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THE PARADOX OF TRANSPARENCY, SHORT-TERMISM AND THE INSTITUTIONALISATION OF AUSTRALIAN CAPITAL MARKETS

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As the ultimate corporate decision-makers, directors directly impact the investment time horizons of the corporations they govern. How directors make this decision has been profoundly impacted by the expansion of the investment chain and the increasing concentration of share ownership in institutional hands. By examining agency in light of legal theory, we highlight that the board is in fact sui generis *and not an agent of shareholders. Consequently, transparency can lead to directors being "captured" by institutional investor objectives and timeframes, potentially to the detriment of the corporation as a whole. The counter-intuitive conclusion is that transparency may, under certain conditions, undermine good corporate governance and lead to excessive short-termism.*

Historically, shareholder value as the goal of the corporation has been paramount in the corporate governance research agenda and agency theory has been held as a central tenet. Both practitioner and academic publications alike highlight the importance of shareholders (and the issues surrounding them) to modern corporations. At the centre of this approach lies the relationship between shareholders and the board of directors, a topic described as underdeveloped (for example, see Daily, Dalton and Rajagopalan 2003) and overly narrow (see Daily, Dalton and Cannella 2003; Hillman and Dalziel 2003; Huse 2003).

THE CHANGING NATURE OF CORPORATE OWNERSHIP

There has been long-held interest in the ownership structure of society's major corporations by both practitioners and scholars (for example, see Monks 2001, Beatty 2001, Micklethwait and Wooldridge 2003). These studies have generally concluded that in industrialised nations, the modern corporation has evolved through three distinct phases: entrepreneurial capitalism,[1] managerial capitalism[2] and institutional capitalism (Daily et al. 2003). As a result, under institutional capitalism the ownership structure of firms has shifted from a fragmented base of

[1] The first corporations were largely owned and controlled by entrepreneurs and their families who formed the basis of the emerging entrepreneurial capital system (Micklethwait and Wooldridge 2003).

[2] Managerial capitalism saw the ownership structure of corporations become more fragmented and an increase in the specialisation of labour, which led to the separation of ownership from control (see Berle and Means 1932).

diversified owners to a concentration of legal ownership in the hands of large institutional investors (Black 1992; Coffee 1993; Useem, Bowman, Jones, Myatt and Irvine 1993; Romano 2001). This concentration of ownership into the hands of institutional owners has profound implications for the control of corporations.

LEGAL VS BENEFICIAL OWNER

While there has been a concentration in legal ownership, institutional capitalism has also caused the beneficial ownership of shares to fragment further, largely as a result of often complex and opaque ownership structures. Retail investors (the beneficial owners) are generally far removed from the company in which their funds are invested, sometimes with several investment vehicles between them and the companies that make up their investment. As a result of this segregation, beneficial owners are unlikely to know in which company their capital is invested and therefore will not be in a position to exercise the traditional rights of a shareholder. In essence, the rights that accrue with shareholdings have passed from the beneficial owner to those who manage the investment. An example of this phenomenon is shown in Figure 1.

INSERT FIGURE 1 ABOUT HERE

Figure 1 illustrates how in August 2003 a UK-based international financial services company, the Man Group, launched a capital guarantee fund, ‘Series 9 OM-IP 220 Limited’. This fund enabled the retail investor (the beneficial owner) to buy shares in the company Series 9 OM-IP 220 Ltd. Series 9 OM-IP 220 Ltd then invested the money through three key methods: (1) a capital guarantee with Westpac Bank; (2) investment using Man’s proprietary AHL Diversified Program, which examines more than 100 markets; and (3) investment in the Glenwood Multi-Strategy Program, which uses more than 90 of the world’s leading specialised international fund managers. Under such a scenario the retail investor (or beneficial shareholder) has no knowledge, let alone understanding of the companies in which she or he has invested.

This pattern of investing has become widespread with the growth of the managed funds and superannuation industry. A review of the shareholding structure of Australia’s major institutions demonstrates a remarkably similar pattern of ownership. Table 1 shows the shareholding of ten major institutional investors (or legal shareholders) across Australia’s top 20 companies. These 20 companies represent more than 60% of the market capitalisation in Australia. Table 1 vividly highlights that the weight of capital in the current system is controlled by the same legal owners who are often far removed from the beneficial owners.

INSERT TABLE 1 ABOUT HERE

THEORETICAL IMPLICATIONS OF THE INSTITUTIONAL OWNERSHIP STRUCTURE

The shareholding structure of the modern corporation is fundamental to current thinking on corporate behaviour and decision-making. There is a rich tradition of work investigating this structure, particularly the problems that may occur when ownership is separated from control (for example, Smith 1776; Berle and Means 1932; Rutherford, Bucholtz and Brown 2007).

