Discussion Paper No. 2002/9

Institutional Investors, Corporate Ownership and Corporate Governance

Global Perspectives

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January 2002

Abstract

We examine the role of institutional investors in financial markets and in corporate governance. In many countries, institutional investors have become the predominant players in financial markets and their influence worldwide is growing, chiefly due to the privatization and development of pension fund systems. Moreover, foreign institutional investors are becoming a significant presence, bringing their trading habits and corporate governance preferences to international markets. In fact, we argue that the primary actors prompting change in many corporate governance systems are institutional investors, often foreign institutional investors. In other countries the role of institutional investors is limited. Instead, large blockholders, often in the form of individuals, family groups, other corporations, or lending institutions are the dominant players. We present the theoretical arguments for the involvement of investors in shareholder monitoring and a brief history of institutional ownership and activism in the United States and other countries. We also discuss studies of the efficacy of such activism.

We then examine differences in ownership structures around the world and the implications of the interactions of these ownership structures for institutional investor involvement in corporate governance. Although there may be some convergence in corporate governance systems across countries, because of the endogenous nature of the interrelation among the factors of corporate governance the evolution will most likely .../…

Keywords: institutional investors, corporate ownership, corporate governance

JEL classification: D23, F23, G32, G34

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This study has been prepared within the UNU/WIDER project Property Rights Regimes, Microeconomic Incentives and Development directed by Laixiang Sun

vary across countries. We would expect, however, that over time institutional investors will increase the liquidity, volatility, and price informativeness of the financial markets in which participate. In turn, the increased information provided by institutional trading should result in better corporate governance structures, including more effective monitoring.

The views expressed in this paper are those of the authors and do not necessarily reflect those of TIAA-CREF or its employees.

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Camera-ready typescript prepared by Lorraine Telfer-Taivainen at UNU/WIDER
Printed at UNU/WIDER, Helsinki

ISSN 1609-5774
ISBN 92-9190-136-9 (printed publication)
ISBN 92-9190-137-7 (internet publication)

1. Introduction

Managers' activities are potentially constrained by a number of factors that constitute and influence the governance of the corporations that they direct. Examples of these factors include the board of directors, who set policies and monitor managerial actions, labour agreements, debt constraints, governmental laws and regulations, and even the competitive environment. An increasingly important factor affecting governance worldwide is the role of the institutional investor. Institutional investors can exert direct influence on management's activities through their ownership, and indirect influence by their ability to trade their shares. In this paper we consider the role of institutional investors in corporate governance, the motivation for that role, and how the role has changed during the recent past.

Before assessing the role of institutional investors in corporate governance, we must first define what we mean by corporate governance. Recent research has viewed the concept in different ways. Gillan and Starks (1998) define corporate governance as 'the system of laws, rules, and factors that control operations at a company'. They highlight that a firm's governance comprises the set of structures that provide boundaries for the firm's operations. This set of structures includes participants in corporate activities, such as workers, managers, and suppliers of capital, the returns to those participants, and the constraints under which they operate. Shleifer and Vishny (1997) define corporate governance in terms of the economic interests of the participants. In particular, they refer to corporate governance as dealing '…with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. Similarly, Zingales (1998) defines corporate governance as '…the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm'.

The need for governance derives from the potential conflicts of interest among participants (stakeholders) in the corporate structure. These conflicts of interest, often referred to as agency problems, arise from two main sources. First, different participants have different goals and preferences. Second, the participants have imperfect information as to each others' actions, knowledge, and preferences. Berle and Means (1932) are credited as being among the first to address these conflicts by focusing on the separation of corporate ownership from corporate management—commonly referred to as the separation of ownership and control. Berle and Means noted that this separation, absent other corporate governance mechanisms, provides managers with the ability to act in their own self-interest rather than in the interests of shareholders.

Corporate governance practices have evolved since the time of Berle and Means (1932), primarily in response to changes in the corporate environment. The evolution in corporate governance, which has varied internationally, has been particularly strong in countries where the banking, capital markets, and legal systems have undergone dramatic change. Further, governance changes have been prevalent in countries with relatively high levels of institutional investment. In fact, we argue that the primary actors prompting change in many corporate governance systems are institutional investors, often foreign institutional investors. We first present the theoretical arguments for the involvement of institutional investors in shareholder monitoring. A short history of institutional ownership and activism in the United States and other countries is then followed by a discussion of the efficacy of such activism. We also examine how the legal environment in which a company operates can impact governance structures and ownership structures, and discuss differences in ownership structures around the world. We then consider the implications of these different ownership structures and how different owners may interact thus affecting the role of institutional investors as owners. After a brief discussion of the evolving environment in which corporations operate, we conclude the paper.

2. Rationale for institutional shareholder involvement in corporate governance

In a number of countries institutional investors have become a dominant presence in financial markets. For example, in the United States, institutional investment grew from 6.1 percent of aggregate ownership of equities in 1950 to over 50 percent by 1999 (Board of Governors of the Federal Reserve System, 2000). The character of US institutional ownership has also changed, with shifts in the relative importance of different types of institutional investors. Today independent investment advisors (primarily for pension funds), mutual fund advisors, and bank trust departments control the majority of institutional assets in the United States.

Assets held by institutional investors have also been growing in other financial markets. For example, by the mid 1990s, institutional investors owned 76.5 percent of outstanding equities in the UK, 59.8 percent in France and 39 percent in Germany. Further, total financial assets held by institutions in each of these countries grew by over 50 percent during the 1990-5 time period (Conference Board, 1998). Although institutional investors have not played as prominent a role in emerging markets, pension reform has started to influence the financial holdings of institutions and thus the capital markets in emerging economies. For example in Chile, domestic pension funds held over 50 percent of outstanding corporate, government and mortgage bonds by the 1990s and over 10 percent of equities (Walker and Lefort, 2000). By 1999, pension fund and life insurance companies' financial holdings represented over 10 percent of the total savings in Chile (Iglesias, 2000). Given the differences in institutional ownership across markets, we consider the role of institutional shareholder monitoring in economies characterized by diffuse ownership and in economies characterized by dominant controlling shareholders.

