RESPONSIBLE OWNERSHIP, SHAREHOLDER VALUE AND THE NEW SHAREHOLDER ACTIVISM

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 297

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December 2004

This Working Paper forms part of the CBR Research Programme on Corporate Governance.

Abstract

In this paper we use interview data to explore the 'new shareholder activism' of mainstream UK institutional investors. We describe contemporary practices of corporate governance monitoring and engagement and how they vary across institutions, and explore the motivations behind them. Existing studies of shareholder activism mainly assume that it is motivated by a desire to maximise shareholder value, and we find some evidence both of this and of alternative political/moral motivations related to ideas of responsible ownership. We conclude, however, that in the current situation both these act primarily as rationalisations rather than as genuine motivators. The main driving force behind the new shareholder activism is the institutions' own profit maximisation and the need to position themselves against competitor institutions in the context of political and regulatory changes that have significantly changed the non-financial expectations of their clients.

Keywords: Corporate governance, institutional investors, shareholder value, stock market.

JEL codes: G3, G11, G30, G34

Acknowledgements

We would like to thank the ESRC and ESRC Centre for Business Research, who funded the research project on which this paper is mainly based, and the various investment professionals who gave their time to be interviewed. We would also like to thank Antony Marsden of PIRC and Han-Kyun Rho of Brunel University for their helpful contributions and the management and Ulrike Kranz and the staff of Citigate Dewe Rogerson, in particular Michael Berkeley, Marina Zacharova, Steffi Bartels, Nina Soon and Anita Lawton, who supported and facilitated the secondary research project on which this paper also draws.

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Introduction

In the last few years there has been a significant increase in the activism of UK institutional investors. Most of the large investors now question companies on their corporate governance policies and practices, vote against management and in many cases take their criticisms to the press. This new wave of shareholder activism appears to differ in both kind and extent from anything that has gone before, and also from contemporary American practice, and the question naturally arises as to what is driving it. Existing studies of shareholder activism assume almost without question that it is driven by a desire to maximise shareholder returns, and while this assumption might reasonably be challenged in the case of many self-proclaimed shareholder activists, whose social or political motivations are strongly in evidence, it would on the face of it seem natural here, where the activism extends across the mainstream institutions. The context in which the new activism has emerged is, however, highly politicised, and it could also be seen very naturally as a response to government calls for "responsible ownership", in which active shareholder oversight of corporate governance is presented as a moral and not merely an economic duty. In this paper we explore UK institutional investors' attitudes and activities with respect to the monitoring of corporate governance and active intervention in the companies in which they invest.

Our main source of data for the study is a series of in-depth interviews with 19 senior managers (chief investment officers, heads of UK or European equities, heads of research and senior fund managers) from eleven of the twenty largest UK asset management companies, as measured by funds under management. Six of these were subsidiaries of global investment banks, four were subsidiaries of life assurance companies and one was independent. The interviews, averaging 80 minutes, were carried out in the winter-spring of 2002-2003. The primary focus of the interviews was on the face-to-face meetings that take place on a regular basis between the investment institutions' fund managers and analysts and senior corporate management, but interviewees were encouraged to talk freely around a whole range of issues related to this, and corporate governance and activism consistently emerged as topics of discussion. This seems partly to have reflected the interviewees' perceptions of our own likely interests, as academics, at a time when these topics were being much debated in the press. It also reflected the fact that, with very rare exceptions, the meetings are not used to raise governance issues. In explaining what they are used for, interviewees naturally discussed also what they are not. To supplement this main data source we have also drawn on interview data from a separate, slightly later, study of the relationship between the corporate governance and investment activities of UK and European institutional investors. The interviews for this study were carried out in the summer of 2003 and covered nine senior fund managers and twelve heads of corporate governance from 20 large institutions. They were structured but open-ended and interviewees were again encouraged to talk freely about their own and their institutions' attitudes and concerns. With three exceptions (all from the main study) the interviews were recorded, transcribed and thematically coded using a two stage process, the first stage based on themes arising from our research questions and the second on categories emerging from the texts.

Using these data sources we look both at what institutional investors are doing by way of corporate governance monitoring and engagement and at their various justifications and apparent motivations for doing it. We find some predictable differences in both practice and attitudes between the more active investors, who have considerable freedom to buy and sell the shares of individual companies, and the more passive index fund or quantitative investors who do not. These differences are not always consistent, however, and to the extent that they are justified in either economic or political/moral terms, these justifications appear more as post-hoc rationalisations than as genuine motivators. Our main conclusion is that investor behaviour appears to be economically driven, but that the drivers have more to do with the competition between investing institutions than with the maximisation of shareholder value.

The New Shareholder Activism

Shareholder activism is not in itself a new phenomenon. There is a long history, especially in America, of individual activists and religious groups challenging corporations on specific social or moral issues. Beginning in the mid-1980s, these social activists were joined by two other much more powerful groups. Individual activists such as Robert A. G. Monks have acquired holdings in under-performing firms specifically to challenge incumbent boards and management (Rosenberg, 1999), and large public pension funds such as Calpers and TRIAA-CREF have used their significant voting power to bring pressure on companies to improve their corporate governance (Gillan & Starks, 1998, 2000; Useem, 1996).

Although Robert Monks has been an influential promoter of the ideas of shareholder activism, and has scored a number of major 'successes' in securing the removal of the boards of under-performing corporations (Rosenberg, 1999), his activities have not significantly changed the relationships between companies and their investors. Private investors with very large individual holdings in companies, often acquired in anticipation of a recovery or takeover bid, have long acted behind the scenes, and where necessary more publicly, to bring about the changes they thought necessary to secure their aims. Monks's activities have been more public, and have been carried out on the basis of lower shareholdings, and under the banner of shareholder activism, but underneath the rhetoric they have been not dissimilar to the activities of other turnaround investors.

The activism of the public pension funds, and more recently of trades union pension funds, has had a greater effect on company-shareholder relationships, but this too has been restricted in various ways. The pension funds have been very vocal in advancing the case for improved corporate governance and in publicly identifying companies whose governance needs improving, and they have been active both in sponsoring proxy proposals and in seeking to engage corporations to make the concessions that might forestall such proposals. While the largest funds can have very high individual shareholdings, however, they do not collectively dominate the market and have only been able to gain limited support for their proxy proposals, which under American law are advisory only (Gillan & Starks, 2000). Instances of effective shareholder activism remain relatively rare, and even after 20 years of activist pressure American corporations remain reluctant to communicate directly with their shareholders. Sociologist Michael Useem's (1996) account of a new era of "investor capitalism" now seems strongly overstated.

The phenomenon we explore in this paper is in some respects a further development from the established shareholder activism of the American public pension funds, but it is different in two important respects. First, it is being conducted by mainstream institutions, most of which are intermediaries, investing other people's money. One of the reasons for the limited effects of shareholder activism to date has been that it has been the preserve of self-managed pension funds, and has never been taken up by the retail and wholesale fund managers and insurance companies that between them dominate the market. The new shareholder activism, in contrast, is being pursued cross the board by mainstream institutional fund managers, most of which act for a range of clients. It is also embodied in the recommended practices of the cross-industry Institutional Shareholders Committee (Institutional Shareholders Committee, 2002).