In addressing the challenges of this separation of ownership from control, agency theory has been a central tenet with obvious appeal. Under agency theory, an agency relationship is created when one person delegates work to another (Jensen and Meckling 1976). This has clear parallels to the structure of the modern corporate form where shareholders are seen to delegate the running of the company to management. Consequently, the majority of academics examine this specific separation and the challenges, consequences and remedial actions it brings about (Daily et al. 2003). Similarly, from a normative perspective much advice, policy and regulation is also still being developed to address this separation (for example, ASX Corporate Governance Council 2007, Higgs 2003).

The increasingly concentrated legal ownership of listed companies has been seen as positive development in limiting agency costs. Recent empirical work (for example, Rutherford, Bucholtz and Brown 2007) has examined the expected reduction in agency costs while normative pronouncements (Zhang 2008) extol the virtues of an increased concentration of ownership. Further, the development of proxy voting advisory firms point to the possible positive impacts of an increasingly powerful shareholding group able to monitor and discipline management.

Despite this development, critics have increasingly questioned the applicability of agency theory to boards of directors. This criticism results from the conflicting findings of a plethora of academic studies examining agency costs and controls and their applicability to boards of directors and corporate governance (for example, Rhodes, Rechner and Sundaramurthy 2000; Coles, McWilliams and Sen 2001; Deutsch 2005). The majority of criticism falls into two categories: (1) the assumption of unquestioning self-interested behaviour by agents (Donaldson 1990); and (2) the view that the interests of agent and principal can be clearly and simply summarised (Daily et al. 2003) in what are typically numerous, complex relationships between thousands of individuals.

Putting aside the questionable assumption of inherent managerial self-interest (Donaldson and Davis 1991), the emerging institutional shareholding structure outlined earlier makes the second assumption (of singular principal interest) highly questionable. There are two reasons why a clear and unambiguous ‘principal interest’ is questionable, particularly from the view of the beneficial investor. First, each shareholder will have a different preference set for non-economic investment factors. Consider the ethical preferences of a particular investor (say, the construction of a highly polluting but legal manufacturing facility). A typical investor would normally follow a company’s operations and so would possess information surrounding the particular ethical issue. If the company fails to meet the ethical expectations of the particular individual investor (for example, the company builds the polluting plant), the investor would possess the relevant piece of information and would be in a position to exercise their shareholding rights, including exit. Under typical institutional arrangements, however, beneficial investors do not know the companies in which they have invested and so the potential ethical decisions of investing are ceded to the institutional owner.

Second, many institutional products contain multiple investment vehicles (for example, see Figure 1). Under these circumstances it is entirely possible that the position of one investment vehicle may conflict with the other. For instance, one investment fund takes a short position on a stock believing it will fall in value while another takes a long position believing it will rise. This is quite illogical in terms of the beneficial investor who, investing in a single fund, now holds the position of hoping the stock will simultaneously rise and fall.[3]

These examples highlight that the exercise of shareholder discretion, and therefore principal interest under an agency relationship, moves from the beneficial investor to the institutional investor. In what could only be considered an ironic outcome, the concentration of ownership in institutional investors can lead to higher, not lower agency costs. Where the motivations of institutional investors diverge from those of the beneficial owners, we will find a loss of utility for the beneficial investors as the institutional investors pursue their own aims.

DEFINING INSTITUTIONAL INVESTOR INTEREST

Despite serious implications, the divergent aims of institutional investors are not treated with the same alarm as that of divergent aims of

[3] This is different from portfolio theory, where positions are held in non-correlated assets or stocks. Here, we are talking about investors holding different positions in the same stock. The logical actions for an investor to take are to net the two positions and take the consolidated position.

management. It is interesting to note that the average CEO salary of a Fortune 500 company in the US is 7% of the company's turnover (Walsh 2008). While CEO salaries can be considered extreme (they are reported at peaking at 150 times the median household income in 2001 (Kaplan 2008)), they are dwarfed by fund managers' remuneration. In 2005 the top 20 hedge funds managers in the US were paid a total of $8.6 billion – some 18% more than the pay of all CEOs in the entire Fortune 500 (Kaplan 2008).

Given the scale of the interests involved, it is reasonable to examine the practices of the institutional investment industry. Despite claims that equity investments are long term in their nature (typically seven years or more) (Peirson, Brown, Easton, Howard and Pinder 2006), institutional investors generally promote their products on annual, three-year, and at most five-year returns. Further, the typical remuneration package for investment managers concentrates on quarterly and/or annual returns (for example, see Donaldson 2003, Partnoy 2003). Given these pressures and the scale of motivation, it is clear that there is a significant likelihood that institutional investors may diverge from the long-term value creation position that lies at the heart of equity investing.

