, cash-financed, and bad acquisitions, respectively.

In columns 5-8, we find similar results when using *CEO Chair*_{*i,t*} as a measure of CEO power. CEOs who also serve as chairman of the board are significantly more likely to announce acquisitions during periods of high distraction. This effect is consistent for diversifying, cash-financed, and bad acquisitions. Overall, we find that the CEOs' ability to exploit shareholder distraction is significantly amplified when the CEOs hold power over their boards.

4.5 Trading Activity After Acquisitions

When firms make value-reducing decisions, existing research suggests that institutional investors, as sophisticated and informed monitors, respond by 'voting with their feet' (i.e., reducing or exiting their positions) or by exercising their 'voice' through direct engagement or proxy voting with the firm. [Admati and Pfleiderer \(2009\)](#) show theoretically that large shareholders do not always need to engage in direct monitoring or public activism, as the threat of exiting the firm can discipline managers by reducing agency costs and aligning management interests with those of shareholders. Similarly, [Edmans and Manso \(2011\)](#) show that when multiple smaller blockholders trade based on information, the threat of disciplinary trading is just as effective in inducing higher managerial effort. In a survey of institutional

⁹We arrive at 0.510 by summing 0.136 (the baseline estimate) and 0.374 (estimate on the interaction term).

investors, [McCahery, Sautner and Starks \(2016\)](#) report that when direct monitoring fails, institutional shareholders often resort to governance-motivated exit to signal their disapproval with management. Empirical research supports these theoretical predictions. For example, [Parrino et al. \(2003\)](#) and [Helwege et al. \(2012\)](#) find that institutional ownership and the number of institutional investors decline in the year prior to forced CEO turnover, arguing that institutional investors exit the firm when dissatisfied with management. In this section, we examine whether distracted institutions respond to these value-reducing decisions by voting with their feet.

We hypothesize that due to temporary disengagement stemming from ongoing disciplinary actions, distracted institutions may respond less effectively or more slowly to value-reducing firm events than their undistracted counterparts. Value-destroying acquisitions are negative corporate events that institutional shareholders can respond to by adjusting their portfolio holdings. In contrast, an institutional investor temporarily distracted by regulatory investigations or disciplinary actions would be less likely to respond to poor outcomes, such as a bad acquisition. Evidence in [Table 2](#) provides preliminary support to the assumption that distracted institutional investors trade less actively. Building on this evidence, we further examine whether institutional trading behavior around value-diminishing acquisitions is affected during periods of disciplinary distraction.

[Goldman, Kim and Wang \(2024\)](#) find that institutional shareholders tend to decrease their holdings of acquirers when deals are value-destroying, arguing that these trades reveal negative information about the firm’s future performance. Conversely, they tend to increase their holdings when deals are value-creating. Our hypothesis is that following a bad acquisition, institutional investors dissatisfied with the deal will vote with their feet by decreasing their holdings in the firm. In contrast, investors who are temporarily distracted are less likely to adjust their portfolios due to their limited attention during periods of disciplinary events.

To investigate how distracted institutions adjust their portfolios following a firm’s acquisi-

tion announcement, we restrict the sample to quarter-firm observations in which at least one acquisition occurs, allowing us to compare bad acquisitions to good ones. This distinction is important because acquisitions can be either value-enhancing or value-destroying, information that informed institutions would react to. By focusing only on acquisition quarters, we can compare institutional response to a bad deal relative to a good one.

We define *Bad Deal* as an indicator variable equal to 1 if the acquisition’s three-day CAR is below the sample median. Then, we regress changes in the institution’s portfolio holdings on $Distracted_{j,t}$, *Bad Deal*, and their interaction term (the variable of interest). We include an array of firm controls (lagged stock returns, total assets, book-to-market ratio, illiquidity, and institutional ownership) as well as an array of institutional investor controls (lagged portfolio returns, flow, churn ratio, portfolio turnover, and portfolio size) in our specifications. We also include institutional investor fixed effects and quarter fixed effects to absorb the effect of market conditions in a given year as well as constant trading patterns of institutions. We define three measures of institutional trading activity. First, we define $Large\ Decrease_{i,j,t}$ as an indicator variable equal to 1 if the decrease in investor j holding of firm i during quarter t is in the top quartile of its holding changes during quarter t . Second, following [Kempf et al. \(2017\)](#), we define $\% Decrease_{i,j,t}$ as the percent change in investor j number of shares held of firm i during quarter t . Third, $Full\ Exit_{i,j,t}$ is an indicator variable equal to 1 if investor j liquidated its holdings in the firm i during quarter t .

We report our results in Table 11. In columns 1 – 3, we start with the sample of all acquisitions. In column 1, the dependent variable is $Large\ Decrease_{i,j,t}$. We find that institutional investors that are not distracted are more likely to dramatically decrease their holdings following a bad acquisition. This finding is consistent with the hypothesis that institutional investors vote with their feet in response to dissatisfaction with managerial actions. More importantly to our hypothesis is the interaction term, as it captures the effect of distraction on ‘voting with their feet’ as an effective monitoring mechanism for large shareholders. The interaction term enters the equation with a negative and significant

coefficient, suggesting that when distracted, investors fail to vote with their feet following a bad acquisition. In terms of economic magnitude, non-distracted shareholders are 0.2 percentage points more likely to dramatically decrease their holding in a firm following a bad acquisition. In column 2, the dependent variable is $\% Decrease_{i,j,t}$, capturing the effect on the intensive margin. Again, we find a negative coefficient on the interaction term. However, this effect is statistically insignificant for the sample of all acquisitions. In column 3, the dependent variable is $Full Exit_{i,j,t}$, examining whether distracted investors are less likely to fully exit the firm after a bad acquisition. In contrast to the findings on large decreases, the likelihood of an exit by distracted shareholders after a bad acquisition is similar to the likelihood of their exit after a good acquisition, supporting the hypothesis that distraction limits their ability to fully internalize the information and respond accordingly. In conclusion, consistent with our hypothesis, we find that while investors that are not distracted decrease their position in the firm following a bad acquisition, distracted investors are less likely to alter their holdings.

[Chen et al. \(2007\)](#) argue that large acquisitions are more likely to be motivated by managerial agency problems. Moreover, because large deals are economically significant, they are more likely to attract the scrutiny of shareholders. Hence, next we repeat our tests focusing on large acquisitions, defined as acquisitions larger than \$250 million. In columns 4 – 6, we repeat our analysis for the sample of large transactions and find very similar results, supporting the hypothesis that shareholder distraction limits the monitoring role of voting by trading or exit. Acquisitions financed with cash are also shown to be less valuable, measured by announcement returns, long-term performance, and synergies ([Harford, 1999](#); [Fuller et al., 2002](#); [Oler, 2008](#)). In columns 7 – 9, we repeat our analysis for the sample of cash deals and find stronger patterns. Taking column 9 for example, non-distracted shareholders are 0.5 percentage point more likely to exit the firm following a bad acquisition, an increase of 10% relative to the unconditional average of an exit following an acquisition. In contrast, the likelihood of an exit by distracted shareholders after a bad acquisition is only 0.3

percentage points higher than the likelihood of their exit after a good acquisition, supporting the hypothesis that distraction limits their ability to internalize the information and respond accordingly. Diversifying acquisitions are more likely to be motivated by managers’ private benefits (Morck et al., 1990). In columns 10 – 12, we focus on the sample of diversifying deals and find strong patterns consistent with the mitigating role of distraction on monitoring.

The results in Table 11 indicate that distracted investors are less responsive to value-destroying acquisition announcements across all types of deals. Overall, the findings suggest that institutions constrained by ongoing disciplinary actions are unable to internalize information following negative corporate events, and thus fail to vote with their feet.

