6 The Role of Institutional Investors in Corporate Governance

LEARNING OBJECTIVES

- to appreciate who institutional investors are
- to understand the growing influence of institutional investors and why they are increasingly interested in corporate governance
- to realize the importance of institutional investors' relationships with their investee companies
- to be aware of the 'tools of governance' that institutional investors have available to them
- to be able to assess the potential impact of 'good' corporate governance on corporate performance

Introduction

The potential influence of large shareholders was identified back in the 1930s when Berle and Means (1932) highlighted the separation of the owners (shareholders) from the control of the business, 'control' being in the hands of the directors. This separation of ownership and control leads to the problems associated with agency theory so that the managers of the business may not act in the best interests of the owners. Throughout the twentieth century, the pattern of ownership continued to change and, in the US and UK in particular, individual share ownership has declined and institutional share ownership has increased. Over seventy years later institutional investors own large portions of equity in many companies across the world, and the key role played by institutional investors in corporate governance cannot be underestimated. With the internationalization of crossborder portfolios, and the financial crises that have occurred in many parts of the world, it is perhaps not surprising that institutional investors increasingly look more carefully at the corporate governance of companies. After all, corporate governance goes hand in hand with increased transparency and accountability. In this chapter the rise of the institutional investors and their role in corporate governance is examined.

Table 6.1 Summary of main categories of share ownership in the UK 1963–2004

Type of investor	1963%	2004%
Individuals	54	14
Insurance companies	10	17
Pension funds	6	16
Unit trusts	1	2
Overseas	7	32

Source: ONS Share Ownership 2005
(*Other categories owning shares include banks, investment trusts, public sector, and industrial and commercial companies.*)

Growth of institutional share ownership

In the UK the level of share ownership by individuals has decreased over the last thirty years, whilst ownership by institutional investors has increased. In the UK, these institutional investors comprise mainly pension funds and insurance companies. The nature of the changing composition of the UK shareholder base is summarized in Table 6.1.

In 1963 individual investors owned 54% of shares in the UK. The proportion of shares owned by this group fell steadily until by 1989 it had dropped to just under 21%. Since 1989 there have been a few factors that should have encouraged individual share ownership. First, there were the large privatization issues which occurred in the UK in the early 1990s, and in more recent years, the demutualization of some of the large building societies. However, by 2004 the percentage had dropped to 14%.

In contrast to the individual investors' level of share ownership, the ownership of shares by the insurance companies and the pension funds has increased dramatically over the same period. Ownership by insurance companies has increased from 10% in 1963 to 17% in 2004 whilst that of pension funds has seen an increase to 16%. The large increase in pension funds' investment is attributable to more people investing in pensions. There has also been a notable increase in the overseas level of ownership – this is particularly noteworthy as it has increased from 7% in 1963 to 32% in 2004. Many of the overseas holdings are US investors, with European Union countries being another group of overseas holdings. The US institutional investors tend to be much more proactive in corporate governance and this stance has started to influence the behaviour of both UK institutional investors and UK companies. From Figure 6.1 which shows the beneficial ownership of UK shares at the end of 2004, the extent of institutional share ownership can be seen quite clearly. Similarly, the influence of overseas investors on corporate UK is shown by their level of equity ownership.

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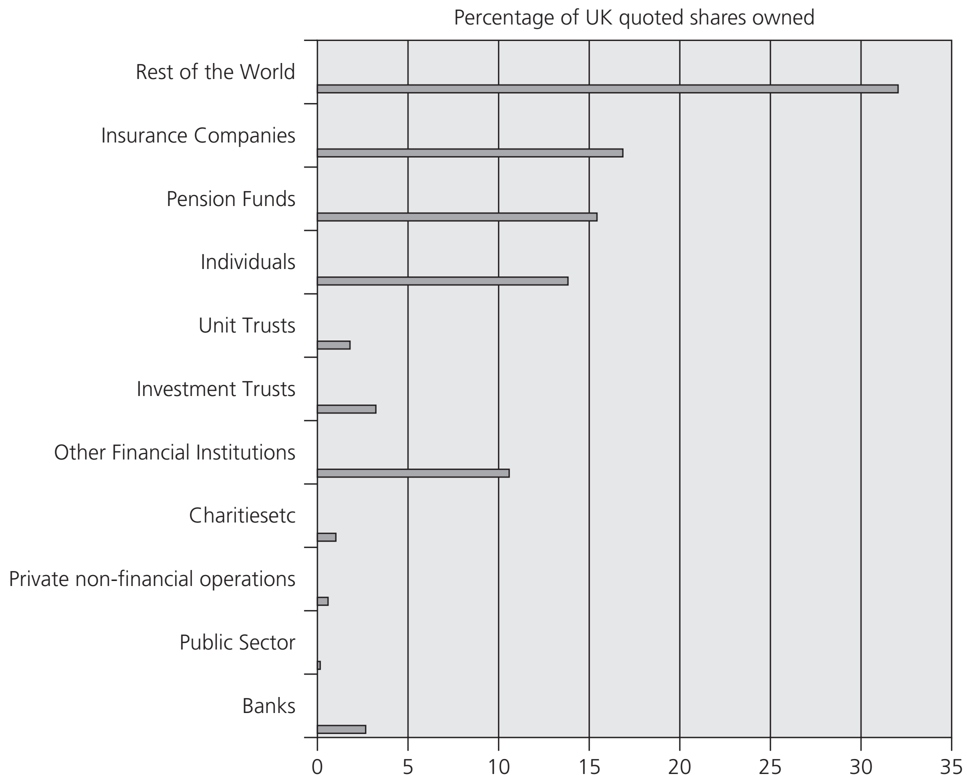


Figure 6.1 Beneficial ownership of UK shares end 2004
Source: ONS Share Ownership 2005

Influence of institutional investors

Given the size of their shareholdings the power of the institutional investors cannot be doubted. In his seminal work, Hirschman (1970) identified the exercise of institutional power within an 'exit and voice' framework, arguing that 'dissatisfaction [may be expressed] directly to management', the *voice* option, or by selling the shareholding, the *exit* option. The latter choice is not viable for many institutional investors given the size of their holdings or a policy of holding a balanced portfolio.