The role of institutional shareholder monitoring in any economy is the subject of continuing debate. Shareholders, as the owners of the firm, have certain rights, including the right to elect the Board of Directors. The Board, as the agent of the shareholders, has the direct responsibility to monitor corporate managers and their performance. The potential for shareholder activism, in particular, institutional investor shareholder activism, arises when shareholders believe that the Board of Directors has failed in its duty. That is, the shareholders are dissatisfied with the performance of the Board of Directors (and presumably the firm). In other words, the potential for activism is high when agency costs are high. In such a case, shareholders can (1) 'vote with their feet,' i.e., sell their shares; (2) hold their shares and voice their dissatisfaction, or (3) hold their shares and do nothing. Hirschman (1971) has characterized these alternatives as: exit, voice and loyalty. The question naturally arises as to what conditions would lead an investor to exercise the voice option rather than the other two.

3. The institutional investor as a large shareholder

As Roe (1990) has pointed out, it is not just the separation of ownership and control that gives rise to the agency problem between shareholders and managers, rather it is the atomistic or diffuse nature of corporate ownership. That is, an ownership structure characterized by a large number of small shareholders. Given a diffuse ownership structure, there is no incentive for an individual owner to monitor corporate management. The rationale is that the individual owner bears the entire monitoring costs, although the benefits accrue to all shareholders. Roe's point suggests that the magnitude and nature of agency problems is related to ownership structures. Given the differences in ownership structures around the world, one would expect differences in the form, consequences, and solutions to the shareholder-manager agency problem across countries. In countries where ownership structures are dominated by the existence of a large shareholder, there may be a lower likelihood of agency problems as envisioned by Berle and Means (1932) and Roe (1990).

Numerous authors have argued that an important role for large shareholders is to ameliorate agency problems by monitoring or otherwise taking control of the corporation (Shleifer and Vishny (1986), Admati, Pfleiderer, and Zechner (1993), Huddart (1993), Maug (1998) and Noe (1997)). These authors have further argued that, because all shareholders benefit from the actions of a monitoring shareholder without incurring the costs, only large shareholders have sufficient incentives to monitor.[1] Put another way, large investors have stronger incentives to undertake monitoring activities, as it is more likely that the gains on their investment as a result of monitoring would be sufficient to cover the associated costs.[2]

Empirical evidence on the role of large shareholders as monitors has supported this theory to some extent. For example, Bethel, Liebeskind, and Opler (1998) find that company performance improves after an activist investor purchases a block of shares. In addition, Kang and Shivdasani (1995), and Kaplan and Minton (1994) have found that the presence of large shareholders in a firm is associated with management turnover, suggesting that these shareholders provide a monitoring function. Further evidence is provided by Agrawal and Mandelker (1990) who report smaller 'overpayment' in corporate takeovers when the bidding firm has a large shareholder.

Another perspective on the large shareholder arises when that shareholder is a lending institution. Previous research has argued that lenders occupy a unique position in a firm's corporate governance given their monitoring and control abilities. In particular, the argument is made that banks have a comparative cost advantage in monitoring firms due to their access to inside information. The bank lenders' access to superior information, relative to the information available to bondholders, reduces potential agency costs of debt financing (Fama, 1985).

[1] That is, the existence of a large shareholder can provide a partial solution to the free-rider problem inherent in diffusely owned companies pointed out by Grossman and Hart (1980).

[2] However, as pointed out by Shleifer and Vishny (1986), because the large shareholder can only reap the gains to his or her own shares, even the existence of such a monitoring shareholder will still lead to too little monitoring.

There is also evidence concerning the role of lenders as equityholders in countries that do not have restrictions on equity investments by financial lending institutions. For example, in the US, for most of the twentieth century, banks were prohibited by law from holding equity in a firm, but in Japan, banks could take large equity positions in firms, including firms to which they made loans. One implication of these differences in restrictions is that if lending institutions who are equity holders are more effective monitors, then the agency problems in Japan could be less than in the US, everything else equal.

Prowse (1990) concludes that agency problems in Japan are, in fact, lessened by the Japanese lenders' equity holdings, which suggests that lenders can contribute positively to a firm's performance through equity positions.[3] Further, Kaplan and Minton (1994) study the outside appointments of former bank employees to boards of directors in Japanese firms and conclude that banks (along with corporate shareholders) are an important aspect of corporate governance in Japan. However, Boehmer (1999) reports contrasting evidence for Germany. Banks in Germany control a substantially higher fraction of corporate voting rights than cash-flow rights (due to proxy votes and board memberships). Since the banks typically have larger loan positions than equity investment in portfolio companies, it is unclear whether banks' voting power is used in shareholders' interests. Indeed, Boehmer provides empirical evidence that bank control appears to have only a modest effect on firm stock market performance.

The evidence from studies comparing corporate governance structures and their effects should be interpreted with caution. For example, the observed differences in bank equity holdings between Germany, Japan, and the United States do not arise in isolation, and may be related to other differences in corporate governance. Moreover, lenders may have different goals from other types of shareholders. Thus, it is not clear that lender equity positions would uniformly benefit corporate governance and firm performance.

4. Institutional investors, monitoring, and information transmission

4.1 Theory and evidence

Another potential role for large institutional investors is to provide a credible mechanism for transmitting information to the financial markets, that is, to other investors (Chidambaran and John, 2000). Large institutional investors can obtain private information from management and convey that information to other shareholders. But for such monitoring to be credible, the large shareholder needs to maintain their investment for a sufficiently long period of time and hold enough shares to mitigate the free rider problem. The result is that, under certain conditions, there will be a payoff for the institutional investor who performs costly monitoring to oversee managers and a payoff for the manager who co-operates. Thus, Chidambaran and John argue that relationship investing is optimal for both the large investor and management. This view of a large investor who engages in non-control monitoring analysis can be contrasted with that of Shleifer and Vishny (1986) who envision a large shareholder willing to take control of the firm.

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[3] He bases this conclusion on his finding of a significant negative relation between debt ratios and firms' potential for risky, suboptimal investments for US firms and no significant relation for Japanese firms.

