EDITORIAL

The Role of the Institutional Investor in Corporate Governance

The relationship between boards of directors and their shareholders is an uneasy alliance, at best. An approach that has become fashionable, as shareholder activism has grown, is to expect institutional investors to act as watchdogs for all shareholders. A number of official reports, including the recent Hampel Report in the UK, have called for institutional investors to play a role in corporate governance. They should exercise their voting rights, the argument goes, police recalcitrant boards, act as mediator on behalf of all shareholders when necessary, and overall support the creation of shareholder value. In his recent, seminal book `The Emperor’s Nightingale — restoring the integrity of the corporation in the age of shareholder activism,' Bob Monks (a member of this journal’s editorial advisory board) emphasises the way that chief executives, particularly in companies listed in the United States, have seized power over their corporations: he also looks to institutional investors to redress the balance.

But the notion of shareholder activism needs to be approached rigorously. Uncritical exhortations to institutional investor involvement, found in some official reports, need to be more closely defined. The phrase ‘institutional investors’ is often used as though institutional investors were a homogeneous group. They are not. They differ significantly in size, in their purpose and, thus, their goals.

At one extreme lie the relationship investors — including Bob Monks, who leads the Lens Fund, itself a partner in the recently formed Focus Fund with the major UK pension fund Hermes, and Warren Buffet’s well known Hathaway Fund (see Corporate Governance Update in this issue). These investors tend to identify shares in which they see unrealised potential which could be released with their intervention. They take a significant stake in the target company, large enough to have access to management, to receive privileged information and to influence (and improve) management performance and release shareholder value. In some cases the stake will be large enough to qualify for a seat on the board.

At the other end of the scale are those mutual funds or unit trusts which have a purely short-term orientation, with fund managers rewarded by the performance of the fund — including its ability to raise its price and attract new investment, even to the extent of encouraging them to ‘churn’ their portfolios to maximise the unit price.

Between these extremes lies the bulk of institutional investment around the world. But these funds are spread between investment funds which own the shares as trustees for their subscribers, financial institutions which hold shares in their own right as well as in the names of their customers, and insurance companies which hold shares as part of the underlying securities to provide the cover for their life assurance, pension and other policy holders.

This array of different purposes affects the ability of the fund managers to vote their shares. It also influences the decision of whether or not to vote the shares and, if they do, on whose behalf and to what ends. It affects the extent to which it is in the interests of the fund managers ‘to vote with their feet’ (thus reducing their fund’s exposure to risk, taking a profit or avoiding a loss), as against retaining the investment in the portfolio for the longer term and accepting a role in the governance of the company, voting the shares and shouldering the attendant costs and the risks associated with being locked into the investment.

At the relationship investing end of the scale the issue is not in question: involvement
with management is their rationale. Similarly, at the other extreme, for the short-term maximiser involvement with management is the last thing he wants. But what of the rest? Pressure is on them for more involvement.

The institutional investor as mediator between shareholder and management

The potential for institutional investor involvement is certainly there. The case histories of institutional investor activism in governance are well known, as the directors of companies such as American Express, General Motors and IBM had cause to rue when dramatic board changes were forced on them by pressure from their institutional investors. The outcry at allegedly excessive director remuneration (the so-called ‘fat-cat’ issue) was also led by institutional investors.

The efforts of CalPERS, the California State Employees Pension Fund, in the United States; PIRC, the Pensions Investment Research Consultants, in the UK; and AIMA, the Australian Investment Managers Association, in Australia, are well known. For example, CalPERS has proposed a set of corporate governance bench-marks, including ten relatively strict definitions of ‘independence’ for outside directors.3

But that is not the end of the story. There are other unresolved issues. Questions are increasingly being asked about the governance and accountability of the institutional investors themselves. Frequently, they are found to be less accountable to their shareholders than the companies they purport to oversee. As the Roman writer Juvenal commented: *Quis custodiet ipsos custodes?* Who will guard the guards?4

Sir Adrian Cadbury (also a member of this journal’s editorial advisory board) commented recently that “the issues of power and accountability were raised at the outset in relation to corporate boards. They will increasingly be raised in the context of the growing power and relative lack of accountability of institutional investors. Their exercise of power over boards will only be seen as legitimate if it is open and reflects the views of those who have entrusted their money to them.”5

There is a need for a fundamental rethink of the role of the different types of institutional investor in corporate governance and of their accountability for shareholder activism. Indeed there is an urgent need for a study of the governance of institutional investors themselves. Key questions include: are institutional investors capable of involvement? Do they have the relevant knowledge and skills? What form should their involvement take? What are the legitimate boundaries? How transparent should they be to those they seek to govern? What should they be called on to disclose? Are they genuinely independent themselves? And to whom are they accountable?

Moreover, it does not follow that what is good for the institutional investor is also, automatically, good for the individual shareholder. Michael Smith, quoted recently in the Los Angeles Times,6 shows that individual shareholders generally do not gain by investing in companies that CalPERS has targeted, because the price of stocks changes as soon as the market finds out about the targeting – long before the individual can benefit. According to the Corporate Governance website,7 CalPERS itself does not invest more heavily in the companies they have targeted; and they do have the advance information.