The Cadbury Committee (1992) viewed institutional investors as having a special responsibility to try to ensure that its recommendations were adopted by companies, stating that 'we look to the institutions in particular . . . to use their influence as owners to ensure that the companies in which they have invested comply with the Code'. A similar view was expressed in the Greenbury Report (1995) as one of the main action points is 'the investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code'. Similarly in the Hampel Report (1998), it is stated 'it is clear . . . that a discussion of the role of shareholders in corporate

governance will mainly concern the institutions'. Therefore three influential committees which have reported on corporate governance in the UK, clearly emphasized the role of institutional investors. The institutional investors' potential to exert significant influence on companies has clear implications for corporate governance, especially in terms of the standards of corporate governance and issues concerned with enforcement. In relation to institutional shareholders, the Combined Code (2003) principles of good governance state:

INSTITUTIONAL SHAREHOLDERS

Dialogue with companies

1. Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

Evaluation of governance disclosures

2. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

Shareholder voting

3. Institutional shareholders have a responsibility to make considered use of their votes.

Source: Combined Code 2003

In 2002, Hermes, a large and influential institutional investor based in the UK, issued its Hermes Principles. The first principle was that 'companies should seek an honest, open and ongoing dialogue with shareholders'. This clearly reflects Hermes' intention to have a dialogue with its investee companies. Similarly in the Hermes Corporate Governance Principles (2006), global principle 3 relating to the board of directors, states 'the board is responsible for facilitating a satisfactory dialogue with the shareholders'.

This perception of the key role to be played by institutional investors is not purely a UK phenomenon. Useem (1996) detailed the rise of 'investor capitalism' in the US and described how the concentration of shares, and hence power, into a relatively small number of hands, has enabled institutional investors to directly challenge management on issues of concern. Monks (2001) identified 'global investors' as being:

> the public and private pension funds of the US, UK, Netherlands, Canada, Australia and Japan. Through extrapolating the specific holding of a number of the largest pension schemes, we conclude that the level of ownership in virtually *all* publicly quoted companies in the world is large enough to permit the effective involvement of owners in the governance of those corporations.

Similarly in the context of the Australian market, Bosch (1993) stated 'institutional shareholders because of their increasing influence, by virtue of their size, should take an

active interest in the governance of the Company and develop their own principles of good practice'.

This emphasis is to be expected from countries such as the US, UK, and Australia which all have a significant concentration of share ownership in the hands of institutional investors. However, the Centre for European Policy Studies (CEPS) reporting in 1995, stated 'in any attempt to understand the control of corporations, the role of insurance companies, pension funds, and other institutional investors, and other actors, such as employees or banks, has to be taken into account to different extents in European countries'. The report goes on to state 'international diversification and increasing cross-border activity of institutional investors will accelerate this process. American and British pension funds, in particular, which represent about 72% of total pension fund assets in the western world, can be instrumental in changing corporate governance standards as a result of the active stance towards investment that is required by local laws and codes'. The aspect of foreign share ownership should not be underestimated as these 'new' investors in Europe will tend to be institutional investors from the US, the UK, and other countries. The large proportion of institutional share ownership in both the US, where around 55% of US equities are owned by institutional investors and 80% of all share trades are made by institutional investors, and the UK, where institutional ownership is around 65–80%, mean that the voice of the institutional investor cannot go unheard. The extent of institutional ownership in the UK is now discussed in detail.

The power of institutional investors such as those cited above clearly cannot be underestimated, and the influence which they can wield is enormous. The institutional investors may be influenced in their views by the various institutional investor representative groups in the UK. Large institutional investors, mainly insurance companies and pension funds, usually belong to one of two representative bodies which act as a professional group 'voice' for their views. These two bodies are the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). Both the ABI and the NAPF have best practice corporate governance guidelines which encompass the recommendations of the Combined Code. They monitor the corporate governance activities of companies and will provide advice to members. Institutional investors will generally consult ABI and/or NAPF reports on whether particular companies are complying with 'good' corporate governance practice, as well as undertaking their own research and analysis. Most large institutional investors have terms of reference which incorporate corporate governance aspects, or have issued separate corporate governance guidelines. These guidelines are generally based around the Combined Code recommendations, and further guidance that may have been issued by the NAPF or ABI. Companies would try to ensure that they meet these guidelines.

The Myners Report on institutional investment issued in 2001 by HM Treasury concentrated more on the trusteeship aspects of institutional investors and the legal requirements for trustees, with the aim of raising the standards and promoting greater shareholder activism. For example, the Myners Report expects that institutional investors should be more proactive especially in the stance they take with under-performing companies.