With the significant problems posed by both management and institutional investor self-interest, there needs to be another party in the investment chain that can safeguard the interests of the company as a whole. The board of directors is an obvious choice to act as this party as they already exist in the organisation and legally should act in the interests of the company as a whole, as discussed below.

THE LEGAL NATURE OF THE SHAREHOLDER–MANAGER RELATIONSHIP

The relationship between the principal and agent lies at the heart of agency theory (Jensen and Meckling 1976). Despite the importance of this relationship, governance scholars, particularly from the management tradition, have not taken into account the true nature of the legal principles that underlie the agency relationship they study (for a rare exception see Kaufman and Englander 2005).

Board as *sui generis*

Early legal theory posited that the shareholder–manager relationship largely mirrored that expected under agency theory. Directors and officers of corporations were considered to act purely in the interests of shareholders (Eisenberg 1969, Friedman 1970) and as such could be conceptualised as agents of the shareholders. This view has been challenged by an alternative contractarian legal theory of the relationship (see Blair and Stout 1989; Bainbridge 2002, 2003). This alternative contraction view is based on Coase's (1937) conception of the organisation as a nexus of contracts (Bainbridge 2003) and contends that shareholders are not owners, as they have no right to exercise control over the corporation.

If we examine a firm from this perspective, we see that the contract between shareholders and other parties (particularly the directors) is quite limited. Shareholders do not hold the all-encompassing control role implied by the agency theory literature. Any 'control' powers of shareholders are limited to those contained in the relevant company's constitution, with the most significant typically being the ability to appoint and remove directors.[4] Outside of these powers, shareholder influence is quite limited and would not be sufficient to be labelled 'control' under a legal definition. It is the sole responsibility of the directors (not shareholders) to direct the corporation to undertake, or refrain from undertaking, any particular action; the shareholders do not have this power. For example, no matter how incompetent or egregious the actions of a CEO, shareholders cannot remove or appoint a new CEO

[4] We note that even this power is not universal. Some companies have other bodies (including the board of directors themselves) that have the power to appoint and remove directors.

or discipline her or him by varying the remuneration package. This does not appear to reflect the principal position that agency theory suggests. Judicial decisions in many different common law systems further support the argument that shareholders are not controllers of organisations. For example, under US law, a sole shareholder would be subject to trespass and/or conversion actions if he or she attempted to deal with a corporation's assets (for example, *Manson v. Curtis, 119 N.E. 559, 562 (N.Y.1918)*). Similarly, the UK and Australian courts have all rejected the notion that there is an agency relationship between the shareholders and the management or directors of the corporation. Quite clearly there is no legal basis for ascribing an agency relationship to the shareholder–management or shareholder–board link.

In fact, directors (and managers) under most legal systems are required to act in the interests of the company as a whole (for example, *Corporations Act 2001* (Cth) s. 181, Companies Act s. 172, Delaware Code Title 8 s. 121), which is generally thought to include a consideration of the interests of shareholders as a group (Farrar 2005). So although the shareholders are not the principals in this agency relationship, they should still be considered when the directors or managers of the company are making a decision. This may seem a subtle distinction, but there are significant implications. Rather than the board being an agent of the shareholders, the board is a separate or unique body – it is *sui generis* and serves the interests of the company as a whole. This idea has been reflected in much legal precedent; for example, the idea that '… the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it' (*Manson v. Curtis, 119 N.E. 559, 562 (NY1918)*). Instead of owning the corporation itself, shareholders only have a residual claim on the corporation's earnings and assets (Blair and Stout 1989, Bainbridge 2003). Thus, it is not up to the board to simply carry out the bidding of the legal owners (that is, the institutional investors in our context), but rather to act in the interests of the company as a whole.

To whom do the directors owe their duties? Acting in the interests of the company as a whole

In the Australian context, the *Corporations Act 2001* requires the directors and officers of a company to act in the interests of the company as a whole (ss 181 and 184). However, the definition of 'company as a whole', due to its non-specific nature, has been the subject of extensive debate. The Joint Parliamentary Committee on Corporations and Financial Services, CLERP Bill 2003 (June 2004) concluded that [emphasis added]:

> 4.31 The committee considers that this interpretation [that is, shareholders' interests being paramount], like the shareholders' restrictive interpretation and the short-term interests interpretation, is too constrained. In addition, as noted above, *the committee does not agree that acting in the best interests of the corporation and acting in the best interests of the shareholders inevitably amounts to the same thing*. Consequently, the committee is not attracted to this interpretation.

The Australian legislation that formed the basis of this investigation mirrors that of other countries; for example, in the UK's Companies Act 2006 and US's Delaware Code Title 8. There is also much case law in common law countries which specifies that a director's duties are owed to the company as a whole and not to individual members (for example, *Percival v. Wright* [1902] 2 Ch 421).