5 Long-term Performance

Our empirical results in Sections 3 and 4 suggest that institutional investors’ distraction, while dealing with ongoing disciplinary actions, results in reduced monitoring at their portfolio firms, and thus opening opportunities for value-destroying decisions that are motivated by managerial interests. The portfolio firms are more likely to increase executive pay and complete poor acquisitions. These value-destroying decisions should lead the firm to lower performance in the long run (Ni, Peng, Yin and Zhang, 2020). Hence, this raises the question: Do firms with distracted institutional investors underperform in the long run?

To answer this question, we estimate Equation 2 where the dependent variable is a long-term performance metric for the firm of up to 4 years. The results are reported in Table 12. Columns 1 - 3 report simple market-adjusted returns, calculated in excess of the S&P500 index, and show that stocks held by distracted institutions underperform in the following quarter and the following year. In columns 4 - 6, we use Four-factor alphas as our performance measure. Four-factor alphas are defined as firm returns in excess of a four-factor model that is estimated with 250 trading days ending 50 trading days prior to the beginning of year t . Similarly, we find that firms with distracted institutional investors

significantly underperform, and this underperformance persists for up to four years following the distraction period. In terms of economic magnitude, one standard deviation increase in investor distraction is associated with 1.21% ($0.209 \times 100 \times 0.058$) lower market-adjusted returns and 0.63% ($0.109 \times 100 \times 0.058$) lower four-factor alphas in the following four years.

Overall, our results suggest that disciplinary distraction by institutional shareholders may have adverse long-term implications for shareholder value and firm valuation.

6 Robustness

As we discussed in section 2.2, the initiation and resolution dates of some disciplinary actions are reported as the same day, typically the day of the press release. While this could be interpreted as the inquiry lasted only one day, the investigative process clearly lasts a lot longer. These instances usually reflect cases in which regulatory authorities, such as the SEC and FINRA, engage in private negotiations with the company to expedite resolution and minimize the costs associated with prolonged investigative procedures.

For example, in 2015, the SEC charged Oppenheimer & Co. with “violating federal securities laws while improperly selling penny stocks in unregistered offerings on behalf of customers.” Oppenheimer agreed to admit wrongdoing and pay \$10 million to settle the SEC’s charges. Moreover, as part of the settlement, Oppenheimer agreed to pay an additional \$10 million to settle a parallel action by the Treasury Department’s Financial Crimes Enforcement Network (FinCEN). In its ADV form, Oppenheimer & Co reports both the initiation and resolution dates as January 27, 2015, which is the same date as the SEC press release on the matter.¹⁰ However, as is apparent from the press release, the SEC’s investigation into this operation started in 2013 and the complexity of the settlement clearly shows an interaction between the SEC and Oppenheimer that lasted longer than a day. Another example in the same year is the case of BlackRock Advisors, charged by the SEC with “breaching their fiduciary duty by failing to disclose a conflict of interest created by the

¹⁰<https://www.sec.gov/newsroom/press-releases/2015-14>

outside business activity of a top-performing portfolio manager.” BlackRock agreed to settle the charges, pay a \$12 million penalty, and engage an independent compliance consultant to conduct an internal review. The press release date on the matter is the same as both initiation and resolution dates.¹¹

As it is evident in the examples above, in many cases institutions privately negotiate settlements with regulatory bodies before any public disclosure, and announce the charges and resolution together in a joint press release once the deal is reached. We conjecture that during these private negotiations, such proceedings would divert attention and resources from company leadership for the months leading up to the resolution of the investigation. In our main measure of regulatory distraction, we consider 2015 as a ”distraction” year for both Oppenheimer and BlackRock. We posit our variable is a reasonable proxy for the distraction institutional investors face in the period leading up to the resolution.

Regardless, in this section, we examine the robustness of our main results with respect to the exclusion of these cases. Specifically, we compute $D\ Robust_{i,t}$ using Equation 1 excluding all regulatory distraction events with the same initiation and resolution dates reported in Form ADV. $D\ Robust_{i,t}$ is free of measurement error since all distraction periods are transparently reported in respective Form ADVs. We reproduce our main findings using our alternative measure and find that our conclusion are robust to the exclusion of these events.

We report our robustness tests regarding CEO compensation in Table 13. In Panel A, we examine the relation between CEO compensation components and regulatory distraction. We find that total compensation, abnormal compensation, annual bonus, options granted, and the likelihood of receiving lucky grants increase during period of elevated regulatory distraction. In Panel B, we examine the role of distraction on CEO turnover and turnover performance sensitivity. Again, our results are robust indicating that CEO turnover is less likely (column 1), and the sensitivity of turnovers to poor performance is weaker during high distraction periods (column 2).

¹¹<https://www.sec.gov/newsroom/press-releases/2015-71>

We report our robustness tests regarding acquisitions in Table 14. In Panel A, we examine the relation between acquisition activity and regulatory distraction. We find that firms are more likely to complete acquisitions during periods of elevated regulatory distraction. Albeit the effect on diversifying acquisitions is statistically insignificant. In Panel B, we compare acquisition characteristics of firms with high and low distraction levels. Specifically, in each column, we report the difference between a portfolio of all acquisitions with high distraction and one with low distraction. In columns 1 and 2, we report announcement CARs. In columns 3 and 4, we report premiums and synergies for acquisitions of public targets. Across all acquisition types, our results indicate that acquisitions completed by firms with distracted investors have lower CARs, higher premiums, and lower synergies. These findings are consistent with the main results reported in the paper and thus provide assurance that our results are not driven by deals without an initiation date.

7 Conclusion

This paper investigates the consequences of regulatory oversight-induced distraction on institutional investors' role as corporate governance monitors in the firms they hold. Our main findings are that firms held by institutions distracted by such disciplinary events are more likely to make value-diminishing corporate decisions, suggesting weakened external monitoring. Specifically, CEOs of these companies receive higher compensation, driven by increased bonuses and larger option grants. Firms with distracted investors are more likely to pursue riskier and value-destroying acquisitions, indicating reduced discipline in strategic decision-making. We show that acquisitions completed by these firms have lower abnormal returns at announcement, have higher premiums, and have lower synergies. We also find that distracted institutions are less likely to reduce or exit their positions following unfavorable firm outcomes, suggesting that regulatory distraction impairs not only monitoring but also institutions' role in impounding information into prices. Importantly, we document

a long-lasting underperformance up to four years among firms with distracted institutional investors.

Collectively, these results paint a consistent picture that institutional investor attention is a critical, finite resource in corporate governance. When attention is diverted, firms exhibit managerial opportunism across multiple dimensions and firm-level decisions reflect reduced oversight and long-term strategic focus. The consistency and depth of these effects underscore the importance of institutional monitoring in constraining managerial behavior. Importantly, the temporary nature of regulatory distractions does not insulate firms from its consequences. Even transitory lapses in attention can lead to value-destroying decisions with long-term effects on the firm.

This study makes several contributions to the literature. First, we extend research on institutional investor attention by identifying a novel and exogenous source of institutional distraction, regulatory enforcement actions, that constrain institutional monitoring capacity. Second, we contribute to the institutional monitoring literature and provide supporting evidence on the value of consistent, efficient monitoring and its critical disciplinary role in firm management. We show that monitoring effectiveness varies not only with shareholder type, portfolio characteristics, or ownership structure, but also with the nature of the shocks to the shareholder base. Third, we contribute to the literature on institutional ownership and price efficiency, showing a temporal disruption to the price-discovery function of institutional investors. Fourth, we contribute to the literature on the spillover effects of regulatory enforcement, which extend beyond the institution under investigation to the firms in its portfolio. This spillover channel is through which enforcement actions affect third parties uninvolved in the underlying misconduct. Lastly, we contribute to ongoing policy debates by highlighting a key trade-off in regulatory design: while oversight of financial intermediaries such as institutional investors is essential for ensuring market integrity and accountability, such regulatory actions may have unintended consequences. Although well-intentioned, regulatory interventions targeting institutional investors may reduce the quality of governance

in the firms they hold, precisely when active monitoring is most needed. Hence, policymakers should consider not only whether regulatory actions achieve their objectives, but also their unintended consequences in the diminished governance of portfolio companies. Our results underscore the importance of considering not only the direct objectives of regulations, but also their potential spillover effects on the broader corporate governance ecosystem.