The Institutional Shareholders' Committee (ISC) whose members comprise the ABI, the NAPF, the Association of Investment Trust Companies (AITC), and the Investment

Management Association (IMA), issued a statement on the responsibilities of institutional investors in late 2002. The ISC state that the policies on activism that they describe 'do not constitute an obligation to micro-manage the affairs of investee companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns over under-performance. Nor do they preclude a decision to sell a holding, where this is the most effective response to such concerns'. In other words, the exercise of 'voice' is recommended but 'exit' is not precluded.

The ISC recommends that institutional investors should **have a clear statement of their policy on activism and on how they will discharge their responsibilities**. The policy would be a public document and would address the following areas: how investee companies will be monitored; the policy for requiring investee companies' compliance with the Combined Code; the policy for meeting with an investee company's board and senior management; how any conflicts of interest will be dealt with; the strategy on intervention; indication of when and how further action may be taken; and the policy on voting.

They also recommend that institutional investors should **monitor performance**. Monitoring performance should be a regular process, clearly communicable and checked periodically for its effectiveness. It would include reviewing annual reports and accounts, circulars and resolutions; and attending company meetings. In particular, institutional shareholders should try to satisfy themselves that the investee company's board and sub-committee structures are effective; that independent directors provide adequate oversight; and maintain a clear audit trail of their meetings and of votes cast on company resolutions, in particular contentious issues. The ISC states that these actions should help institutional investors 'to identify problems at an early stage and minimize any loss of shareholder value'.

The ISC advocates that institutional investors **intervene when necessary** and such intervention may occur when they have concerns about a range of issues including the company's strategy; its operational performance; its acquisition/disposal strategy; independent directors failing to hold executive management properly to account; internal controls failing; inadequate succession planning; an unjustifiable failure to comply with the Combined Code; inappropriate remuneration packages; and the company's approach to corporate social responsibility. Boards should be given the chance to respond constructively but if they do not, then the institutional investors may choose to escalate their action through a range of ways including intervening jointly with other institutions on particular issues, making a public statement in advance of the company's general meeting, or requisitioning an extraordinary general meeting possibly to change the boards. Finally, institutional investors should **evaluate and report** on the outcomes of their shareholder activism.

As might be inferred from its content, the ISC statement is aimed at significantly enhancing 'how effectively institutional shareholders discharge their responsibilities in relation to the companies in which they invest'. It is a milestone in the encouragement of institutional shareholder activism in the UK.

The ISC published a review of their 2002 Statement of Principles on the responsibilities of institutional shareholders and their agents, in September 2005. The review monitored

the progress of the statement for the two years since its launch in 2002 and concluded that there had been a general increase in the level of engagement of institutional investors with their investee companies. The Statement of Principles issued in 2002 has stayed the same but with two modifications: the word 'activism' has been replaced with 'engagement' with this change being 'to emphasise the importance now attached by institutional investors to developing a high quality all-round relationship with the companies in which they invest'; and given that it is a listing requirement that companies must comply with the Combined Code (2003) or explain why they do not, there is no need for institutional investors to state in their policy that they require investee companies to do this.

Institutional investors' relationship with investee companies

Corporate governance may be used as a tool for extracting value for shareholders from under performing, under-valued companies. This approach has been very successful for Lens Inc., CalPERS, Hermes, and Active Value Advisors, to name but a few. By targeting companies which are underperforming in one of the main market indices, and analysing those companies' corporate governance practices, improvements can be made which unlock the hidden value. These improvements often include replacing poorly performing directors and ensuring that the companies comply with perceived best practice in corporate governance.

Corporate governance may also be used as a key to help restore investor confidence in markets which have experienced financial crises. We have seen this happening in the last few years in Malaysia, Japan, and Russia, for example. In these countries, as in a number of other countries that have similarly been affected by a lack of investor confidence, particularly overseas investor confidence, new or improved corporate governance practices have been introduced. Key features of these changes include measures to try to improve investor confidence by improving transparency and accountability in these markets.

Tools of corporate governance

(i) One-to-one meetings

The meetings between institutional investors and companies are extremely important as a means of communication between the two parties. This is one clear example of the way that individual investors are at a disadvantage to institutional investors as corporate management will usually only arrange such meetings with large investors who are overwhelmingly institutional investors.

A company will usually arrange to meet with its largest institutional investors on a one-to-one basis during the course of the year. The meetings tend to be at the highest level and usually involve individual key members of the board in a meeting once, or

maybe twice, a week. Their 'target' institutional investor audience would include large shareholders (say the top 30) and brokers' analysts (say the top 10), and any large investors who are underweight or selling their shares. In addition, they would tend to phone an institutional investor if they hadn't seen them in the last year to eighteen months. Meetings are often followed up with phone calls by the firm to the institutional investor to ensure that everything has been discussed.

The issues which are most discussed at these meetings between firms and their large institutional investors are areas of the firm's strategy and how the firm is planning to achieve its objectives, whether objectives are being met, the quality of the management, etc. Institutional investors are seen as 'important for the way the business is managed', and their views may be fed back to the board in the planning process, and incorporated, as appropriate, in an annual strategy paper. They are seen as having a collective influence, with management paying most attention to the commonality of institutional investors' views in meetings over time. The firms want to ensure that institutional investors understand the business and its strategy so that the value of the business is fully recognized.

As a way of saying 'well done', Hemes sent letters to various companies in 2005 stating when they found their annual report particularly informative and useful in terms of various areas, for example directors enumeration and risk management.