Second, the phenomenon is primarily a UK one. Although the American activists had their British counterpart in Hermes, the UK post office and telecommunications pension fund, this was one investing institution only. Many countries, including Britain, have their individual activists ('gadflys' in the

American terminology) but institutional shareholder activism has until now been an essentially American phenomenon that has not impacted significantly on the British markets. The new shareholder activism, in contrast, has emerged in Britain and has not as yet impacted significantly on America.

Over the last five years the mainstream UK institutions, which have traditionally been non-interventionist and monitored only for trading information, have significantly increased both the resources they devote to corporate governance related activities and their active engagement with companies. Almost all the institutions now have senior managers responsible for corporate governance activities and many have built up substantial dedicated teams of corporate governance experts. Their more active approach is also evidenced by a rapid growth in opposition to company resolutions expressed both through voting (PIRC 2002, 2003) and, more recently, through the press. In early 2004, for example, after a series of highly publicised interventions, the growing tension between the increasingly vocal institutions and the boards of the companies in which they invest was reflected in reports of dinner meetings between representatives of the two sides, supposedly called by the companies in an attempt to make peace (Lewis, 2004).

In subsequent sections we shall look in more detail both at what this new shareholder activism involves and at what appears to motivate it. First, though, we shall briefly review the existing literature on the motivations for activism, beginning with the standard accounts of economic motivations.

Motivations for Shareholder Activism

Economic Motivations

Mainstream theories of Anglo-American corporate governance treat the relationship between shareholders and company managers as one between principals and agents (Jensen & Meckling, 1976; Fama, 1980; Eisenhardt, 1989). On the assumption that managers are, as rational utility maximisers, out to further their own interests, the central problem for shareholders becomes one of how to get the managers to act instead in their (the shareholders') interests (Shleifer & Vishny, 1997). Three possible mechanisms for achieving this are generally identified. One is the takeover market, or market for corporate control, which disciplines managers to act in line with shareholder interests or risk losing their jobs as a result of a hostile takeover. A second is incentive pay, which seeks to align the interests of managers with those of shareholders. The third is active monitoring and control of management decisions by shareholders, which seeks to replicate within a diversified ownership system the monitoring of management banks and other block shareholders (governments, family trusts, other corporates) in the more concentrated ownership systems found outside Britain and the USA.

Within the British context, the first two of these mechanisms are greatly in evidence. With its active stock market, diversified ownership and single class shares, and without the proliferation of poison pills and other anti-takeover devices that stymied the American takeover market in the 1980s and1990s, Britain has arguably the most active market for corporate control in the world (Black & Coffee, 1994; Black, 2000). Since Jensen and Murphy's influential *Harvard Business Review* article of 1990, highly geared incentive pay packages for chief executives have also become the norm in British as well as American companies, and while there is little evidence of these impacting significantly upon performance (see e.g. Barkema & Gomez-Mejia, 1998; Conyon et al, 2000; Tosi et al., 2000), and growing evidence of their manipulation by executives (Hallock, 1997; Core et al, 1999; Bertrand & Mullainathan, 2001), they are now a well established feature of the British corporate governance system.

Shareholder activism, in contrast, is a still a nascent phenomenon, and given the existence of alternative governance mechanisms, and in particular the freedom afforded by a liquid stock market to simply sell shares if things look bad, the conventional wisdom is that it cannot be financially justified (Pozen, 1994). All institutional investors engage in some monitoring of the companies in which they invest, analysing their financial reports and strategic statements and, in the case of the larger institutions, meeting with and questioning their senior executives. While some UK investors have long used such meetings to give their own views as well as to hear what the executives have to say, however, the indications are that they are used primarily as a basis for their buying and selling decisions (Holland, 1998; Jackson, 2001). Investors will indeed monitor and even meet with companies in which they do not currently invest as well as for those in which they do. The general consensus of the academic literature is that to go beyond this basic monitoring and invest resources in trying to control management by acting directly to influence the structure, processes or decisions of the board, is prohibitively expensive in relation to the potential returns (Bainbridge, 1995). Scholars have also pointed to the deterrent effect of the conflicts of interest arising from the multiple business relationships between financial institutions and business corporations (Black, 1990), and to the free-rider problem that arises as any institution engaging in activism bears the entire cost of its actions, while the benefits are distributed across all shareholders (Bainbridge, 1995). This makes it rational to leave activism to others rather than engaging in it oneself. In support of these theoretical arguments, the evidence from empirical studies of shareholder activism in the USA suggests that they have little or no effect on company performance (Black, 1998; Karpoff, 1998; Romano, 2001)

The literature cited above would seem to explain quite well why shareholder activism has not hitherto been a particularly widespread phenomenon. It also offers some possible explanations of why it may now be becoming more common, and of why it may be growing particularly in Britain.

First, it can be argued that the economic case against shareholder activism has been significantly weakened by recent developments. The evidence already noted that incentive pay is being manipulated by executives suggests that investors may benefit from a more active involvement in the determination of remuneration contracts. In Britain as in America, legal and regulatory changes have gradually increased the scope for shareholder involvement (Lannoo, 1999). In the last two decades the proportion of funds managed by the large institutional investors has also steadily increased, re-concentrating ownership, reducing the free-rider effect and making it harder for investors to deal with problems by simply selling (Hawley & Williams, 1997). In the American context, Useem (1996) has documented a growth of shareholder activism dating back to the late 1980s and has linked this with both the growing assets of the large pension funds, which have made it increasingly difficult for them to offload blocks of unwanted stock without destroying the market value of their remaining holdings, and the growing use of index funds, in which the option to sell is intentionally sacrificed in favour of a low cost base. Hawley and Williams (1997) have also observed that some forms of activism may have a spill-over effect from one company to another, so that engagement with a single company may improve returns not only from that company but also from others that act to prevent further engagements. This effectively leverages any lowering of the relative costs of activism.

Second, it can also be argued that although Britain has a more effective takeover market than the USA it also has more favourable conditions for shareholder activism, both on account of its legal structures, which place fewer formal constraints on the actions of institutional shareholders (Black, 1990; Black & Coffee, 1994) and on account of the relatively higher voting power of the large institutions. Share ownership of companies listed on the London stock exchange is significantly more concentrated than that of companies listed on the main American exchanges, and a much greater proportion of shares are held by institutions (Becht & Mayer, 2001). In Britain, moreover, these institutions tend to have delegated voting rights for all the shares they have under management (Black & Coffee, 1994; Stapledon, 2000). As we have already noted, direct communication between shareholders and management is also much more common in Britain (Black & Coffee, 1994).

Third, the opportunities for shareholder engagement in Britain have recently grown, as legislation has been introduced requiring companies to put an annual remuneration report to a shareholder vote. There is, moreover, a positive feedback effect as shareholder engagement has pushed companies to open themselves up to further engagement, for example by reducing executive contract to what is now a standard one year, which allows an annual vote on their reappointment.

Political and Moral Motivations

All the arguments reviewed so far assume that the primary motivation of institutional shareholder activism is to maximise shareholder returns, and existing studies of activism, not only in the extensive finance literature but also in law (e.g. Black & Coffee, 1994; Roe, 1994; Black, 1990, 1998), management (Davis & Thompson, 1994; Thompson & Davis, 1997; Ryan & Schneider, 2002) and sociology (Useem, 1996) almost all adopt this assumption without question. However Davis & Thompson (1994) make the point that the growth of shareholder activism in the 1980s, while economically motivated, was enabled by changes in the political climate. Romano (2001) goes further, arguing that while activism *should* be motivated by the maximisation of shareholder returns, some institutional agendas have in practice been distorted by political motivations.