A differentiation can also be made between the monitoring incentives and abilities of institutional investors versus those of large non-institutional blockholders. Gorton and Kahl (1999) argue that institutional investors may provide imperfect monitoring due to their own internal agency problems. Because there are not sufficient individual large blockholders to provide better monitoring, however, even imperfect monitoring is beneficial. Thus, one would expect large institutional investors and large non-institutional blockholders to coexist. Further, the incentives and abilities of institutional investors to monitor will vary. Different institutional investors have different clienteles, constraints, goals, and preferences. For example, Brickley, Lease and Smith (1988) discuss the difference between pressure-sensitive and pressure-insensitive institutional shareholders and argue that pressure-sensitive institutions would be more likely to 'go along' with management decisions. The rationale is that pressure-sensitive investors may have current or potential business relations with the firm that they do not want to jeopardize. The authors find evidence consistent with their hypothesis—firms with greater holdings by pressure-sensitive shareholders have more proxy votes in line with management's recommendations and firms with greater holdings by pressure-insensitive shareholders experience more proxy votes against management's recommendations.

In studying the adoption of antitakeover amendments Borokhovich, Brunarski, and Parrino (2000) provide evidence consistent with the hypotheses of Gorton and Kahl (1999) and Brickley, Lease and Smith (1988). Specifically, Borokhovich, Brunarski and Parrino find that the relation between announcement date abnormal returns and the percentage of outside blockholdings depends on the identity of the blockholder. When the blockholders are individuals or pressure-insensitive institutions (investment companies or independent investment advisers), abnormal return and percentage blockholdings are positively related. When the blockholders are pressure sensitive institutions, such as banks or insurance companies, abnormal return and percentage blockholdings are negatively related.[4]

Further evidence on monitoring differences across institutions is provided by Bushee (1998) in a study of the relation between a firm's aggregate institutional ownership and its R&D investment. He suggests that institutions serve an overall monitoring role by reducing pressures for managers to behave myopically. However, he also finds that the strength of this monitoring role varies across types of institutional investors. Institutions characterized by high turnover and momentum trading appear to encourage myopic behaviour by managers. In studying expenditures on R&D and property, plant and equipment, Wahal and McConnell (1999) reach a somewhat different conclusion. They argue that, regardless of the investment style of the institutional investor, there is no evidence that institutional investors contribute to managerial myopia and further, that institutional investors reduce pressures contributing to managerial myopia.

Hartzell and Starks (2001) find evidence suggesting that institutional investors provide a monitoring role with regard to executive compensation contracts. They find a positive association between the concentration of institutional ownership and the pay-for-performance sensitivity of a firm's executive compensation and a negative association between the concentration and excess salary. One implication of this result, consistent with the theoretical literature regarding the role of the large shareholder, is that institutions have

[4] Borokhovich, Brunarski and Parrino (2000) use the terms affiliated and unaffiliated rather than pressure sensitive and pressure insensitive.

more influence when they have larger proportional stakes in firms. Hartzell and Starks also find that the monitoring influence is associated more with investment companies and pension fund managers (pressure insensitive) than with banks and insurance companies (pressure sensitive).

Even institutions that choose to sell their shares rather than trying to instigate change in the firm can affect corporate governance. As noted by Parrino, Sias and Starks (2000), there are several potential effects from institutional selling of shares: downward price pressure due to supply-demand effects, information signals to other investors, and changes in shareholder composition. The first effect is supported by empirical evidence demonstrating that heavy institutional selling can put downward pressure on the stock price (e.g., Brown and Brooke, 1993). Alternatively, institutional selling may be interpreted as bad news, thus triggering sales by other investors and further depressing the stock price. Finally, the composition of the investor base holding the shares may change, for example, from institutional investors with a long-term focus to investors with a more myopic view. This last effect may be important to directors if the types of institutions holding the stock affect share value or the management of the company.

Parrino, Sias and Starks (2000) find those firms that fire their top executives have a significantly greater decline in institutional ownership in the year prior to the CEO turnover than do firms that experience voluntary CEO turnover. These results are consistent with the hypothesis that institutional selling influences decisions by the board of directors—institutional investors selling a stock increases the likelihood a CEO is forced from office.[5] Further, the authors find that greater decreases in institutional ownership are associated with a greater probability of an outsider being appointed to succeed the CEO. This indicates that directors are more willing to break with the current corporate management and institute change.

Although a large institutional shareholder may receive benefits from monitoring there are also potential costs. For example, concentrated ownership may reduce market liquidity and thus reduce the ability of the investor to sell their shares (Holmstrom and Tirole, 1993)). This link between monitoring and liquidity has been addressed by a number of studies, including Coffee (1991), Bhide (1994), Maug (1998) and Kahn and Winton (1998). One view is that liquidity and control are antithetical (Coffee (1991) and Bhide (1994)). Historically, institutional investors have preferred liquidity to control because the ability to exercise control over corporate management entails a sacrifice of liquidity—a sacrifice that is an unacceptable cost to many institutional investors (Coffee, 1991). For example, in the US, while extensive regulation has promoted liquidity, it has also promoted diffuse, arm's length stock holding (Bhide, 1994). This in turn has detracted from the establishment of close relationships between owners and managers. Corporate and pension fund managers become reluctant to receive private information from managers because they believe the receipt of such information could compromise their fiduciary responsibility to protect the liquidity of their portfolio. The Securities and Exchange Commission has further reinforced this perspective by the issuance of new disclosure regulations ('Regulation Fair Disclosure'.) In addition, institutional investors tend to stay below the 10 percent

[5] As noted by the authors, these results are also consistent with the hypothesis that institutional investors are better informed than other investors, and thus become net sellers over the period prior to forced turnovers when these firms typically experience negative market-adjusted returns.

ownership level lest they trigger federal regulations pertaining to short-term and insider trading. Bhide provides evidence supporting the contention that regulatory constraints affect the activities of institutional investors.