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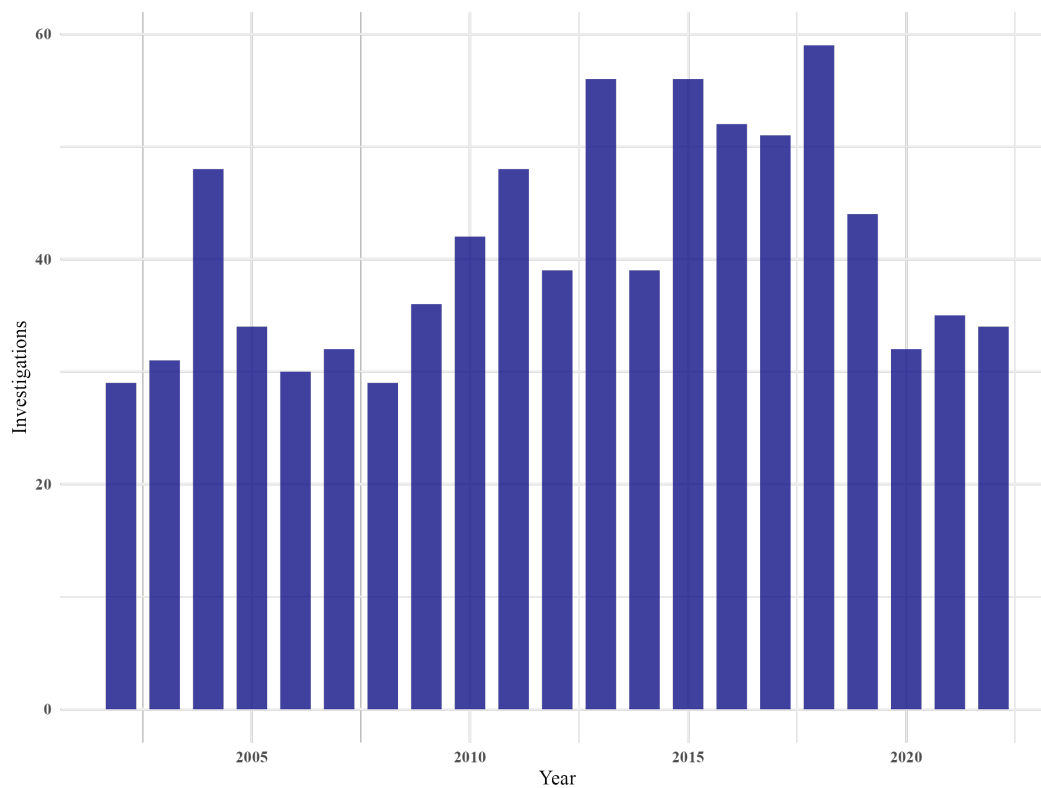


Figure 1: Number of institutional investor investigations overtime

This figure plots the number of regulatory investigations initiated in each quarter of our sample period from 2001 to 2022.

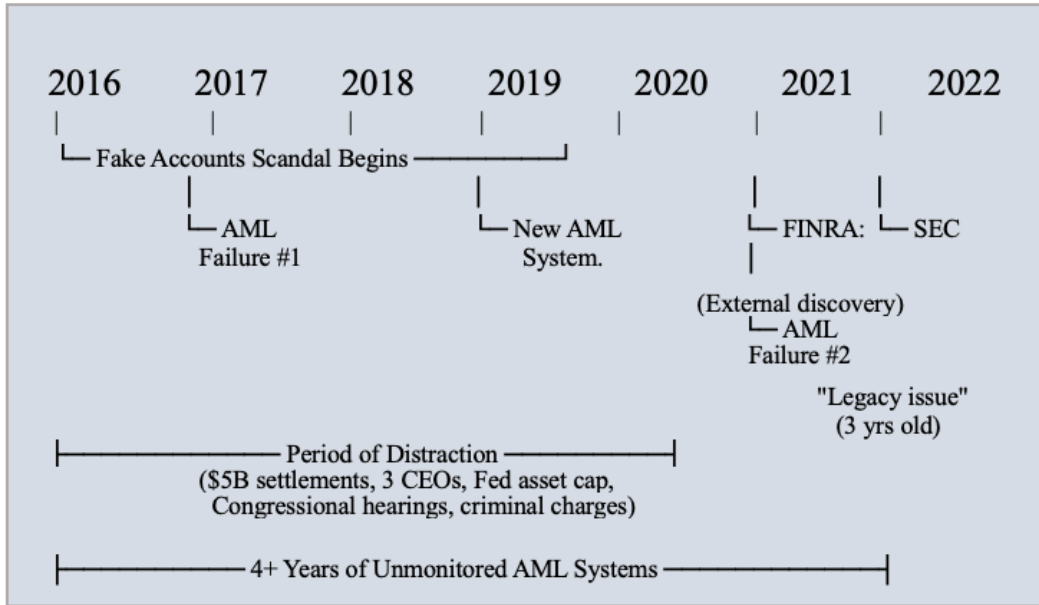


Figure 2: Example of institutional distraction at scale

This figure represents a timeline of Wells Fargo's fake account investigation that continued from 2016 to 2020 and its overlap with the bank's multiple failures of its anti-money laundering AML system. Wells Fargo investigation lasted from 2016 to 2020 during which the company was absorbed in investigations and litigation resulting in over \$5 billion in settlements, three CEO changes, a Federal Reserve-imposed asset cap, Congressional hearings, and a criminal deferred prosecution agreement (Sources:<https://www.congress.gov/crs-product/IF11129>). Simultaneously, from 2017 to 2021, the bank's anti-money laundering (AML) systems were unmonitored and were failing. And these failures went undetected by the bank itself and were only discovered externally. The first charge came from the SEC in April 2017, and the bank implemented a new AML system in 2019, all while it was in the middle of its fake account investigations. In 2021, FINRA discovered that the bank's new AML system had failed again, and in 2022, the SEC charged Wells Fargo with deficient implementation and failure to test its internal anti-money laundering (AML) system (Source:<https://www.sec.gov/newsroom/press-releases/2022-85>).