The focus of Romano's critique was the claimed intervention by politicians on the CalPERS board in its investment and corporate governance policies, insisting on positions that were not, according to its professional staff, financially optimal (Romano, 2001: 226). The argument can be extended well beyond CalPERS, however. Many public pension funds, including but by no means restricted to the leading American activist funds, are quite open in adopting a social and ethical agenda and in rejecting the narrow economic rationalism that has characterised academic studies in shareholder activism. They wish to secure the best returns for their members, but they do not measure those returns solely in terms of money. They argue, quite rationally, that the pensioners of the future also have an interest, perhaps a significant interest, in such things as environmental sustainability and ethically and socially responsible capitalism.

These considerations may be particularly apposite in the present context. Since it came to power in 1997 the Blair government has consistently argued that institutional investors should act as 'responsible owners' by holding the companies in which they invest to account, not only for their financial performance but also for their corporate governance and social and ethical responsibility. Following the stock market collapse of 2000-1, the publication of the Myners report on institutional investment in 2001, and the post-crash scandals at Enron, Tyco, Worldcom and Marconi, these arguments have been put with growing force. As well as being set out in ministerial speeches and papers (e.g. DTI, 1999; Hewitt, 2002, 2003), these arguments were consistently transmitted through the medium of the press. Especially from 2001 onwards, the broadsheet UK papers all carried regular stories quoting unnamed government "sources" or "officials" and conveying the government viewpoint that companies needed to become more responsible and that responsible ownership, manifest through institutional investor activism, was the best way to achieve this (see for example Morgan, 2003: many more similar sources could be quoted). The Myners report also led to specific demands that pension funds take a more active oversight of the companies in which their funds are invested. Following publication of the report, private pension fund trustees were required by government to formulate corporate governance policies and this requirement was subsequently extended to local authorities. The Myners report was also strongly critical of the commercial investment houses that manage the pension funds' assets both for their fee basis (and the stock churning that this encouraged) and for their lack of accountability, raising the prospect of regulation and encouraging them to toe the government line (Myners, 2001).

A particular feature of corporate governance debates in this period was a media focus on the moral aspects of 'fat cat' pay. Over the last fifteen years, executive remuneration levels in Britain have grown dramatically. This has been justified economically in terms of shareholder value, higher pay levels being deemed necessary to secure and retain the best managers in an internationally competitive environment (American pay levels being greatly higher than British ones) and generous incentive schemes being introduced to align management and shareholder interests. For much of the British public, however, who are largely unaware of the comparable or greater pay levels of other elite groups (investment bankers, lawyers, accountants, surgeons etc.) the levels now being reached seem morally obscene, and the media have naturally played to this. Their concern has been enhanced, moreover, by a growing association of fat cat pay with rewards for failure, as executive pay packets have been apparently unaffected by the collapse of the stock market and the job losses and pension shortfalls that have accompanied this, and as sacked chief executives have been seen to walk away with multi-million pound severance payments. In response to this concern, the government acted by stressing the accountability of companies to their shareholders and facilitating this accountability by requiring the submission of remuneration reports to an annual vote at the AGM (HMSO, 2002). This immediately opened up a new opportunity for active shareholder engagement, on an issue in which shareholder value considerations were inevitably coloured by moral concerns.

Responsible Ownership

One other feature of the British government's encouragement of more active shareholding that deserves explicit comment is the use of the language, derived from CalPERS and the American shareholder activist movement, of responsible ownership.

Ever since Berle and Means's classic text of the 1930s (Berle & Means, 1932 and see also Berle, 1932) the core problem of corporate governance in a diversified ownership system has been described in the language of the separation of ownership and control, with the shareholders cast as the 'owners' of the firm. Over the last twenty years it has become commonplace for not only the press and public but also corporate executives in both Britain and the USA to describe shareholders as the owners of the firms they manage. Even under American law, however, the corporation, as a legal person, cannot be 'owned' by anyone, and in the British system shareholders are explicitly defined as 'members' of a company and not as owners (see e.g. Kay and Silberston, 1995; Parkinson, 2000; and for a general review of the concept of ownership in this context, Learmount & Roberts, 2002). Moreover contemporary 'nexus of contracts' theories of the firm, including those underlying the principal-agent theory of shareholder-manager relationships, clearly distinguish the ownership of capital from ownership of the company, which in these theories is an "irrelevant concept" (Fama, 1980: 290; and see also Hart & Moore, 1990).

In the case of institutional investors, the concept of ownership is, on the face of it, even less appropriate than it is for individuals. Many of the shares 'held' by institutions are not owned by them but by their clients, and many of the larger clients, as well as the financial institutions that hold shares in their own names, are investing for other beneficiaries, such as pension fund members, insurance policy holders or individual unit trust investors. The institutions are, in effect, money managers, who happen to hold shares on their clients' behalf, and not the beneficiary owners of shares. This situation, which is itself a manifestation of a separation of ownership from control, is accentuated by the relatively short investment time horizons of some of the more active fund managers.

Until recently, popular use of the language of ownership has suited the institutions well. It has encouraged the view that the job of corporate management is to maximise shareholder returns, which is evidently in their interests, while leaving them free to behave as money managers, without any of the burdens that ownership might be thought to impose. The new emphasis on responsible ownership changes all this, or at least threatens to change it, by placing part of the onus for making companies accountable and for ensuring that they are generally well governed on the investing institutions.

The New Shareholder Activism in Practice

Whereas traditional kinds of shareholder activism have been reasonably well documented (e.g. Useem, 1996; Rosenberg, 1999; Rho, 2002), the new shareholder activism of mainstream UK institutional investors has not. In this section we shall draw on our interviews to describe the institutions' administrative approaches to corporate governance and the governance activities, including activist activities, in which they engage. We shall begin by distinguishing between two broad categories of investor, those taking a relatively active approach to fund management (not to be confused with an *activist* approach to governance issues), and those taking a more passive approach.

The Institutions

The institutions we researched included wholesale and retail asset management companies, pension funds and the investment arms of life assurance companies. They had a wide range of client types and product offerings and a correspondingly wide range of investment strategies and approaches to corporate governance and engagement but could be roughly split into two main groups, which we shall call "active" and "passive" investors.

Active investors are mainly the fund management arms of global investment banks. Many have ranges of retail investment products, but their main business lies in managing the financial assets of pension funds, charities, local authorities and other wholesale clients. A significant proportion of their funds under management is actively invested in the stock market, with fund managers having considerable discretion as to the shares they hold. The extent of this discretion – in effect the amount of risk than can be taken in an attempt to outperform the index – varies from institution to institution and from fund to fund. The performance of individual funds and their managers is measured against benchmark indices, and constraints may be in place to prevent them straying too far from, say, a given sector weighting. The institutions also vary in the extent to which decisions are based on formal valuation models and, more generally, the extent to which they are taken by individuals or by the investing team as a whole. In general, however, fund managers are relatively free to buy and sell, and seek to generate returns for their clients by strategies of active trading. Many describe themselves as "traditional stock pickers", and many of the houses have a kind of macho, hero culture, self-consciously aggressive and dismissive of the 'second rate' fund managers to be found in the less active institutions.