(ii) Voting

The right to vote which is attached to voting shares (as opposed to non-voting shares) is a basic prerogative of share ownership, and is particularly important given the division of ownership (shareholders) and control (directors) in the modern corporation. The right to vote can be seen as fundamental for some element of control by shareholders.

The institutional investors can register their views by postal voting, or, is many companies the facility to vote electronically is now available. Most of the large institutional investors now have a policy of trying to vote on all issues which may be raised at their investee company's AGM. Some may vote directly on all resolutions, others may appoint a proxy (which may be a board member). Generally an institutional investor will try to sort out any contentious issues with management 'behind the scenes', however if this fails, then they may abstain from voting on a particular issue (rather than voting with incumbent management as they generally would) or they may actually vote against a resolution. In this case they would generally inform the firm of their intention to vote against. It tends to be corporate governance issues that are the most contentious, particularly directors' remuneration and lengths of contract.

The high level of institutional share ownership in the UK has been discussed above. Looking back at the Cadbury Report (1992), this states 'Given the weight of their votes, the way in which institutional investors use their power . . . is of fundamental importance', and encourages institutional investors to 'make positive use of their voting rights and disclose their policies on voting'.

A number of similar statements can be found in the guidelines issued by various institutional investor representative groups. For example, the two main groups representing institutional investors in the UK, the NAPF and the ABI, both advocate voting by

institutional investors. NAPF (1995) refers to 'the powerful vote' and 'encourage – as a matter of best practice – the regular exercise of proxy votes by pension funds'; whilst ABI recommends that 'large shareholders should vote wherever possible and support boards of directors unless they have good reason for doing otherwise'. In 1999 the ABI and NAPF issued some joint guidance on responsible voting in which they emphasized the importance of voting and advocated that voting should be done in a considered fashion rather than 'box ticking', that it could contribute to effective corporate governance, and that it could be seen as an integral part of the investment management function.

So, it would seem that the main institutional investor representative groups in the UK are in agreement that votes should be exercised on a regular basis in an informed manner.

There have been a number of efforts to try to ensure that voting levels do improve. These include the NAPF Report of the Committee of Inquiry into UK Vote Execution (1999). The report identified various impediments to voting, a major one being the cumbersome and outdated paper-based system. As a result of this a number of projects were established to try to find a suitable electronic voting system to make voting easier and the process more efficient. The NAPF report additionally identified a number of other areas of concern including a 'lack of auditability or adequate confirmatory procedure in the voting system' and communication problems between the pension funds, fund managers, custodians, registrars, and companies. It recommended that regular considered voting should be regarded as a fiduciary responsibility; voting policy ought to be specifically covered by agreement; the UK's voting system should be modernized; companies themselves should actively encourage voting; member associations should offer help and guidance; registrars should support electronic voting arrangements; voting in the context of stock lending should be re-examined; and custodians should actively assist in the voting process.

The Shareholder Voting Working Group (SVWG) was established in 1999, under the chairmanship of Terry Pearson, as an industry-wide body to address the issue of improving the voting process in the UK. The SVWG has subsequently been chaired by Paul Myners, the current chair, and has issued several reports on the impediments to voting UK shares. Its report in November 2005 highlighted that UK voting levels do seem to be increasing; that the voting system has become more automated with the vast majority of FTSE 100 companies now facilitating electronic voting and the expectation that all the FTSE 100 companies will in 2006; that the audit trail of the voting process has also improved; that final decisions on contentious voting issues are taken at a senior level; and that various recommendations relating to a company's AGM, such as that quoted companies should disclose on a website the results of polls and votes for and against at general meetings and enhancements to the rights of proxy voters, have been included in the Company Law Reform Bill. The potential problems associated with votes that are lent to other investors (stocklending), including shares not being voted at all, or being in a way that would be against the wishes of the original lender of the stock, are also highlighted.

Voting levels by institutional investors in the UK have gradually begun to increase in recent years, with voting levels in the FTSE 100 companies rising to around 58% during 2004 and 2005 according to manifest (2005). Institutional investors recognize

that unless voting levels increase across their investee companies in the next couple of years, the government may make voting mandatory. Whilst the question of mandatory voting has been fairly widely discussed in the UK, there is no real consensus on this issue. However, there is undoubtedly a sense that institutional investors should have a more active involvement, especially in areas of corporate governance such as voting, and, in the course of time, if voting levels do not improve, then voting may well become mandatory. There is also a concern to try to ensure that individual shareholders who hold shares through nominees and not directly, do not lose their right to vote – this is another dimension of institutional investor power and influence.

The situation in continental Europe is rather different as the shareholder structure in many European countries differs quite significantly from that in the UK. For example, large banks and corporations tend to dominate German and French companies, whilst Italian companies tend to be dominated by non-financial holding companies and families. However, the report of the CEPS working party set up to give policy directions on the future of corporate governance in Europe stated 'Shareholders should be given the responsibility to exercise their voting rights in an informed and independent manner. This activity should also be adapted to the growing internationalization of shareholding and not be limited to national borders'. This seems to indicate that whatever the shareholding structure in a particular country, the vote is seen as being of importance, and once again informed voting is emphasized. It is also interesting to note the reference to the internationalization of shareholdings and the implication that cross-border holdings should be voted.

