

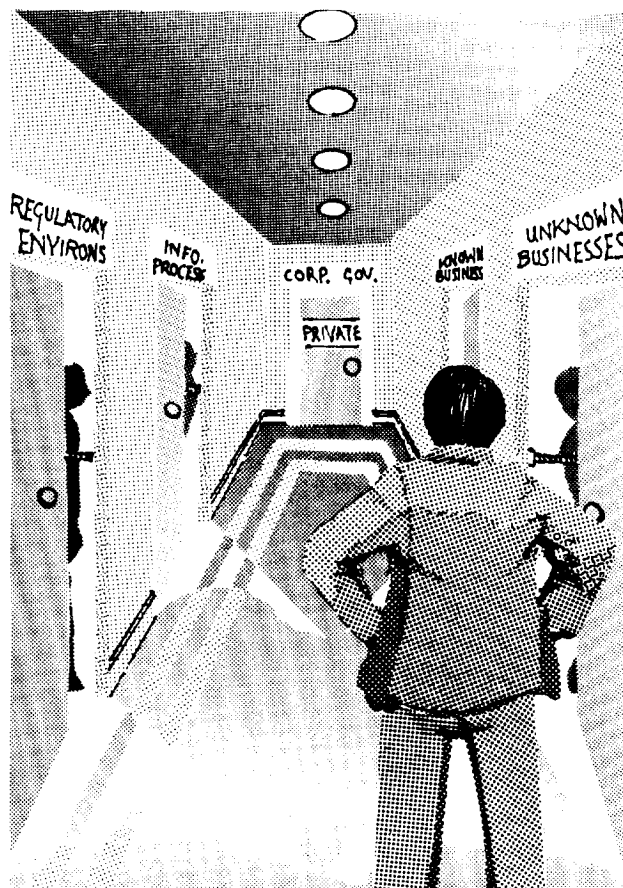
Barriers to Effective Corporate Governance by Institutional Investors: Implications for Theory and Practice

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With their increasing equity ownership, institutional investors have been hailed as a possible solution to governance problems with the ability to reduce the power of managers. However, there are some barriers that decrease their effectiveness in providing such governance. These include barriers arising from: a) business relationships of institutional investors with firms in which they invest, b) extensive government regulations that constrain the activities of these investors, and c) limitations on their ability to process the information required to monitor firms. This paper examines these barriers to corporate governance faced by institutional investors, and presents some implications for research and practice. Copyright © 1996 Elsevier Science Ltd

accompanying the increase in size of public corporations decreases the power of its owners and provides managers significant discretion over corporate policy (Berle and Means, 1932). The increased power of managers has allowed them to potentially pursue their own interests which could differ from those of shareholders (Berle and Means, 1932; Herman, 1981). As individual shareholders generally do not have the resources or the economic incentives to participate in monitoring, managerial actions often go unchecked, resulting in strategies that reduce shareholder value. These strategies, such as excessive diversification and lower innovation, can culminate in diminished international competitiveness.

The ownership structure of American corporations has changed dramatically in the past few decades with a new class of owners – financial institutions –



Introduction

The diffusion in ownership

emerging as dominant players in the capital markets (Davis and Thompson, 1994). The primary types of institutional investors include public and private pension funds, mutual funds, insurance companies, investment funds, and funds managed by banks or foundations. Unlike individuals, institutional fund managers tend to be more sophisticated investors and manage their money professionally. Currently, this group owns about half of the outstanding equity of large public companies in the US (Brancato, 1991). A similar pattern of increased institutional holding has also been observed in Britain, where aggregate institutional ownership is even higher than in the US (Charkham, 1994). This shift in ownership patterns suggests that shareholders may be able to regain some of the power that they lost to managers. Thus, institutions may be able to intervene in firms to improve corporate governance and influence managers to pursue appropriate strategies. Improved monitoring should produce superior firm performance and enhance the value of shareholders' investments (Jensen, 1993).

Notwithstanding the increased presence of institutional investors, their observed influence remains a matter of controversy. While their extensive ownership stakes suggest that they should monitor firm managers, alternative perspectives exist on their actual role. Some scholars (e.g., Porter, 1992) argue that institutional investors are myopic and sell their shares in response to short-term price fluctuations. This forces firms to reduce long-term investments (e.g., in innovation), in order to bolster share prices and avoid the threat of takeover. Others have argued that institutional investors are undoubtedly skilled investors but lack the capability to monitor managers (Prowse, 1991). Empirical research has not provided unequivocal support for any one viewpoint, further fueling the controversy.