> There are a lot of low quality fund management houses out there. Most [fund managers] are low life. They just aren't up to the job. And if [the corporates] do go to insurance companies as big shareholders, then they might as well have a meeting with my mum. She's probably got more intelligent things to say.

Passive investors are mainly the fund management arms of large life assurance companies. Although they may have retail and wholesale investment products, including in some cases actively managed funds, a large part of their business is managing the funds held by their parent companies. These tend to be managed either as index funds or as what some of their more active critics term "closet index" funds, meaning that although they trade actively they stay very close to the index, going overweight on some shares and underweight on others, but within very tight constraints. Also included in the passive investor category are a number of large self-managed pension funds, which are mainly index investors, and "quant" funds, which trade according to sophisticated computer programmes designed to outperform the index without any intervention from fund managers. Fund management in a passive firm is undeniably less glamorous, and less well paid, than in an active firm. The cultural model tends to be more sober and less dramatic, and the investment performance – after allowing for trading costs – rather better. From a passive perspective the stock-picking claims of the more active fund managers are a bit of a joke, not to be taken seriously and not backed up by results.

Not all institutions fit neatly into these two main groups. Some firms with a mixture of wholesale, retail and life assurance funds under management combine active and passive investment strategies and elements of the cultures associated with these. Even within the groups, moreover, there is considerable variety. In cultural terms, however, the difference between the active and passive investors we researched was very strong and could be sensed just on entering their offices. An active fund manager would be like a fish out of water in a passive firm and vice versa, and the rhetorical tones of the interviews in the two kinds of institution tended to be very different. Beneath the rhetoric, the practices described and the attitudes revealed were not so divergent, and most of the findings we shall report apply across the board, but there were some differences of emphasis and in what follows we shall adopt the terminology of active and passive investors to capture these.

Administrative Arrangements and Attitudes to Corporate Governance

One of these differences was in the institutions' general attitudes to corporate governance. For the passive investors, corporate governance, however defined, was generally seen in a positive light, as both value enhancing and ethically desirable. In the active investors, however, we found some sharply contrasting views. Some of the fund managers were dismissive.

> [Corporate governance] is only useful if it causes companies to generate better investment returns, and largely what's been discussed most recently has nothing to do with that.

Their job and their institutions' job, as they saw it, was to make money for clients, and most of what people talked of as corporate governance – executive pay, board structure, code-following – was an irritating irrelevance. Worse, it was a harmful distraction.

> …. if you are going to do corporate governance then effectively the person who should be doing it is the investment manager, because they are the people who actually have the best understanding of the company and ultimately are making the investment decision.

But

> … were [the investment managers] to get heavily involved then it would tie up the time they should be spending doing other things.

When we interviewed the people in the same institutions who were charged with corporate governance responsibilities, however, and when we looked at their promotional materials, we found a very different message. For these people and in these presentations, corporate governance was important, value adding and socially worthwhile, very much as for the passive investors.

The outspoken views of some of the active fund managers could be interpreted simply as arrogance – only we are capable of doing it and we have more important things to do. There was also an explicit element of nostalgia as they harked back to the glory days when they were free simply to manage money without having to worry about corporate governance or even about their clients. A well-publicised 2001 legal action by the Unilever pension fund against Mercury Asset Management, whose active fund management had resulted in significant underperformance against the index, was seen by some as ushering in a new era of constraints in which stringent risk controls were imposed, as one of the active fund managers interviewed put it, "to prevent you from over or out-performing”. But they also raise an important issue concerning the scope of corporate governance related activities. When asked to define good corporate governance for themselves, most of our interviewees from active investors, whether fund managers or governance specialists, talked in terms not of specific issues but of running a company for its shareholders – “making sure the board is overseeing the management in the interests of shareholders”, “the structural process by which companies run themselves … in the interests of shareholders”, “mak[ing] sure that companies are run in the interests of shareholders”. From this perspective, as one interviewee put it, “it’s all corporate governance in a sense”, including not only the issues that active fund managers found so irrelevant but also issues of investment, and especially mergers and acquisitions, that they saw as central to creation of shareholder value and the determination of share price.

These latter issues were not only in the fund managers’ domain; they were also issues on which there was already a tradition of engagement. One thing that came over clearly from our interviews was that from the perspective of a fund manager, whether active or passive, mergers and acquisitions are the single most important destroyer of shareholder value. Indeed, for many of those we interviewed, acting against the shareholders’ interests was implicitly identified with making non-value enhancing acquisitions. Such an acquisition might be presented to shareholders as a fait accompli, but as the level of communication between companies and their shareholding institutions has been built up over the years they have increasingly been trailed beforehand. Thirty years ago, such communication was minimal; Twenty years ago it was conducted through the company’s brokers; but for the last fifteen years or so UK companies have held regular one-to-one meetings with the largest institutions, at which they have set out their strategies and plans for the future. Only a few of the fund managers we talked to saw these meetings as an opportunity for giving their own views, as opposed to questioning the companies on theirs, but they did open up channels of communications. Faced with a prospective acquisition that looked likely to depress shareholder value, a fund manager holding a substantial stake in a company would use these to ‘have a word’, to put across the shareholder perspective and, as one fund manager pointed out, to counter the pro-acquisition messages that might be coming from the company’s investment bankers.

Overall, we were able to distinguish three distinct types of corporate governance issue on which institutions might act. First there were the investment and M&A issues, the judgement of which needed specialist company and sector knowledge and the responsibility for acting on which traditionally lay with the fund managers and chief investment officers. Here the issues tended to be localised in time and the information needed to engage was also needed for valuation purposes, so engagement, though rarely effective, was cheap. Second, there were the issues of pay, of contracts, and of compliance with corporate governance codes, issues on which the institutions felt encouraged or obliged to act, but in which the fund managers had little if any interest. These issues also needed specialist knowledge but of a very different kind, and were most naturally delegated to a dedicated team of governance analysts. Third, lying somewhere between these, were general issues to do with the way the company was being run: the effectiveness of the board and senior management and the transparency of their communications with shareholders. As we have already noted, there was general agreement among our interviewees that these were actually the most important corporate governance issues of all, and that they could not be judged without drawing on the fund managers' experience of meeting with senior management (for further analysis see *reference suppressed*), but they were not issues on which fund managers had traditionally intervened. The issues were chronic and soft, judgement was intuitive, and there was often no specific handle on which a focused intervention could be based. This was the area in which the Wall Street Rule – if in doubt, sell – had always applied.

To manage this range of issues, institutions have adopted a variety of administrative arrangements. In some institutions corporate governance issues are treated as part of every fund manager's job, with one fund manager often taking a lead responsibility but only on a part-time basis. In others there are separate corporate governance teams, ranging from just one or two people up to five or six. In some cases these teams report to a senior fund manager with corporate governance responsibilities, in others they are led by former fund managers but are effectively independent of the fund management arm. In others they are composed entirely of governance specialists, with no fund management experience. Of the institutions we researched, the passive investors tended to have specialist corporate governance teams and the active investors tended to integrate governance activities with fund management, the latter arrangement being justified in terms of the relevance of general corporate governance issues (M&A, board effectiveness, transparency) to investment decision-making. This was consistent with what one would expect on the basis of economic theory, with the active investors having and needing to exercise the sell discipline and the passive investors needing to invest in voice. There were exceptions, however. One relatively passive investor outsourced it's governance analysis and voting and kept the governance activities it did undertake within the fund management team. One active investor had a completely separate corporate governance team, albeit headed by an ex-fund manager. There were also clear signs of ongoing change, with several active institutions in the process of increasing their attention to corporate governance and/or reducing its burden on fund managers. The head of fund management for the active investor that had developed a separate governance team explained this in terms of regulatory pressures that were also reported by his counterparts in other institutions.