In 2002 the EU High Level Group of Company Law Experts, chaired by Jeap winter, emphasized the importance of facilitating voting by electronic and other means, and also of enabling cross-border voting. The recommendations of this group fed into the EU Communication 'Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward'. Approximately a third of the share capital of EU listed companies in any given country is held by non-residents. Non-residents may office a number of obstacles when trying to exercise their shareholder rights such as lack of sufficient information being received in a timely manner, share blocking, and difficulties in voting cross-border shares. In the context of shareholder rights, two main objectives were identified: (i) 'to strengthen shareholder rights and third party protection, with a proper distinction between categories of companies', and (ii) 'to foster efficiency and competitiveness of business, with special attention to some specific cross-border issues'. In practice this led to the issue in January 2006 of a Directive on Shareholders' Rights which made the following proposals to enhance shareholders rights:

- General meetings should be convened with at least one month's notice. All relevant information should be available on that date at the latest, and posted on the issuer's website. The meeting notice should contain all necessary information.
- Share blocking should be abolished and replaced by a record date which should be set no earlier than 30 days before the meeting.
- The right to ask questions should be accessible to non-residents. The maximum shareholding thresholds to benefit from the right to table resolutions should not

exceed 5%, in order to open this right to a greater number of shareholders while preserving the good order of general meetings.

- Proxy voting should not be subject to excessive administrative requirements, nor should it be unduly restricted. Shareholders should have a choice of methods for distance voting.
- Voting results should be available to all shareholders and posted on the issuer's website.

Like the UK, the US stock market is dominated by institutional investors. One significant difference to the UK though is that private pension funds are mandated to vote by the Department of Labor's (DOL) regulations governing proxy voting by Employee Retirement Income Security Act (ERISA) funds. ERISA was enacted in 1974 and established federal fiduciary standards for private pension funds. The fiduciary duty is deemed to encompass voting. The DOL has, especially in more recent years, been fairly proactive in monitoring compliance with ERISA, and in offering interpretive advice on it. Early in 1994 Olena Berg, Assistant Secretary for Pension and Welfare Benefits, clarified the issue of global voting by stating that '*voting foreign proxies should be treated the same way as voting domestic proxies*'. However, it was recognized that voting overseas proxies can be an expensive business and it is advised that fiduciaries look at possible difficulties of voting a particular stock *before* purchasing it and also evaluate the cost of voting the shares against the potential value to the plan of voting the shares. Combined with the dramatic growth in the level of US institutional investors' holdings of overseas equities, this pronouncement can also be expected to have a significant effect on the attitude towards voting in the overseas countries in which US institutional investors hold equities.

ERISA does not apply to public pension funds but the major public pension funds tend to vote their own shares or instruct their managers how to vote. Funds such as the California Public Employees' Retirement System (CalPERS), the New York City Employees' Retirement System (NYCERS), and the State of Wisconsin Investment Board (SWIB) all have a policy of voting all their shares. CalPERS, the US's largest pension fund and the third largest in the world, makes available its voting actions on its website.

In the Australian context the Bosch Committee (1993) stated that institutional investors should 'take an active interest in the governance of their company' and commented that shareholders in general should make 'a sufficient analysis to vote in an informed manner on all issues raised at general meetings'. Stephen Smith, Chairman of the Parliamentary Joint Committee on Corporations and Securities, argued that 'institutional investors have a clear moral, if not legal, obligation to examine each proposal and decide how they will best exercise their voting rights'. In its 1995 guidelines, the Australian Investment Managers' Association recommends that 'voting rights are a valuable asset of the investor and should be managed with the same care and diligence as any other asset', and urges that 'institutions should support boards by positive use of their voting power unless they have good reasons for doing otherwise'.

A survey of institutional investors carried out by the ICGN in 2001, found that most institutional investors state that they try to exercise their overseas proxies but there may be problems in trying to do so. Problems that may be encountered when trying to vote cross-border include the following. Timing problems whereby just a couple of weeks'

notice of the agenda items to be voted on at the companies' annual general meeting may be given, making for a very tight deadline. Information relating to agenda items being insufficient and/or in a foreign language making detailed analysis of items very difficult in the available timescale. The blocking or depositing of shares which means that shares have to be deposited with a central depository, public notary, or depositary named by the company, and so cannot be traded for a period of time before the company's annual general meeting (usually between five and eight days). Finally, voting procedures or methods may be problematic in cross-border voting, for example, having to physically attend the annual general meeting to vote rather than being able to send in votes by post or other appropriate means. Recent developments in a number of countries including various EU countries have gone some why to address a number of these issues.

However, there remain a number of barriers to the effective exercise of voice by means of voting. It is, though, a powerful and public means of exercising voice. We are likely to see increased voting levels over time as there is both increasing pressure from institutional investors on companies to try to ensure a more efficient and effective voting system, and pressure from governments on institutional investors for more institutional investors to vote regularly. If institutional investor voting levels do not increase, then the UK government may legislate so that voting would become mandatory, but this is something which both the government and institutional investors would prefer not to happen as it is felt that this might lead to mere 'box ticking' rather than to considered voting.

(iii) Focus lists

A number of institutional investors have established 'focus lists' whereby they target underperforming companies and include them on a list of companies which have underperformed a main index, such as Standard and Poor's. Underperforming the index would be a first point of identification, other factors would include not responding appropriately to the institutional investor's enquiries regarding underperformance, and not taking account of the institutional investor's views. After being put on the focus list, the companies receive the, often unwanted, attention of the institutional investors who may seek to change various directors on the board.