Bhide (1994) also suggests that diversification rules in the US lead to institutional investors holding only small amounts of any one firm. This in turn compounds the free rider problem. Moreover, insider trading and disclosure rules that have enhanced liquidity for passive shareholders adversely affect governance by limiting liquidity for active shareholders. As such, many of those shareholders that could play an active role in the governance of the corporation instead remain passive. Bhide's view contrasts with the more recent work of Maug (1998), Kahn and Winton (1998), and Noe (1997). Maug argues that the alleged trade-off between liquidity and control does not exist. Liquid markets make it less costly to sell a large stake, but also make it easier for investors to accumulate large stakes and to capitalize on shareholder activism. He concludes that the impact of liquidity on corporate control is unambiguously positive. Kahn and Winton (1998) focus on how firm characteristics affect an institutional shareholder's decision to intervene into a corporation's decision-making process and the implications of this intervention for firm ownership structure. They show that the intervention decision depends on the benefits from increasing value of the existing stake in the firm and the effects on the institution's trading profits.

Noe (1997) demonstrates that a core group of institutional investors can naturally develop with the goal of monitoring the corporation and preventing managers from engaging in opportunism. In his model a wide range of institutions exist, from small to large, not all of which will be motivated to monitor. Some will choose to be passive, but there is not a monotonic relation between size of shareholdings and incentives. Noe also shows that institutional investors can be motivated to monitor managers because they can gain from the monitoring, even in the presence of costly monitoring, free rider problems, and no initial stake in the corporation. He further suggests that if the informed institutional investors increase the size of their shareholdings, that is, increase ownership concentration in the stock, it may actually lower bid-ask spreads.

In summary, the consensus in the literature is that there are many costs associated with shareholder activism and increased ownership concentration. Moreover, existing regulations impair governance by encouraging diffuse ownership and liquidity while simultaneously discouraging active investing. Despite these barriers to shareholder action, there has been an increased amount of non-control related monitoring over the recent past by large blockholders and by institutional investors.

5. Institutional shareholder activism across countries

5.1 The US experience[6]

Given the increasing influence of institutional investors in the financial markets, it is perhaps not surprising that they have become more active in their role as shareholders. The activism by these investors has been both private and public, with much of the public

[6] For surveys of shareholder activism, see Black (1998), Gillan and Starks (1998) or Karpoff (1999).

activism most visible in the United States. Regulation in the United States has strongly influenced institutional investors' three action choices of exit, voice, or loyalty. In the early 1900s, insurance companies, mutual funds, and banks began to become active in corporate governance, i.e., exercise voice. In all cases, however, laws were passed to limit the power of financial intermediaries and to prevent them from having an active role in corporate governance (Roe, 1993). In particular, banks were prohibited from owning equity directly. Thus, the corporate governance system in the United States has historically differed from that in other countries such as Germany and Japan where, by design, institutions (particularly banks) played a large role in the ownership and monitoring of corporations.

The position of the US government agencies regarding institutional activism has changed in recent years. This change is apparent given Labour Department encouragement of pension funds to actively monitor and communicate with corporate management if such activities are likely to increase the value of the funds' holdings.[7] It is also apparent in the 1992 decision by the Securities and Exchange Commission to allow shareholders to freely communicate with each other without gaining prior approval from the SEC, and in the 1999 repeal of the Glass-Stegall Act, which ended restrictions on direct ownership of US equity by banks.

Despite the legal and regulatory impediments they have faced, there is evidence that some US institutional investors have become more active in corporate governance in recent years. Beginning in the mid 1980s, for example, some public pension and union funds started submitting shareholder proxy proposals, individually and in collaboration with each other.[8] Later, they changed their strategy somewhat by negotiating more directly with corporate management and by publicly targeting corporations through the media. In addition to public pension funds, private pension and mutual fund advisors also began to take more active roles in the corporate governance of firms in which they hold investments (although their activism has tended to be less publicized). For instance, some money managers have purportedly influenced high profile decisions to replace top managers (Myerson, 1993; *Pensions and Investments*, 1993). Others, such as the Lens Fund and Relational Investors, specifically target poorly performing companies with a perceived poor governance structure and actively pressure management for reform.

In a survey of 231 portfolio managers and institutional shareholders, 77 percent of the respondents had participated in some form of activism in the previous year, either by communicating their opinions directly to a board (verbally or by letter), seeking more involvement in board oversight, sponsoring a shareholder resolution, or voting in favour of a shareholder resolution (*Directors and Boards*, 1997). According to Ettorre (1996), 'Fifteen years ago, the CEO and CFO did not know major holders and really didn't care. CEOs are now more accessible to money managers'. This attitude demonstrates the increasing importance of institutional investors.[9]

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[7] The Labor Department has oversight responsibility for corporate pension funds through ERISA (the Employee Retirement Income Security Act).

[8] The major issues raised by these proposals dealt with corporate governance, in particular, the problems arising from the misalignment of the interests of managers and shareholders.

[9] For a more complete discussion on management's view of institutional investor activism, see Martin and Kensinger (1996) who interviewed a number of executives whose firms had been targeted by institutional investor activists.

Although there has been activism on the part of private US pension funds, and the US Labour Department has encouraged such activities, corporate pension funds in general have been reluctant to engage in activism against other corporations. One argument for this reluctance is a fear that the activism could result in retaliation. Because of business relations with the corporation, pressure -sensitive institutional investors may be compelled to vote with the management even if contrary to their fiduciary interests (Pound (1988) and Brickley, Lease, and Smith (1988)). Thus, there is a presumption that corporate pension funds have a conflict of interest in monitoring management at other corporations. Further, Romano (1993) cites a widely held hypothesis that public pension funds are more effective monitors of management because they vote their own shares, in contrast to private pension funds that typically delegate their voting to external money managers. However, she finds no evidence that this hypothesis is valid. According to a survey of institutional investors from the IRRC, there is no significant difference in voting policy between public and private pension funds; both groups supported management over the survey period.

One other study has attempted to determine whether there are differences across institutional investors in regard to shareholder activism. In a survey of the 40 largest pension funds, 40 largest investment managers, and 20 largest charitable foundations, Useem, Bowman, Myatt, and Irvine (UBMI) (1993) find wide differences across institutions, even institutions of the same type, with regard to their opinions and activities on shareholder activism. For example, we might expect that indexed portfolios would be more likely to engage in activism. Because they cannot exit their investments in the company, the index fund managers who are unhappy with a firm would be constrained to giving voice. However, UBMI's survey finds that this does not appear to be the case—some index fund managers are highly active while others engage in no activism.