> [Corporate governance now] requires talking to both companies … and to clients about what is happening and therefore it needs more time and resources devoted to it than it used to have historically. … If you go right back to the days before 1987, before Big Bang, you would have expected companies to have been responsive to a quiet word from their major shareholders. Since that time we've had more formal regulation, and the relationship with companies … is also more formal and the pressure … there's been more concern from clients, particularly public sector clients and therefore the processes of formally looking at the corporate governance structure of a company, of doing the proxy voting, of talking to clients and reporting to clients on what proxy voting occurs, has developed out of that. … Because it's taken a higher profile it can't be done just part-time by one of the fund managers.

Activities

The following quotation, from the head of corporate governance at a passive investor, captures the way in which corporate governance activities are routinely carried out.

> … ahead of the meeting we receive research from the NAPF, the ABI and PIRC. We look at the research to make our decisions for voting and obviously, if any of those providers say 'vote against ..' then that's a flag to us that there is a problem. We then investigate it against our own policy … If we are going to vote against or it's just not clear, then we phone the company secretary and, very often, when it has looked an obvious vote against, after I have spoken to the company secretary and we've heard the background … we actually reverse it and vote for, so that communication is two-way and that's important. Sometimes, just talking to the company secretary, you get the feeling that the outside shareholders are just not important and that's more likely to maintain our view to vote against. … In that process, maybe when we're looking at the issues, when we're talking to the company, we probably email around the other institutions that we talk and there's a group of 15 of us … We

> just ask questions like ‘anybody else got a problem with this contract, or this remuneration or whatever?

Almost all the institutions routinely monitor corporate governance issues in the companies in which they invest and they do this by subscribing to the services offered by the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF) and the private UK specialists in this field, Pension Investment Research Consultants (PIRC). Ahead of each company’s annual general meeting (AGM) these will provide data on the governance issued raised, together with voting recommendations. The institutions work on the presumption that they will vote with management unless they have good reasons not to, so it is normally only when they receive a ‘vote against’ recommendation that this leads to further research. If the corporate governance activities are in the hands of fund managers, it will then be left to them to decide whether they need further information from the company. Where institutions have developed their own detailed corporate governance policies (as several of them have), or where clients have particular policies (which seems to be relatively rare) they will check out the company’s proposals against these. Where governance activities are handled by a specialist team they will also consult with the fund managers and sector analysts, to get any relevant company-specific information.

If there is still felt to be a problem, the next step is to go to the company for clarification of the proposal and the reasons behind it. Some may approach the company’s brokers or investment relations departments, but in the great majority of cases this means going first to the company secretary. Company secretaries are considered by the investors to much more knowledgeable about governance issues than either house brokers, whose future role several interviewees questioned, or IR teams, for whom they have little time or respect. Company secretaries are also considered important contact points because they can be relied on to communicate investor concerns to the board, and are thus critical to the two-way communication referred to. As the same interviewee explained:

> It’s the same with all corporate governance issues. The starting point is always the company secretary because they do, or they should, know everything that’s happening in the company, and if they don’t that’s actually an indicator that maybe the chairman is being secretive. ..If we phoned the chairman, we always suspect that the chairman feels they can give a reply on behalf of the company and that’s it – no-one else knows about it. But if we speak to the company secretary, the company secretary might give the

> background ….it's quite a good insight. They will actually pass on the input from us, around the board, so it's not focused on the chairman.

If, after discussion with the company secretary, investors still have concerns on a governance issue – a pay package, say, or contract terms – the next step will depend on the perceived seriousness of the problem. They may just vote against the resolution concerned, but if the problem is considered serious enough most will telephone or perhaps meet with the chairman, and if that fails to resolve the issue with the senior non-executive director. Some will also contact their counterparts in other institutions. For some of the active investors this still seems to be taboo. All information, from their perspective, is trading information, and they have no contacts at all with their competitors.

> Shareholders … are all competitors, and [it's] therefore difficult for us to talk to one another, and if we did talk to one another regularly, we would probably be in the Office of Fair Trading for collusion et cetera. Perhaps there should be some big forum where big shareholders get together easily, but at the moment there isn't one. I don't even know the names of most of my counterparts. I wouldn't know which chief investment officers to call to arrange something. Then they might wonder why I was calling them. They'd probably think I was trying to headhunt them or something.

Attitudes appear to be changing rapidly, however. Some active investors admitted to a limited, albeit reluctant collaboration.

> The other thing we've done as well on the odd occasion is we've actually participated in institutional investor lobbies. It's been very rare but we have … but generally speaking we like to plough our own furrow on this.

In one institution, the senior fund managers told us quite clearly that they did not cooperate with other institutions, but publicity material produced just a few months later stated – for the benefit of potential clients – that they did, and that such cooperation was a key part of responsible ownership. For many of the passive investors it is already routine. About 15 of the large institutions, mainly passive investors with specialist corporate governance functions, belong to a Corporate Governance Forum. They interact regularly, sharing both information and opinions, and as explained by two of our interviewees they use their combined weight to bring pressure on companies to follow corporate governance good practice:

> We will work with other fund managers. X is actually quite well-connected with a network of colleagues and peer group …(also

> through ABI) We deliberately try and work [with other fund managers], rather than necessarily going solo, because there's strength in numbers and it would be very rare that we could actually achieve anything working entirely on our own.
>
> By shareholders communicating with each other it's nullifying the company's attempts to divide and conquer the shareholders, which has certainly happened in the past; but they really can't do that any more. …… I don't think any company wants to receive 15 phone calls nagging them.

Whether they act together or independently, most institutions will now engage directly with companies, and since the requirement for an annual vote on a remuneration report was introduced many companies have recognised this and begun to short circuit the process described above by sounding out their largest shareholders before publication of the report. In such cases investors refer to the general NAPF and PIRC guidelines rather than to specific voting recommendations, but the process is otherwise much the same.

If the engagement process fails either to satisfy the investors on these specific governance issues or to change a company's policy so as to satisfy them, most are now willing to vote against. Like the engagement itself this is a relatively recent development. As one interviewee explained:

> Ten years ago, if I even hinted that I was not going to support management, the chairman of the company would ring up [my] chairman and complain.

Nowadays a vote against is still, as many interviewees noted, a last resort, and given the extent of prior communications it might not be a very effective one. It is the engagement itself, and the threat of the vote, that matters. But the threat is a real one, and most mainstream institutions are now willing to act on it.

Where investor concerns are related to acquisitions and investment decisions, or to the crucial middle ground of transparency and board effectiveness, none of which are normally voting issues, the process of engagement is slightly different. Acquisition and investment concerns tend to emanate from the fund managers rather than from the monitoring carried out by corporate governance specialists, and if they relate to proposals trailed in advance by the companies, these proposals will also come to the fund managers, either directly through their regular company meetings or via the companies' brokers. Concerns over transparency and board effectiveness are also more likely to originate from fund managers, though they might also be triggered by a perceived lack of openness in communications on more specific governance issues. On all these issues engagement with companies is the exception rather than the rule. For the more activist of the passive investors, there might be a dozen ongoing cases at any time.