(iv) Corporate governance rating systems

With the increasing emphasis on corporate governance across the globe, it is perhaps not surprising that a number of corporate governance rating systems have been developed. Examples of such firms which have developed corporate governance rating systems are Deminor, Standard, and Poor's, and Governance Metrics International (GMI). The rating systems cover several markets, for example, Deminor has tended to concentrate on European companies whilst Standard and Poor's have used their corporate governance rating system in quite different markets, for example, Russia. GMI ratings cover a range of countries including the US, various countries in the Asia-Pacific region and Europe. These corporate governance rating systems should be of benefit to investors, both potential and those presently invested, and to the companies themselves.

In turn, the ratings will also be useful to governments in identifying perceived levels of corporate governance in their country compared to other countries in their region, or outside it, whose companies may be competing for limited foreign investment. In emerging market countries in particular, those companies with a corporate governance infrastructure will, *ceteris paribus*, be less subject to cronyism and its attendant effects on corporate wealth. These companies would tend to be more transparent and accountable, and hence more attractive to foreign investors.

A corporate governance rating could be a powerful indicator of the extent to which a company currently is adding, or has the potential to add in the future, shareholder value. This is because a company with good corporate governance is generally perceived as more attractive to investors than one without. Good corporate governance should, for example, indicate a board that is prepared to participate actively in dialogue with its shareholders, ensuring the effective exercise of voice (Hirschman 1970) thus enabling investors to articulate their interests.

An appropriate approach for a corporate governance rating system is to first have a rating of the corporate governance in a given country. For example, how transparent are accounting and reporting practices generally in the country; are there existing corporate governance practices in place; is there a code of best practice; to what extent is that code complied with; and what sanctions are there against companies which do not comply? Having set the scene in any given country, the individual company can then be given a corporate governance rating. With regard to the individual company, the ratings would generally be based on the company's approach to the rights of shareholders; the presence of independent non-executive (outside) directors; the effectiveness of the board; and the accountability and transparency of the company. Corporate governance rankings of companies in, for example, the banking sector can be assessed both within a country and also across countries, providing a valuable additional indicator/comparator benchmark for investors.

Overall, corporate governance rating systems should provide a useful indication of the corporate governance environment in specific countries, and in individual companies within those countries. Such systems will provide a useful benchmark for the majority of investors who identify good corporate governance with a well-run and well-managed company and investors will increasingly take into account companies' governance profiles in investment decisions.

Corporate governance and corporate performance

Is there a link between corporate governance and corporate performance? Whilst there have been many studies carried out to determine whether there is a link between corporate governance and corporate performance, the evidence appears to be fairly mixed.

One of the earlier and much-quoted studies is that of Nesbitt (1994). Nesbitt reported positive long-term stock price returns to firms targeted by CalPERS. Nesbitt's later studies show similar findings. Subsequently, Millstein and MacAvoy (1998) studied 154 large

publicly traded US corporations over a five-year period and found that corporations with active and independent boards appear to have performed much better in the 1990s than those with passive, non-independent boards. However, the work of Dalton, Daily, Ellstrand, and Johnson (1998) showed that board composition had virtually no effect on firm performance, and that there was no relationship between leadership structure (CEO/Chairman) and firm performance. Patterson (2000) of the Conference Board produced a comprehensive review of the literature relating to the link between corporate governance and performance and states that the survey does not present conclusive evidence of such a link.

Whilst the evidence seems to be quite mixed, there does appear to be a widely held perception that corporate governance can make a difference to the bottom line. The findings of a survey by McKinsey (2002) found that the majority of investors would be prepared to pay a premium to invest in a company with good corporate governance. The survey states that ‘good’ governance in relation to board practices includes a majority of outside directors who are truly independent, significant director stock ownership and stock-based compensation, formal director evaluations, and good responsiveness to shareholder requests for governance information. The findings indicate that investors would pay 11% more for the shares of a well-governed Canadian company, 12% more for the shares of a well-governed UK company, and 14% more for the shares of a well-governed US company, compared to shares of a company with similar financial performance but poorer governance practices. The premiums rise to 16% for a well-governed Italian company, 21% for a Japanese company, 24% for a Brazilian company, 38% for a Russian company and, at the top of the scale with the highest premium for good governance, 41% for a well-governed Moroccan company. It is therefore the investor’s perception and belief that corporate governance is important and that belief leads to the willingness to pay a premium for good corporate governance.

Some of the significant papers in recent years which have found evidence of a positive link include Gompers et al. (2003) and Deutsche Bank (2004a and 2004b). Gompers et al. (2003) examined the ways in which shareholder rights vary across firms. They constructed a ‘Governance Index’ to proxy for the level of shareholder rights in approximately 1500 large firms during the 1990s. An investment strategy that bought firms in the lowest decile of the index (strongest rights) and sold firms in the highest decile of the index (weakest rights) would have earned abnormal returns of 8.5% per year during the sample period. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. Deutsche Bank AG (2004a and 2004b) explored the implications of corporate governance for portfolio management and concluded that corporate governance standards are an important component of equity risk. Their analysis also showed that for South Africa, Eastern Europe, and the Middle East, the performance differential favours those companies with stronger corporate governance.