Thus, a key challenge for directors is to identify and act in the interests of the company as a whole, particularly if that interest were to conflict with the interests of a legal owner of shares. Since those running institutional investment vehicles are often rewarded on short-term performance results (Donaldson 2003), whereas the company's (and beneficial shareholders') interests are in long-term performance results, directors may face difficult decisions. This conundrum has, we contend, been intensifying given the increasingly influential lobbying power of institutional investors (particularly their capacity to influence director selection) and is examined in more depth in the following sections.

GOALS OF THE LEGAL OWNER AND DIRECTOR MOTIVATION

A traditional agency theory of director motivation would imply that directors are faced with the choice of acting in the interests of a mythical ‘average’ shareholder or acquiescing to management’s demands in order to serve the director’s self-interest. This choice is based on the assumption that directors are rational, self-interested human beings (Eisenhardt 1989), and therefore will undertake a cost–benefit analysis of the trade-off between enhancing their own wealth and power (through mechanisms such as entrenchment) and solely pursuing shareholder interest.

Using this same logic, institutional investors with the ability to appoint and remove directors (through their shareholding powers) would (as rational utility-maximisers) consider the costs and benefits of influencing directors to act on the institutional investor’s behalf. Since institutional investors report and are often rewarded on a quarterly or annual basis, there is a strong incentive for those in key positions to pursue a short-term focus. If they successfully influence directors, it would lead to short-termism, where decisions made by directors increase the value of the share capital in the short-term at the expense of long-term value creation, both for the corporation and the beneficial owner.

Thus, the ownership structure brought about by institutional investing leads to directors facing three key options under agency theory, not the two generally acknowledged. Directors can act in their own interest (that is, not in the interests of any investors or the company as a whole), in the interest of the legal owners (institutional investors that are often short-term in nature), or in the interest of the company as a whole (which we assume is long-term in nature and better aligned to the interests of beneficial owners).

Our goal in the remainder of this paper is to generate reliable predictions about the behaviour of key actors – in particular directors – when making corporate governance decisions, through an understanding of the political elements of modern corporate governance. We also develop a model to explain the behaviour of the boards of directors. These powerful but straightforward tools would be helpful in characterising corporate governance behaviour.

DEVELOPING A NEW MODEL

Thus far we have established that the notion of how and for whose benefit a director should act is itself an ambiguous concept. Even the simple aim of acting to maximise shareholder value, as suggested by many scholars (see Demsetz and Lehn 1985), brings with it many questions including, what time frame should directors consider? As the earlier institutional investor (i.e. OPM investments – see figure 1) example highlights, the legal owner of a single share and the beneficial owner may have differing preferences about the investment time frame. Legal investors (that is, institutional investors) may seek to maximise the returns over a short-term period to maximise reporting and compensation benefits while beneficial investors (that is, retail investors) may seek to maximise the value of their share in the long run.

This ambiguity highlights that any corporate governance model must account for the various motivations of governance actors, the key processes involved in aligning interests as well as the outcomes of decisions. Our model directly accounts for the motivations of the directors and investors (that is, what it is the various governance actors are attempting to maximise) and the effect of the review process necessary to ensure the alignment of interests. The model also directly examines decision outcomes (that is, the nature of decisions that directors will make) under differing conditions of monitoring and director motivation.

Through the model it can be seen that director motivation is a function of monitoring and slack (Levine and Forrence 1990). Slack has been used by organisation theorists to argue that it leads to an increase in a firm's performance despite its costs (Cyert and March 1963, Pfeffer and Salancik 1978, Thompson 1967), and by agency theorists to argue that it leads to a decrease in a firm's performance due to agency problems (Fama 1980, Jensen and Meckling 1976). In this article the term 'slack' refers to where the directors have some discretion surrounding their decisions due to the lack of monitoring. By 'slack', we mean a situation where directors are shielded from monitoring when they take action or make decisions (Kalt and Zupan 1984).

When there is no slack in the system, directors are forced to follow the interests of the legal investor (that is, institutional investor) or they will be removed from the board. When there is slack, however, there may be differing forms of motivation (Kalt and Zupan 1984). Directors may be motivated by: (1) trying to gain legal investor (that is, institutional investor) support for their governance role through being seen to act in the institutional investors' interests; (2) garnering the support of some other special interest group such as management for their own interest; or (3) acting in some other way unrelated to the directors' own tenure or interests (that is, acting in the company's best interests). This situation highlights that recognising a potential difference between company interest (long-term value) and institutional investor interest (short-term value) compounds the traditional agency cost focus on director or manager self-interest. We follow Levine and Forrence (1990) and divide the interests into two dimensions, private interest versus company interest and general versus specific interests.