There is another unresolved issue in expecting institutional investors to play a leading role in the governance oversight of companies. Inevitably the involved institutions will get closer to the management of the firms they target (after all that, essentially, is the lever for improved governance): but could that give them insider information, enabling them to buy on positive information and stop-loss on negative? Might not the relentless pursuit by stock exchanges around the world to ensure that price sensitive information is available to all shareholders equally, through accurate, consistent and immediate reporting, be open to question if some institutional investors have the inside track?

Improving the uneasy alliance

In the end of the day, relations between boards and shareholders are about trust. The shareholders have to trust the directors they have put in place to direct their company and oversee the well being of their investment. That is how company law sees it: directors are the stewards of the shareholders’ funds. They are to be trusted to put the shareholders’ interests before their own. Of course, bad rice may be found in any sack, so the shareholders appoint auditors to report that the directors’ report and accounts show a true and fair view. In recent times stock exchange listing rules call for further checks and balances such as audit committees and codes of good corporate governance practice. But the stewardship view puts every director in a position...
of trust. A position calling for honesty, integrity and candour as well as care, diligence and skill.

There is, of course, another view. In the modern financial world, in listed companies, the shareholders’ meeting does not nominate and elect the directors; nor does it appoint the auditors – voting at shareholder meetings has become a legal fiction. Management directs and governs the modern public company. In the words of Lord Caldecote, “executives are marking their own examination papers.” Moreover, directors cannot really be trusted to act objectively on behalf of all the shareholders. Directors are the agents of the shareholders, but being human and out to maximise their own utility, they will put their own interests first. This is the essential tenet of agency theory, which is currently the vogue in academic research of corporate governance as witnessed by the theoretical underpinning of many papers accepted for publication in this journal. This view justifies the costs of checks and balances seen as necessary to off-set the suboptimal behaviour of directors – greater transparency; widespread and more disclosure; genuinely independent directors; audit, remuneration and nomination committees of the board; separation of board chairman from chief executive; and institutional investor involvement in governance. From this standpoint sound governance requires the checks and balances which are needed because directors cannot be trusted to act in the interests of others.

So should directors be trusted? The reports in the press and the cases in the courts over the past decade and more demonstrate conclusively that some certainly cannot. But equally the majority have shown that they can. Throughout history people have put the interests of others alongside, even ahead, of their own. Maybe, sometime in the future, when social historians come to write the history of corporate governance, they will mark the present era as the point when that truth was rediscovered.

This is not to make a naïve call for less supervision of boards, nor for a return to the laissez-faire days of board level governance in the 1980s. But it is to make the point that the primary responsibility for good governance lies inside the board room, with the top management, not with people and systems imposed from the outside. It is really a matter of how the directors see their shareholders – are they sources of finance or partners in the enterprise?

Hong Kong provides an interesting vignette case. Nine out of ten companies listed there are family firms, often dominated by an owner-manager chairman and chief executive. Less than a controlling percentage of the voting shares are in public hands. How do these boards perceive their shareholders? Over the past decade there have been a parade of corporate governance debacles: for example – Carrian, which pursued a dramatic acquisition programme before being raided by the anti-corruption commission and collapsing; Ming Pao, where the chairman overlooked his previous criminal record when listing; and other companies in which the listed vehicle had less than arms length dealings with other family companies, or in which directors’ remuneration took the greater part of the total free cash flow. At first sight, such cases do support the view that directors can be expected to exploit their investors. But there are far more examples where they have not.

The question might be rephrased – are the shareholders seen as a faceless, financial resource: in which case the shareholders’ trust may well be limited and their need for governance checks and balances very real. Or are the shareholders seen as part of the family business: in which case, given the overseas Chinese belief in the importance of family, the shareholders can be seen as within the family circle: the owner manager being at the centre surrounded by concentric rings, first of the immediate family members, then those with interests in the business, and with the shareholders in the outer ring of this extended family. Now directors can be trusted to act with shareholders’ interests in mind. Shareholders can expect to be given the consideration and the respect their membership merits.

In other company law jurisdictions, in other business cultures, directors may see their shareholders in a different light. Given the scale and complexity of modern business, the relationship between the board and the shareholders is always likely to be an uneasy alliance: how much better for both if that alliance is rooted in trust.

Bob Tricker, Editor

Notes

Some of the material in this editorial appeared in the Company Secretary, Hong Kong Institute of Chartered Secretaries, May 1998


2. Robert Monks; The Emperor’s Nightingale – restoring the integrity of the corporation in the age of shareholder activism, 1998.
3. Although CalPERS has recently softened its proposals, turning the bench-marks into ‘guidelines’. See http://www.corpgov.net/news.html.

4. [Although this Latin tag is often quoted in corporate governance debates, few of the authors seem to know that Juvenal’s concern was not with governance issues, but with how to guard his wife while he was off fighting wars!]


10. [and nearly all the rest have a dominant shareholder or are part of another corporate group]