We argue that the controversy surrounding the observed role of institutional investors may be due to the failure of researchers to consider the effects of various impediments to effective corporate governance. That is, although these investors have the intent to monitor managers, certain factors limit the extent to which they can exercise their influence. The activities of a corporation are often dominated by managers (Berle and Means, 1932; Herman, 1981), and although institutional investors may have incentives to exercise 'voice' (active intervention and participation in firm decisions), several obstacles make it difficult for them to gain power over managers.

The next section examines the various incentives that motivate institutions to actively monitor managers. In their present capacity as large and dominant owners, institutions have many reasons to play an active part in corporate governance. However, we explain three important barriers that can limit monitoring effectiveness, and thereby prevent the full effect of monitoring from being translated into improved firm performance. The three barriers are: a) relationship-oriented barriers, arising from the business relationships of institutional investors with firms in which they invest,

b) regulatory barriers, arising from government regulations that constrain the activities of these investors, and c) information-processing barriers, arising from limitations on their ability to fully process the information required to monitor the firms in their portfolios. We also present some implications for each of these barriers.

Institutional Investors and the Need for Corporate Governance

Domination by Managers

Large firms are run by managers, not shareholders. It has been argued that the separation of ownership and control in public corporations is advantageous because it permits the specialization of risk-bearing (by owners) and decision-making (by managers) (Fama and Jensen, 1983). However, it also creates potential conflicts as owners and managers may have opposing interests (Jensen and Meckling, 1976). While there are corporate governance mechanisms to monitor managers or align their interests with shareholders, these mechanisms often have limitations (Walsh and Seward, 1990). For instance, although the board of directors is delegated the task of safeguarding shareholders' interests, it has frequently been ineffective in checking managerial hegemony – the selection of directors and the information disseminated to them is controlled by managers (Herman, 1981). Similarly, the market for corporate control, which provides discipline by displacing ineffective managers through hostile takeovers, has also declined in America and Britain following the passage of antitakeover laws, and the adoption of sophisticated takeover defenses by firms (Davis, 1991; Davis and Thompson, 1994). Consequently, the performance of firms has suffered because managers have been left unchecked by traditional governance mechanisms.

Incentives for Institutional Intervention

The dominance of managers suggests that institutions cannot rely on traditional mechanisms to provide adequate governance to safeguard their investments. As the funds invested by financial institutions are essentially 'other people's money', institutional investors have a fiduciary duty that obligates them to closely monitor their holdings and take action to protect investments against erosion in value (Krikorian, 1991). While there are variations in the regulations affecting different types of institutions, all institutions are subject to a 'prudent person' rule, under which they have a duty to their beneficiaries to 'exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property' (Krikorian, 1991: 262).

The fiduciary duty requires an active role by institutions in the full exercise of their shareholder rights, which includes voting of proxies, and failure to do so constitutes a breach of their obligations. Institutional

investors are held liable for losses arising from lack of prudence in their investments. The US Department of Labor has issued several directives reinforcing the importance of an ongoing evaluation of their portfolio of stocks, and of actively voting on proxies. Similarly, in the UK, institutional investors have a fiduciary duty to their ultimate beneficiaries to evaluate their investments and act on this evaluation (Charkham, 1994). Institutional investors must, therefore, safeguard their investments by monitoring and influencing firms in which they invest. This requires demonstrating an ongoing interest in the activities of these firms and the use of their voice. The simpler 'exit' mode of divesting a declining stock is not sufficient.

In addition to their fiduciary responsibility, the increased ownership by institutional investors also makes it difficult for them to sell off their shares providing economic incentives to exercise 'voice'. An attempt to offload large blocks of shares in a single firm adversely affects its stock price. As such, the selling institution will obtain a price that is well below market value and will be faced with an even greater loss in value of their holdings. Furthermore, it is difficult for institutional investors to find appropriate alternative investments considering that they already own significant stakes in most firms in the economy. Their increasing presence in the capital markets implies that the opportunity set of new, profitable equity investments is greatly reduced. According to Taylor (1990: 71):

The very act of buying or selling large blocks of shares ... can't help but affect prices in the wrong direction. When pension funds exit, they take everyone with them – and administer self-inflicted wounds on their own valuation. Moreover, when a small group of institutions is investing hundreds of billions of dollars, even the thousands of companies on public stock exchanges begin to look like a small universe. What's the likelihood that all or most of the funds will come out ahead by essentially swapping shares among themselves?