> Big companies like us often have to hold shares with certain companies for risk reasons. So … [instead of selling] … you might have meetings with a company's non-execs and pursue a more aggressive line … I'd say there's probably at least 10 or 12 of those running on a yearly basis.

For an active investor with a relatively high freedom to sell, there might be only a couple.

> If you were to cause a fuss and try to influence things behind the scenes – very difficult to do in public this because immediately you lock horns you are probably not going to succeed – if behind the scenes you can do it we would try. At any one stage we've got a couple that would do that – this is outside the small cap – two companies, that probably means four a year. Two are on the backburner and two are a bit more live but it takes at least a year to try and change this. Mostly you fail. Our success rate in this is very low.

Most institutions, even the most active, are clearly prepared to engage on these issues, however. In most cases the engagement is led by fund managers rather than corporate governance specialists, and it begins with a call to the chairman. If the chairman fails to give the appropriate assurances, and seems to be part of the problem, then the institutions will seek to press their concerns on the non-executive directors, both directly and through the company secretary, who in this case acts as a conduit to the board as a whole. With the engagement being pursued largely by fund managers there appears to be less cross-institution collaboration on these kinds of issues, but as one interviewee pointed out, the more serious concerns were likely to be shared.

> … By the time you speak to non-execs you're probably pretty unhappy. Normally at that stage you would probably have other institutions doing that.

Whatever the nature of a governance engagement, one possible approach is to 'go public' by leaking concerns to the press. Some institutions remain very reluctant to do this, believing it sours their relationships with the companies, but others are more willing. One interviewee noted that directly approaching a company's non-executive directors could also be difficult, and that going public could be an easier way of gaining their attention if the chairman was not responsive.

> We've talked to the press when we are unhappy about things and one of the reasons we do that, one of a multiplicity of reasons, but one of the reasons, is if we get something in the FT that says we are unhappy about it, there is no way that the executives or advisors can keep that away from the board.

A chairman might not pass on investor concerns (especially if they reflected on his chairmanship) or might not hear them in the first place, especially if they came from relatively young fund managers or governance experts (who were the people with the relevant detailed knowledge) and not from someone at his own level. There was also a suggestion that communications between investors and chairmen or non-executive directors might sometimes be too polite, that the investors found it difficult to get their message across with sufficient force.

> I'd sat in the meetings … when we had seen [the senior non-executive directors] and I felt that the message had been clearly delivered that [a particular appointment] was not something that was going to be acceptable … but that was not a message which appeared to have been heard by those two senior non-execs.

Only when another of the investors went public, did the message begin to get through. There was, finally, a suggestion that some institutions might actively be seeking publicity for their activist stance, to promote their brand image. This leads us to the general question of the motivations underlying the new shareholder activism.

Explaining the New Activism

Motivations

The reasons given by our interviewees for engaging in activism were both many and varied. Several people from both active and passive investors talked of a basic duty to exercise 'due diligence' monitoring and act where necessary to protect their clients' investments. For example:

> It is a necessary duty on our part to ensure that there isn't a misuse of company funds.

> In the end, we have a responsibility towards our clients to make sure their long-term interests are protected.

> It is important to protect shareholders' investments from failure for the pensions of our beneficiaries in the future. We regard it as our beneficiary responsibility.

This duty was particularly evident where an institution held a particularly large stake.

> [T]here are certainly a handful of companies out there where we are the largest shareholder and that, I think, actually increases the obligation on us to act responsibly and so we do actually now actively seek to engage with certainly any company where we hold a significant stake.

Similar sentiments, often linked with the expression ‘responsible ownership’ also appear regularly in the institutions’ promotional literature, but the exact nature of the underlying motivations is unclear. One interviewee, from a passive investor, tried to capture some of the nuances.

> There is this strong view here, and I don’t think this is an ethical thing as much, and I don’t think it’s a moral choice we’re making, it’s more coming from the intellectual roots, as intellectually it’s the right thing to do, so people here are driven very strongly what is right in some way but it’s what is right in some sort of intellectual sense rather than a moral or ethical sense. … ultimately there’s some sort of moral thing in there as well and you can’t disengage that but certainly from an intellectual point of thing it’s not the wrong thing to do.

There’s also the question of the institution’s reputation. The same interviewee went on to talk of “being … criticised if we were seen to be tossing a coin” rather than voting responsibility and someone else from the same institution commented in respect of the duty when they held a particularly large stake that:

> If you’ve got 5% in a company and it goes wrong, then there’s a risk to our reputation.

Other responses, though less explicit, also suggested to us that this sense of duty had as much to do with the institution’s reputation as with anything more fundamental.

In fact, although many of the institutions present themselves publicly as being dutiful and responsible owners, relatively few of our interviewees discussed their motivations for activism in these terms. Far more common were references to the standard economic motivation for activism, namely the creation or preservation of shareholder value in cases in which selling was either not an option or prohibitively expensive. For the passive investors, it was not an option, and activism was described as the only way in which they could effectively add value for their clients. For example:

> We're here to make money for our clients and that's why we look at corporate governance. . [It] is a means to an end rather than an end in itself.

> As indexed investors we're not going to sell, so what can we do to improve our client holdings? We can get involved with the management of the companies we invest in, to encourage their better management and lead to an improvement in value.

> In an index fund environment, you don't actually have the option of selling the stock if you don't like what's going on, so we decided at a reasonably early point that … we needed to be active with regard to engagement with companies and active with the use of our votes.

For more active investors it might be a less costly option than selling.

> If it's bad for the share price then just sell it. We want to get out unless we think we can change it. There are occasions when we think there is so much value … We had a big stake, and couldn't really sell, but we also thought we could change their minds. We had a big battle and voted against them.

> Sometimes … you get a situation where you are not happy with the management. Normally you can sell the shares but sometimes it is not always that simple … [so] … you might have meetings with a company's con-execs and pursue a more aggressive line. …Some of the meetings might be us trying to ensure that the trigger we want to see is pulled, bye bye X, bye bye Y. If we think that's absolutely essential to the long-term benefit of the company we will put our weight behind it.

It could even be a reason for buying, if there was shareholder value to be released.

> It could be that you have the existing stock and it could be difficult to get out of the position, so effectively you are pushed into it, but ultimately it could be that you currently do not have the stock and you decide that there is value there and you decide to build a position and then engage the company and get the value that you believe is there to be released.

Where the active and passive shareholders differed was not so much in their justification for activism, as in the rules of engagement that followed. For an index investor, all companies are treated equally, and thanks to the spill-over effect the perceived benefits are cumulative.

> By [taking an activist approach] you improve the overall quality of the market as well, because if other companies who are borderline realise that shareholders are becoming much more activist, their reaction will be different.

Or again,

> … in that sense, we're similar to some of the arguments that CalPERS use about how you improve the aggregate quality of the stock market and the absolute level of returns, even if it's not a relative gain, by engaging the companies.

Part of the justification for activism here is that the very act of monitoring, of watching over company managements, has performance benefits.