Table 1: Regulatory Investigation Initiations And Portfolio Characteristics

This table reports estimation results from regressions of $Targeted_{j,t}$ on past institutional investor portfolio characteristics. $Targeted_{j,t}$ is an indicator variable taking value of 1 if a regulatory investigation is initiated against institutional investor j in quarter t . All independent variables are defined in Appendix A. The sample includes all institutional investors with reported 13(f) holdings from Whale Wisdom database and with available Form ADV filings between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Targeted _{j,t}				
	1	2	3	4	5
Portfolio Returns _{j,t}	-0.249** (0.022)	-0.312** (0.021)	-0.346** (0.026)	-0.295* (0.092)	-0.306 (0.114)
# Stocks Held _{j,t}	0.172*** (0.000)	0.117*** (0.000)	0.128*** (0.000)	0.130*** (0.000)	0.128*** (0.000)
Portfolio Returns _{j,t-1}		-0.231 (0.156)	-0.194 (0.189)	-0.211 (0.146)	-0.250 (0.128)
Size _{j,t-1}		0.106*** (0.000)	0.103*** (0.000)	0.110*** (0.000)	0.117*** (0.000)
Flow _{j,t-1}		-0.115 (0.184)	-0.090 (0.344)	-0.105 (0.310)	-0.110 (0.312)
YZ Churn Rate _{j,t-1}		-0.041 (0.694)	-0.063 (0.571)	-0.037 (0.751)	-0.015 (0.913)
GMM Turnover Ratio _{j,t-1}		0.273*** (0.006)	0.086 (0.600)	-0.041 (0.839)	-0.213 (0.451)
Portfolio Returns _{j,t-2}			-0.001 (0.995)	0.005 (0.979)	-0.010 (0.961)
Flow _{j,t-2}			0.179* (0.069)	0.212** (0.049)	0.200* (0.080)
YZ Churn Rate _{j,t-2}			0.048 (0.711)	-0.028 (0.849)	-0.050 (0.790)
GMM Turnover Ratio _{j,t-2}			0.244* (0.084)	0.220 (0.257)	0.223 (0.411)
Portfolio Returns _{j,t-3}				-0.050 (0.774)	-0.043 (0.840)
Flow _{j,t-3}				-0.143 (0.197)	-0.147 (0.235)
YZ Churn Rate _{j,t-3}				-0.012 (0.938)	-0.033 (0.853)
GMM Turnover Ratio _{j,t-3}				0.262 (0.116)	0.151 (0.499)
Portfolio Returns _{j,t-4}					-0.218 (0.252)
Flow _{j,t-4}					0.109 (0.345)
YZ Churn Rate _{j,t-4}					0.190 (0.534)
GMM Turnover Ratio _{j,t-4}					0.241 (0.238)
Observations:	282,062	251,684	224,408	199,724	177,312
Adjusted R ² :	0.002	0.003	0.003	0.003	0.003
Fixed Effects:	Quarter	Quarter	Quarter	Quarter	Quarter

Table 2: Portfolio Activity And Regulatory Distraction

This table reports estimation results from regressions of measures of portfolio activity on $Distracted_{j,t}$ and past institutional investor portfolio performance and flow. $YZ\ Churn\ Rate_{j,t}$ is defined as the lesser of total buy or total sell dollar value scaled by average of assets under management quarters t and $t-1$ (Yan and Zhang, 2009). $GMM\ Turnover_{j,t}$ is defined as the mean of the last 4 quarters portfolio churn rate, including the current quarter (Gaspar et al., 2005). $Entry/Exit_{j,t}$ is the fraction of equity holdings that experience a complete buy or sell during the quarter. $Trade_{j,t}$ is the fraction of equity holdings that are traded (full or partial) during the quarter. $Distracted_{j,t}$ is an indicator variable taking value of 1 if institutional investor j is involved in a regulatory investigation in quarter t . All variables are defined in Appendix A. The sample includes all institutional investors with reported 13(f) holdings from Whale Wisdom database and with available Form ADV filings between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Churn Rate $_{j,t}$	Turnover $_{j,t}$	Entry/Exit $_{j,t}$	Trade $_{j,t}$
	1	2	3	4
Distracted $_{j,t}$	-0.363** (0.026)	-0.341* (0.062)	-0.714*** (0.002)	-0.389* (0.054)
Portfolio Size $_{j,t-1}$	-0.924*** (0.000)	-2.211*** (0.000)	-2.980*** (0.000)	0.887*** (0.000)
# Stocks Held $_{j,t-1}$	1.201*** (0.000)	2.390*** (0.000)	6.203*** (0.000)	1.965*** (0.000)
Portfolio Returns $_{j,t-1}$	-1.221 (0.165)	-1.160* (0.054)	-1.824** (0.030)	-0.684 (0.449)
Portfolio Returns $_{j,t-2}$	-1.012 (0.256)	-0.483 (0.468)	-0.437 (0.570)	-0.440 (0.536)
Portfolio Returns $_{j,t-3}$	0.624 (0.420)	-0.539 (0.405)	0.041 (0.948)	-0.398 (0.573)
Portfolio Returns $_{j,t-4}$	0.653 (0.442)	-0.579 (0.250)	-0.546 (0.445)	-1.026 (0.251)
Flow $_{j,t-1}$	-1.533*** (0.000)	-1.031*** (0.000)	-2.777*** (0.000)	-1.408*** (0.000)
Flow $_{j,t-2}$	-0.669** (0.030)	-2.191*** (0.000)	-1.479*** (0.000)	-1.024*** (0.000)
Flow $_{j,t-3}$	-0.399 (0.221)	-2.132*** (0.000)	-0.898*** (0.000)	-0.962*** (0.000)
Flow $_{j,t-4}$	-0.323 (0.325)	-1.021*** (0.000)	-0.809*** (0.004)	-1.154*** (0.000)
Observations:	177,341	177,343	177,349	177,349
Adjusted R^2 :	0.508	0.792	0.710	0.667
Fixed Effects:	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor

Table 3: CEO Compensation and Distraction

This table reports estimation results from regressions of measures of CEO compensation on $D_{i,t}$ and lagged firm characteristics. *Total Comp._{i,t}* is the natural log of CEO's total compensation at firm i in year t . *Abnormal Comp._{i,t}* is the residual from regression of Total Comp. on firm assets, operating performance, firm risk, and industry fixed effects. *High Abnrml Comp._{i,t}* is an indicator variable taking value of 1 if firm i Abnormal Comp. is above the sample median in year t . *Increased Comp._{i,t}* is an indicator variable taking value of 1 if firm i CEO's total compensation increased by at least 20% in year t from the previous year. $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. *p-values* are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Total Comp. _{i,t}	Abnormal Comp. _{i,t}	High Abnrml Comp. _{i,t}	Increased Comp. _{i,t}
	1	2	3	4
$D_{i,t}$	0.444** (0.010)	0.412** (0.016)	0.317*** (0.000)	0.062*** (0.000)
$IO_{i,t}$	0.703*** (0.000)	0.720*** (0.000)	0.395*** (0.000)	0.007 (0.702)
Log Assets _{i,t-1}	0.416*** (0.000)	-0.028** (0.045)	-0.008 (0.102)	-0.020*** (0.000)
Cash Ratio _{i,t-1}	0.113 (0.328)	0.102 (0.389)	0.197*** (0.000)	-0.049** (0.049)
BM Ratio _{i,t-1}	-0.383*** (0.000)	-0.310*** (0.000)	-0.186*** (0.000)	-0.004 (0.618)
Cash Flow Ratio _{i,t-1}	-0.105 (0.228)	-0.206** (0.014)	-0.046 (0.231)	-0.029 (0.316)
Log CEO Tenure _{i,t-1}	-0.004** (0.043)	-0.005** (0.039)	0.001 (0.264)	-0.002*** (0.000)
Leverage _{i,t-1}	-0.046 (0.408)	-0.004 (0.935)	-0.025 (0.395)	-0.027* (0.066)
Log Age _{i,t-1}	0.054* (0.100)	0.066** (0.047)	0.012 (0.395)	-0.054*** (0.000)
Observations:	27,129	26,888	26,888	23,676
Adjusted R^2 :	0.471	0.043	0.055	0.027
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 4: CEO Compensation Components and Distraction