The activism by some institutional investors in the United States has been a matter of debate, both with regard to its efficacy and with regard to its appropriateness. Those in favour of institutional investor activism maintain that it results in improved corporate governance and that it has positive externalities because the monitoring benefits all shareholders. Proponents of activism further argue that an additional benefit is that some types of institutional monitoring provide incentives for managers to focus on the firm's longer-term prospects, rather than its shorter-term prospects, thus, counteracting tendencies toward managerial myopia.

In contrast, others contend that institutional investors should not have a role in corporate governance. For example, the argument has been made that portfolio managers lack the expertise to advise corporate management. (This argument is essentially the same as that behind the passage of early twentieth century laws limiting control by institutional investors. The legislators did not want 'Wall Street' directing 'Main Street'.) Opponents to institutional shareholder activism also maintain that the activism detracts from the primary role of pension funds, which is managing money for the beneficiaries. Further, Murphy and Van Nuys (1994) question the incentives that public pension fund managers have to undertake such activities. Indeed, these authors contend that the incentive structure of the public pension funds is such that it is rather surprising that we see them engaged in this activity at all. Woidtke (2001) tests this hypothesis by comparing the relative value of firms held for public versus private pension funds. She reports that relative firm value is positively related to private pension fund ownership and negatively related to (activist) public pension fund ownership. She interprets these results as being consistent with the view that the actions of public pension fund managers may be motivated more by political or social influences than by firm performance. Finally, Monks (1995) makes the point that public pension funds would have a more natural role as valuable allies for activism by other investors rather than as primary activists themselves.

5.2 Effectiveness of institutional shareholder activism

Measuring the effectiveness of shareholder activism is problematic. First, it is difficult to determine the activism's outcome and whether it had positive consequences for the firm. For example, after the submission of a shareholder proposal, we can explore whether changes in the firm's governance structure reflect the intentions of the activists. That is, do firms repeal their antitakeover amendments, change their compensation plans or change the structure of their board of directors after shareholder proposals are submitted? But there is the problem of determining whether any changes that do occur are caused by the activism and whether the changes are beneficial, that is, whether they actually result in economic changes for the targeted firm. For example, one major goal of shareholder activists has been increased board independence. Although we can observe whether there are more independent directors, it is difficult to directly attribute the increase to shareholder activism. More importantly, it is difficult to assess whether changing the composition of the board in this way actually results in economic changes for the corporation.[10]

A second problem arises in that much of the activism is conducted 'behind the scenes" through private negotiations: there is no external observation of the event. For example, CalPERS submitted a shareholder proposal to Texaco calling for the creation of an advisory committee of major shareholders to work with management. After directly negotiating with Texaco and getting an agreement that Texaco management would nominate a pro-shareholder candidate to its board of directors, CalPERS withdrew their shareholder proposal (Parker, 1989). More recently, TIAA-CREF has pressured companies to remove 'dead-hand' provisions from poison pill antitakeover measures. The dead-hand provision allows only the directors who put the poison pill in place to remove it, thus potentially delaying a new board's desire to sell the company. Since 1998, when TIAA-CREF began its focus on dead-hand pills, 51 of 60 corporations approached have removed their dead hand provisions, or have removed their pills altogether. Such activities are not included in most of the studies of shareholder activism. An exception to this is the paper by Carleton, Nelson and Weisbach (1998) of direct negotiations between TIAA-CREF and targeted companies during the 1992-96 period. The authors state that of the 45 firms contacted by TIAA-CREF, 71 percent reached a negotiated settlement prior to a vote on the shareholder proposal. The remaining 29 percent of the firms resisted TIAA-CREF's pressures and the shareholder proposals went to a vote. This suggests that academic studies may substantially understate the effects of shareholder activism because they do not observe the full set of (potential) shareholder proposals and their effects.

The substantial body of empirical evidence as to the influence of shareholder activism has mixed results. While papers have found some short-term market reaction to the announcement of certain types of activism, there is little evidence of improvement in long-

[10] For an analysis of whether board independence results in improved performance for firms, see Bhagat and Black (1998a). For a more general survey of the empirical evidence on the relation between the composition of the board of directors and firm performance, see Bhagat and Black (1998b).

term stock market performance or operating performance after the activism. Studies have found some change in the real activities of the firm subsequent to the shareholder pressure, but it is difficult to establish a causal relationship between shareholder activism and these changes.

6. Institutional investor monitoring in other countries

The relatively active role of institutions in the US contrasts with that of institutional investors in other countries. For example, although it is estimated that institutional investors own between 65 and 80 percent of the equities in the UK they have, at least historically, not voted their shares.[11] Mallin (1995) notes that of 250 large UK companies surveyed, 90 percent report voting levels of less than 52 percent. The Report of the Committee of Inquiry into UK Vote Execution (sponsored by the National Association of Pension Funds (NAPF)) reports voting levels at UK companies were as low as 20 percent in 1990, increasing to 50 percent by 1999.[12] This increase may be attributable to external pressures on institutions to actively vote their shares. Specifically, during 1998, the Trade and Industry Secretary used the 'bully pulpit' to pressure institutional investors to vote their shares, threatening legislative action in the absence of any improvement. Indeed, this appeared to spark the NAPF to encourage members to vote. Although voting turnout of 50 percent is evidence of an increase, it is low by US standards. In the US, voting turnout, the level of votes represented at annual meeting, can easily reach 70-80 percent at many companies (Bethel and Gillan, 2001.)

The differential between voting turnout in the US and in the UK may be due in part to differences in the institutional and regulatory environments between the two countries. For example, in the US the Department of Labour mandates that pension funds regulated by the Employment Retirement Income Security Act (ERISA) should vote their proxies. Although there has been increased pressure for institutional investors in the UK to vote their shares, voting was not mandated by regulation. In fact, part of the recent increase may be attributable to the NAPF recommending that its members actively vote in order to forestall regulatory intervention. It appears, however, that changes may be on the horizon for UK institutions and companies. The Myners report, commissioned by HM Treasury, advocated the adoption of standards analogous to those under ERISA '..articulating the duties of managers to intervene in companies—by voting or otherwise—where there is a reasonable expectation that doing so might raise the value of the investment'.[13] In the March 2001 budget speech, the Chancellor of the Exchequer supported the Myners' report indicating that legislative actions may be introduced to achieve the prescribed improvements.