> When executives know that they have a few large shareholders who are constantly monitoring their moves, they will be very careful.

As in agency theory, the argument is that the act of monitoring curbs self-interest, and focuses the minds of management on shareholder interests.

For an active investor, in contrast, performing against the index as a benchmark, the cumulative effects are irrelevant. The key considerations are how far the governance problem is already reflected in the share price, and whether the institution is under- or over-weight in the stock. If the problem is already reflected in the share price, and if the institution is over-weight, then the economic arguments point to activism. If an investor perceives a problem ahead of the market, however, this represents a trading opportunity. To paraphrase one interviewee, why engage when you know more about a company's weaknesses than your competitors, and can trade on that information? Or, from another,

> I know this is terrible because it's not good for the national utility of the United Kingdom – but why would we want to educate everybody, because that is a way in which we can make some relative money.

And if an investor is underweight, then any gain will be to its relative disadvantage, as two of our interviewees pointed out.

> In a benchmark driven environment, if you don't own the company you almost have a vested interest in it continuing to do badly.

> You are not going to invest an inordinate amount of man or woman hours on looking at a company where you are underweight and therefore you'd shoot yourself in the foot. …

This last consideration raises a point that is generally neglected in discussions of shareholder activism, namely that mainstream institutions are not just shareholders, with common interests in achieving shareholder value, but also, perhaps primarily, competitors. This may have been irrelevant when the only significant activist institutions were self-managed pension funds, but it is central to understanding the new shareholder activism. All active investors measure their competitive performance and market their services on the basis of performance against index-based benchmarks, not on the basis of absolute shareholder returns (Myners, 2001, 2003). And all the large UK institutions, whether active or passive investors, are in competition with each other for clients. In the case of some of the insurance company subsidiaries, the external funds managed may be a relatively small part of their overall portfolios, but they are still significant and the ability to secure and retain clients, both wholesale and retail, is an important part of their business. Even the largest self-managed pension fund, Hermes, manages money for other pension funds as well.

Given this situation, it is perhaps not surprising that it was competitive considerations, and not shareholder value or moral duty, that dominated our interviewees' justifications of their activism. In particular, it was clear from many comments that the pension fund trustees who were the institutions' main clients had become increasingly preoccupied with corporate governance, and that fund managers had had to follow suit in order to pitch for, gain and retain their business. For example:

> The corporate governance was put in place principally at the behest of the clients. … If it hadn't been for external pressures I don't think a lot of people would have done it.

> Some clients request that we pay a lot of attention to corporate governance, corporate governance is very important to them.

> I'm going to present for a £500 million local authority fund. Unless I can demonstrate to them, that actually I have some resource devoted to corporate governance, I will stand no chance of winning the pitch.

For the more active investors, including those just quoted, this seems to have been by far the most important reason for voting and engaging on specific governance issues such as pay and contract terms that were not immediately linked to shareholder value. It was also a significant factor for the more passive investors. Having explained to us at length how her institution had a duty to take an activist line on governance, one interviewee finished by noting that this wasn't entirely altruistic: it was also a very good pitch to clients.

Apart from some of the local authorities, it does not appear that the institutions' clients were explicitly seeking a high level of activism. Their mandates did not normally include this as a specific requirement, and they put little pressure on investors to engage with companies. Indeed some of the active fund managers who were generally dismissive of corporate governance tended to the view that the clients themselves were often just trying to be politically correct, suggesting that a minimalist approach would be sufficient to keep them happy.

> We have to pay a bit of lip service to corporate governance, particularly this current government, but actually for us, our clients aren't giving us money to say make Britain a better place.

> [Clients want it] because they then, to the members of their schemes, will be seen to be politically correct.

Others suggested, however, that their clients expected them to exercise a certain level of responsibility in respect of governance matters and appreciated an activist stance when they took it.

> The pension schemes and the pension fund trustees actually put very little pressure on us to engage with companies [but] they like it when we do … We're very explicit about the voting activity we've done. We've always told our clients how we've voted … and they've always liked that. But … the trustees haven't put us under pressure, with some exceptions. There'd be some who are, in some senses, politicised, the local authorities perhaps.

> [It's] not so much specific client demand, it's more like standard client expectation. … It would be damaging to our reputation if we just said … we're not doing anything. I don't think that's an option these days. … It's all down to this developing concept of responsibility of ownership, isn't it?

Whether this concept of responsible ownership was something that had been pushed on society by government, or whether it had been taken up by government in response to public feeling, was unclear. But it was clear that government had been pushing it onto the pension funds and that they in turn were pushing it onto the fund managers. Some funds had developed their own policies and expected to see them implemented. Others simply looked to their fund managers to provide policies for them.

> A few years ago maybe shareholders could just sit back and take the dividend cheque and the capital out-performance and things; now, whether it's just this government or (I don't know what comes first, whether it's society or whether it's the government – people [could] argue about this for years) it's this responsibility I think that's being

> imposed on our clients and the clients just look to us to actually implement that for them.
>
> It's client demand, it's government regulation, and I don't know which is coming first. … Obviously the government is putting the pressure on pension funds to do this sort of thing and I suppose they think they can have a go at pension funds because they perform more of a social role … So, obviously, a couple of years ago we had the Pensions Act Amendment which required pension funds to give a policy on corporate governance and SRI, if they had one, and we've now got regulations for local authorities as well, just to keep them level with commercial owned pension funds. A lot of the smaller clients just have to do something … but a lot of big clients who have more resources actually consult with us, demand to know more detail, they want an example of, perhaps, engagement with a company, they are drawing up their own policies [and want to work them out together].

Barriers

Alongside the various motivators for corporate governance activism, our interviewees also drew attention to some of the barriers that made such action difficult. Of the barriers described in the literature, the free rider problem was mentioned only once, and in a context in which an active investor had engaged despite it, and fully covered their costs. Several interviewees referred to the conflicts of interest that arose either from the business activities of their parent banks or from the dual role of finance directors as company executives and company pension fund trustees. For example,

> There's a conflict as well in that finance directors of companies are in many cases on the boards of trustees of pension schemes. So. All these people are potential clients, and in many cases are clients, so that is a big issue.
>
> We gave [X] a really hard time about their acquisition policy, and three weeks later were invited to present on the pension fund and the Finance Director roughed our guys up. It was pathetic, absolutely tragic.

The second person quoted went on to say, however, that things were changing and trustee boards becoming more independent. And others suggested that while the conflicts could be "challenging" they could be managed.

> Yes there are obviously conflicts of interest … [but] we just manage them. … If we're going to vote against a company and that company is a client sponsor, I'd just make sure that the client

> director knows and can notify the client first … Generally the clients understand; [they] would rather know that we are not going to buckle to that sort of conflict … I don't think we've ever had a problem.

One conflict of interest that we had expected to arise was, interestingly, hardly mentioned. As we have already noted, a number of interviewees referred to mergers and acquisitions as destroyers of shareholder value, and some of these worked for investing institutions that were subsidiaries of investment banks, which earn significant fees from such mergers and acquisitions. As one interviewee pointed out, there is an evident conflict here between the interests of shareholders and investment bankers.

> Let's give a general example where twice if leading companies had actually come and talked to us they wouldn't have done stupid things, but they were kept away from investors by investment banks in the context of raising the finance, because investment bankers are very gung ho. … One of the reasons why we feel it is very important to have some sort of communication with independent directors is a fear that independent directors who are involved in the strategy aren't getting any input from shareholders.