This table reports estimation results from regressions of measures of CEO compensation components on $D_{i,t}$ and lagged firm characteristics. $Bonus_{i,t}$ is bonus paid to firm i CEO in year t . $Salary_{i,t}$ is salary paid to firm i CEO in year t . $Options\ Grants_{i,t}$ is the the natural log of the number of options granted to firm i CEO in year t . $Lucky\ Grants_{i,t}$ is an indicator variable taking value of 1 if at least one tranche of options granted to CEO is granted on a day with the lowest stock price of the month (Bebchuk et al., 2010). $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Bonus _{<i>i,t</i>}	Salary _{<i>i,t</i>}	Options _{<i>i,t</i>}	Lucky Grants _{<i>i,t</i>}
	1	2	3	4
$D_{i,t}$	1.632*** (0.001)	-0.125 (0.587)	0.991** (0.040)	0.306** (0.037)
$IO_{i,t}$	-0.690*** (0.000)	0.444*** (0.000)	1.353*** (0.000)	0.058 (0.236)
Log Assets _{<i>i,t-1</i>}	0.042 (0.104)	0.150*** (0.000)	0.566*** (0.000)	-0.005 (0.421)
Cash Ratio _{<i>i,t-1</i>}	-0.029 (0.884)	-0.469*** (0.000)	0.555 (0.106)	0.078 (0.153)
BM Ratio _{<i>i,t-1</i>}	-0.133* (0.068)	-0.084** (0.012)	-1.105*** (0.000)	0.050* (0.056)
Cash Flow Ratio _{<i>i,t-1</i>}	0.164 (0.365)	-0.199*** (0.007)	-0.265 (0.312)	0.037 (0.521)
Log CEO Tenure _{<i>i,t-1</i>}	0.004 (0.336)	-0.002 (0.481)	-0.027*** (0.000)	0.001 (0.872)
Leverage _{<i>i,t-1</i>}	-0.239* (0.076)	0.097* (0.077)	-0.471* (0.077)	-0.003 (0.943)
Log Age _{<i>i,t-1</i>}	-0.013 (0.845)	0.095** (0.016)	-0.060 (0.584)	0.100* (0.098)
Observations:	27,200	27,200	27,140	1,773
Adjusted R^2 :	0.348	0.176	0.185	0.055
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 5: CEO Turnover, Performance Sensitivity, and
Distraction

This table reports estimation results from regressions of CEO Turnover on $D_{i,t}$ and lagged firm characteristics. $CEO\ Turnover_{i,t}$ is an indicator variable taking value of 1 if the CEO of firm i is replaced during year t . $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . $Operating\ ROA_{i,t-1}$ is defined as firm i income before depreciation and interest divided by total assets at year t . All variables are defined in Appendix A. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	CEO Turnover $_{i,t}$		
	1	2	3
$D_{i,t}$	-0.050** (0.025)	-0.047 (0.141)	-0.078** (0.033)
$IO_{i,t}$	-0.005 (0.622)	-0.005 (0.630)	-0.003 (0.768)
$\text{Log Assets}_{i,t-1}$	-0.001 (0.345)	-0.001 (0.347)	-0.001 (0.494)
$\text{Cash Ratio}_{i,-1}$	0.017 (0.153)	0.018 (0.148)	0.014 (0.228)
$\text{BM Ratio}_{i,t-1}$	0.024*** (0.000)	0.024*** (0.000)	0.015*** (0.001)
$\text{Cash Flow Ratio}_{i,t-1}$	-0.044*** (0.003)	-0.044*** (0.003)	0.027* (0.083)
$\text{Log CEO Tenure}_{i,t-1}$	-0.001*** (0.000)	-0.001*** (0.000)	-0.001*** (0.000)
$\text{Leverage}_{i,t-1}$	0.034*** (0.000)	0.034*** (0.000)	0.031*** (0.001)
$\text{Log Age}_{i,t-1}$	-0.006 (0.392)	-0.006 (0.384)	0.004 (0.380)
$\text{Four-factor alpha}_{i,t-1}$	-0.036*** (0.000)	-0.039*** (0.000)	
$D_{i,t} \times \text{Four-factor alpha}_{i,t-1}$		0.081* (0.068)	
$\text{Operating ROA}_{i,t-1}$			-0.097*** (0.000)
$D_{i,t} \times \text{Operating ROA}_{i,t-1}$			0.270* (0.065)
Observations:	25,068	25,068	27,187
Adjusted R^2 :	0.014	0.014	0.012
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry

Table 6: CEO Power, Compensation, and Distraction

This table reports estimation results from regressions of measures of CEO compensation on $D_{i,t}$, measures of CEO power, and lagged firm characteristics. $Total\ Comp_{i,t}$ is the natural log of CEO's total compensation at firm i in year t . $Abnormal\ Comp_{i,t}$ is the residual from regression of Total Comp. on firm assets, operating performance, firm risk, and industry fixed effects. $High\ Abnrml\ Comp_{i,t}$ is an indicator variable taking value of 1 if firm i Abnormal Comp. is above the sample median in year t . $Options\ Grants_{i,t}$ is the the natural log of the number of options granted to firm i CEO in year t . $High\ Tenure_{i,t}$ is an indicator variable taking value of 1 if the CEO's tenure at firm i is above the sample median in year t . $CEO\ Chair_{i,t}$ is an indicator variable taking value of 1 if the CEO at firm i is also the chairman of the board in year t . $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. Control Variables from Table 3 are included in the regressions but are not reported for brevity. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Total Comp. $_{i,t}$	Abnormal Comp. $_{i,t}$	High Abnrml Comp. $_{i,t}$	Option Grants $_{i,t}$	Total Comp. $_{i,t}$	Abnormal Comp. $_{i,t}$	High Abnrml Comp. $_{i,t}$	Option Grants $_{i,t}$
	1	2	3	4	5	6	7	8
$D_{i,t}$	0.255 (-0.141)	0.197 (-0.254)	0.240** (-0.012)	0.316 (-0.675)	-0.015 (-0.946)	-0.047 (-0.836)	0.139 (-0.235)	0.145 (-0.868)
High Tenure $_{i,t}$	-0.103*** (-0.002)	-0.111*** (-0.001)	-0.012 (-0.435)	-0.441*** (0.000)				
$D_{i,t} \times High\ Tenure_{i,t}$	0.336** (-0.012)	0.958* (-0.070)	0.353* (-0.072)	2.955* (-0.050)				
CEO Chair $_{i,t}$					-0.013 (-0.610)	-0.014 (-0.590)	0.033*** (-0.008)	0.024 (-0.805)
$D_{i,t} \times CEO\ Chair_{i,t}$					0.976*** (-0.007)	0.974*** (-0.007)	0.354** (-0.032)	1.716* (-0.056)
Observations:	27,129	26,888	26,888	27,140	28,167	27,901	27,901	27,179
Adjusted R^2 :	0.473	0.047	0.058	0.185	0.466	0.045	0.060	0.184
Control Variables :	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 7: Acquisition Activity and Distraction

This table reports estimation results from regressions of measures of acquisition activity on $D_{i,t}$ and lagged firm characteristics. Diversifying acquisitions are defined as deals where the acquirer and target industries, based on 2-digit SIC codes, are different. Cash acquisitions are those in which consideration is all cash. Bad acquisitions are defined as acquisitions whose CARs at announcements are below the sample median. CARs are measured as realized returns in excess of expected returns, which is based on a four-factor model estimated with 250 trading days ending 50 trading days before the announcement. $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all publicly traded firms between 2001 and 2022. *p-values* are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	All Acquisitions $_{i,t}$	Diversifying Acquisitions $_{i,t}$	Cash Acquisitions $_{i,t}$	Bad Acquisitions $_{i,t}$
	1	2	3	4
$D_{i,t}$	0.203*** (0.000)	0.049** (0.017)	0.199*** (0.000)	0.147*** (0.000)
$IO_{i,t}$	0.069*** (0.000)	0.030*** (0.000)	0.023* (0.060)	0.017* (0.095)
Log Assets $_{i,t-1}$	0.035*** (0.000)	0.008*** (0.000)	0.032*** (0.000)	0.024*** (0.000)
Cash Ratio $_{i,t-1}$	-0.027** (0.045)	-0.031*** (0.000)	-0.009 (0.353)	-0.004 (0.675)
BM Ratio $_{i,t-1}$	-0.039*** (0.000)	-0.014*** (0.000)	-0.020*** (0.000)	-0.021*** (0.000)
Cash Flow Ratio $_{i,t-1}$	0.019*** (0.000)	0.005** (0.028)	-0.003 (0.187)	0.006** (0.014)
Log Age $_{i,t-1}$	-0.001 (0.752)	-0.002 (0.408)	-0.003 (0.202)	0.001 (0.737)
Observations:	59,657	59,657	59,657	59,657
Adjusted R^2 :	0.090	0.031	0.088	0.052
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 8: Acquisition Announcement CARs and Distraction