The high costs of 'exit' provide incentives for exercising 'voice' (Hirschmann, 1970); if institutions cannot inexpensively sell off their holdings, it becomes imperative for them to gain influence over managers to take actions necessary to safeguard their investments. The trend of increasing ownership by institutions is indicative of changes in the economic incentives for their intervention. Equity ownership of US corporations by institutions has increased from about 15.9 per cent in 1965 to nearly 50 per cent currently. The amount of their total financial assets has also increased tremendously, from about \$107 billion in 1950 to over \$6 trillion currently. Furthermore, increasing competition among firms in the financial services industry has forced financial institutions to demonstrate higher returns. The implication is that they are not able to invest in financial assets that may lead to lower returns. This is evident in the shift in the composition of the investment portfolio of pension funds, the dominant form of financial institutions. Whereas in 1950, 6 per cent of their

financial assets were in equity and 56 per cent in bonds, the figures were 40 per cent and 30 per cent respectively in 1989 (Brancato, 1991).

Over the past few decades, then, the following changes have occurred. First, the absolute amount of assets held by financial institutions has increased greatly. Second, in the pursuit of higher returns, institutions have shifted toward investing more in stocks and less in fixed-income securities such as bonds. Third, a greater proportion of outstanding equity of public corporations is held by one group of owners, namely institutional investors. Because of their fiduciary obligations, institutions are expected to monitor and evaluate their holdings. This responsibility, along with vanishing alternative investment opportunities, has provided institutions with strong incentives to intervene and participate more actively in firm activities.

Power of Institutional Investors

Institutional investors gain explicit and implicit power from the voting rights present in their ownership stakes (Easterbrook and Fischel, 1983). Arguably, the most important right granted to shareholders is that of selecting or dismissing the board of directors by voting for or against board members during the Annual Shareholders Meeting. Fundamental changes, such as mergers or sales of substantial assets, and charter amendments (including certain kinds of takeover defenses) must also be approved by a shareholder vote. In addition to voting on these management-initiated proposals, shareholders can initiate proxy contests in which they propose their own lists of candidates for board seats. Shareholders can also initiate non-binding shareholder proposals under the US Security and Exchange Commission's (SEC) rule 14a8. Similarly, in the UK, shareholders with five per cent of the vote have the right to file resolutions under provisions of the Company's Act, 1985 (Charkham, 1994). Thus, institutional investors have explicit power from their voting rights, which they can exercise to induce managers to pursue actions that are consistent with shareholder preferences.

The ownership of voting rights can also provide implicit power to shareholders. A strong showing of votes that are unfavorable to management can increase the threat of takeover. Such a showing signals the ineffectiveness of the incumbent management team and indicates the potential need for disciplining them. It indicates that shareholders are dissatisfied with incumbent management and may be more willing to tender their shares in the event of a hostile takeover bid. Finally, voting may defeat management proposals related to takeover defenses and result in their removal, thereby reducing the barriers to takeover. Increasing takeover threat affects managers' employment risk adversely by exposing them to a potential job loss (Walsh and Seward, 1990). Accordingly, with their large ownership stakes, institutional investors should gain a degree of implicit power over managers by indirectly strengthening the market for corporate control.



Barriers to Effective Governance

The previous section has examined some of the underlying factors that have prompted Anglo-American institutional investors to play a more active role in corporate governance. It would be expected that with their large equity holdings, greater level of sophistication, access to superior resources, and the power inherent in voting rights, these investors would be able to have a significant impact in governance of corporations. As they are spread out over large equity holdings, the costs incurred in monitoring activities are likely to be less than those for individual investors. Thus, institutional investors appear to have the means, the ability, and the incentives to influence firm managers to take actions to create shareholder value and prevent them from acting in a self-interested fashion.

Accordingly, institutional investors should improve the corporate governance in a firm. For example, institutional investors can strengthen the board of directors by increasing the proportion of independent outside directors and also facilitate board independence by separating the posts of Chairman and CEO. The threat of hostile takeovers as an implicit disciplining force on managers can be increased by limiting the adoption of takeover defenses. Furthermore, institutional investors can influence managers to pursue value-enhancing corporate strategies. The effect of these actions should enhance firm performance and increase the value of the investments of institutional investors.