Private v. Company Interests

Most economic theories, including agency theory, concern private interests. In our model, private interests refer to the self-interested behaviour of directors, mediated by the values and beliefs that directors use to govern the choices they make. Company interests are harder to define (for example, see our earlier discussion on the company as a whole). They are different from private interests, in that they require a degree of altruism – they are the interests of someone other than the director. Thus, from directors perspectives, they only exist in the social context of the company. This occurs when directors fulfil their legal duties and act not in their own interests, but in the interests of the company as a whole.

Thus, directors constantly face a choice: make self-interested decisions or other-regarding decisions. Further, where the other-regarding decision is based on a self-interested motivation,[5] this is still a private interest under our definition. The key to this difference is in *motivation* – are directors motivated by self-interest or is their motivation other-regarding?

General v. Specific Interests

Directors' decisions can also be classified as having either general or specific interest. A decision would be considered of general interest where, in the absence of transaction costs, it would be agreed that the action is in the interests of the company as a whole – it is in the general interests of the company. If the decision is not in the general interest of the company, then it would be classified as a special interest action as it would only benefit a niche subset of the company, which may not include any investors; for example, a decision may be made to satisfy external environmental pressure groups.

Special interest actions require significant monitoring costs to exist in an organisation. The monitoring and transaction costs must be lower for the

[5] For instance, where directors acquiesce to a legal owner preference even when not in the interests of the company as a whole in order to retain their position on the board

special interest group than for the rest of the investors/interested parties for the special action interest to occur.

In the modern corporation, these conditions may often be the norm, particularly when we classify institutional investors and management itself as special interest groups. The organisational form and business environment allows the opportunity for directors and these two special interest groups to jointly exploit the slack (Kalt and Zupan 1984, pp. 282–4) caused by the cost–benefit balance available to other governance participants.

In essence, true monitoring of board decision-making is a costly exercise. Only those close to the process (for example, management) or with significant investments (for example, institutional investors) have sufficient motivation to monitor this activity. Other interested parties operate with a lower level of information – a situation that will lead to director discretion – particularly if the director acts in favour of a special interest group. Since directors are often rewarded for acting in favour of a special interest group, both parties benefit. Examples of the benefits flowing to directors after supporting special interest groups occur where a director accepts support for continued tenure, is offered additional or alternative employment or other benefits.

Slack in itself does not always lead to self-interested actions; however, where directors are sufficiently shielded from special interest monitoring, their actions may be Burkean in nature. That is, they may make a decision without expecting to gain personally from any source. With sufficient slack, directors can pursue an ideological agenda such as acting in the long-term interests of the company free from the pressures of special interest groups such as institutional investors. Burkean actions that directors can take include blocking popular courses of action that are in directors' opinions ill advised, and using the complexity of issues to obscure unpopular decisions to further what directors believe to be the best interests of the company.

In theory, the classification of directors' actions seems straightforward, but in reality the classification's boundaries become more blurred when applying it to theories such as agency theory.

Table 2 highlights the interaction of the presence of special interest groups and directors' actions. Panel A shows that with no slack (that is, no transaction costs or total transparency) directors will act in the interests of the company as a whole. This is because they are required to do so by law and, since there are zero monitoring costs, any deviation from this position will result in sanctions.

Table 2, Panel B indicates that with moderate slack and with a high presence of institutional investors, directors have no choice but to act with a short-term focus favouring the institutional investors, irrespective of whether they are other-regarding or self-interested. If they fail to do so, the institutional investors have the power to remove the director. Self-interested directors are still constrained into acting in the interests of the institutional investors, as there is no discretion to act in their own interests (what we have termed personal fiat) as parties with sufficient inside information (for example, management) or sufficient investments (for example, legal owners) can expose such action. A long-term focus may be possible only where there is low institutional investment and directors are other-regarding as the lack of a unified voting block may free them from pressure to conform to the will of the majority.

INSERT TABLE 2 ABOUT HERE

Panel C of Table 2 highlights the norm with high slack (that is, where large monitoring costs are present). High slack allows directors to make decisions and take actions without being completely observable to institutional investors and other shareholders. If directors are self-interested it will result in them making decisions that have some personal payoff, no matter whether there is pressure from institution investors or not. Institutional investors may still be able to coerce directors into acting in their interests by ‘rewarding’ them in some way. This places directors in a weakened position, as now they must be coerced into acting in their interest, not pressured into it. On the other side, this absence of slack would also see non-self-interested directors taking a more long-term focus whether or not there is pressure from institutional investors or not. The next section integrates these three states of slack into a model.