This table reports Cumulative Abnormal Returns (CAR) around acquisition announcement windows for acquirers with high and low distraction levels (D). CAR[-1,+1] measures CARs for a 3-day window centered on the announcement. CAR[-5,+5] measures CARs for an eleven-day window centered on the announcement. CARs are measured as realized returns in excess of expected returns, which is based on a four-factor model estimated with 250 trading days ending 50 trading days before the announcement. An acquisition is characterized as *High D* if the acquirer's $D_{i,t}$ is above the sample median. Similarly, an acquisition is characterized as *Low D* if the acquirer's $D_{i,t}$ is below the sample median. Large acquisitions are defined as acquisitions with offer value higher than \$250 million. Large-target acquisitions are defined as acquisitions with relative size above the sample median. Relative size is defined as the acquisition value scaled by the acquirer market cap. Cash acquisitions are those in which consideration is all cash. Diversifying acquisitions are defined as deals where the acquirer and target industries, based on 2-digit SIC codes, are different. $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all acquisitions announced by publicly traded firms between 2001 and 2022. *p-values* are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	CAR[-1,+1]			CAR[-5,+5]		
	1	2	3	4	5	6
	High D	Low D	High - Low	High D	Low D	High - Low
All Acquisitions	0.53%	1.34	-0.81*** (0.000)	0.43	1.24	-0.82*** (0.000)
Large Acquisitions	0.41	1.61	-1.19*** (0.000)	0.25	1.49	-1.24*** (0.000)
Large-target Acquisitions	1.00	1.80	-0.80*** (0.000)	0.81	1.66	-0.84*** (0.000)
Cash Acquisitions	0.61	1.25	-0.64*** (0.000)	0.64	1.22	-0.58*** (0.000)
Diversifying Acquisitions	0.72	1.33	-0.62*** (0.000)	0.75	1.39	-0.64** (0.000)

Table 9: Acquisition Premiums, Synergies, and Distraction

This table reports acquisition premiums (Panel A) and synergies (Panel B) for acquirers with high and low distraction levels (D). *Acquisition Premium* is defined as the offer price scaled by the target share price 5 trading day before the announcement. *Acquisition Synergy* is defined as the sum of change in market value of the acquirer and the target, scaled by acquirer size. Change in market value is defined as market cap multiplied by announcement CAR. An acquisition is characterized as *HighD* if the acquirer's $D_{i,t}$ is above the sample median. Similarly, an acquisition is characterized as *LowD* if the acquirer's $D_{i,t}$ is below the sample median. Large acquisitions are defined as acquisitions with offer value higher than \$250 million. Large-target acquisitions are defined as acquisitions with relative size above the sample median. Relative size is defined as the acquisition value scaled by the acquirer market cap. Cash acquisitions are those in which consideration is all cash. Diversifying acquisitions are defined as deals where the acquirer and target industries, based on 2-digit SIC codes, are different. $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all acquisitions of publicly traded targets by publicly traded acquirers between 2001 and 2022. *p-values* are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: Acquisition Premiums				
	1	2	3	4
Sample:	Observations	High D	Low D	High - Low
All Acquisitions	568	56.44	50.21	6.24* (0.066)
Large Acquisitions	373	52.37	48.37	4.00* (0.084)
Large-target Acquisitions	502	51.88	46.66	5.22* (0.083)
Cash Acquisitions	241	61.59	59.32	2.27* (0.076)
Diversifying Acquisitions	96	49.17	56.73	-7.56 (0.447)
Panel B: Acquisition Synergies				
	1	2	3	4
Sample:	Observations	High D	Low D	High - Low
All Acquisitions	461	1.52	3.45	-1.93*** (0.000)
Large Acquisitions	266	1.48	3.83	-2.35*** (0.000)
Large-target Acquisitions	461	1.96	4.05	-2.09*** (0.000)
Cash Acquisitions	171	1.95	4.02	-2.07*** (0.000)
Diversifying Acquisitions	89	1.27	3.18	-1.90** (0.043)

Table 10: CEO Power, Acquisitions, and Distraction

This table reports estimation results from regressions of measures of acquisition activity on $D_{i,t}$, measures of CEO power, and lagged firm characteristics. Diversifying acquisitions are defined as deals where the acquirer and target industries, based on 2-digit SIC codes, are different. Cash acquisitions are those in which consideration is all cash. Bad acquisitions are defined as acquisitions whose CARs at announcements are below the sample median. CARs are measured as realized returns in excess of expected returns, which is based on a four-factor model estimated with 250 trading days ending 50 trading days before the announcement. *High Tenure* $_{i,t}$ is an indicator variable taking value of 1 if the CEO's tenure at firm i is above the sample median in year t . *CEO Chair* $_{i,t}$ is an indicator variable taking value of 1 if the CEO at firm i is also the chairman of the board in year t . $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. Control Variables from Table 3 are included in the regressions but are not reported for brevity. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. *p-values* are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	All M&A $_{i,t}$	Diversifying M&A $_{i,t}$	Cash M&A $_{i,t}$	Bad M&A $_{i,t}$	All M&A $_{i,t}$	Diversifying M&A $_{i,t}$	Cash M&A $_{i,t}$	Bad M&A $_{i,t}$
	1	2	3	4	5	6	7	8
$D_{i,t}$	0.136 (-0.122)	0.087* (-0.082)	0.099 (-0.177)	0.105* (-0.082)	0.214* (-0.061)	0.069* (-0.078)	0.135** (-0.012)	0.145* (-0.071)
High Tenure $_{i,t}$	-0.035*** (-0.001)	-0.012** (-0.028)	-0.020*** (-0.009)	-0.018*** (-0.005)				
$D_{i,t} \times \text{High Tenure}_{i,t}$	0.374* (-0.074)	0.044* (-0.057)	0.373** (-0.023)	0.112* (-0.084)				
CEO Chair $_{i,t}$					0.004 (-0.672)	-0.002 (-0.777)	-0.001 (-0.929)	-0.004 (-0.546)
$D_{i,t} \times \text{CEO Chair}_{i,t}$					0.028* (-0.090)	0.054* (-0.076)	0.084** (-0.035)	0.042** (-0.029)
Observations:	27,200	27,200	27,200	27,200	28,250	28,250	28,250	28,250
Adjusted R^2 :	0.073	0.034	0.081	0.044	0.072	0.033	0.081	0.043
Control Variables :	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 11: Institutional Trading After Acquisitions and Distraction