Research evidence on institutional investors, however, is equivocal. For example, their effect on takeover defenses is mixed: some studies indicate that they vote against value decreasing takeover defenses (Brickley *et al.*, 1988) and others find that institutional investor ownership is associated with the adoption of more defenses (Davis, 1991). Studies examining the effect of institutional investors on corporate strategy are also inconsistent. While some authors report a negative relationship between institutional investor ownership and corporate innovation (Graves, 1988), others have found a positive association (Baysinger *et al.*, 1991; Hansen and Hill, 1991). Similarly, some studies have found a negative association between institutional ownership and corporate diversification (Palmer *et al.*, 1987), while others have found a positive association (Hill and Hansen, 1991) or no association (Bethel and Liebeskind, 1993). It seems clear, therefore, that the evidence regarding the impact of institutional investors on firms is mixed and no definitive conclusions can be drawn.

The preceding discussion assumes that if institutional investors have the incentive to intervene in firms, they will be able to successfully do so. In other words, their

influence will be directly observable on firm-level outcomes. It is quite possible, however, that various structural and regulatory barriers can impede this influence. These barriers can prevent institutions from fully exercising their power or motivate them to exercise it in a different direction. In most prior research, there has been a general lack of focus on the obstacles that might prevent these investors from performing their governance functions effectively. We examine three such barriers.

Barriers from Business Relationships

The primary intent of most shareholders is to earn a return on their investments in firms. In addition to this investment role, some institutions may also have a business relationship with firms in which they own shares. For these institutions, part of their revenue is dependent on economic exchanges with the firm, independent of their investment income from their shareholdings. For example, in addition to holding equity in firms, insurance companies may provide them with underwriting services, and banks can provide loans. Accordingly, for these investors, exchanges with the firm include two components: a) the safeguarding of their investment, and b) the maintenance of a business relationship. The dual

nature of these activities may pose a conflict of interest for these investors (Heard and Sherman, 1987; Herman, 1981). As discussed earlier, institutional investors should exercise influence to safeguard their investment. However, if they take an interventionist stance toward a firm, its managers may impose a penalty by severing the business relationship. Thus, the increase in investment value possible through active intervention may be nullified through loss of business with the firm. An institution's ability to influence the firm will be limited by the extent to which it depends on the firm for business. Institutional investors are thus faced with a dilemma – intervention may actually lead to a net decrease in value. Institutions that aim to maintain an amicable business relationship may be hesitant to intervene and question managerial actions.

Heard and Sherman (1987) explain how these conflicts of interest can be exploited by managers in their bid to retain their dominance. For example, when manager-sponsored anti-takeover charter amendments come up for proxy voting, managers actively canvass shareholder groups for support. Managers have access to the list of shareholders eligible to vote and can approach them for support. Furthermore, voting is usually not confidential and managers can request shareholders to change their votes even after they have been cast. While it may not normally be inappropriate for managers to canvass support, in some instances they might resort to coercion as indicated in this comment by a banker: 'We have had

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certain situations where there were apparent threats ... suggesting to us that if we proceeded with our particular position they might want to find another commercial banking arrangement' (cited in Heard and Sherman, 1987: 44). It may not even be necessary for managers to intimidate institutional investors with threats. Herman (1981) narrates an incident where, notwithstanding the supposed Chinese wall that insulates bank trusts from the commercial operations, information about important customers was provided by commercial operations to trust operations. The intent of this action is seemingly to avoid interventions that might jeopardize business interests. Some institutional investors may take actions to support management even without being asked to do so, in the interests of further cementing a valued business relationship.

There has been some research examining the effects of differences among institutional investors on corporate governance. Brickley *et al.* (1988) examined the role of institutional investors in checking manager initiated anti-takeover charter amendments. They found that mutual funds, endowments and foundations, and public pension funds are more likely to oppose anti-takeover charter amendments than banks, insurance companies, and trusts, investors that frequently have business relationships with companies. Similarly, in a detailed case study of the Honeywell 1989 proxy solicitation, Van Nuys (1993) found that banks and insurance companies were significantly more supportive of management-sponsored anti-takeover proposals than institutional investors without business relationships. Interestingly, Van Nuys (1993) found that this voting pattern was independent of whether or not the banks and insurance companies actually had business relationships with the firm. This suggests that certain institutional investors, such as banks and insurance companies, may be reluctant to exercise governance in any of the firms in which they hold shares because they are concerned that their portrayal of an anti-management stance toward some firms could prove counterproductive to their business interests in other firms. This further reinforces the view that such institutions may not play an active role in corporate governance. Our research on the effect of institutional investors on innovation has confirmed these findings (Kochhar and David, 1996). We found that only institutional investors without potential business relationships positively influenced firms' investment in innovation. Other institutions had no effect. This supports the view that only certain types of institutions will influence firm managers, while others are hesitant to intervene actively.