THE MODEL

The model draws upon agency theory and modern political analysis to explain directors’ decision-making with the inclusion of slack and institutional investors. It highlights that, using agency theory, directors face a self-interested versus other-regarding trade-off. It also draws heavily on political analysis (see Downs 1957, Olson 1971, Fenno 1973). With the presence of institutional investors and in the absence of slack, directors (no matter what their preference) will be constrained to act in the institutional investors’ interests, leading to short-termism. The presence of slack allows directors to either pursue their own interests or act in the interests of the company as a whole. This will lead to either agency costs for the organisation or allow it long-term growth and wealth.

The key component of the model is slack. This lack of monitoring is caused by high monitoring costs. Therefore slack is more commonly a feature of large or complex organisations, or where there are unstable operating environments.

INSERT FIGURE 2 ABOUT HERE

The first point to note in the model is that in the presence of total transparency (that is, the condition of no slack) directors are obliged to act in the interests of the company as a whole. Interested parties (that is, all stakeholders and shareholders) would have cost-free access to information to allow for monitoring of directors' actions and decisions, leading to an obligation to act in the long-term interests of the company. Thus we propose that:

> Proposition 1: Under the condition of total transparency between the board of directors and shareholders, directors will act in the long-term interests of the company as a whole.

As the model also demonstrates, where it is possible for a motivated group to monitor directors more easily than others (that is, in the presence of some, but not high slack) and where there is a motivated special interest group (in the case of the model, institutional investors), directors are more likely to be ‘captured’. This capture occurs since the directors have no discretion in their decisions due to high visibility to the special interest group (that is, institutional shareholders) that occurs in the absence of high slack.

Institutional investors often report and are rewarded on a more short-term basis, in some cases as short as quarterly. With pressure on them to make returns in the short term, they will often pressure boards to make decisions that will increase the stock price to create wealth quickly; this may be contrary to the long-term health and strategic direction of the organisation.

Directors are not, however, easily subject to review by all interested parties (including minority shareholders and stakeholders) due to the presence of some monitoring slack. Further, as a result of the institutional investors’ short-term focus, directors’ actions and decisions will also become short term in their focus. Thus we propose that:

> Proposition 2: In the presence of moderate transparency between the board of directors and investors, directors will be subject to capture to the preferences of the special interest group and so will

focus on short-term outcomes where there are institutional investors.

Institutional investors have this power over the board due to their large shareholdings in organisations, essentially making them the ‘voice’ of the shareholders. We would, therefore, expect the relationship between short-termism and slack to be moderated by the concentration of institutional ownership. The higher the concentration of ownership, the greater the likelihood of capture and we therefore propose that:

> Proposition 3: An increase in institutional investment in an organisation leads to a greater likelihood of short-termism.

In contrast, when there is high slack in an organisation the likelihood of directors acting in the short-term decreases. The actions and decisions of directors will now be more dependent on their internal locus on control. If directors are self-interested, they may act in their own interests. Because there is no pressure to conform to the requests of any special interest group (that is, institutional investors) there is no pressure to create short-term gains. Instead, directors can approve excessive remuneration and perquisites for themselves. This can also lead to a situation where institutional investors, due to an inability to pressure directors, are forced to use financial or other incentives to coerce directors to act in their interest. Thus we propose that:

> Proposition 4a: An increase in slack between the board and institutional investors leads to an increase in the likelihood of directors acting self-interestedly.

However, the presence of slack also allows directors to act in the interest of the company as a whole by making decisions that will support long-term growth and wealth creation. Freed from the scrutiny of institutional investors, a Burkean director can make decisions in the long-term interests of the company as a whole. Thus we propose that:

> Proposition 4b: An increase in slack between the board and institutional investors leads to an increase in the likelihood of directors taking a long-term view of wealth creation when making decisions.

An interesting conclusion drawn from the model is that an increase in slack can lead to contrary effects; that is, slack can lead to directors pursuing personal fiat or acting in the long-term interests of the company as a whole. Research to date has focused on one particular aspect of the model – slack and a proposed relationship to self-interested behaviour. This has lead to a general belief that reducing slack, through mechanisms such as increased transparency, will reduce the potential for director self-interest. The model that we have developed shows that the opposite may also be true, reducing slack can lead to a reduction in Burkean actions, such as long-term investment horizons, stakeholder recognition and ethical behaviour.

CONCLUSION

We commenced by noting the dominance of agency theory in the corporate governance research agenda and the growing dissatisfaction with the narrowness of an agency approach. We have revisited the basis of the director–shareholder relationship and the ownership structure of the modern listed company to examine the applicability of agency theory. By combining agency theory and political motivation analysis we have modelled a more complete understanding of director decision-making. The model captures the impact of a new stakeholder (the institutional investor) on the corporate governance process. This has great potential benefit for academics and practitioners alike, through a new insight into why directors make the decisions they do. It also highlights that old ways of thinking, such as an increase in transparency leading to better board behaviour, may need to be revisited with the changing nature of the ownership of corporations.