This is not to imply that there is a complete absence of active monitoring in the UK For example, in response to the Myners' report eight major institutional investors, representing over 5 percent of the UK stock market, wrote to the CEOs of 750 UK companies requesting that they voluntarily put their compensation reports to a shareholder vote.

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[11] Also see Ersoy-Bozcuk and Lasfer (2000).

[12] The National Association of Pension Funds is the principal U.K. body representing the interests of occupational pension funds. With more than £450 billion of pension fund assets, its membership includes companies, local authorities, and public sector bodies.

[13] http://www.hm-treasury.gov.uk/docs/2001/myners_report0602.html.

Also of note is that Hermes Pensions Management Limited (Hermes), which is wholly owned by the BT Pension Scheme, established a Focus Fund in October 1998, to 'invest in companies whose businesses are fundamentally strong, but where concerns about the company's direction mean that its shares are underperforming'. The manager of the Focus Funds, Hermes Focus Asset Management (HFAM) meets with directors and shareholders in an attempt to resolve governance concerns and enhance long-term shareholder value. HFAM has over £600 million invested in UK Focus Funds. Moreover, in the fourth quarter of 2001, Hermes planned to expand activities with the proposed launch of a European Focus Fund to invest in underperforming European equities.

7. The legal environment

A further influence on the role of institutional shareholders is the legal system within a country. For example, the ability to monitor by means of voting may be limited due to features of the legal and regulatory environments. In many European countries the voting system may entail 'share blocking' which requires investors who wish to vote their proxy to hold those shares on the day of the annual meeting (in contrast with the US where a record date is set and holders as of the date of record are permitted to vote at the annual meeting.) This highlights the potential tradeoff between liquidity and control, as 'blocking' the shares effectively prohibits the investor from trading prior to the annual general meeting. This type of mechanism may be associated with low voting turnout at some companies.

The case of the French company Vivendi Universal provides an illustration as to how governance structures and the legal environment may affect shareholders' rights and ability to vote. At the 2000 annual meeting Vivendi shareholders approved a resolution curbing voting rights. The resolution permitted the company to scale back the voting power of blocks above 2 percent contingent on the level of voting turnout. Given the company's historical 30 percent voting turnout, it was argued that the resolution would prevent blockholders from applying a disproportionate influence on the company. Investors in France, and internationally, condemned the action.[14] Not only do such voting caps limit shareholder voting rights, they also have the potential to entrench management and exacerbate agency problems.

More generally, differences in countries' legal and financial systems have led to disparity in corporate governance systems. For example, Roe (1990) contends that in the early part of the twentieth century, institutions in the US became active in corporate governance, but their participation was curtailed by the federal government. In contrast, the roles of institutional investors in other countries differ due to differences in their development and differences in the laws that govern their behavior. It has been suggested that these laws are the major reason for evolutionary differences between corporate governance systems in the United States and those in other countries, such as Germany or Japan. By design,

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[14] It appears that the company has responded to this condemnation. Vivendi recently eliminated a long-standing policy of double voting rights (a process by which shares held for more than two years are entitled to two votes each instead of one), and at the annual shareholder's meeting on April 24, 2001, submitted to shareholders a resolution aimed at eliminating the cap on voting rights for holdings in excess of 2%. The company states that these actions are consistent with the implementation of the '…best international practices in terms of corporate governance'.

institutions (particularly banks) in Germany and Japan play a large role in the ownership and monitoring of corporations.

Shareholder protections also affect the ability of a firm to raise capital, including capital from institutional investors. As the demand for funds increases in emerging markets, foreign institutions will demand stronger legal protections and stronger corporate governance. Moreover, financial liberalization and the ensuing development of pension systems and other domestic institutional investors may provide a catalyst in improving legal protections and corporate governance. More generally, the protection of shareholders, particularly minority shareholders, is important for corporate governance and the continued ability of firms in emerging markets to attract external capital (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997).

8. Differences in ownership structure across countries

In many economies, large shareholders and concentrated ownership, as opposed to institutional ownership, are important factors in a firm's governance structure. Majluf, Abarca, Rodriguez, and Fuentes (1998) provide striking evidence of these differences. Although the largest shareholders in Chile control 40 percent of the shares of the largest companies, this drops to 22 percent for Germany, and 7 percent for Japan. These findings can be contrasted with the US where there is substantially more dispersion in share ownership and the largest shareholder often controls as little as 5 percent of voting rights.

As noted earlier, the agency problems between managers and shareholders as envisioned by Berle and Means (1932) and Roe (1990) may not be prevalent in economies where ownership structures differ. Indeed, La Porta, Lopez-de-Silanes, and Shleifer (1998) conclude that in many economies the primary agency problem is that of restricting expropriation of minority shareholders by the controlling shareholders, rather than that of restricting the activities of professional managers unaccountable to shareholders. The authors report that, for a sample of large publicly traded firms around the world (the largest 20 firms in each country), 36 percent are widely-held, 30 percent are family-controlled, 18 percent are state-controlled and the remaining 15 percent exhibit a variety of other ownership structures. The authors find little use of differential voting rights, but widespread usage of pyramidal structures, to control firms. Some 26 percent of their firms have pyramidal structures, and in the average country, the ultimate family owners control, on average, 25 percent of the value of the largest 20 firms. Finally, other than Germany, La Porta, et al. find little evidence of control by single financial institutions, such as banks. They also find little evidence of cross-shareholdings by other corporations.