Implications of business relationships

The power gained from their ownership stake tends to be weakened by institutional investors' dependence on the firm for business. Thus, it is likely that only institutions such as public pension funds, mutual funds, and endowments and foundations – those that do not have potential business relationships – will play an active role in corporate governance; institutions such as banks and insurance companies that potentially have

business relationships with firms are unlikely to actively influence managers and may actually help entrench them. For researchers, it may be misleading to utilize aggregate institutional ownership data to understand institutional investors' activity in corporate governance. Instead, it is important to differentiate between institutional investors. One of the reasons for the conflicting evidence present in prior research may be the adoption of aggregate ownership as the measure of institutional investors' power without considering how this power may be reduced because of potential business relationships.

Conflicts of interest pose several public policy implications for the proxy voting system (Heard and Sherman, 1987). It might be necessary to design ways to improve the voting system to limit the dangers of managerial domination. Confidential voting can be provided to all shareholders, so that managers will not know how institutional investors have voted, hence, these investors can vote without fear of loss of business. Furthermore, institutional investors can be required to disclose their votes to their ultimate beneficiaries who can better scrutinize whether investors have voted to safeguard their investments or to further their own business interests. Finally, regulatory agencies can set higher standards for fiduciaries and provide better enforcement of existing standards.

Barriers from the Regulatory Environment

As discussed previously, institutional investors have fiduciary obligations and economic incentives to exercise 'voice' to safeguard their investments. However, similar to business relationships, the regulatory environment faced by institutional investors may prevent them from fully exercising their 'voice'. Several regulatory barriers may constrain the ability of institutions to exert their influence in corporations. These regulations restrict institutional investors in two ways: a) by limiting their ownership stakes in individual firms, and b) by placing barriers to coordinated action within groups of institutional investors (Roe, 1990). Institutional investors in the US are restricted from owning too much of a single firm and from working together with other institutional owners of that firm to influence managers.

Although aggregate levels of institutional ownership average about 50 per cent in the American markets (Brancato, 1991), ownership by individual institutions is fragmented. For instance, the 41.6 per cent institutional stake in General Motors in 1990 was distributed among 537 institutions, with the largest holding only 2.6 per cent of the equity. There are two primary reasons for this high degree of fragmentation. First, the popular concern dating back to the 1930s, that financial institutions may gain excessive control over corporations, has resulted in laws restricting the institutional shareholdings in individual firms. Such a restriction, separating Wall Street from Main Street, was an attempt to prevent institutions from gaining



dominance over the economy (Roe, 1990). The separation of commercial from investment banking stipulated in the Glass-Steagall Act of 1933 was designed to limit the power of banks. The Bank Holding Company Act of 1956 restricted equity ownership by bank holding companies. Similarly, the provisions of the Investment Company Act of 1940 discouraged mutual funds from obtaining a controlling interest in any individual firm. There are onerous tax burdens if mutual funds do not hold diversified portfolios, or if their representatives sit on the board of a firm in which it owns shares. All institutions are required to hold diversified portfolios and specific restrictions have been placed limiting ownership in individual firms for some institutions. Accordingly, banks are prohibited from owning stock; bank holding companies cannot own more than five per cent, bank trust firms 10 per cent, and non-diversified mutual funds 10 per cent (Roe, 1990). The intent behind these laws was to limit the role of institutions to financial activities and discourage them from influencing managers.

The second cause of high fragmentation arises from fiduciary laws designed to protect beneficiaries of institutional investments from the risk of large losses (O'Barr and Conley, 1992). Even institutions, such as pension funds, that do not have specific regulatory limitations on the extent of their holdings in a single firm, must comply with the diversification requirement. This implies that each individual institution will have smaller holdings in individual firms and lack the muscle to influence firm managers.