Hermes (2005) provided a succinct summary of academic and practitioner research in this area, splitting it into three categories: opinion-based research, such as McKinsey (2002); focus list research and performance of shareholder engagement funds (such as ‘the CalPERS effect’, on which there were various studies such as Nesbitt (1994)); and finally governance ranking research (such as Deutsche Bank, 2004). Hermes concludes

their review of the literature by stating that they recognize that a number of the authors of the various studies cited in the review have mentioned that there is further empirical work needed on the issue of causation but Hermes states: 'nevertheless, we consider there to be sufficient evidence in support of our view that good corporate governance improves the long-term performance of companies'.

In sum the evidence, both academic and practitioner, points on balance towards the view that good corporate governance helps realize value and create competitive advantage, this is more of an intuitive feeling as the studies are trying to single out corporate governance variables that may affect performance and that it is very difficult to do. However, shareholder activism is the key to ensuring good corporate governance and without this there is less accountability and transparency, and hence more opportunity for management to engage in activities which may have a negative effect on the bottom line.

Conclusions

In this chapter the extent of institutional share ownership, and hence the growth of institutions' power and influence, has been examined. The chapter highlights the emphasis that is increasingly placed on the role of institutional investors in corporate governance in a global context. The tools of governance for institutional investors include one-to-one meetings, voting, the use of focus lists, and the use of rating systems, are discussed.

We have seen how, in the UK and the US, institutional investors have become very important over the last thirty years as their share ownership has increased and they have become more active in their ownership role. Institutional investors tend to have a ***fiduciary responsibility***, this is the responsibility to act in the best interests of a third party (generally the beneficial, or ultimate owners of the shares). Until recently this responsibility has tended to concentrate on ensuring that they invest in companies that are not only profitable but which will continue to have a growing trend of profits. Whilst this remains the case, governments and pressure groups have raised the question of how these profits are achieved. We now see institutional investors being much more concerned about the internal governance of the company and also the company's relationship with other stakeholder groups. The growth of institutional investor interest in socially responsible investment is the subject of a separate chapter.

SUMMARY

- Institutional investors such as large pension funds, insurance companies, and mutual funds, have become the largest shareholders in many countries, having significant shareholdings in the companies in which they invest.

- The relationship between institutional investors and their investee companies is very important. Institutional investors can have a powerful 'voice' in their investee companies.
- The 'tools' of governance include one-to-one meetings, voting, focus lists, and rating systems.
- The evidence as to whether 'good' corporate governance impacts on corporate performance is rather mixed but, looking at it another way, good governance can help to ensure that companies do not fail. Also, a company with good corporate governance is more likely to attract external capital flows than one without.

Example: Kingfisher plc

This is an example of a company which engaged in constructive dialogue with its institutional shareholders and changed certain aspects of its directors' remuneration packages after criticism from some of its institutional shareholders.

In the first half of 2002, Kingfisher plc received a number of adverse comments from some of its large institutional investors about some aspects of its directors' remuneration packages which were seen as overly generous. Kingfisher responded by discussing the terms of the directors' remuneration packages with its institutional investors and also with two institutional investor representative bodies, the National Association of Pension Funds and the Association of British Insurers.

A compromise was reached and Kingfisher revised the terms of the packages agreeing to introduce tougher performance targets on the share options and also to reduce the amount of compensation paid in the event of loss of office, with payments limited to one year's salary.

This is a good example of both the influence of institutional investors and the usefulness of constructive dialogue between company and investors.

Kingfisher has continued to be committed to an active dialogue with its shareholders. There are regular meetings between investors and managements and all non-executive directors are available for meetings with institutional shareholders.

Example: Xerox Corporation

This is an example from the USA of the use of a focus list by an institutional investor to highlight poor corporate governance in Xerox Corporation.

Xerox Corporation had shown poor performance in recent years. The Securities Exchange Commission (SEC) fined the company and forced it to restate earnings for the years 1997 to 2000. CalPERS (the Californian Public Employees' Retirement System) is one of the largest and most influential pension funds in the US and is active in pursuing good corporate governance in its investee companies. It included Xerox on its 2003 corporate governance focus list of poorly performing companies. The main reason for Xerox's inclusion was that it retained a board which consisted of the same board members as were present when Xerox was experiencing financial problems. This appeared to be affecting investor confidence in the company as the same directors remained on the board and also the company had combined the roles of Chairman/CEO. CalPERS would have liked to have seen three

more independent directors on the board, and believed that the audit, remuneration, and nomination committees should comprise totally independent directors. The roles of Chair and CEO should be split. Xerox initially disappointed by appointing only one new independent director although it agreed to adopt a new charter to provide for key board committees to be comprised totally of independent directors, so CalPERS' action of including Xerox on the focus list seems to have had some positive effects. Subsequently Xerox appointed five new directors in 2004 and 2005 although it has retained a council chair/CEO post.

Mini case study: Premier Farnell

This is a good example of institutional investor activism in action. It illustrates the fact that institutional investors are prepared to take a public stance when they feel that their investee company is about to take an inappropriate course of action that may be damaging to shareholder value. It is particularly interesting as one of the earliest examples of corporate governance activism in the UK.

In February 1996 Farnell Electronics, a UK-based company, made a bid for fellow electronic components distributor, Premier Industrial Corporation of the US. The bid was for £1.1 billion and there was an immediate outcry from some of Farnell's large institutional shareholders, who feared that the company was paying too much to acquire Premier Industrial.