This table reports estimation results from regressions of measures of institutional investors' trading activity after acquisitions on $Distracted_{j,t}$ and lagged firm characteristics. $Large\ Decrease_{i,j,t}$ is an indicator variable taking value of 1 if the decrease in investor j holding of firm i during quarter t is in the top quartile of its holding changes during quarter t . $\% Decrease_{i,j,t}$ is the percent change in investor j number of shares held of firm i during quarter t . $Full\ Exit_{i,j,t}$ is an indicator variable taking value of 1 if investor j sells all of its holding of firm i during quarter t . $Bad\ Deal$ is an indicator variable taking value of 1 if the acquisition's CAR at announcements is below the sample median. CARs are measured as realized returns in excess of expected returns, which is based on a four-factor model estimated with 250 trading days ending 50 trading days before the announcement. Large acquisitions are defined as acquisitions with offer value higher than \$250 million. Cash acquisitions are those in which consideration is all cash. Diversifying acquisitions are defined as deals where the acquirer and target industries, based on 2-digit SIC codes, are different. $Distracted_{j,t}$ is an indicator variable equal to 1 if investor j is under regulatory scrutiny in quarter t . All other variables are defined in Appendix A. Control Variables are lagged stock returns, total assets, book-to-market ratio, illiquidity, and institutional ownership at the firm level as well as lagged portfolio returns, flow, churn ratio, portfolio turnover, and portfolio size, and portfolio weight at the institutional investor level. Controls are included in the regressions but are not reported for brevity. The sample includes all quarterly holdings of publicly traded firms by 13F institutional investors between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	All Acquisitions			Large Acquisitions			Cash Acquisitions			Diversifying Acquisitions		
	Large	%	Full	Large	%	Full	Large	%	Full	Large	%	Full
	Decrease _{i,j,t}	Decrease _{i,j,t}	Exit _{i,j,t}	Decrease _{i,j,t}	Decrease _{i,j,t}	Exit _{i,j,t}	Decrease _{i,j,t}	Decrease _{i,j,t}	Exit _{i,j,t}	Decrease _{i,j,t}	Decrease _{i,j,t}	Exit _{i,j,t}
	1	2	3	4	5	6	7	8	9	10	11	12
Distracted _{j,t}	0.002 (0.467)	0.219 (0.435)	−0.002 (0.965)	0.001 (0.595)	0.261 (0.363)	−0.001 (0.668)	0.002 (0.483)	0.292 (0.323)	−0.001 (0.700)	0.002 (0.609)	0.135 (0.700)	0.002 (0.960)
Bad Deal	0.002** (0.026)	0.099** (0.035)	0.004*** (0.007)	0.003*** (0.000)	0.290*** (0.000)	0.002*** (0.000)	0.004*** (0.000)	0.422*** (0.000)	0.005*** (0.000)	0.006*** (0.000)	0.904*** (0.000)	0.006*** (0.000)
Distracted _{j,t} × Bad Deal	−0.002** (0.044)	−0.071 (0.629)	−0.002* (0.081)	−0.002** (0.014)	−0.258* (0.084)	−0.002** (0.031)	−0.003** (0.029)	−0.135** (0.045)	−0.002** (0.019)	−0.008** (0.024)	−0.637*** (0.016)	−0.009*** (0.007)
Observations:	2,683,221	2,683,221	2,683,221	1,689,847	1,689,847	1,689,847	1,717,867	1,717,867	1,717,867	794,628	794,628	794,628
Adjusted R^2 :	0.108	0.12	0.106	0.114	0.126	0.112	0.111	0.123	0.109	0.112	0.123	0.111
Control Variables :	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects:	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor	Quarter & Investor

Table 12: Firm Long-term Performance and Distraction

This table reports estimation results from regressions of measures of long-term firm performance on $D_{i,t}$ and lagged firm characteristics. Market-adjusted returns are in excess of the S&P500 index during the same period. Four-factor alphas are defined as firm returns in excess of a four-factor model that is estimated with 250 trading days ending 50 trading days prior to the beginning of year t . Performance variables are measures for one, two, and four years. for $D_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . All variables are defined in Appendix A. The sample includes all publicly traded firms between 2001 and 2022. *p-values* are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. * * *, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Dependent Variable:	Market-adjusted Returns			Four-factor Alpha		
	$(t, t + 1)$	$(t, t + 2)$	$(t, t + 4)$	$(t, t + 1)$	$(t, t + 2)$	$(t, t + 4)$
	1	2	3	4	5	6
$D_{i,t}$	-0.117*** (0.004)	-0.167** (0.017)	-0.209 (0.104)	-0.085** (0.021)	-0.097* (0.067)	-0.109* (0.080)
$IO_{i,t}$	0.042*** (0.000)	0.052** (0.010)	0.064 (0.143)	0.041*** (0.000)	0.092*** (0.000)	0.092*** (0.000)
Log Assets $_{i,t-1}$	-0.001 (0.700)	0.001 (0.796)	0.010 (0.114)	-0.001 (0.567)	0.005*** (0.004)	0.026*** (0.000)
Cash Ratio $_{i,t-1}$	-0.029** (0.027)	-0.084*** (0.001)	-0.138** (0.012)	-0.015 (0.150)	-0.009 (0.534)	-0.012 (0.582)
BM Ratio $_{i,t-1}$	0.037*** (0.000)	0.066*** (0.000)	0.097*** (0.000)	0.119*** (0.000)	0.155*** (0.000)	0.072*** (0.000)
Cash Flow Ratio $_{i,t-1}$	0.078*** (0.000)	0.154*** (0.000)	0.295*** (0.000)	-0.032*** (0.002)	-0.008 (0.431)	0.036** (0.036)
Leverage $_{i,t-1}$	0.024** (0.030)	0.086*** (0.000)	0.154*** (0.000)	0.050*** (0.000)	0.069*** (0.000)	-0.017 (0.305)
Log Age $_{i,t-1}$	0.035*** (0.000)	0.058*** (0.000)	0.100*** (0.003)	0.012** (0.048)	0.032*** (0.001)	0.062*** (0.000)
Volatility $_{i,t-1}$	-0.244*** (0.000)	-0.424*** (0.000)	-0.767*** (0.000)	-0.701*** (0.000)	-0.886*** (0.000)	-1.061*** (0.000)
Observations:	49,045	45,991	36,652	49,045	45,991	36,652
Adjusted R^2 :	0.076	0.099	0.089	0.054	0.069	0.114
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry

Table 13: Robustness of CEO Compensation Results -
Excluding Cases With Concurrent Start and Resolution Dates

This table reports estimation results from regressions of measures of CEO compensation (Panel A) as well as CEO turnover (Panel B) on $D\ Robust_{i,t}$ and lagged firm characteristics. $Total\ Comp_{i,t}$ is the natural log of CEO's total compensation at firm i in year t . $Abnormal\ Comp_{i,t}$ is the residual from regression of Total Comp. on firm assets, operating performance, firm risk, and industry fixed effects. $High\ Abnrml\ Comp_{i,t}$ is an indicator variable taking value of 1 if firm i Abnormal Comp. is above the sample median in year t . $Bonus_{i,t}$ is bonus paid to firm i CEO in year t . $Options\ Grants_{i,t}$ is the the natural log of the number of options granted to firm i CEO in year t . $Lucky\ Grants_{i,t}$ is an indicator variable taking value of 1 if at least one tranche of options granted to CEO is granted on a day with the lowest stock price of the month (Bebchuk et al., 2010). $CEO\ Turnover_{i,t}$ is an indicator variable taking value of 1 if the CEO of firm i is replaced during year t . $D\ Robust_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . $D\ Robust_{i,t}$ is calculated similar to $D_{i,t}$ except that regulatory investigations in which start and resolution dates are the same are excluded from the sample. All variables are defined in Appendix A. The sample includes all publicly traded firms with available executive compensation reported in Execucomp between 2001 and 2022. p -values are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: CEO Compensation						
Dependent Variable:	Total Comp. _{i,t}	Abnrml. Comp. _{i,t}	High Abn. Comp. _{i,t}	Bonus Comp. _{i,t}	Option Grants _{i,t}	Lucky Grants _{i,t}
	1	2	3	4	5	6
D Robust _{i,t}	0.499** (0.016)	0.499** (0.015)	0.376*** (0.000)	1.873*** (0.001)	1.152* (0.052)	0.291* (0.065)
Observations:	26,936	26,700	26,700	27,006	26,947	1,769
Adjusted R^2 :	0.474	0.046	0.059	0.349	0.185	0.054
Control Variables :	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry	Year & Industry
Panel B: CEO Turnover Performance Sensitivity						
Dependent Variable:	CEO Turnover _{i,t}					
	1	2				
D Robust _{i,t}	-0.069** (0.049)	-0.106*** (0.008)				
Operating ROA _{$i,t-1$}		-0.098*** (0.000)				
D Robust _{i,t} $\times$ Operating ROA _{$i,t-1$}		0.308* (0.054)				
Observations:	25,039	26,993				
Adjusted R^2 :	0.014	0.012				
Control Variables :	Yes	Yes				
Fixed Effects:	Year & Industry	Year & Industry				