Although individual institutions own small stakes in a given firm, the high level of aggregate institutional ownership suggests that a joint action could provide them with control over management. If institutional investors could coordinate decisions on how best to influence the firm, they would be able to intervene in an effective manner. However, proxy rules make it difficult for institutions to communicate with each other and join forces to form larger blocks with which to influence management (Roe, 1990). According to Rules 13(d) of the SEC, when a shareholder group's membership exceeds five per cent, the group is required to file its intent and ownership composition. Institutions shy away from making such filings because of the complexity of the regulations involved, and the potential for litigation by managers seeking to dissuade institutions from gaining control (Conard, 1988). Furthermore, shareholder groups that make 13(d) filings may have reduced liquidity as they are not permitted to gain profits from trades on stock held for less than six months (Roe, 1990). Finally, although some of the restrictions on cooperative action by institutional investors were relaxed in 1992, the usual difficulties attendant on cooperative joint action make it expensive for institutions to coordinate with each other. The high level of complexity and resulting expenses in coordinating the 537 institutional investors of General Motors may offset any gains that may possibly arise from joint intervention.

Interestingly, although several of the above discussed regulatory barriers are not present in Britain, institutional behavior is still similar to that of American institutional investors. For instance, there are not many formal regulations regarding limits on stock ownership and joint coordination, yet the governance system is characterized by the presence of strong informal constraints. Guidelines (rather than regulations) by the Bank of England and cultural norms that encourage independence of managers have ensured that British financial institutions are faced with similar barriers as are those in the US (Bishop, 1994).

Implications of regulatory barriers

It is important to recognize that the direct exercise of voting rights is ultimately possible only through the mechanism of proxy voting. However, in the absence of regulatory barriers, the relative ease with which shareholders can mobilize to oppose management provides them with tacit power, which they can exercise without resorting to voting. In countries like Japan and Germany, where institutional investors are not restricted by stringent regulations (as they are in the US), these investors (usually banks) have been able to exercise influence without the need for proxy voting. Apparently, in the absence of regulatory barriers, their voting power provides them with the authority to intervene when they deem it necessary. For example, when Akai Electric, a major Japanese electronics manufacturer, faced problems in the 1980s after the appreciation of the yen, Mitsubishi Bank, a major shareholder, intervened quickly to engineer a turnaround and replaced the managers of the company (Kester, 1991). Similarly, when a crisis situation developed at Daimler Benz, Deutsche Bank, a major shareholder, was able to take actions that led to the replacement of the management team. Intervention by institutional investors is considered as legitimate in these countries and is not challenged by management.

With regulatory barriers in place, as is the case in the US, the situation is considerably different. Intervention by institutional investors is more difficult because they lack the authority to force managers to directly comply with their demands. In fact, institutional intervention in corporate governance is frequently considered an unwarranted intrusion into corporate affairs. When General Motors experienced poor performance, California's public pension fund, CalPERS (California Public Employees Retirement System) attempted to meet the CEO Roger Smith in 1990 to influence the succession process. Mr. Smith would not meet with CalPERS and complained to California's governor that the State's pension fund was unreasonably interfering in issues that were not its concern. This contrasts with the cases of Akai Electric and Daimler Benz where powerful institutional investors were easily able to intervene directly.

Institutional activism

Because of regulatory barriers, institutional ownership alone is not a sufficient force to induce managers to

comply with shareholder preferences. Instead, institutional investors have to bolster their voting power through other actions that pressure managers to comply with their demands. Collectively, these actions are sometimes referred to as institutional activism. Activism includes a broad set of actions including public announcements, shareholder proposals, and proxy contests, through which institutional investors attempt to gain power. Activism does not directly force managers to comply with shareholders' preferences, but is usually designed to bring public pressure in the hope that managers ultimately respond favorably to shareholders. For example, shareholder proposals or proxy contests are included in the proxy materials that are sent to all shareholders, and along with public announcements made by institutional investors receive wide publicity in the business press. Accordingly, institutional activism engenders considerable debate and provides all shareholders with an opportunity to decide if the firm is being adequately managed. Such negative scrutiny can increase the accountability of the board that is receiving the unwanted publicity.

While managers can resist some of these pressures, they must ultimately recognize that the investors cannot be ignored because of their substantial voting stake, and because these actions can increase the risk of a takeover. Activism by institutional investors can be likened to an environmental jolt that awakens complacent managers and provokes a reexamination of the fundamental paradigms used to manage the firm (Meyer, 1982). Anecdotal evidence suggests that activism by institutional investors is successful in providing them with a degree of power. In the General Motors case, while institutional investors were not able to exercise direct influence, they continued to exert pressure through public announcements. Ultimately the board responded to these investor initiatives by dismissing Robert Stempel (the CEO who succeeded Roger Smith), because he was perceived as being slow to implement changes. Similarly, in the UK, shareholder activism in recent years has led to the dismissal of top executives of Burton Group and British Airways.