More recently, Becht and Roell (1999) provide evidence of dominant block ownership in Western European firms including those domiciled in Austria, Belgium, France, Germany, Italy, Spain, and the Netherlands (with less evidence of dominant block ownership in the UK). In many of these countries the largest voting stake for the median firm in their sample exceeds 50 percent. The authors conclude that in much of continental Europe there exist large blockholders who can and do exercise control over management. Consistent with La Porta, Lopez-de-Silanes, and Shleifer (1998), the authors also conclude that the main conflict of interest lies between controlling shareholders and minority shareholders as opposed to dispersed owners and professional managers as in the United States. Faccio, Lang and Young (2000) provide further evidence on the control of large blockholders in

Asia as compared to Europe. They also examine the possibility of shareholder-wealth expropriation. The authors argue that capital markets generally appear capable of containing expropriation within tightly-controlled groups by requiring that higher dividends be paid to corporations affiliated with such groups. This is especially true at companies exhibiting a wide discrepancy between ownership and control. By contrast, the authors argue that capital markets are ineffective at containing expropriation of corporations that are loosely-affiliated to groups, that is, groups whose control links all exceed 10 percent but do not all exceed 20 percent. Specifically, capital markets fail to extract more dividends from such corporations and a greater discrepancy between ownership and control is associated with lower dividend rates. Thus, ownership structures and the role of institutional investors differ across developed economies, including those in Asia and Western Europe. As we discuss below, the same is true in transitional economies.

9. Ownership in transitional economies

In the context of developing economies and markets the evidence on ownership structure and control is more preliminary. Djankov (2000) finds large differences in ownership structure across six newly independent state countries: Georgia, Kazakstan, the Kyrgyz Republic, Moldova, Russia, and Ukraine. These differences in large part are a result of the country's choice of privatization process. Companies in Georgia and Ukraine, where managers were favoured in the privatization process, are characterized by high managerial ownership (53 percent and 46 percent respectively). In contrast, markets where mass privatization dominated, such as Kazakstan and the Kyrgyz Republic, have higher levels of outside ownership (37 percent and 21 percent respectively.) In Russia, privatizing firms primarily chose 51 percent insider ownership with the remaining shares being given to investment funds or retained by the state. Moreover, in each of these markets the state still has significant ownership of many companies. A further factor is the low level of foreign ownership, ranging from 0.9 percent in Ukraine to 6.8 percent in Kazakstan by 1999. Djankov suggests that these low levels of foreign ownership are due to governance mechanisms external to the firm, including foreign ownership restrictions, the legal framework, and the lack of development of secondary capital markets. Similarly, Frydman, Gray, Hessel, and Rapaczynski (1999) report that previously state-owned companies in the Czech Republic, Hungary, and Poland are typically characterized by four types of owners: insiders (25 percent of sample), foreign investors (25 percent), privatization funds (20 percent), and the state (15 percent).

Two studies of equity ownership in China provide similar results. Xu and Wang (1997) report that, for 311 Chinese stock companies during 1995, a mixed ownership structure is typical with domestic individuals, domestic institutions, and the state, being the three main groups of shareholders. Each of these three groups held about 30 percent of total outstanding shares. The authors also note that employees and foreign investors together held less than 10 percent of shares outstanding. Moreover, ownership concentration is high with the five largest shareholders accounting for 58 percent of shares outstanding.[15] For 826 Chinese companies with large shareholders in 1998, Tian (2001) reports that the most important blockholders are the state (43.9 percent of firms), domestic companies (39.2 percent), domestic institutions (10.9 percent), and foreigners (5.1 percent).

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[15] During the sample period Class 'B' shares were only for foreign investors.

More recently, Lins (2001) reports on equity ownership in a sample of 1448 firms spanning 18 emerging markets.[16] He finds that control in emerging markets is concentrated, and more so than prior studies. Indeed, on average, Lins finds that management groups hold 30 percent of corporate control rights in the firms studied. Also of note is that non-management blockholders hold on average 20 percent of control rights. This suggests that control by unaffiliated blockholders may play a particularly important monitoring role in transitional economies. Of the 1821 blockholders in the sample, 66 percent are management, 20 percent are other companies, 6 percent are government and less than 8 percent are mutual funds, pension funds or insurance companies. This evidence supports the contention that institutional investors, foreign or domestic, may currently play a limited role in many emerging equity markets. However, one would anticipate that this role will evolve with the increased demands of these companies and countries for additional capital. For example, in Brazil, Oehl (2000) argues that local institutional investors have the potential to be an important force in improving minority shareholder rights.

In addition to increased investment by domestic institutions, some countries have experienced an influx of capital, primarily from foreign institutional investors. Indeed, in some cases foreign institutions hold more shares than do domestic institutions. For example, recently Mexico’s stock markets has had over 30 percent foreign investment, while its domestic mutual fund industry holds about 1 percent of outstanding equity (Cervantes, 1999).

The question of the influence of foreign investors is significant because they have become such a large component of some markets. Several authors have studied whether the presence of foreign investors has significant impacts on financial markets operations and valuation. For example, Bekaert, Harvey, and Lumsdaine (1999) find that after liberalization in an emerging stock market, capital flows to that market increase by 1.4 percent of market capitalization annually for three years after the liberalization and then the increase slows down. They also conclude that there is evidence of a permanent price pressure effect from these capital flows, but that the actual return effect is not solely due to price pressure. Finally, they find that capital tends to leave more quickly than it arrives. Choe, Kho and Stulz (1999) examine whether foreign investors are a destabilizing influence on the Korean stock market and conclude that they are not. Similarly, in a review of the literature, Stulz (1999) concludes that opening a country to international investors decreases firms’ cost of capital without adverse effects on its securities markets. Specifically, he finds no evidence that volatility, contagion or destabilization increase following a liberalization of a country’s financial markets.

10. Interaction between ownership structures

The trade-off between the concentration and dispersion of ownership raises further questions. The first is the extent to which diverse types of equity owners: domestic institutional investors, employees, large blockholders, and foreign institutional investors will participate in corporate ownership. The second question is how the interaction of these investors will affect corporate governance structures. Third, will the increased presence of institutional investors (whether domestic or foreign) cause corporate ownership in general

[16] Argentina, Brazil, Chile, the Czech Republic, Hong Kong, Indonesia, Israel, Malaysia, Peru, Philippines, Portugal, Singapore, South Africa, South Korea, Sri Lanka, Taiwan, Thailand, and Turkey.

to become more dispersed, changing firms' corporate governance structures? Finally, would dispersed ownership lead to more efficiently managed firms or would agency problems become magnified in the absence of a large blockholder with incentives to monitor?