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Figure 1 Typical institutional investment vehicle

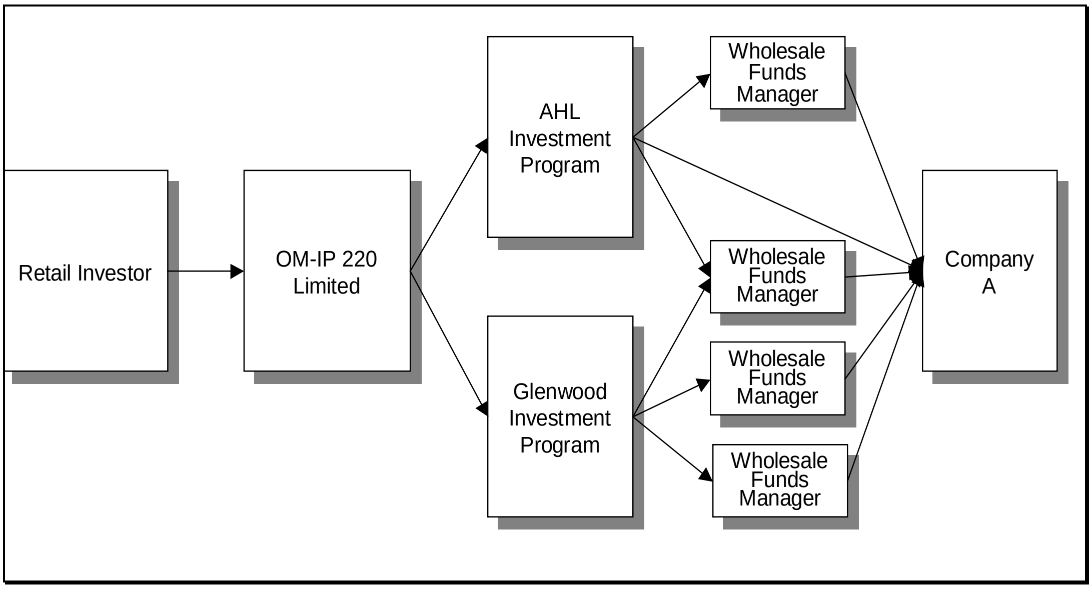

Figure 2 Short-termism model

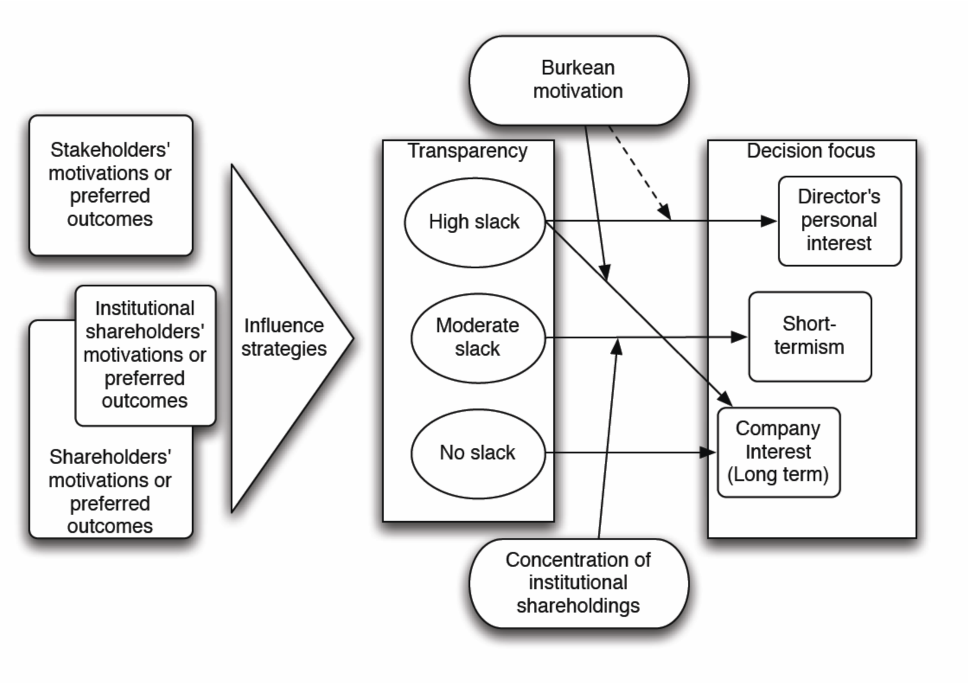

Table 1 Ownership of the top 20 Australian companies as at 30 June 2007

Company/investor (position and percentage)	Citicorp Nominees P/L* #	ANZ Nominees Ltd* #	Cogent Nominees P/L* #	JP Morgan Nominees Aus. Ltd #	National Nominees Ltd #	HSBC Custody Nominees (Aus) Ltd #	Queensland Investment Corporati	AMP Life Ltd	Dexia Investor Services Aus. Nominees	UBS Nominees P/L* #	dings of Top 10 Institution
National Australia Bank	5 3.82%	4 3.52%	6 1.74%		3 9.89%		7 1.07%				20.04%
BHP Billiton	1 13.12%	5 3.70%		3 11.11%	4 9.65%	10 0.55%	7 1.22%		8 1.14%	9 0.62%	41.11%
Commonwealth Bank	4 6.15%	6 2.51%	7 1.66%	2 8.40%		1 8.42%	8 1.20%	9 0.81%	5 2.63%	10 0.69%	32.47%
ANZ Banking	4 5.11%	5 4.84%	7 2.19%				8 1.08%	9 0.99%	6 2.52%		16.73%
Westpac Banking Group	4 6.60%	6 3.02%	7 2.51%	2 11.81%	3 9.86%	1 15.10%	9 1.11%	8 1.13%	5 3.17%		54.31%
Telstra	6 1.98%	7 1.75%	8 0.81%	5 4.60%	4 6.12%					9 0.65%	15.91%
Westfield Group	4 7.59%		8 3.21%	2 15.79%	3 12.07%	1 20.70%		9 1.85%			61.21%
AMP	4 5.09%	5 1.90%	6 1.59%	2 13.82%	3 7.17%	1 15.84%	7 0.93%	8 0.93%			47.27%
QBE Insurance Group	4 7.20%	5 3.41%	6 2.74%	2 20.34%	3 14.78%		8 1.84%	9 1.05%		10 0.93%	52.29%
Woolworths	5 3.83%	4 4.06%	7 1.11%	2 12.24%	3 9.26%	1 12.72%	6 1.52%	8 0.87%			45.61%
St George Bank	4 1.41%	6 1.27%	7 1.22%	1 9.99%	3 4.77%	2 5.24%	9 0.64%	8 0.65%	5 1.37%		26.56%
Macquarie Bank	5 4.38%	4 4.61%	7 1.67%	1 15.83%	3 13.19%	2 14.85%	6 2.07%	10 1.12%			57.72%
Coles Group	4 7.05%	7 1.90%	8 1.34%	2 8.30%	3 7.32%	5 6.98%				9 1.33%	34.22%