The process of intervention is, thus, very different because of the presence of regulatory barriers. However, intervention through activism may also help institutional investors influence managers although it may take considerable time and effort. Some research has examined if activism by institutional investors can be successful. In a qualitative study, Useem (1993) provided some evidence that managers restructured firms in response to pressure from activist institutional investors. Research in finance, on the other hand, finds that activism in the aggregate has no effect on shareholder wealth, although activism by CalPERS has a positive effect (Nesbitt, 1994). The results are interesting and consistent with the view that governance by

institutional investors is limited by regulatory barriers preventing them from gaining the degree of power indicated by their ownership, but that activism may provide these investors with an opportunity to improve their returns.

Activism can, however, be fairly expensive; CalPERS is estimated to spend about half a million dollars a year on its activist campaigns. Clearly, more research is required to determine if activism can enhance long-term shareholder returns, or whether the expenditure is unnecessary. At present, several regulations place limitations on the nature of the campaigns that institutional shareholders can mount against firms. If shareholder activism can improve competitiveness, it would be worthwhile for agencies like the SEC to relax regulations allowing institutions greater flexibility in mounting challenges. Conversely, the failure of activism to foster positive outcomes suggests that it may be necessary to rein in activist institutions, thus avoiding wastage of their resources and those of the firms.

Barriers from Information Processing Limitations

Ideally, corporate governance should provide 'an early warning system to put the organization back on track before problems reach a crisis stage' (Jensen, 1993: 862–3). If institutions are to be effective corporate governance mechanisms, they need to be able to identify a crisis before it occurs. This implies the ability to gather, process and evaluate information to identify potential problems. Therefore, institutional investors should try to create control systems for all firms in their portfolio in order to facilitate the initiation of changes required to correct any detected deviations from optimal strategic actions. This process requires the use of

elaborate information processing systems to evaluate the existing strategy and determine the desired strategic actions. If existing strategy deviates from the desired strategy, changes may need to be initiated by intervening and pressuring managers.

Limitations on information processing may pose barriers to this type of corporate governance. Institutional investors hold highly diversified investment portfolios due to the reasons discussed previously. They have considerable wealth, and have relatively smaller equity stakes in several firms. For example, CalPERS owns shares in more than a thousand firms. Institutional investors find that, with such a large number of holdings, investment decisions tax the abilities of investment managers to process the necessary information. Accordingly, these investors are increasingly holding indexed portfolios of stocks (usually a mix of stocks that emulates the Standard & Poor 500) to economize on the information processing requirements of making



investment decisions. The information requirements for analyzing and evaluating strategic actions for all the firms in their portfolios are likely to be far more stringent than those required for investment decisions. Accordingly, institutional investors may find it impossible to play an active governance role in all of the firms in their portfolios. Hence, the amount of information required to analyze all firms can become a barrier to effective governance.

Implications of information processing limitations

Information processing limitations have implications for the number of firms in which institutional investors intervene actively. To economize on the information processing costs, institutions choose to pressure only a few, especially poorly managed firms in their portfolios. Identifying the most poorly managed firms is likely to be relatively less taxing in terms of information processing, as it may not take much analysis to recognize that firms such as Sears, Westinghouse, or W.R. Grace, have been poorly managed. While targeting a smaller subset of firms is a logical response to the information processing difficulties, it poses a limitation as in many of these firms considerable damage has occurred before institutional investors intervene. Therefore, activism cannot be expected to provide, through intervention in individual firms, the ideal corporate governance system. This would require continual monitoring and initiation of corrective action before a crisis erupts. Furthermore, while institutional investors target one particularly egregious offender, other firms may also be in decline, but not have reached the level of targeted firms.

In response to such concerns, institutional investors argue that targeting a firm is part of an overarching strategy to provide better governance for all the firms in their portfolio. A prominent activist institution likens the policy of targeting individual firms to a lion chasing a herd of wildebeests (Scism, 1993: B1): 'The significance is not the three or four laggards you catch – it's that you get the whole herd to run ... We need to scare all the animals.' That is, pressuring an individual firm is done not to induce changes only in that one firm. It is also intended to signal that institutional investors are able to discipline ineffective managers, and that other firms should shape up or be ready to face the consequences. This, of course, leads to the empirical question of whether activism in a few firms in an institution's portfolio will improve performance in other firms in that portfolio.