This was not, however, someone for whose institution the conflict arose, and in this context it was a reason for rather than against activism. Those for whom it did arise, which included those active investors who were most vocal on other barriers to activism, were silent on the issue. Whether this was because it was not, for them, an issue, or whether it was because it was not an issue they wished to discuss, is not clear. When they were asked in another context about the networks of information they used to take a view on companies as investments, it became apparent that they had few if any contacts with their investment banking counterparts. But given the selectiveness of their engagement we found it hard to believe that they would fight actively against acquisitions that were earning large fees for their parent companies.

A key difference underlying the responses noted above was that the interviewees who saw conflicts of interest as being manageable tended to be governance specialists focusing primarily on specific governance issues, while those who saw them as a serious problem were active fund managers who were dismissive of such specific corporate governance issues and only interested in engaging on issues of shareholder value, such as acquisitions and investment decisions. For these people the reluctance of some companies to listen to their arguments could also be a disincentive to engagement.

> I think by and large most of them treat this as a partnership but there are, I don't know how many, there's a good whack that really – you're just an irritant.
>
> Big companies think the rest of the world can sod off. … They just don't care. They are more interested in the Mercedes Benz waiting outside for them than engaging with us. (exceptions where, because of longevity perhaps, have very good relations) … Do we have some intelligent things to say to them? Yes. In some cases we do but we keep it to ourselves.

These were not arguments we heard from the majority of institutions. Indeed several interviewees commented on how open UK companies had become in recent years. One person did suggest, however, that that openness was already being threatened by the pressures of activism, and that there was a growing sense in the companies that engagement – or interference – had gone too far. Since our interviews were substantially completed the Higgs Report (Higgs, 2003) has called for increased communications between investors and non-executive directors, and in a series of very public spats investors have turned down pay proposals, forced the departure of chief executives and chairmen, and effectively vetoed the appointment of one large company chairman. In February 2004, at a meeting between company chairmen and senior fund managers called to discuss the implications of the Higgs Report, the irritations on the corporate side evidently spilled over prompting one serious newspaper (briefed by one of the fund managers) to label the event as "secret peace talks" (Lewis, 2004). From our own conversations with those present it was evident that there were, as the newspaper reported, some serious concerns expressed on the corporate side about the power fund managers were wielding. But the main concern seems to have been about the channels of communication through which institutions were engaging, and in particular the use of the press, rather than about the engagement itself. Certainly some managers resent being told how to run their companies by investors with no management experience. Investors similarly resent it when managers with track records of destroying shareholder value put themselves forward as governance experts. But on the whole UK companies look like becoming more open in the near future, not less.

Conclusions

Although it draws to some extent on existing practices, the new shareholder activism is quite different from anything that has gone before. The institutions pursuing it, mainstream fund managers who are in direct competition with each other and whose primary responsibility is to manage other people's money, are in critical respects quite different from the self-managed public pension funds associated with previous kinds of activism. The issues addressed are broader, covering investment and acquisition decisions, board effectiveness and transparency, as well as specific governance issues such as remuneration, contract terms, and board structure. To pursue these issues, new administrative structures and practices have been developed, and new channels of communication opened up, both between investors and the companies in which they invest and between the investors themselves. The motivations are also different. The new activists are more interested in making money than in making political points, but because they make their living out of managing other people's money, and are rewarded for relative not absolute performance, they are more interested in out-performing their competitors than in adding shareholder value for its own sake.

The new shareholder activism is also peculiar to the UK. In Europe, with its large block holdings and tradition of insider governance, institutional engagement is almost unknown. As one interviewee commented with respect to the French market, which she knew well:

> I think you would be laughed out of the room [if you tried to engage]. We do vote in France, obviously, but it's interesting to see people's reactions when you actually say to an investor you might want to vote 'no'. They look at you as if to say 'which planet do you live on? You don't vote against management!' What you do … is you write a letter saying that you are not happy, but you still vote in favour of the current management … So everybody's happy because you've covered your back.

In America, too, there is very little communication between corporations and their shareholders, and voting, which UK institutions do for themselves, is largely subcontracted to proxy voting services. While activist institutions might seek to engage with management and put forward proxy proposals, mainstream investors seem happy to play by the traditional Wall Street rules. Again, a knowledgeable interviewee captures the situation well:

> If you go to the States they don't feel that obligation [to engage with companies] at all. They see the investment management process as being far more 'you are making a financial bet' and they see it … as they are in possession of a betting slip. …

Why, then, has the new shareholder activism arisen in the UK? Part of the answer seems to lie in enabling factors, which make it easier for the mainstream institutions to take an activist line there than it is elsewhere. In the first place, they dominate the market. In other European countries, most companies are effectively controlled by a single blockholder, so that an institutional investor has little to gain from activism. In America, in contrast, the shareholdings of listed companies are arguably too diversified for any voice to be felt. UK shareholdings are not only more evenly distributed than in the major European economies but also, given the pension fund practice of delegating voting rights to their fund managers, significantly more concentrated than in the USA. Most of the largest 15 or 20 investing institutions in Britain hold significant voting stakes (typically between 1% and 5%) in most of the FTSE 100 companies (see Brecht & Mayer, 2001).

Secondly, this voting power is exercised predominantly on behalf of pension funds and life assurance companies, whose beneficiaries have an essentially long-term interest. At the turn of the century over 20% of UK listed shares were held by insurance companies and just under 20% by or on behalf of UK pension funds (Myners, 2001). The comparable figure for the USA was about 24% held by pension funds but only 6% by insurers (Ryan & Schneider, 2002).

The third enabling factor, and in our view the most important, vis-à-vis America, is a culture than encourages dialogue rather than compliance. Whereas American corporate governance reforms over the past decade have focused on legislation and strict compliance with a series of requirements, British reforms have proceeded through self-regulation and the development of advisory standards within a culture of ‘comply or explain’. In one way this has placed a much lower burden on British businesses, as they have been able, more or less, to make their own governance rules. The quid pro quo has been that they have had to communicate with shareholders to explain what they are doing and why. Even where legislation has been produced it has required companies to produce a report to shareholders on *what* they are doing, specifically on their remuneration policy, rather than to report *that* they are meeting specific criteria. This has opened up the channels of communication through which the new shareholder activism is operating.

Alongside these enabling factors are driving forces, the most obvious of which has been the government pressure on pension funds to act as responsible owners by holding companies accountable both for their performance and for their good governance. Similar pressures have been brought to bear by other North European governments on their own pension fund communities, but in a different corporate governance context the emphasis there has been on corporate social responsibility and socially responsible investment rather than on corporate governance. In Britain, the government line has been that social responsibility is a matter for companies and their shareholders and the emphasis has been on creating a regime of accountability rather than encouraging particular policies.

For the institutional investors whose staff we interviewed, the new shareholder activism is rationalised partly as a response to the duties imposed by responsible ownership, and partly as a means of generating shareholder value. But as driving forces these seem to be secondary to the need to maintain their own competitive positions by responding to the needs of the pension funds, their clients, to respond to the pressures of government. Subject to the competitive forces of the market in which they operate, they find themselves caught, willingly in some cases reluctantly in others, in a chain of accountability.

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