Suncorp-Metway	5 2.85%	6 2.26%	7 1.73%	2 10.73%	3 8.99%	1 10.84%	10 1.21%	8 1.23%	4 3.84%	9 1.21%	44.89%

Brambles	4	9.27%	5	8.07%	7	2.29%	2	16.72%	3	12.53%			8	1.45%	10	0.71%	9	0.76%			51.80%
Qantas Airways	4	9.29%	5	5.83%	7	3.70%	3	15.77%	2	16.08%	1	19.91%			9	1.37%	6	3.77%			75.72%
Insurance Australia Group	5	4.54%	4	3.38%	7	1.21%	1	14.01%	3	6.73%	2	6.97%	8	1.06%			6	1.46%			39.36%
Wesfarmers	4	3.77%	5	2.73%	8	0.71%	3	4.48%	1	6.59%	2	5.03%					10	0.65%			23.96%
Woodside Petroleum	6	2.27%	5	3.81%	10	0.60%	2	9.45%	4	7.36%	3	8.57%	7	0.76%	9	0.67%					33.49%
Foster's Group	4	8.57%	5	6.72%	7	2.52%	2	15.90%	3	12.48%	1	17.41%	8	1.17%					9	0.92%	65.69%

* Various accounts amalgamated.

Nominee companies are companies formed by banks or other organisations that operate nominee accounts; that is, the holding of shares for the beneficial owner.

NOTE: Table for demonstration purposes only, figures drawn from the top 20 annual reports.

Table 2 Interactions between directors' actions and concentration of institutional investment

Panel A: No Slack

Context	Self-interested director	Other-regarding director
High institutional investment	Long-term focus	Long-term focus
Low institutional investment	Long-term focus	Long-term focus

Panel B: Moderate Slack

Context	Self-interested director	Other-regarding director
High institutional investment	Short-term focus	Short-term focus
Low institutional investment	Majority shareholder focus	Long-term focus

Panel C: High Slack

Context	Self-interested director	Other-regarding director
High institutional investment	Opportunistic personal fiat that may include short-term focus	Long-term focus
Low institutional investment	Opportunistic personal fiat that may include short-term focus	Long-term focus