Table 14: Robustness of Acquisition Results - Excluding Cases
With Concurrent Start and Resolution Dates

This table reports estimation results from regressions of measures of acquisition activity on $D\ Robust_{i,t}$ and lagged firm characteristics in Panel A. Panel B reports the difference in CARs, premiums, and synergies for two sample of acquisitions with *High* and *Low* $D\ Robust_{i,t}$. An acquisition is characterized as *High* D if the acquirer's $D_{i,t}$ is above the sample median. Similarly, an acquisition is characterized as *Low* D if the acquirer's $D_{i,t}$ is below the sample median. $D\ Robust_{i,t}$ is a measure of regulatory distraction among institutional investors at firm i in year t . $D\ Robust_{i,t}$ is calculated similar to $D_{i,t}$ except that regulatory investigations in which start and resolution dates are the same are excluded from the sample. All variables are defined in Appendix A. The sample includes all publicly traded firms between 2001 and 2022. *p-values* are based on two-way clustered standard errors at firm and year-quarter levels and are reported in parenthesis. ***, **, and * represent statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: Acquisition Activity				
Dependent Variable:	All M&A _{<i>i,t</i>}	Diversifying M&A _{<i>i,t</i>}	Cash M&A _{<i>i,t</i>}	Bad M&A _{<i>i,t</i>}
	1	2	3	4
D Robust _{<i>i,t</i>}	0.191*** (0.000)	0.032 (0.177)	0.207*** (0.000)	0.141*** (0.000)
Observations:	58,490	58,490	58,490	58,490
Adjusted R^2 :	0.090	0.032	0.088	0.053
Control Variables :	Yes	Yes	Yes	Yes
Fixed Effects:	Year & Industry	Year & Industry	Year & Industry	Year & Industry
Panel B: Acquisition CARs, Premiums, and Synergies				
Dependent Variable:	CAR[-1,+1]	CAR[-5,+5]	Premium	Synergy
	1	2	3	4
	High - Low	High - Low	High - Low	High - Low
All Acquisitions	-0.81*** (0.000)	-0.89*** (0.000)	5.96** (0.047)	-1.56*** (0.002)
Large Acquisitions	-1.02*** (0.000)	-0.92*** (0.009)	5.37* (0.095)	-1.56** (0.014)
Large-target Acquisitions	-0.68*** (0.000)	-0.71*** (0.008)	2.09* (0.085)	-1.46** (0.017)
Cash Acquisitions	-0.67*** (0.000)	-0.61*** (0.004)	2.93** (0.043)	-2.31*** (0.000)
Diversifying Acquisitions	-0.78*** (0.000)	-0.76*** (0.009)	-7.38 (0.528)	-1.82** (0.40)

Appendix A: Variable Definitions

Variable Name	Variable Definition
Institutional Investors	
Distracted	A dummy equal 1 if the institutional investor is distracted by a disciplinary action in the quarter.
Targeted	A dummy equal 1 if a disciplinary action in the quarter is initiated against the institutional investor.
Entry/Exit	The fraction of equity holdings that experience a complete buy or sell during the quarter.
Trade	The fraction of equity holdings that are traded (full or partial) during the quarter.
Churn Rate	The lesser of total buy or total sell dollar value scaled by average of assets under management quarters t and t-1.
Turnover	The mean of the last 4 quarters portfolio churn rate, including the current quarter.
Portfolio Returns	Institutional investor's DGTW quarterly returns.
Portfolio Size	Total value of assets under management.
Flow	Net capital flows into the portfolio during the quarter.
# Stocks Held	Total number of stocks held in the portfolio that are matched to CRSP.
Large Decrease	Dummy equal 1 if the decrease in the investor's holding of the firm during the quarter is in the top quartile of its holding changes during quarter.
% Decrease	The percent change in investor's holding of the firm during the quarter. This measure is based on the number of shares held.
Full Exit	Dummy equal 1 if the investor's holding of the firm is fully liquidated during the quarter.
Institutional Ownership	
D	A measure of regulatory distraction among institutional investors at the firm during the year based on Equation 1.
D Robust	A measure similar to D, except regulatory events with similar start and resolution dates are excluded from the calculation.
IO	Total number of shares owned by institutional investors reported by 13F filings, scaled by total number of shares outstanding.
CEO Compensation	
Total Comp.	Natural log of total compensation reported in Execucomp for the year (Salary, Bonus, Equity, Options, Deferred).
Abnormal Comp.	The residual from regression of Total Comp. on firm assets, operating performance, firm risk, and industry fixed effects.
High Abnrm1 Comp.	Dummy equal 1 if Abnormal Comp. is above sample median.
Increased Comp.	A dummy equal 1 if CEO's total compensation increased by at least 20% from the previous year.
Bonus	Bonus paid to CEO for the year reported in Execucomp.
Salary	Salary paid to CEO for the year reported in Execucomp.
Options Grants	Black-Scholes estimated value of options granted to CEO during the year.
Lucky Grants	A dummy equal 1 if at least one tranche of options granted to CEO is granted on a day with the lowest stock price of the month. This variable is from Bebchuck et. al. (2010) and defined for the 2001–2005 period.
CEO Turnover	A dummy equal to 1 if the CEO is replaced by a new CEO.

Variable Name	Variable Definition
Acquisitions	
All Acquisition	Dummy equal 1 if the firm announces an acquisition during the year.
Diversifying Acquisition	Dummy equal 1 if the firm announces an acquisition during the year for which the target is in a different industry according to Fama and French FF10.
Cash Acquisition	Dummy equal 1 if the firm announces an acquisition paid by cash during the year.
Bad Acquisition	Dummy equal 1 if the acquisition announcement CAR is below the median.
Large Acquisition	Dummy equal 1 if the firm announces an acquisition larger than \$250 million during the year.
Large-target Acquisition	Dummy equal 1 if the firm announces an acquisition with relative size above the sample median during the year. Relative size is defined as the acquisition value scaled by the acquirer market cap.
CAR[-1,+1]	Cumulative Abnormal Return around a 3-day window of the acquisition announcement. Abnormal Returns are measured using a four-factor model estimated with 250 trading days ending 50 trading days before the announcement.
CAR[-5,+5]	Cumulative Abnormal Return around an eleven-day window of the acquisition announcement. Abnormal Returns are measured using a four-factor model estimated with 250 trading days ending 50 trading days before the announcement.
Acquisition Premium	Offer price scaled by the target share price 5 trading day before the announcement.
Acquisition Synergy	The sum of change in market value of the acquirer and the target, scaled by acquirer size. Change in market value is defined as market cap multiplied by announcement CAR.
Firm Characteristics	
Log Assets	Natural log of total assets reported in Compustat
Cash Ratio	Cash holdings scaled by total assets.
BM Ratio	Book value of common equity divided by market capitalization.
Cash Flow Ratio	Free Cash Flow (operating income before depreciation minus interest and dividends) scaled by total assets.
Leverage	Long-term debt and short-term liabilities scaled by total assets.
Operating ROA	Income before depreciation and interest divided by total assets
Log Age	Natural log of firm age in years.
Log CEO Tenure	Natural log of CEO tenure at the firm reported in Execucomp.
High Tenure	Dummy equal 1 if CEO tenure at the firm is above the sample median.
CEO Chair	Dummy equal 1 if CEO is the firm's Chairman of the board.
Four-factor Alpha	Abnormal Returns from a four-factor model estimated with 250 trading days ending 50 trading days before the beginning of the year.
Market-adjusted Returns	Cumulative firm raw returns minus cumulative S&P500 returns.
Volatility	Standard deviation of the firm's monthly stock returns during a 36-month trailing period.