A second limitation of the targeting strategy adopted is that it may not lead to value maximizing behavior on the part of managers; rather they may adopt a satisficing approach. That is, managers may design strategies to maintain a reasonable level of performance, above the threshold level that attracts institutions' attention. Whether the net gain to an institutional investor in this case is greater than the alternative strategy of targeting all portfolio firms (and incurring higher costs) should be examined.

Institutional investors are also trying to make system-wide changes in corporate governance by lobbying for better overall rules. For example, institutional investors have been active in campaigning for a change in the proxy rules to provide better disclosure of executive compensation. Many stakeholders are concerned that CEOs are being paid excessively, and that their pay bears little relation to performance. One option for institutional investors is to target individual firms where executive pay is deemed inappropriate and pressure the firm to redesign the pay package. However, this is cumbersome to do in many firms, especially as executive compensation is often not clearly reported, making it hard to determine if it is indeed a serious problem. Improvements in pay disclosure may lead to the adoption of more equitable pay practices as firms realize that pay disclosure rules make it easier for stakeholders to evaluate the appropriateness of the pay package. By having better corporate governance mechanisms in place institutions may find it less imperative to intervene in individual firms.

Conclusion

There has been considerable debate on the emerging role of institutional investors. Our analysis suggests that institutional investors do have incentives to provide effective corporate governance. However, the effects of their influence may not always be observable due to certain barriers that limit the extent to which they can exercise this influence. First, business relationships with firms for some institutional investors can act as barriers to effective corporate governance by changing the proclivity towards intervention. Accordingly, only institutions that lack business relationships may be effective. Second, the regulatory environment poses a barrier by limiting the institutional investors' authority over managers. When institutional investors cannot influence managers directly to comply with their preferences, they resort to activism to pressure them to do so. Finally, information processing barriers make it difficult for institutional investors to play an active role in all firms in their portfolios. Institutional investors cope with this barrier by: a) targeting a few firms in the hope that this sends an appropriate signal to all other firms in their portfolios, and b) lobbying for system-wide changes in corporate governance to foster better governance without intervening in individual firms.

As institutional investors gain attention, comparison with an alternative governance mechanism, the market for corporate control, is inevitable. The market for corporate control exercises discipline by threatening poorly managed firms with takeover. Thus, corporate managers must make appropriate changes or lose their jobs to corporate raiders. Institutional investors attempt to exercise governance in a less extreme fashion. Unlike corporate raiders, they usually do not seek active control over firms, but instead attempt to pressure managers to be more responsive to shareholder preferences.

Currently, there is no evidence to suggest whether a hostile takeover or activism by institutional investors is more effective in improving poorly managed firms. Hostile takeovers appear to provide greater potential for change and several studies have shown that manager turnover increases following this event (Walsh and Seward, 1990). However, other studies have found that hostile takeovers can lead to reduced innovation (Hitt *et al.*, 1996), suggesting that they may produce long-term negative effects on firm performance. Given the barriers to institutional governance, it appears that institutional investors may have less dramatic effects than hostile takeovers. However, it may be the case that pressure exerted by these investors, while not leading to immediate and dramatic change, can ultimately make managers more accountable to shareholders. Presumably such intervention may not be accompanied by the negative consequences found for hostile takeovers.

The discussion about the role of institutional investors in the Anglo-American context raises interesting comparisons with governance systems in other countries. From a value-creation perspective, is it better to direct institutional investors to spread their investments across numerous firms, thereby reducing the efficacy of their governance mechanisms, though providing the benefits of portfolio diversification? Or is it better for them to have closer relationships with fewer firms and participate in critical decision-making? It has been suggested that one of the sources of Japanese competitive advantage is the adoption of the latter form of governance (Gerlach, 1992). The close relationships between industrial firms and their financial institutions, relationships that include both debt and equity tie-ups and a greater stability in ownership patterns, lead to a more active involvement of the institution in the firm, thereby reducing the likelihood of occurrence of crises. Whether the system of governance can affect the competitive advantage of a nation, resulting in higher long-term growth, profitability, and innovation among its firms is an important question that should be examined in future research.

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