Thus, important questions arise concerning how these ownership structures and the interrelations between the different types of investors will affect markets. Since the relative roles of institutional investors and large blockholders are not well understood, this too becomes an important issue to consider. Although their roles can overlap, as mentioned previously, there is little evidence that when an institutional investor takes on the role of an activist blockholder, there is a change in the corporation. On the other hand, there is evidence that corporate performance improves after an activist share block purchase. Regardless of the interaction between different types of owner, the implications of the previous research are that the presence of institutional investors should lead to more informative prices, and consequently lower monitoring costs for all investors. Thus, the outcome should be better monitoring of managers and better corporate governance.

11. The evolving environment

We speculate that in the future increased ownership by foreign institutional investors will be an important influence in many economies, particularly emerging market or transitional economies. According to a recent IMF report on international capital markets, emerging market demands for capital are on the increase. Emerging markets' issuance of bonds, equity, and syndicated loans increased by 32 percent during 2000 to some US$216 billion. Of this, approximately US$86.7 billion of debt was raised by private sector entities. Emerging market equity issuance increased by 80 percent between 1999 and 2000 to US$41.8 billion, the highest level since World War II. China accounted for about 50 percent of new issues during 2000 (Mathieson and Schinasi 2001).[17]

Due to the increased globalization of their investments during the past decade, foreign investors have had, and can be expected to continue to have, a large influence on some emerging stock markets and the firms traded in these markets. Such influence will affect the firms' corporate governance either through direct intervention or through indirect supply-demand effects. Examples of direct intervention include the efforts of investors such as the California Public Employees Retirement System (CalPERS) and TIAA-CREF to improve corporate governance systems in their holdings, including those companies that have foreign domiciles. This type of intervention may be limited because of the costs to the institutional investor, because of the limited number of institutional investors that participate in such activities and because of the restrictions on voting rights that are often afforded foreign investors. (To have an active voice, investors need voting power.)

However, the indirect supply-demand intervention could partially overcome these limitations. That is, in order to raise capital, firms may be motivated to change their corporate governance structures in order to attract investors. For example, an article in the *Wall Street Journal* discusses the problems some emerging markets now have in attracting foreign institutional investors. These problems arise because of the firms' poor corporate

[17] The remaining debt issues were public sector debt or sovereign debt.

governance, ‘Unless companies start paying more attention to corporate governance, emerging markets could remain stuck in the backwaters of global finance for years to come. Many investors say it is easier to "vote with their feet" and simply abandon many of these markets’. (Karmin, 2000). In addition, Anthony Neoh, senior adviser to the China Securities Regulatory Commission has stated that China must improve the corporate governance of enterprises. ‘We have to establish a preventative mechanism and a damage control mechanism, because some of the directors try to hide their activities’. (Deutsche Presse-Agentur, 2001). Similar sentiments aimed at attracting and retaining capital appear to underlie the promulgation of corporate governance ‘codes of best practice’ in many markets. The development of governance codes, oftentimes with legislative backing, is taking place in developed countries such as Hong Kong, Singapore and the United Kingdom, and in emerging markets such as Brazil, India, and Thailand amongst others. A further example of the indirect influence of a firm’s corporate governance structure in attracting capital is the development of international corporate governance ratings services. In Europe, Déminor has established a Corporate Governance Rating Service providing research on corporate governance practices of the FTSE Eurotop 300 index companies, covering 17 countries. Déminor’s ratings are based on corporate governance criteria spanning four main areas: rights and duties of shareholders, absence of takeover defences, disclosure, and board structure.

Similar ratings services exist elsewhere. For example, in Russia the Institute of Corporate Law and Corporate Governance states that ‘…the authorities are unable over the foreseeable future to achieve any material change for the better as far as corporate governance in Russia is concerned’. Institute activities include the evaluation of Russian companies for corporate governance efficiency and development of a corporate governance rating system. Standard and Poor’s has developed a corporate governance rating system for emerging markets (Cullison, 2000). Finally, Credit Lyonnais Securities Asia’s Emerging Markets Division has also released corporate governance rankings for 495 companies in 25 countries. The existence of such services reflects the perceived desire of institutional investors to have that information in order to make investment decisions.

12. Conclusions

This paper examines the role of institutional investors in financial markets and the governance of corporations. Previous research tells us that in terms of corporate governance, institutional investors are important in the ownership and trading of corporate debt and equities. In particular, for many countries, institutional investors have become the predominant players in the financial markets. Their ownership and influence worldwide is growing, chiefly due to the widespread privatization and development of pension fund systems. In addition, foreign institutional investors are becoming a significant presence in financial markets, bringing their trading habits and corporate governance preferences to these markets.

Due to the size of their holdings, institutional investors have the potential to play an important role in monitoring the agency problems that exist between the shareholders and managers of a corporation. Previous researchers have shown that because of the costs involved, only large shareholders have the incentive to provide extensive monitoring of management. Whether institutional investors as large shareholders should or will provide such monitoring depends in part on the constraints they are subject to, their objectives, and their preferences for liquidity. These characteristics also vary across countries, leading to differences in the involvement of institutional investors in corporate governance practices. As markets become more integrated, however, there has been some convergence in the behaviour and practices of institutional investors. Evidence also suggests that as foreign institutional investors enter a country, although their trading may differ from that of domestic investors, they do not constitute a threat in terms of destabilizing financial markets.

Countries also differ with regard to the existence of large blockholders in their markets, whether institutional investors, rich individuals, family groups, other corporations, or lending institutions. These differences lead to variation in corporate governance practices and differences in the role and influence of institutional investors. The relative importance of institutional investors in corporate governance varies across countries, due in part to legal and regulatory systems and in part to the manner in which the role of institutional investors has evolved. Of particular importance is the interrelation between institutional investors and other factors of corporate governance such as the legal and regulatory system, the market for corporate control, the board of directors, other large blockholders, lenders, and employees.

Although there may be some convergence in these systems across countries, because of the endogenous nature of the interrelation between the factors of corporate governance, the evolution will most likely vary across countries. In some cases financial liberalization and the development of domestic institutions will influence change. This will likely spur the development of both debt and equity markets. In other cases, foreign institutional investors will play a major role, particularly given the capital they control. On balance, would expect that institutional investors will increase the liquidity, volatility, and price informativeness of the markets in which they invest. In turn, the increased information provided by institutional trading should result in better monitoring of corporations and in better corporate governance structures.

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