Some of the institutional investors took the unusual step of identifying themselves publicly as dissenting on the terms of the bid. Standard Life was an early opponent of the deal, issuing a statement which underlined the dilution to earnings per share (eps) and the risk it felt that Farnell was taking by having so much debt to pay for the deal.

However, the Farnell team managed to talk around many of the institutional investors – although not Standard Life – by making more than sixty institutional presentations to try to convince the institutional investors of the merits of the deal. Some institutional investors took more convincing than others and had to be visited twice or even three times in some cases!

At the Extraordinary General Meeting (EGM) the resolution was passed in Farnell's favour with an exceptionally high level of shares being voted (77%). Standard Life sold its shareholding in Farnell. In subsequent years it seemed that Standard Life's stance had been correct as Farnell experienced problems and saw a drop in its share price of 41% in 1997 alone.

In recent years Premier Farnell has shown a fluctuating performance with earnings per share of 17 p in 2001 down to 11.7 p in 2005.

QUESTIONS

The discussion questions below cover the key learning points of this chapter. Reading of some of the additional reference material will enhance the depth of the students' knowledge and understanding of these areas.

1. Why has the influence of institutional investors grown so much in recent years?
2. What role do you think that institutional investors should play in corporate governance?

3. To what extent is the internationalization of investment portfolios responsible for institutional investors increased interest in corporate governance?
4. What 'tools of governance' do institutional investors have at their disposal?
5. What evidence is there to show that 'good' corporate governance can improve corporate performance?
6. 'Institutional investors have a responsibility to vote the shares in their investee companies'. Critically discuss.

FT ARTICLE

Unhappy investors force change

Activism has become an investment strategy, say **John Authers** and **David Wighton**

As US boards of directors know to their discomfort, shareholder activism is back.

The past few weeks have seen a rash of companies acting to reform their corporate governance rules, or even to split up, under pressure from investors.

Shareholder activism is now regarded almost as its own separate and institutionalised asset class, with managers of mutual funds and less regulated hedge funds declaring it as a key strategy.

The latest company under attack is Sovereign Bancorp, which is facing mounting opposition to its proposed sale of a $2.4bn stake to Grupo Santander of Spain to fund the acquisition of Independence Community Bank.

On Friday, Franklin Mutual Advisers, a fund manager with a lengthy reputation for shareholder activism that has a 5 per cent stake in Sovereign, expressed "outrage" at the proposals that were among "the worst examples of management and board entrenchment and disdain for shareholder rights".

Unhappy shareholders also include Relational Advisors, a San Diego-based hedge fund that has been pressing for board changes.

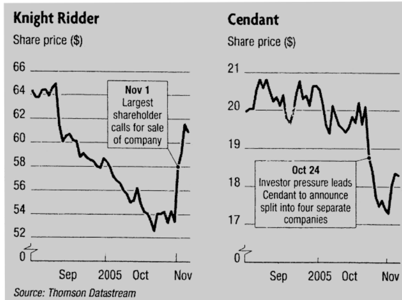
Peter Langerman, Franklin's chief executive, said that although there was nothing new about shareholder activism, there seemed to have been an increasing number of examples recently.

"This may be in part related to hedge funds. But there are also investors who didn't pursue this avenue before who are becoming more active. Twenty years ago, if you were unhappy with a company you walked away. That is no longer considered acceptable."

The list of companies that have fallen foul of shareholder activists is growing. Within the past month Cendant, a conglomerate whose assets include hotel chains, has announced that it would split itself into four. Henry Silverman, chief executive, blamed pressure from hedge funds.

Last week, shares in the Knight-Ridder newspaper chain surged after Private Capital Management, a Florida-based investment manager owned by the brokerage Legg Mason, called for the company to be sold. The company has a 19 per cent stake in Knight-Ridder.

And in Europe, shareholders last week forced Deutsche Börse to take on a new chief executive, after objections to the market's hostile bid for the London Stock Exchange.



Among fund managers "shareholder activism" is now regarded as a strategy in its own right, occupying a role between traditional "value" investment – buying into under-valued companies in the expectation that they will turn round – and private equity, which involves taking controlling stakes.

A shareholder activist strategy involves taking a stake of about 20 per cent – short of control but enough to force the board to pay attention – and then hoping to improve the share price.

Interest from investors is partly because of the lacklustre returns available from conventional investment strategies in the past six years. There is also growing statistical evidence that the strategy delivers strong performance.

According to Calpers, the largest institutional money manager in the US, the 113 companies to appear on their "focus list" for bad corporate governance from 1987 to 2003 have outperformed the S&P 500 index by 8.1 per cent in the five years after coming under pressure to reform themselves. In the five years before Calpers targeted them, they underperformed the index by an average of 97 per cent.

Financial Times Monday November 7 2005

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USEFUL WEBSITES

www.napf.co.uk The website of the National Association of Pension Funds offers topical articles on a range of corporate governance issues of particular relevance to UK pension funds.

www.abi.org.uk The website of the Association of British Insurers offers topical articles on a range of corporate governance issues of particular relevance to the UK's insurance industry.

www.dti.gov.uk The Department of Trade and Industry website offers a range of information including ministerial speeches and regulatory guidance.

http://calpers.ca.gov/ The website of the California Public Employees' Retirement System, a large pension fund active in corporate governance matters.

http://asp.thecorporatelibrary.net The website of the Corporate Library provides a useful and topical range of corporate governance items.

http://ewopa.eu.int/comm/internal-market/company The website of the European Union coring company law and corporate governance aspects.